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Implementing the Illustration Regulation: The Clock Is Ticking

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Moderator: DANIEL THEODORE
Panelists: THOMAS L. BAKOS
DAVID N. KARO
ROBERT E. WILCOX
Recorder: DANIEL THEODORE

Summary: The New Illustration Regulation takes effect beginning January 1, 1997. This session is aimed at potential illustration actuaries and others involved with illustrations or concerned about illustration compliance. You will get a crash course on the requirements of the regulation and the tasks to be accomplished in order to achieve compliance.

Mr. Daniel Theodore: I work at Milliman & Robertson in New York. As you are all aware, the NAIC Life Insurance Illustrations Model Regulation will become effective in a few states in two months, and several more states are expected to come on board during 1997. This is a far-reaching regulation that will change how life insurance is priced, sold, and serviced. Agents in the field will be subject to greater home office oversight and stricter rules regarding what they tell and deliver to their clients, and they will have to collect even more signatures than they already are doing. Actuaries will face greater scrutiny over their pricing assumptions and the resulting projected profitability. In addition, they will carry more responsibility for monitoring in-force results and reflecting them adequately in subsequent disciplined current scales.

Programmers and the actuaries assigned to checking illustration systems will be burdened with more than the usual volume of system changes. The marketing professionals will face an increased challenge to provide clear and helpful disclosure that uses more strictly regulated illustrations for selling their products. The home office administration will have to keep illustrations on file, provide new illustrations for those policies not issued as applied for, and provide additional information in the required annual policyholder statements and in-force illustrations.

Finally, the customers will face additional disclosure that may produce more informed purchasing decisions that will result in fewer misunderstandings, greater customer satisfaction, and hopefully, it will contribute to better persistency and higher profitability. It might even be envisioned that this regulation will ultimately result in improved public perception of the life insurance industry. (However, we should not hope for too much too soon.)

Another panel at Session 8 discussed *Actuarial Standard of Practice (ASP) No. 24* and its relationship to the regulation. Our focus will be somewhat more nuts and bolts. Many of you are facing the risk that in just 41 business days your company will be effectively barred from the market in several states until you manage to comply with the model regulation. Unfortunately, there is no magic bullet and no quick path to compliance. It is unlikely that your existing illustration systems can produce output that complies with the layout, format, and the numbers that are required by the regulation. The process required to determine and document the disciplined current scale is large, if not monumental, and I should hasten to point out that greater care taken by the appointed illustration actuary can reduce the risk of being hauled into court.

Luckily, we have a distinguished and well-balanced panel. Insurance Commissioner Robert Wilcox of Utah can address the point of view of the insurance regulators. Thomas Bakos of the Guardian will speak as the appointed illustration actuary of a life insurance company. David Karo of ECTA Corporation can speak on the implementation from the point of view of a third party illustration software vendor. Together, I believe this panel can help you grapple with this difficult and pressing issue.

What are the key provisions of the new regulations? How does the new standard of practice (SOP) relate to the regulation? What states are expected to have the regulation in place, and what are the prospects for expanded regulation of other product illustrations? Our first speaker is in a good position to answer these questions. Leading off is Utah Insurance Commissioner, Robert E. Wilcox, who should be known to all of you. He is chairman of the NAIC Life Disclosure Working Group from which the illustration regulation emerged. He is also a member of the NAIC Life and Health Actuarial Task Force, and to all of his assignments he brings his credentials as an associate of the Society of Actuaries and a member of the AAA.

Mr. Robert E. Wilcox: Some of my comments are going to be background information. I think that many of you have been through the background and are now interested in the nuts and bolts. I am going to try to move through this background information rather quickly, to cover some of the details in which you may be interested, and get to the other two speakers. Then, during our question-and-answer period, I hope to be able to address some of your specific questions.

