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Session 8PD Nonforfeiture Law Developments

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Summary: This session updates actuaries in the current status of nonforfeiture law changes for life insurance. Panelists discuss the impact of these changes on product design, compensation, and other product features.

Mr. Craig R. Raymond: Due to the speed of the developments in the revisions to the nonforfeiture law and the timing of those developments, the National Association of Insurance Commissioners (NAIC) Life/Health Actuarial Task Force decided it was necessary to schedule a meeting to discuss nonforfeiture law. This presented us with quite a problem because we had already scheduled this panel. We had a lot of discussion about either canceling this panel or possibly doing some things differently. With some really fantastic cooperation from the Society of Actuaries staff, as well as the NAIC staff, we arranged to do what we are going to do here, which is to combine the two meetings together. One of the major elements that the regulators are looking for in the work that has been going on in revising the nonforfeiture law, or presenting a proposed revision to the nonforfeiture law, is to get input from the

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Note: The Report of the SOA Task Force on Life Nonforfeiture is not available online. Please contact Sheree Baker at sbaker@soa.org or call 847/706-3565 for a copy.

industry and the actuarial profession. We saw this as a very unique opportunity to get that input and to give you a chance to speak directly to the people that are working on this project.

We are going to start with a brief presentation from Walt Rugland to give everybody an update on where we stand. Walt is with Milliman & Robertson (M&R) and has been chairing the American Academy of Actuaries' Working Group, which has presented the framework for this proposal to the NAIC. Walt, under the auspices of the Academy, will continue to work on that project with the NAIC as we go forward. Tom Foley, with the North Dakota Insurance Department, is the chairperson of the NAIC Life/Health Actuarial Task Force, which is charged with the development of changes to actuarial laws and regulations, including the nonforfeiture law. He is also chairperson of the Life Nonforfeiture Working Group. We also have Larry Gorski from the Illinois Department of Insurance and Sheldon Summers from the California Department of Insurance. Frank Dino, from the Florida Department of Insurance, is not currently a member of the Actuarial Task Force, but has been very active in its development for the last few years and I'm sure he will continue to be active. Commissioner Bob Wilcox is from Utah. Darin Zimmerman is with Tillinghast–Towers Perrin, and he will be our recorder for the session.

This panel represents the core group that is working on this proposal. I am hoping this gives us a unique but effective forum for discourse.

Mr. Walter S. Rugland: For those of you who do not know Craig Raymond, he is the chairperson of the Life Insurance Committee of the Academy. There is one other regulator in the room who I want to introduce to you because I hope he will have some comments for us, and that is the Government Actuary of the U.K., Chris Daykin. Chris is here wearing several hats, so I encouraged him to give us his perspective on this nonforfeiture issue.

Now for some background. Larry Gorski pointed out that 15 years is a long time rather than a short time. I think that is when we began the nonforfeiture change. The change was brought about because we were recognizing the fact that the existing nonforfeiture law did not work well with some of the new designs of contracts and products that were coming out in the marketplace. There were attempts to deal with those new designs—I call them shoehorn attempts—and they have worked in some areas, but not in others. What has happened is there have been two views which have evolved. The first says we need to somehow get a handle on all of the nonguaranteed elements that are involved in these new contracts, and the way to do that is with changes in the nonforfeiture law. The other view comes from a group of people saying the nonforfeiture law is in our way

with respect to modernizing life insurance company products for the future. They say we need to remove the rigidity and the cost associated with it. In fact, perhaps the nonforfeiture law is one of our problems with respect to the solvency risk. We have these two different issues that have been floating around over the last ten years.

The regulatory thrust has been to try to see if we could regulate nonguaranteed elements through the nonforfeiture law. The various attempts at dealing with the revisions to the nonforfeiture law have been focused that way. We have heard words like fair and equitable, and then we have also heard concepts like bait-and-switch and boxcar illustration numbers. They have all been brought back when trying to deal with the nonforfeiture law as a solution but have really turned out to create other types of problems. The illustration regulation effort came out of that, but there are still people who are concerned that it does not do enough to regulate nonguaranteed elements.

Perhaps the breakthrough in this whole development came about two years ago when this group sat down and looked at the nonforfeiture issue again to try to figure out how to deal with it. Within that discussion we needed to embrace three ideas: (1) perhaps the nonforfeiture law was too rigid; (2) it did have a solvency threat aspect to it; and (3) it needed to be looked at as freshly as possible from the ground up. The Society of Actuaries (SOA) was asked to prepare a paper on nonforfeiture "theory," and a task force from its board was put together to work on a paper which was completed in spring 1996. Donna Claire was the leader of that task force. It opened up a wider dimension and more prospective view of how to deal with nonforfeiture issues.

Then, in June 1996, the Life and Health Actuarial Task Force of the Academy was asked to undertake what was intended to be a concluding phase of this whole effort. It was to present a proposal by September that would reflect a consensus view of what they thought might be possible to accomplish soon, and I was asked to be the leader of that group. Our starting point was the premise that there needed to be some type of regulation of nonguaranteed elements, then we needed to acknowledge that cash surrender values needed to be optional in the future and that the status quo perhaps does not serve the industry or the public well in the long run; therefore, changes needed to be made.

The proposal came from the work of what was essentially a group of volunteers. Anyone who wanted to participate on this team could. The proposal is what the group thought was a consensus and what had a chance to make it through all of the various debates. We readily admit that when we identified deal-breakers, we removed them from the discussion. Our goal was not to create the "perfect wheel."

The goal was to create what we thought was a consensus that could be carried forward. There were several points of view on this. The regulators have points of view. Each line-of-business actuary has a point of view. The solvency people have a point of view. Management has a point of view, and the public has a point of view. One of the things I have been criticized for is for not getting enough public input into this. In my defense, I think we have had a lot of proxies for the public, but acknowledge that, in reality, the public has not given us direct input.