Why did we need a model regulation dealing with illustrations? Back in the 1980s, we found some overly optimistic sales illustrations being used by some companies. Prior to that time, the insurance benefits had been the focus of the illustrations. We then found advertising from competitors that changed the atmosphere of illustrations. The insurance industry responded in kind and made a number of significant changes. The insurers were earning double-digit investment returns and illustrations showed those returns. There was no adjustment for the effect of inflation that was a part of the pictures being presented. The current scales that were being paid were extraordinarily high—something we had not experienced before—and resulted in fierce competition. This brought projected assumptions, persistency bonuses, and new money investments rather than portfolio investments that made a more dramatic picture.

First of all, what are sales illustrations? They are columns of numbers for future years that show premiums, death benefits, dividends, guaranteed cash values and illustrated cash values, and many footnotes and disclaimers. In addition, interest adjusted cost indexes were introduced into the picture.

Sales illustrations have some valid uses and some invalid uses. Positive applications include some “what if” illustrations and demonstrations of how policies work. Negative applications produced overly optimistic forecasts that oversold and ultimately underdelivered in the product that was illustrated.

The primary reason for the failure was a change in the investment environment. Other reasons include inadequate consumer understanding, a lack of industry ethics, not across-the-board but in isolated pockets a lack of adequate regulatory standards, and a lack of enforcement of the standards that we did have.

The net investment income of all U.S. companies before taxes for a period starting back in 1946 was at the low point in 1947, increasing to a high point in 1985. This is a period of 39 years where the before-tax rate of return of the life insurance industry increased every year. It not only increased, it increased by at least five basis points every year. It is really quite amazing that there is a period of nearly 40 years during which the rate of return went up every year. Since that time, the rate of return has gone down by an average of 27.5 basis points each year. These are portfolio rates that increased and decreased over that period of time. With investment year rates, it was easy to see rates dropping from 12% to 6% on a new money basis in a very short period of time.

Let me say a word about how we develop regulations, to give you a picture of this process. The public policy decision process is generally driven through state legislatures, state insurance commissioners, the industry, all of you folks out here, as well as consumers who have specific interests that they want to see developed. You will note that you have groups that support the legislatures, like the National Conference of State Legislatures and the National Conference of Insurance Legislators (NCIL), and groups that support the insurance commissioners, primarily the NAIC.

Out of the public policy decision process comes laws and regulations. Independent state action is the focus here because most laws and regulations come by the states acting independently from a variety of sources.

Model laws and regulations are generally developed through the NAIC, sometimes with concurrence and involvement of the legislative groups like the NCIL, but they generally have broad support and meet some specialized needs. Often, there are alternative models, as we have seen. In some cases, we have produced as many as three different models dealing with the same issue from which states can pick and choose based on their perceived needs.

Now in the development of a model, it is valuable to look at the structure of the NAIC so you can see how the development of this model actually takes place. Under the NAIC we have the geographic zones: western, midwestern, southeastern, and northeastern.

In addition to zones, we have an executive committee. Under the executive committee are committees, special committees, subcommittees, task forces, and joint committees and boards. When you move down to the next level you see that one column is for special committees, one column is for the standing subcommittees, one is for task forces, one is for boards, and within this particular structure, the A committee is one of those standing committees that is responsible for life insurance development.

But within the NAIC hierarchy there are more than 100 separate working groups, task forces, and committees that participate in the development of these models.

The actual development of a model law begins usually with a working group that develops a draft with input from industry technical advisors, often the AAA, often consumer advocates who are involved in this process. In the case of this particular model, we had substantial input from all three of those elements. The AAA contributed primarily through the Actuarial Standards Board (ASB) and the committees associated with the ASB. The assistance of industry technical advisors cannot be given too much credit, because their involvement in this has been just phenomenal. A great many people spent many, many hours heavily involved in developing this model.

After this comes from the working group, the task force adopts a working group draft. The committee adopts the task force draft. The executive committee adopts the committee draft, and the plenary adopts the executive committee draft, so you can see that there is a great deal of due process that takes place in the development of the model.

Once you get that done, you go to 55 separate jurisdictions that are members of the NAIC, adopt the regulations, and try to put them in place.

Where are we relative to the adoption of the model? It has been adopted for action as of January 1, 1997, by, I think, seven states now. The first state to adopt it was North Carolina. It has subsequently been adopted by North Dakota and Utah. I believe Louisiana is now in place too. Iowa has adopted the model for January 1, 1997. Alaska may have one more part of the process to do, but should be in place January 1, 1997. Colorado expects to be in place January 1, 1997. Finally, a number of states are following close behind with a number anticipating mid-1997 effective dates, such as California, Nebraska, New York, Pennsylvania, and Wisconsin. Texas will have its own version in place by mid-1997, and we will still have to see how many changes actually take place in that one.

With the exception of just a couple of states, most notably Texas, we have been successful in getting everyone to adopt the model with only the kinds of technical changes that are necessary to bring about consistency with the requirements in the individual states. Each state has its own rules as to how to write complete sentences. All of those sorts of things have to be followed and, generally speaking, only those kind of changes have been made by the states. That is a real favor to the industry, but also to the consumer, because we know that if regulation forces you to provide illustrations with several different flavors, that increases the costs. Consumers have to pay those costs, so those of us on the working group have put a great deal of effort into trying to persuade the states to follow a consistent pattern all across the board.

Another element of consistency that will be important as we move into the future is consistency between this model that is applicable to nonvariable life insurance and a subsequent model covering other related products such as variable life insurance. The working group is working closely with the SEC, the National Association of Securities Dealers, and the industry participants who are involved with those products to come up with a new illustration model for variable life insurance that is as consistent with the nonvariable life model as possible. Obviously, there will be some differences, but we are trying to minimize those differences in every way that we can. I think that shortly after the first of the year we should be able to see that picture begin to come together.

There is a subgroup of our working group that has been focusing on the development of a model for annuities that will take a little different twist in terms of the use of disclosure statements. But where they come together, again we will have maximum consistency with the model for nonvariable life insurance. It is our expectation that the model would move through the process so that you will see what you need to do on that before mid-1997. It should not take any longer than that from where we are right now.

There is a conference call that will take place among a group of people who are involved technically from the industry. After that, I think we will have a fairly good idea of exactly where we are going to go from here. This is real. The results, I think, will be very positive for the industry. It may not do all that was suggested in terms of bringing credibility to the industry. We will probably still be behind used car dealers, but it should be an improvement nonetheless, and I look forward to some questions at the end of the session.

Mr. Theodore: Now that the regulators have created a new and exciting class of actuary, who will fill that role? How does someone become an illustration actuary, and if, by chance, you become one, what do you do about it? Next at bat is Tom Bakos. Tom is vice president and life actuary for the Guardian Life Insurance Company of America in New York. Coincidentally, he has been appointed as the illustration actuary for the products offered through Guardian’s life profit center. The Guardian has appointed four separate illustration actuaries for its various lines of business, and Tom is also designated as the coordinating illustration actuary. He will be discussing his experience implementing the regulation at the Guardian and the responsibilities inherent in being appointed an illustration actuary.

Mr. Thomas L. Bakos: One of the first things that a serious reader of the NAIC Life Insurance Illustrations Model Regulation will realize is that it is not a tightly written document. That is, while the rules that the regulation lays down are generally fairly clear, they do not cover every possible illustration situation. Therefore, its application, in many respects, must be subjective rather than objective. Because of this, many organizations, including the ACLI, the NAIC, and the SOA, have felt it necessary to provide implementation guidance. This guidance has been presented in a question-and-answer format. If you are the illustration actuary, it would be wise for you to devote some time and effort to reviewing this material. It will help you understand the requirements of the model regulation by showing you how others have interpreted the sometimes fuzzy wording.

The SOA's version of this implementation guidance takes the form of a practice note. This practice note, currently available in draft form and on Actuaries Online, is focused on actuarial issues only. Therefore, the illustration actuary would find this of particular interest. For those of you who attended the earlier session, a copy of the practice note was distributed at that time. I think that if you look at the practice note you will see that it is labeled a draft document. It was pointed out at another session that if you do not like something or want to comment on something that exists in the practice notes, you have until November 15, 1996 to do so. These comments should be directed to Bob Conover.