Our proposal was presented at the NAIC meeting in Reno in September 1996. Tom Foley's task force took the proposal and had some discussion of it. Some of them had a discussion of it in Anchorage. It was being discussed in many forums, and issues have emerged from those discussions.

In a nutshell, I think the concept that is in the proposal is that when an initial premium is paid by a contract owner, it closes a deal—a deal that focuses on the understanding of what the insurer and the insurance policy contract payor have agreed to. The thrust of this development says the deal needs to be articulated. This deal has several components, and one is with respect to premiums. If they are not guaranteed or fixed, there needs to be an understanding of how they can vary. With respect to nonforfeiture values, if they are not fixed or guaranteed, there needs to be an understanding of how they will be developed. There also needs to be some type of regulation that dictates when you need nonforfeiture benefits and when you do not. It also addresses what is a legitimate approach to nonguaranteed elements in terms of pricing and in terms of premium payments.

The thrust of the paper is to say that we need to be able to articulate how policyholders are going to be treated by explaining the company's "plan" for determining contract components. For example, when a premium is paid, the contract holder will want to know the basis of the premiums. If they are guaranteed, that is an easy plan. If they are not guaranteed, they have the right to know what the company's plan is in terms of deciding how they are going to determine premiums in the future. In terms of nonforfeiture benefits, if they are guaranteed, that is an easy plan. That is what we currently have. If they are not to be guaranteed, the policyowner has the right to know how they are going to be determined in the future. We get to the concept of having a "plan" for determination of policy charges and credits. This idea came out of the New York regulation for interest-sensitive products or flexible-premium products. We decided that we also needed a plan for determination of nonforfeiture benefits. With respect to participating insurance, there is probably a need for a plan in terms of how surplus is going to be distributed as dividends.

The plan becomes a responsibility and a duty of the insurance company. The proposal essentially says that actuaries are to support the insurance company's management in putting those plans together, and companies must say they have the plans in place. Then, on a regular basis, they must confirm or attest to the regulatory authorities that the plans are, in fact, being followed.

Mr. Robert E. Wilcox: Do not expect consistent answers from the panelists because we are still talking this through, and I can assure you that we are far from reconciling this issue in our own minds, let alone with each other.

Mr. Thomas C. Foley: Many of you have probably seen the October 1996 issue of *The Actuarial Update*, in which there is a front-page article which quotes both Walt Rugland and me talking about the fact that we need to get this done in the next several months. We are charged with bringing to our parent committee a white paper at the mid-December 1996 NAIC meeting. We are going to do that. We are going to do that primarily out of discussion. It is our anticipation at this point that if this process is going to go, it is going to have to go early in 1997. I would anticipate that there is going to be rapid progress throughout the first half of 1997 leading to some conclusion. We do not have any expectation about what the conclusion will be, but there will be some conclusion. It is very important that we get your input. This is not going to go on for another 15 years. This is going to come to a head one way or the other within the next several months, so this meeting is very timely. We very much would like to have your input and observations about the direction we are going.

Mr. Rugland: We really want to gather data and get opinions out.

Mr. Raymond: Right, but from a constructive point of view, please.

Mr. Armand M. de Palo: As Walt Rugland knows, I have studied this subject for quite some time and have given comments all along in the process. I think it is an enormous task that you are taking on because there are a lot of facets to this that will make it difficult, if not impossible, to do it in the time frame that Tom Foley is talking about. One issue I see is moving away from a net premium-type basis to a gross premium-type basis with or without cash values. Much of it depends on the plan, and that plan depends very much on the monitoring of the actuary. That opens up two more issues. The first issue is how do we value these plans? The valuation law must be in place before we can move to a dynamic nonforfeiture law, and I am convinced that to do this we must move away from a valuation law that is based on net premiums. We have seen massive manipulation of reserves through net-to-gross ratios both on the issues that were raised under XXX and that we are now seeing through very long-term, no-lapse guarantees, secondary guarantees on

universal life. Those doors must be closed. The only way to close them is to move to a gross premium valuation with margins and future assumptions that discount back all values. In a recent note I gave to Walt Rugland, I expressed my opinion that I think we should move to a gross premium, release-from-risk basis, and I plan to write more on that subject in the future.

On the consumer side, if cash values are not available upon the ceasing of the payment of premiums or deposits, the evaluation of how the plan continues on that contract is critical. It would be a travesty to the consumer if he or she stops making payments and gets a nonforfeiture value that may have some value on an actuarial basis at the point of ceasing payment, but the company proceeded to charge large guarantee charges instead of following the plan. The consumer's real value in that situation will be rapidly diminished.

What I am leading to is the point that we cannot allow the ongoing lapse-supported pricing that has proliferated in the marketplace as a means of being pro-consumer. Pro-consumer means all consumers have the benefit. If the actuaries are going to take on the role of certifying the plan, the American Academy of Actuaries (AAA) also must get in front of the issue and say that when actuaries act in this capacity, their duty is to the consumer, and not to the employer or the regulators. They must ensure that equity and fair treatment of the consumer prevail. This is going to be very difficult because many consumers will look to the actuary whenever a negative value occurs in the plan and will sue, even if the actuary follows the plan's operation. That is a problem no matter what words we put in there to ensure the actuary is acting in good faith.

The issue that many actuaries have to face is how they can continue following the plan when the employer wants to do something else. We need to give some backing on it. I do not know how to do this, and it has not been done, but we need some active position to protect the actuary, acting in a role that is intended to protect the consumer, from both the legal system and from their employer.