Of course, *ASP No. 24*, adopted by the ASB in December 1995, is an adjunct part of the model regulation and is required reading for every illustration actuary. The SOA’s illustration practice note also provides some guidance for interpreting the subjective aspects of this SOP.

One of the first things you must decide if you are the illustration actuary is whether you will make more of an effort to comply with the letter of the law or with the spirit of the law. While it may sometimes be difficult to interpret the letter of the law, I think the spirit is clearly evidenced after even a quick reading of the “Purpose” section of the regulation. I think you should all read it. Do not skip over it on your way to the “Definitions.”

Summarizing a bit, the purpose of the regulation is to protect consumers and foster consumer education. Its goal is to ensure that illustrations do not mislead the purchasers of life insurance and to make illustrations more understandable. By moving a few words around, I think you can say that the spirit of the regulation is to protect consumers by not misleading them and to educate consumers by making the illustrations more understandable.

In October 1991, the SOA Task Force for Research on Life Insurance Sales Illustrations produced a preliminary report. You may recall that this report identified two types of uses for illustrations. Type A usage attempts to demonstrate how policy values change over time and how a particular financial concept works (for example deferred compensation or split dollar). Type B usage tries to project future performance and compare cost or performance of several policies. The task force concluded that the Type A usage helps a consumer understand what is being purchased. They concluded that the Type B usage is inappropriate, unless the illustration includes a measure of risk. It seems to me that the spirit of the NAIC model is to prohibit Type B usage and encourage Type A usage.

While these may seem like easily attainable goals for a properly motivated illustration actuary, we live in a society where a surprisingly large number of people believe in alien abductions, that Elvis Presley is still alive, or that Elvis Presley has been abducted by aliens. In this kind of an environment, our task is a little bit more formidable. With respect to the NAIC model, following the letter of the law, even if it were absolutely determinable, may not be good enough. Even in the saner portions of our community, people seem to have a tendency to believe the very best of what they see. Hopes and dreams usually prevail over thoughts of failure. Very few people are skeptical observers. Therefore, ensuring that consumers understand what they are purchasing and are not misled may require an extra special effort.

If you are an illustration actuary and you have just started thinking about how you are going to satisfy the requirements of the regulations in states that adopted effective January 1, 1997, you are running a little late. Here is how we at the Guardian have addressed this issue. We started paying serious attention to the development of the illustration model regulation in December 1994. We watched its many versions and considered how each would affect the business of the Guardian through December 1995 when the model regulation was finalized. In early 1996, with the regulation and the ASP finalized, we designated an illustration actuary and another “responsible officer” for each line of business. These designated individuals were formally appointed to their positions by the company's board in September 1996.

As Dan said, I am the illustration actuary for the company's individual life portfolio, and because the regulation impacts primarily on this line of business, I was asked to oversee and coordinate all filing requirements for the company. At the Guardian, it seems that illustration systems are always going through some kind of change or development. Therefore, in early 1996, we began incorporating the illustration format changes required by the model into our illustration systems being modified for release at the end of this year. It is our intention to conform all of our illustrations in all states to the form requirements of the model by the end of the year. There would, of course, be state differences as required to conform to any special and unique state requirements, particularly with respect to illustration regulations that existed prior to the NAIC model in states that have not yet adopted it.

During the past year, we also began modifying our administrative system to handle the annual reporting and record retention requirements. We have kept our field force apprised of what changes are coming, particularly the signature requirements and the need to use only authorized illustrations.

If you are the pricing actuary as well as the illustration actuary, then you should already have a fairly good idea as to how well your products and illustrations conform to the substance requirements of the model regulation. That is, are nonguaranteed elements illustrated per a disciplined current scale? Do products satisfy the prescribed self-support and lapse-support test? What kind of expenses are used in illustrated values? How are old and new policyholders treated relative to each other?