Maybe we need a British system where there is some centralized control so that if the actuary is asked to leave because they want to follow the plan, then the employer is stopped from doing that. That is a new world we have not gotten into, but when you move into a world where guarantees are no longer withdrawable in cash, we have to raise many new issues. There are a lot of issues here. I applaud Walt Rugland for moving forward on this. I agree wholeheartedly we have to move away from using only a net-premium, book-value, cash-value basis. We have to give people options. I am a little concerned about no cash value as an option, only because of the risk of a secondary market developing where people will try selling their policies to somebody else. I am not sure I am comfortable with a life policy in

the hand of an investor. I think that is just a reality we are going to have to accept. The consumer has to come first in any analysis we do. They have to be protected, and the terminating policy has to get a fair value and not be lapse supported. We need a new valuation law.

Mr. Rugland: I just want to clarify one thing Armand. You characterized the actuary's role in this proposal as kind of standing out there on the point in the Grand Canyon and getting pushed from all sides. We took great care to ensure that the proposal states that it is the insurer's responsibility to, first, have a plan that complies with the regulations, and, second, to attest on a regular basis that the plans are being followed. The regulation will also state that in certain instances actuaries need to support the insurer with respect to their confirmation of the fact that the plan is being followed and is appropriate. That is a little different than having the actuary out there all alone. The responsibility is not the actuary's with respect to complying with this plan. It will be the company's responsibility.

Mr. de Palo: I realize that the way it is written it says the actuary reports to the company on whether the plan is in compliance. The question I am raising is, will the legal system view it in the same way? I also believe that the Academy must take an upfront position on anything where the actuary is acting in a manner affecting the values of the consumer by saying that when performing those roles, the actuary's responsibility is first to the consumer prior to any responsibilities they have to their company. I know that is a difficult position for the Academy to take.

Mr. Rugland: Protecting the public's interest is, in fact, high on the list of the Academy's functions. The discussions with respect to standards of practice have already taken place in terms of alerting the Actuarial Standards Board that there will be actuarial functions that need assistance when we get down that track.

Mr. Wilcox: Armand, I appreciate very much the things that you have to say, and I think that you are very much on track in terms of the responsibility that has to be placed on the actuary. It is an interesting dilemma that we, as a profession, find ourselves in. We have the skills and the experience necessary to take control of the situation, but then we have a reluctance to take on that large of a role given the threat of litigation. Perhaps the best protection from litigation is to put the actuary in the clear position of being able to speak for the consumer or to work on the consumer's behalf. I think that it may be up to the regulators to insist that some of that requirement end up in the final product.

Mr. Kerry A. Krantz: I am with the Florida Department of Insurance. Frank's role is in forms and rates. Mine is in valuation and market conduct. As the valuation and market conduct actuary, it seems to me that under this new rule, market conduct

might get a lot more of my attention than it does now. I am wondering if anybody has addressed what kind of work the industry would like to see me doing with regard to that. For example, right now if a company has a traditional product, and I calculate the cash value, I can use a canned program. If it is universal life, I take their policy form, I look at their interest rates, and I calculate the value. I am wondering what they are expecting me to do as far as checking market conduct with regards to company policy rather than stated, known facts.

Mr. Larry M. Gorski: Well, the framework, as envisioned, would lead one to that answer because it is really the nonforfeiture actuary's role to ensure that values are being determined according to the plan. The regulators' role is to review the opinion of the nonforfeiture actuary to make sure that it says what we are expecting it to say, and if it does not, to follow up from that end. In terms of actually calculating values, I do not see much role for the regulatory actuary under this framework.

Mr. Rugland: By "opinion" you mean the company's certification that it is complying with the regulations dealing with the plans.

Mr. Foley: One of the unresolved questions is what we do with the plan. We expect to get a certification from the nonforfeiture actuary of the company, and a detailed plan will be developed. Where that detailed plan goes is still under discussion. Most likely it will not end up with insurance departments but, probably, will not stay completely with the company either. We need to put it in some holding place so that regulators can be assured that the detailed plan was, indeed, constructed. The market conduct activity that may occur downstream would come if we get a number of consumer complaints and it turns out that either the plan was not in place or it is not being followed. Then I can envision more market conduct activity than we have right now.

Mr. Joseph M. Rafson: My question relates to how specific you envision these plans being. My thinking is they are on a very simple basis for an interest-sensitive product. Companies in a dynamic world, for very valid reasons, change their thinking. They want to shrink their spreads when rates go up, or they might decide to pocket a little bit more when rates go down, to compensate for rates going up. How well can we predict what the company's position will be 10–20 years from now, and how do we deal with that in our plan? How specific does that plan have to be?

Mr. Foley: Would you buy a car from somebody with an attitude like that? "At this point in time, well, we think we will do this, but next week we may do something

different." We are talking about people who buy products and keep them for 20 or 30 years.

Mr. Gorski: There are really two elements to your question. One is about the plan that is developed by the company, and let us say it is for internal purposes and possibly for some regulatory purposes. There is also that abstract of the plan that is delivered to the policyholder. There are really questions of detail in both of these. I have been one of the people who has been on the side of having a rigorous disclosure of the plan to policyholders. When you get to the issues you are talking about, it seems to me the plan needs to be far-sighted enough to contemplate different situations. Obviously, it is not going to only zero in on a level interest rate environment. It needs to consider what the company is going to do or what it could possibly do in both rising and falling interest rate scenarios. I think the answer to your question is it has to be far-sighted enough to contemplate different situations, but it must be specific enough so that management, regulators, and the public will understand what a company could do under these different situations.

Mr. Rugland: Let me refer to page 14 of the Report of the SOA Task Force on Life Nonforfeiture. You asked what might these plans look like? In the report there were two situations put forward. There is nothing magic about these situations. These documents were essentially put forward as examples, and there could be many others. If you look on Page 14 for a term-to-100 type contract, you will see in the third paragraph in the second section, "have experience with respect to company claims, industry experience, maintenance expenses, investment income, and tax costs varies from assumptions at issue" per the exhibit. The exhibit would identify what the assumptions were at the time of issue. "The company may adjust premium levels to reflect the impact of that change." Then it says "competitive conditions at the time of adjustment may cause a company to not fully reflect experience in the adjusted change." The anticipation there is if competitive pressures say you should not increase premiums as much as you might otherwise do, you would not do it. A company could turn around and say, "What if competitive conditions say we do not need to decrease premiums as much as we otherwise would need to?" I think that if you take that position, it would need to be in the plan and it would need to be identified in the plan as your approach.