As the illustration actuary, you have some additional duties and responsibilities. Of foremost importance, as stated in the *ASP No. 24* and supported by plain common sense, is that an actuary should accept in writing an appointment made in writing. Of course, any subsequent withdrawals from the position should also be in writing. No particular reason for this requirement is given in the standard. However, the fact that the appointment and acceptance must establish the effective dates for the term of office of the illustration actuary leads one to the somewhat frightful conclusion that the purpose is to establish a period of responsibility. While the model regulation requires the illustration actuary to certify annually to his or her company's board and to the Insurance Commissioner, it makes no mention at all of whether or not the certification is considered a public document.

Before you accept an appointment as illustration actuary per *ASP No. 24*, you must determine whether you meet the qualifications prescribed in "Qualification Standards For Public Statements Of Actuarial Opinions." This is an AAA Professional Standard. I should emphasize the words "Public Opinion." I can see the writing on the wall as well as you, and I think that no matter what anyone else might tell you, your certification will be public. Because of this, it is probably a good idea to check to what extent you are protected by any insurance your company has covering professional liability. This is not because you may make a mistake or do something wrong, but because sometimes that does not matter.

Many policyholder lawsuits against an insurance company are related in some way to how the company illustrated its product. Because the illustrations being contested were made many years prior to the filing of the lawsuit, you can see why it is important to definitely establish in writing the dates of your professional responsibility and the fact that you have professional liability coverage that extends beyond your dates of employment.

To summarize what I think the illustration actuary is required by the NAIC model to certify and the analysis the illustration actuary ought to do to support this certification; you should note that as illustration actuary you are not required to certify to all of the things that the NAIC model requires your company to do. I think that it is also important to recognize that neither the NAIC model nor the *ASP No. 24* requires that every company illustrate products in the same way.

For example, a disciplined current scale is required to be reasonably based on actual recent historical experience. With respect to the interest component, however, the portfolio average or investment generation approach to allocating investment income are equally acceptable. The use of realized and unrealized capital gains and losses in the derivation of a disciplined current scale need only be consistent with company practice. The same thing is true for the gains or losses with other lines of business, considered an investment of the illustrated lines. Of course, I am sure that there is an assumption being made here that company practice does not change annually.

There are also options with respect to the corporate expenses. However, with respect to expenses, disclosure is required of which expense allocation method is being used and the other "responsible officer" has the responsibility to certify that this information has been disclosed to the company's agents. The use of fully allocated expenses is the least aggressive approach, but marginal or the generally recognized expense table (GRET) can be used subject to some limitations.

The only requirement with respect to nonguaranteed elements is that a disciplined current scale be used. Theoretically, there is a maximum disciplined current scale. Any scale that depicts policy performance less favorable than the maximum is a disciplined current scale. It seems likely, however, that many companies will tend to illustrate close to the maximum.

The illustration actuary per the *ASP No.24*, needs to maintain documentation that supports the actuarial certification. In particular, a description of and a rationale for the assumptions used and the method for allocating interest credits must be included. Other methods and assumptions used must also be spelled out in a similar way. The documentation must also include a demonstration that self-support and lapse-support tests have been met.

Some decisions need to be made with respect to the initial application of the regulation. The illustration actuary is required to make some disclosure with respect to any changes in the currently payable scale that were made with respect to business issued in the last five years and that were unrelated to changes in experience. Also, there is a disclosure required relative to inconsistencies in the treatment between new and in-force policies. Because the regulation only applies to business written on or after its effective date, which probably will not in all cases be prior to January 1, 1997, some interpretation of these requirements will be required.

I have heard comments from embattled marketing people and others who believe that the model illustration regulation will solve no problems because: (1) just like Regulation XXX, states will not adopt it; or (2) even if they do, companies will find a way to abuse it. I hope that they are wrong.

I do not want to get into any kind of detailed discussion at this particular point about the certifications that the illustration actuary has to make, but I thought I would just point out the six things to which an illustration actuary has to certify.

Number one, an illustration actuary has to certify that the scale being illustrated is a disciplined current scale.

Second, there is also a requirement that the actuary certify that the illustrated scale is used and the insurer-authorized illustrations meet the requirements of the regulation. I think the regulation means that the illustrated scale is not to be more favorable than the lesser of the disciplined current scale or the currently payable scale. Clearly, you can only illustrate a product that is self-supporting and that passes the lapse-support test.

Third, you will need to disclose whether, with respect to business issues in the previous five years, the currently payable scale has been reduced since the last certification for reasons unrelated to experience changes.

I think a point made earlier, and one I have certainly heard discussed, was that profit, or a measure of profit, does not need to be included in the derivation of a disciplined current scale. Although that may be theoretically true, it may be a practical impossibility to actually create a disciplined current scale with no profit because the self-support and lapse-support tests have to be met. It seems to me that a company cannot sell a policy and pay dividends or have other nonguaranteed elements that were derived on the basis of no profit. They have to reflect profit at some point in time. One of the results of this disclosure item is that when profit, which may not have been included before, is introduced into a currently payable scale, it would probably have to be disclosed at that time. It could be a little embarrassing.

Fourth, you need to disclose whether nonguaranteed elements illustrated for new policies are consistent with those illustrated for similar in-force policies. I think that items four and five I have listed here get a little confusing. I think this relates to the situation in which you are producing illustrations for a new sale and you are also producing in-force illustrations for a similar policy. You need to disclose on that form or a similar form, with respect to that policy, whether your illustrations for new sales are different than your illustrations for an in-force illustration on a previously issued policy.

You need to disclose whether those future nonguaranteed elements are different from the nonguaranteed elements contained in your actually payable scale. Fifth, I think what they are getting at here is where you are a producing an illustration for new sales and for in-force policies that include future nonguaranteed elements. It gets a little confusing.

I look forward to many interesting questions, and I am now prepared to leave some time for that.

Mr. Theodore: Now that an illustration actuary has certified a disciplined current scale, how do you implement an illustration system? What do you send out to your agents? What is shown to the public? What about universal life?

Our last speaker is David Karo. He is an associate of the SOA and is employed by ECTA Corporation, a software firm providing sales illustration systems. At ECTA, David has been directly involved in the design and implementation of model regulation compliant sales illustrators and has dealt with both actuarial and programming issues. His specialty has been with universal life and variable universal life products, and this work has included hands-on specifications, programming, and project management. From his viewpoint, David has seen several companies working to bring their software into compliance with the regulations and in a hurry.

Mr. David N. Karo: I am going to talk about the illustration regulations from a technological and implementation perspective.

For a piece of material to be considered a sales illustration under the regulation, it must display values over a period of years and also show nonguaranteed elements. Displays of guaranteed elements only are not considered illustrations under the regulation. The regulation applies to three types of illustrations: basic, supplemental, and in force. First, I would like to quickly run through these three types of illustrations to give you a general idea of what content is required for each one.

The basic illustration is a ledger proposal used in the sale of life insurance policies that shows both guaranteed and nonguaranteed elements. It is made up of a narrative summary, a numeric summary, agent and applicant statements, and tabular detail.

The narrative summary consists of: (1) a brief description of the policy being illustrated and the statement that the policy being illustrated is a life insurance policy; (2) a brief description of the premium outlay or contract premium as applicable for that policy; (3) a guaranteed maturity premium to keep the policy in force for all policies that do not require contract premiums, typically universal life policies, assuming no loans or withdrawals; (4) a brief description of the policy features, supplemental benefits and riders on the policy being illustrated; (5) identification and a brief description of the columns and key terms used in the illustration; and (6) a statement similar in substance to the following: "This illustration assumes that the nonguaranteed elements illustrated will continue unchanged for all years shown. This is not likely to occur and actual results may be more or less favorable than those shown."