The second piece of this is on page 16 and is essentially a policyholder summary. The notion is that this is the type of document that would be given to policyholders as a summary of the plans. But you see the way I describe the nonforfeiture plan; it has to have enough in it so that actuaries two generations later can figure out what your deal was with the contractholder. There needs to be enough documentation in this plan. We do not need that now because we just look up in the books what the values are. There needs to be enough material in the plan, with exhibits, examples,

and assumptions, so that two generations later actuaries will be able to figure out what the deal was and be able to deliver the deal. That is the nature of what these particular examples are showing us.

Mr. Gorski: The Report of the SOA Task Force on Life Nonforfeiture has been directed to the regulators. What comes out of the Regulatory Task Force may or may not be exactly like this report. You need to keep that in mind as you are reviewing it.

Mr. Rugland: In other words, we have a moving target here.

Mr. Raymond: I think Larry Gorski's point is important, and I also think Joe hit on one of the key issues that needs to be resolved. One issue is, how much flexibility does this law allow? I think the Academy report allows a lot of flexibility and really just gets to the definition of what that flexibility is. I think Tom's analogy to a car warranty is a good one. Is the objective to regulate what the warranty is, or is it simply the need to make sure that the warranty is clear and present? I think the Academy's proposal was really saying all we need to do is require that there is a clear warranty, and that the policyholder understands what that warranty is and not so much that the exact terms of that warranty be defined by the law.

Mr. Larry J. Bruning: I'm with American Investors Life, and we primarily sell annuities. I know the nonforfeiture law's original focus was on life but, as I understand the law, it would cover annuities as well. Some early proposals I saw threw everything in there: property and casualty, disability, etc. I guess I just want to state my opinion and go back to more of the fundamental questions at hand. What is really driving this need to have a new nonforfeiture law? I would agree there are some problems with our existing law that even I, as a practicing product development actuary have encountered, however, I do not think that we need this revolutionary change in the law. This is a concern I have in addition to the one Walt Rugland mentioned.

How many consumers have we really talked to? In my opinion, we are in an industry that has done a poor job of educating the consumer about the products and services we sell. Unlike beer, cars, or tires, I never see insurance commercials after NFL football games. I think we, as a profession, do a tremendous amount of disservice to our consumer because we do not take the time to educate them on what is available or what it is they have. I am not sure we talk about a "deal" in this proposal. We have always had a deal, since the beginning of insurance. It is called the insurance contract, and it explains provisions in the contract. Maybe they are not as clear as they should be, but to me, if you are going to annually distribute surplus, at the company's discretion, that is a plan. It may not be very clear; there

may be many risks with that, but I think a consumer, if they read their contract, would say, "OK, they have the right to do that."

Someone on the panel asked the question earlier "Would you buy a policy that was like that?" I think there have been trillions of dollars spent on exactly these types of contracts and nowhere near that amount spent in trying to defend these claims. I think that, as an industry, we try to back up what we say we give the consumer. I am wondering where the problem is? What is the issue here? I have not heard of big consumer groups raising this issue. It seems more like we are focused within, and we are afraid to go out and ask the consumer, "What do you really want?" Maybe we need to have some focus groups. But, as I say, maybe that too would be a problem because we do not even know the right questions to ask because we have not educated our customer about our products and services. I feel that our contract does describe the deal. I feel there is a plan in our contract, and it seemed to work very well over a long period of time. I am not suggesting it does not need improvement. I think it does.

The last thing I will say relates to guarantees. In the annuity business the consumers we deal with are those over age 60, and we have talked to many of them. Our phone people talk to them every day, and find that they are concerned about security. If I am 60 years old, I worry about whether I will have enough money to live on. I do not think the customers my company is dealing with would even be interested in talking to anyone about a plan that has no values. The primary reason they are buying annuities from us is because they want that security, and they want that guarantee.

Mr. Foley: That is the fundamental question. If you stop and think about all your comments, you probably answered your own question. Up until 15 years ago, the deal was generally in the contract, but now, a large part of the deal is not in the contract. It is outside the contract because now we have a nonguaranteed element. People do want security, and what we are trying to do is formalize the deal process so that consumers know that the company is not going to decide next week we are going after consumers, and the week after that we are going after something else, because that is exactly what is going on. From a regulator's viewpoint, that is frustrating because we know our consumers are the captive ones. As you said, they do not even know how to ask the right questions. That is what we are trying to do. We are trying to formalize this process with regard to making the deal with consumers, and in some very real sense, then regulators can get out of the way.

Mr. Gorski: The one comment I would make is that maybe neither Walt Rugland nor the task force has had any formal meetings with consumer groups, but as a state regulator we do get a substantial amount of input from consumers through the

complaint process, so it is not like we are working in a vacuum. We are reacting to complaints, and for the most part, the complaints we hear now are ones we have been hearing for the last several years. They are complaints about things that we can't do anything about because the contract might be a universal life type product with nonguaranteed elements, and there is no regulatory framework to deal with those issues. Those complaints just fall by the wayside because there is nothing that can be done. I think that the bottom-line suggestion is that nonguaranteed elements should be regulated (and I am using the word "regulated" in a very general sense) through this plan approach.

Mr. Frank P. Dino: I would like to respond to Tom Foley's comment. If nonguaranteed elements are really the issue, I do not know that we really need a plan certifying something if what you are saying is, we need to put the deal in the contract language and create a better explanation of what is going on. If that is the issue then let us just do that because ultimately, when this ends up in court, the words written on that piece of paper are the deal. You cannot go out and say, well, some actuary certified on this. If it was legally in the contract, then you could. It seems to me what we are talking about then is the language, and what you are upset with is the language that is not in the contract. If that is the case, I think we ought to focus on that rather than say we need some nonforfeiture law to address this issue.

From the Floor: Will it not be necessary to provide each policyholder with a complete copy of the plan so that it will become part of the contract as well?

Mr. Gorski: I do not believe it is necessary to put all of the information contained in the plan into the contract itself. I envision the situation being one in which the contract will potentially make reference to the plan, and then the plan would be the framework that the company will work under. I think really the answer is somewhere between what you are suggesting and simply a naive view that the contracts will stay the same. There will be this other document, the plan, that will control values. There will be an interaction between the two.

Mr. Sheldon D. Summers: I was just going to add that this idea of a plan does not preempt the contract. It does say companies are forced to include nonguaranteed elements so you are free to continue to provide a contract that has only guaranteed elements. Just because you have a plan, you could still have the same type of guarantees in the annuities and still provide that security.

From the Floor: Right, but I would hope that companies that include nonguaranteed elements that are based on future experience continue to uphold their promises, but that does not really answer my original question: What is the issue? Is it companies not standing behind what they said they were going to do, or

is the issue the fact that some companies really do not explain upfront what they have the right to do? If it is the latter, then I maintain that we need some kind of regulation to say more detail is spelled out in the legal document that binds between the parties.

Mr. Rugland: But one of the things that the Academy Working Group wanted to do, in terms of its proposal, was to make sure that it did not preempt companies from being able to do that if they wanted to, and to the extent you think that happens, be sure that you let us know. I refer you to page 23. Every activity for change needs a reason, and at one point in time a case statement for change was developed. It is in Appendix B, and I would just refer you to it in terms of the thoughts of the working group in terms of why this change should be considered and is appropriate. I do not want to quote any of it, but it is basically there as a reference for you to use as you ponder the question that has been asked about why should we do this?

Mr. G. Thomas Mitchell: I want to speak for the revolution. The change statement clearly lays out some important reasons for the ongoing vitality of the American insurance industry and its benefit to the U.S. economy. It also suggests that a law that prescribes a feature that adds perhaps 15% extra cost to consumers, that many consumers may not want or need, may be detrimental to the industry. That is not a trivial matter. I do like the framework we are going to, where we continue to allow what is going on right now to continue, but also allow these new policy structures that will either flourish or die with proper disclosure. In essence we will let the public and the consumers decide what they like. If they like the old-fashioned scheme, it will flourish, and the others will wilt.

I also have two questions. First, one of the major features of the old nonforfeiture law is that there is a fairly bright-line limit on front-loading. In these discussions and the write-ups that I have seen to date, there has been little explicit information on the limitation of front-loading. Will there be some formula-type limit on front-end loads, or is it going to be whatever the actual costs are? Just let me say that if it is the latter, then I believe there could be some real dangers.

My second question is for Chris Daykin. Personally, I am uncomfortable trying to fix these problems "on the fly." That is, as policies work their way forward, I question the wisdom of trying to alter a company's course of action. I think that we would be very interested in hearing the U.K. experience on this issue.

Mr. Gorski: I would like to respond to the lack of explicit mention of acquisition costs and other costs in the discussion. In fact, that has been part of the discussion. If you take a look in your material at the questions that relate to nonforfeiture

benefits, that last question deals with your specific question. What is the threshold level of prefunding? To answer your question, it is really a matter of how that notion of prefunding is defined that will incorporate some of the ideas you mentioned. It is not something we have omitted, but it is something we are still working on.

Mr. Rugland: I would add to that the threshold level needs to be defined by regulation. Standards of practice are not capable of addressing that. If there is a line, it must be defined by regulation, and that is what these regulators are all about.

Mr. Christopher David Daykin: I was not eager to enter this discussion because I think you may have difficulty understanding me. I really do not speak this language at all, and I feel as though I have just popped in from another planet. This idea of nonforfeiture does not occur in the U.K. We would refer to the idea of guaranteed surrender values in the sense of minimum cash values that companies might promise to people who leave before the contract is completed. For years, the U.K. regulators have sought to discourage companies from having any such things because they are fundamentally dangerous from a prudential supervision point of view. We put great pressure on companies not to have guaranteed surrender values. We have gone so far as to write into our regulations, that say if one has guaranteed surrender values, that company must reserve for 100% of the cost of giving them to everybody, in case the whole lot were to leave at one time. There is quite a lot of pressure on companies not to have anything to do with such policies.

You might ask, what is our concern? Our concern is about asset/liability matching. You can only essentially match one set of benefits at the same time, not two. With the use of options and other doubling up of reserving, you can put up reserves that will cover two situations. We feel that it is not in the long-term interest of the policyholders, particularly in traditional contracts, to have any sort of immediate cash guarantee because it prevents the company from investing in the sort of assets that are good for the policyholders. Our participating insurance is invested in more than 80% in equities rather than in bonds, and that gives fantastic returns to the policyholders who stay for reasonable periods. You may say that counts against those who leave early? Yes, it does, but that is not the contract they enter into. They buy contracts that are ten years or more in duration, and they are very badly advised if they are encouraged to leave before that term is completed.

Recently in the U.K., we have had a great deal of regulation of the marketing of insurance. We have two separate bodies that regulate insurance. There are the prudential regulators, the Department of Trade & Industry supported by the Government Actuary's Department. It is responsible for financial strength and for seeing that the reasonable expectations of policyholders are met. It is not a well-

defined concept, so the regulators have enormous power to intervene in any situation where they feel the policyholders had some expectation of performance that the company has not followed through on.