The next section is a numeric summary, and it must follow the narrative summary. It shows guaranteed, illustrated, and midpoint scales. It also shows contract premium including any rider premium. For each basis, it must show the cash surrender value (net of policy loans), death benefits, and the year coverage ceases, if it is before the earlier of maturity or age 100. Values of durations 5, 10, 20, and at attained age 70 should also be displayed. If the account value is shown, it must be in close proximity to the cash surrender value.

Next come the agent and applicant statements, which must be on the same page as the numeric summary. The applicant and agent must sign and date them. These statements must be signed before the application is submitted if an illustration is being used. The applicant statement must acknowledge that: (1) the insured has received a copy of the illustration and realizes that the values are not guaranteed and are subject to change; (2) the agent has told the applicant that this is the case; and, (3) the values are not guaranteed. The agent statement must certify that the illustration is being presented to the applicant, and, as has been explained, the nonguaranteed elements are subject to change. The agent must also certify that no statements inconsistent with the illustration have been made.

The last required piece of the basic illustration is the tabular detail. Numeric summary and tabular detail values should be on a consistent basis, which would include being based on the same premium mode. Guaranteed values must be shown first. Tabular detail should show years one to ten and then every fifth year ending at age 100, or maturity or expiration if earlier. Many companies are showing the first 20 years or even all years on this statement. It also must show any year in which the premium outlay or contract premium changes, except for term policies where changes are occurring after the 20th duration. It should show the mode the applicant intends to pay, the premium outlay and contract premium, the corresponding guaranteed death benefit, and the guaranteed cash surrender value.

Nonguaranteed elements may also be shown, if they are described in the contract. They must be shown for the same durations as the corresponding guaranteed elements. If no guaranteed elements are shown for a particular duration where a nonguaranteed value is available, a zero shall be displayed in the guaranteed column.

A supplemental illustration may be furnished in addition to a basic illustration and must be preceded by a basic illustration. It may only depict a scale of non-guaranteed elements that are not more favorable than those shown in the basic illustration. A supplemental illustration contains the same statement as the basic illustration regarding nonguaranteed elements not being guaranteed. Contract premiums or premium outlays shown must be the same as those shown in the basic illustration. You do not need to show guaranteed values in a supplemental illustration, because they are already shown in the basic illustration, but you must refer to the guaranteed values being shown in the basic illustration. It may be presented in a format that differs from the basic illustration, and you can also have multiple supplemental illustrations that relate to a single basic illustration, as long as their premiums are equal to that in the basic illustration.

In-force illustrations are still required after the first policy anniversary, even for policies that are deemed as not being sold with illustrations. If an in-force illustration is requested within the first policy year, you should not give an in-force illustration. Instead, you should issue a revised new business illustration. If an in-force illustration is requested, you must deliver it within 30 days of the request. The in-force illustration should be based on the insurer's illustrated scale at the time the in-force illustration is requested. An in-force illustration should have a format similar in content to the new business illustrations. A tabular detail page is required for an in-force illustration, but the narrative summary, numeric summary, and signature page are not required.

I know there is a great deal of concern out there over the work that is required to comply with the regulation. Companies are wondering if there will be many significant state variations in the model variation. As you have heard, most states have not passed any form of the regulation at this point in time. Those states that are further along in the process seem to be following the model regulation with only relatively minor changes.

I have had recent conversations with several key state insurance departments and can give you the following updates on their status. In California, the bill has been passed with an effective date of July 1, 1997. It repeals the yield index and substitutes in its place the 10- and 20-year surrender cost and net payment indexes. Indexes do not have to be provided for any durations beyond the premium paying period, and they can be shown in either the basic or the supplemental illustration. The state insurance department can request the sample illustration annual report if it believes the company is not in compliance. The insurer will be billed for examination costs in a manner similar to an audit. You also need to show an agent license number in California on all sales materials including illustrations. This is not part of the model regulation or even the illustration regulation in California, but it is just something that you may want to consider implementing at the same time that you are implementing these changes.

I talked to Florida and, at the current time, it has no plans for adopting the model. It feels that much of it is current practice right now.