We also have a separate system of regulation that deals with the regulation of all investment products, insurance, or other products. This department places greater emphasis on disclosure as the principal method of dealing with problems. When the policyholder is sold a contract, he or she has to be told what it is all about. Policyholders have to be given a key features document, which describes the policy's nature. It is not unlike the ideas that are currently coming out in relation to your plan concept. There is a requirement to disclose what the expected cash values will be, and very often there will be no cash value for the first couple of years. That has to be explained in addition to what the order of magnitude of cash values in later years might be, but nothing is guaranteed in that respect. There will also be disclosure of eventual ranges of potential benefit values and other discretionary items the company may change. These might include policy charges to adjust the policy conditions in one way or another, particularly on policies like universal life and the unit-linked business, which constitutes the vast majority of business written in the U.K. of an investment nature.

These documents, together with the with-profits guide (that has to be given to anybody buying a participating policy) that explains the philosophy of the company in terms of its investment and how it is going to allocate bonuses and so on, would form an essential part in determining the policyholder's reasonable expectations. We can look back on those documents and say, well, this is what was available to the policyholder, that is what they bought, and, therefore, the company has to follow through with what it has promised.

Mr. Robert H. Dreyer: I'm the past chairperson of the Smaller Insurance Company Section. Obviously we have a lot of concern for our members that this program might put us out of the market for indeterminate premium products. Consider the smaller company that has to include in its plan a statement saying it bases its interest rates on the aggregate rates earned by the company's portfolio, and mortality charges are based on the aggregate experience of the company's products. In the minds of the regulators, would it be acceptable for that plan to reserve the right for the company to at some time in the future move away from this so that it could segment its experience by line of business for a new product?

Mr. Gorski: From my understanding of the current plan language and from what I would hope the ultimate language would say, the answer would be no. The only way to do this would be if you came to the state insurance department, either the state of domicile or the state of filing, with a request to change the plan. As it stands

now, you could not make such a unilateral change in a plan without getting some department's approval.

Mr. Peter John Vogt: I agree with this process. I think that for the life insurance industry, our competitors are not just actuaries. It is the Fidelitys of the world and the Goldman Sachs, and it might be Microsoft in five or six years. Due to the way the nonforfeiture law is structured, we are at a disadvantage. There are minimum values that cost money, and they make our products somewhat uncompetitive. It should be up to the consumer whether they want to pay for that. I agree with Tom Mitchell on that. My question relates to the logistics of what happens with the plan once it is filed with the department. We hear the terms equitable and fair value to persisting policyholders versus nonpersisting policyholders, but could the plan be used by a department to say, "Gee, I think your margins are too fat," or "I think you are taking too much profit?" I think if that is the case, it could lead us down the path of what I would call rate regulation, and that would concern me greatly.

Mr. Gorski: I think that element of a plan is probably one of the most controversial among the task force members. When Commissioner Wilcox was saying the task force is not of one mind, I am sure he was referring to this issue. It has not been resolved yet as to what, if any, filing requirement there would be and to what extent there would be precautions to deal with the possibility of rate regulation. The follow-up to this question is that the way the regulatory framework seems to be proceeding, we would be taking a dual-track approach where you could still file contracts and have them approved under the current law or under the new law. If there were large-scale industry concerns relating to overzealous regulators with respect to the nonguaranteed elements, you could test the waters by having only one form filed and then see what happens. There is a built-in safeguard against excessive control of the nonguaranteed elements.

Mr. Rafson: Will these plans be deemed to be guarantees for reserving purposes, and, if so, how can a company possibly put in their plan what they really expect? If current mortality is already well in excess of what a company plans to use, will the existence of the plan require it to put up more reserves?

Mr. Gorski: It is my own personal opinion that the expectations would not be tantamount to a guarantee for valuation purposes. However, for those companies that are required to file a Section Eight actuarial opinion, obviously the plan's content would be a consideration when doing one's asset adequacy analysis testing. Earlier someone said something about the need to modify the valuation law. There is some recognition of the fact that this nonforfeiture framework will impact valuation.

Mr. Rafson: The example given earlier by Walt Rugland was of a term-to-100 product with a plan of up to 150% of the current scale. For a preferred nonsmoker that may be below the 980 commissioners standard ordinary table. Would that specific example have reserve implications for this product? If the answer is yes, how can you expect a plan not to say what the current contract says?

Mr. Rugland: When I did the original draft of that particular example, my view was that in determining a Section Eight opinion the flow of liabilities would be consistent with the policyholder's expectations that are inherent in the plan. When you get into the formula reserving, in some instances, it begins to have a problem. Under this law we could come up with contracts that potentially do not fit the old model for formula reserves. That is why it is so important for us to recognize the suggestion from the American Council of Life Insurance Working Group. We really do not know how to transfer from one approach to the other, because there is so much that is embedded in everything we do which starts out with guaranteed cash values or guaranteed nonforfeiture benefits. Their suggestion was that we should let the market decide which is best and allow companies to go down one track or the other. If a company had difficulty going down this new track because of either a reserving issue, a policyholder issue, or a marketing issue, they still have the option of filing their new products under the current system. Some may argue for consistency by forcing the plan on the old method. If that is the way we end up, there may be some current practices that are outside the scope. You call them the outliers or whatever, but I do not think it is the intent of the task force to force people to change what they are doing unless they find it is to their advantage in the marketplace to do that.

Mr. Raymond: I would like to add a point of clarification. Tom Foley has identified eight questions as the core issues that are being discussed now by the group. We had a two-hour meeting before we came to Orlando, and we will be having a meeting to continue discussions focused on those questions. A number of the issues that have come up, like the question of optionality, are issues that are still on that list. If it is not clear to everybody from the discussion that you have just heard, the current proposal is to present this as an option, and not as a replacement of the existing nonforfeiture law. The reason for presenting it as an option, at least initially, is to open up the doors to some creativity and flexibility in the market, and then to proceed from there based on how well that works in the marketplace.

Mr. Foley: Craig, we are also talking about this being an option on a policy form basis, rather than on a company basis, which is going to be critical for the small company issue, tax issues, and reserving issues.

Mr. Summers: I have a quick answer to the last question. If the plan has guarantees, those have to be taken into account in the formula reserving. The answer would be, yes, it would have an impact under the present valuation system.

Mr. Gorski: I think what I am hearing, at least indirectly from some of the questions, is that in some cases, formula reserves as currently constituted are too stiff of a requirement for some product designs, and that may well be the case. However, there may be other impediments to fully implementing this idea. For instance, in Illinois our policy form approval process looks at life policies, accident and health policies, and annuity policies, separately. One of the ideas in this proposal is that we be able to consider multitrack policies. As I say, there may be other inhibitors to implementing this idea, but it seems to me we have to start somewhere. Nonforfeiture is probably the best place to begin the discussion of revising the regulatory framework.

Mr. Foley: It is very important to clarify where we are with regard to multiple benefits under a policy. One of the key motivating factors behind this proposal is to provide flexibility to our industry. It is theoretically possible that we should be able to provide one contract that currently provides a life benefit, which then becomes disability income, which then becomes long-term care, which could even become medical expense protection that can switch to a source of retirement income or whatever. We should be able to do that under one product. This proposal gives a company the flexibility, using the plan approach, to design the type of contract I just described. In some sense, we are bringing annuity benefits and health benefits and these other benefits under one umbrella.

At this point in time, we are not contemplating that all long-term-care policies sold from this point forward will have to have nonforfeiture benefits. You are going to continue to have the same flexibility you have right now. You can sell a long-term-care policy with rate and health regulations the way it stands. The same is true for life policies. You can also sell this new idea, and, granted, there are going to be questions that we have to resolve, but no one should walk away from this meeting with the sense that we are going to be mandating nonforfeiture benefits on health policies because I know that will kill it. We have already been down that road.

Mr. de Palo: Just a very short point on the reserve issue. I agree with Walt in that the industry needs flexibility. My main point is there are many hurdles we have to get over, and we have to think through the philosophy. As I mentioned earlier, we have to put the consumer first. We also have another important issue. We cannot allow the other companies to be put at risk for the aggressive plans of other companies. That is why the reserve issue is so important. As long as we have a guarantee association, simply relying on cash-flow testing of the company with no

minimum reserve standards is subjecting the balance of the industry to aggressive long-term guarantees of other companies. That cannot be. Maybe one of the options that should be included, and I am seriously making this proposal, is if you are not going to have minimum reserve standards in this regulation, then allow those companies to not be included in the State Guarantee Association and certify that those policies are not covered. Those companies that choose to hold reasonably conservative reserves will be covered by the state. To subject a prudent company to the possible aggressive reserve standards of other companies who are gaining market share is going to harm the industry, and that is why it is so important that we have minimum reserve standards that have reasonable future conservatism in them.

Mr. Rugland: I do not think there is a suggestion that minimum reserve standards not be followed.

Mr. de Palo: The option to allow companies out of the guarantee association should be part of your proposal.

Mr. Rugland: I think that is far beyond the scope of what we are talking about.

Mr. Robert A. Brown: I would like to point out page eight where it talks about summaries of plans. It specifically says that the plan itself will have the formula for the future determination of nonguaranteed elements. Therefore, we are not talking about a plan that says, we will take a look at this and a look at that, and then we will declare our interest rate. It says the plan itself will mechanically tell you how you get that rate.

I think those of us who are in the long-term accumulation business, whether it is individual single premium deferred annuity, big group plans, or 401(k) plans, have a hard time feeling like we know what the right formula is for the determination of declared interest rates 15 years from now. To be required to be committed to a mechanical method forever, unless you get regulatory relief with regard to any one contract, is very troublesome. It is unprecedented in current law. In my view, it has nothing to do with the stated objectives of the new standard nonforfeiture law, but it does play into some very difficult issues that were being debated over that last 15 years. I think that, as it stands, it is a big concern. I think that all of the "would you buy a used car from this company" kind of commentary on the part of the panel suggests that this may be one of the areas where existing regulation and existing rules by themselves may not be allowed to stand. I think that would be a serious problem for our industry, and, again, as somebody pointed out, it is not just an industry that insurance companies are in. The banks do not have to say how they are going to determine the rate on their certificates of deposits ten years from now.

The guaranteed investment contract pools do not say how they are going to determine their rates several years out. It is a serious disadvantage for us if we have to lock into a formula for determination of those rates and live with them for the life of contract. I think we should not go to sleep on this. Minimalizing statements like "it is only an option" and "it just gives us more flexibility" does not comfort me. I continue to hear enough statements that suggests that we cannot rely on that.

Mr. Foley: It seems to me that the plan needs to be able to tell the actuary 15 years from now what the company's intent was and how it is going to go about handling all aspects of that policy form. At this point, I do not know if I have decided whether that implies a formula or general concepts. In fact, that is why we need your input. As a consumer of this product, I would like to have some sense that if I buy a policy today, that some philosophy is going to be tracking with that policy for it's term, not that it has a philosophy that is so inflexible that it cannot ever be changed. I'd rather know that the company has the intention of going about doing things in a certain way. That is what we are talking about.

Mr. Rugland: That was the intent of this proposal, and your comments are well-taken. We should be sure that Tom Foley's view is carried forth as we proceed with this in my view.

Mr. Gorski: This is one area where I break from the thought behind the Academy proposal. When I look at the concept behind the plan summary, which is the document that is going to be provided to the consumer, I see this proposal as being deficient in that area. I will be arguing for greater disclosure to the consumer than I think is assumed by this document. I just wanted everyone to know that upfront.

From the Floor: I think one of the concerns I have on behalf of small companies is an amplification of what Larry Gorski, Tom Foley, and Commissioner Wilcox have said, which is that actuaries have to be able to know two generations down the line what the actuary of today did. If you sell a policy to a four-year-old, that person may easily live well beyond 100. We have to be very concerned about that. At the same time, we are also talking about regulators two or three generations down the road. What may be intended today by the regulators may not be interpreted the same way by future regulators. They may not understand what was done way back, but then again, they may not adhere to it either. It is a very difficult balance. I know that it has taken a great deal of effort just to get to this point, but one of the regulators said something to the effect that small companies have dug in their heels and are not willing to talk. That is not true, but there is a great deal of concern and reticence over this process by a lot of people that do not attend these meetings. I guess one of the things I would like to say is, and I am sure that Tom has said this, that the small companies do not normally get involved in this process but they need

to get involved because there are many different perspectives. There is a concern that on a going-forward basis all these things will not be considered.

Mr. Dreyer: Several regulators have made mention of the optionality of the law, where you could file a plan and go in with one of these new products, but you could also continue the way you are operating today. Does this imply that existing products with nonguaranteed elements will be grandfathered or will there be a date where they have to be pulled unless a plan is filed for them?

Mr. Rugland: What is the reaction to that question, given that it has probably not been decided?

Mr. Wilcox: We are undertaking this dual course somewhat as an experiment to find out whether we have a system that works before we lock everything into it. If it works and works well, I think you could expect that some future generation would say everything ought to be like that. If it works only marginally, then we might find that only certain products have to be done that way, or we might continue on a dual course in the future, but the whole idea behind the experimental approach and the dual approach is to see what happens.

Mr. Gorski: Frankly, I think the marketplace will have a lot to say as to how that issue is resolved. At least in my mind, if you have one universal life product with nonguaranteed elements but without the commitment to a plan for future redetermination of those elements versus a plan subject to this approach, I am clear about the kind of product I would buy. It is possible other consumers would feel the same way. I suspect that the marketplace will have a lot to say in resolving that question.

Mr. Foley: Clearly the U.K. experience indicates that the marketplace can do that and can require that kind of exposure and that kind of direction. Many of the current regulators throughout the states are rapidly coming to the opinion that we need to do whatever we can to really get the marketplace working. Then we can get out of the way and let things evolve as they should.

Mr. James F. Reiskytl: I am all for plans, especially for contracts with non-guaranteed elements. I realize the problems that people are having by being held to that fire, but I think that is appropriate. I am not a lawyer, but the contract says this is the entire contract. How does one have a plan that is not part of the contract that the consumer can enforce? If I am buying such a policy, and you say, well, I have this plan in some mysterious place, I am not sure that is going to hold up legally. As an actuary, that is not an issue for me to address, but I am sure you will have to address it. If the plan is not in there, I do not know how it takes on the force of law,

because I am all for doing more with plans so that the consumer will have a better disclosure. They may still not know where they are going, and I do not know how to make them understand it. I have also been concerned about the sales of insurance. I believe I heard sales are off sharply in the U.K. since adopting this same sort of plan disclosure approach.

I would be negligent if I did not also add how taxes can go up and down rapidly. Think about what may happen to you if you adopt such a policy; remember your change in reserve does drive your taxes. I applaud your efforts and I know you have to sidestep some practical realities, but realities always come back. I was just wondering if you have addressed the question of how you are going to make this plan enforceable to the consumer.

Mr. Foley: The entire contract provision does say exactly that. My initial reaction is that we would need to alter that somehow.

Mr. Wilcox: I will just say that I think that this effort to overhaul the nonforfeiture law is critical to the future health of the insurance industry. Take a look at the trends with regard to the overall sales of life insurance in the U.S. If you do not come to the conclusion that something needs to be done, you are looking at different statistics than I am. I think that it is imperative that we continue this effort and come up with a result that will, in fact, enhance the health of the industry.

Mr. Dino: I appreciate the comments that were made. I have been involved in this for quite a while. There were several concerns that were raised on ancillary issues, and I would hope that we do not lose sight of what the goal is. It was discussed very early on, even before the first draft of nonforfeiture hit the table, that reserve impacts would be there, and that we would have to look at that down the road and maybe change, possibly dramatically, the standard valuation law. We need to keep track of where the secondary concerns are, but I think the primary concern is to focus on nonforfeiture and try to keep that moving for the good of everyone. After that, we can take on the other changes that are necessary as a secondary project. We do recognize that valuation is a concern that needs to be addressed.

Mr. Gorski: We have been working on nonforfeiture issues for 15–17 years and trying to deal with the dual concerns which Walt Rugland identified. This proposal probably has the best chance of meeting the regulators' concerns over nonguaranteed elements, the industry's concerns over flexibility, and the desires of the insurance public.

Mr. Foley: This has been very good for us. When I indicated early on that we were going to wrap this up by mid-1997, clearly that was done to motivate everyone to

come to the table with the types of questions that you have provided. We are going to continue to have outstanding details even if things go very well. But, by mid-1997; we hope to be very close. Do not wait and get involved in the process in July 1997 because by then we are going to have everything identified, and we are going to be going in a given direction. Larry Gorski has been involved in this process for a long time, and it is encouraging to me to hear him say that this has the best chance. This does have the best chance of doing something, and it is really going to be up to the people in our industry to pull this off.

Mr. Raymond: One of the things I want to reiterate, which Tom Foley stated is that I have been watching regulatory activities for the past few years very actively. One of the things I continue to see is once these people make a decision and move forward on it, there is always a large group in the industry that steps forward and says, "How did they do that? I did not know they were doing that. I do not like it." I think it is real important for this effort to get a significant amount of industry involvement and professional input. We must get your comments, your concerns, and your issues out because that is the only way this is going to move forward. I encourage everyone to stay involved and let these regulators know what you think.