Texas is another story altogether. A revised draft regulation is being prepared this week and the effective date of the regulation will be September 1, 1997, or later. It strengthens the definition of the illustration to not be limited to only basic, supplemental, and in-force illustrations. It includes any representation used for the sales of life insurance showing nonguaranteed elements presented over a period of years. Universal life illustrations must disclose cost of insurance, expense charges, administrative fees, and surrender charges. Illustrations must also disclose and explain the meaning of the rating class illustrated, showing where the used rating class falls in a scale ranging over excellent, good, average, fair, or poor. The regulation specifies a standard format language that would also be used as a safe harbor, if you so choose. Stronger disclaimer language on the projection of nonguaranteed elements has also been included. The regulation states that loans and withdrawals may be shown in supplemental illustrations, but cannot be shown in the basic illustration. The illustration also must disclose a net yield as defined in the regulation if the policy is being compared to another investment product. Texas is also very firm about not allowing nonguaranteed interest rates that increase by duration to be shown. It also requires an annual report for all policies whether marketed with or without an illustration.

Pennsylvania is also very close to passing a bill. The state senate has passed a life insurance and annuity bill with an effective date of July 1, 1997. It excludes life insurance issued in connection with the pension, profit sharing, or other benefit plan qualifying for deduction of premiums. Producers must use an insurer-approved illustration system. The producer may not withhold, alter, or modify the results from that system. The regulation includes more precise rules about the timing of the delivery of the illustration, and it contains rules pertaining to sales made using computer screen illustrations. The producer must certify in writing on a form provided by the insurer that the computer screen illustration was used. That form will include information such as the generic name of the policy, any riders shown, guaranteed and nonguaranteed interest rates, initial death benefits, and a few other items. A hard copy matching the on-screen illustration should be provided no later than the time the application is provided to the insurer. The regulation also details penalties for violations of the act.

Clearly, there are many changes that need to be made to systems to comply with the regulation. We must consider interest rate limitations. Therefore, your systems should be able to illustrate any rate between the guaranteed rate and the lesser of the disciplined current scale and the current payable scale. Maximum interest rate utilities should be used in the systems to guarantee compliance. These utilities could be either home office utilities only or the users could be given interest rates that expire on a particular date. You could also approach this by using encrypted rate updates; that way the users are given a code that updates their system rates, and if that update is not made, then the rates expire and they cannot run illustrations on their system.

You must add the midpoint values to your calculations and input procedures. Midpoints are based on dividends at 50% of the illustrated scale used, nonguaranteed credited interest rates at rates that are the average of the guaranteed rate and the rate used in the illustrated scale, and nonguaranteed charges that are the average of the guaranteed maximum charges and the charges used in the illustrated scale. This can become quite an involved process when you are dealing with something like midpoint Fraserized mortality. You must also include a guaranteed maturity premium for flexible premium policies. The insurer must show at least the lesser of the premium outlay that must be paid to guarantee coverage for the term of the contract or the maximum premium allowable to qualify as a life insurance policy.

If the premium calculated exceeds the guideline level premium, then it does not have to be shown. However, the illustration must clearly disclose that the guideline level premium will not fund the contract to maturity based on the guaranteed assumptions. If the premium calculated exceeds the guideline level premium and you determine that you want to show it, then the insurer must disclose that the premium is in violation of the guideline premium test. You are free to choose any type of premium paying period in calculating the guaranteed maturity premium.

Another part of the regulation states that the premium outlay column cannot be left blank or show a zero premium unless your policy is paid up, otherwise an asterisk or similar mark must be shown there. This can cause system problems because the output may not be able to mix numeric and character data in the same column. One solution that we have seen is to create a skinny column next to your premium outlay column, which just contains these explanatory marks.

The processing order is also an important consideration when developing a system to produce illustrations that comply with the regulation. If your requested illustration can be run as the basic illustration, then it should be run first followed by any supporting reports and supplemental illustrations. If the requested illustration is a sales concept, then it must be run as a supplemental illustration. You must run that before the basic illustration so that any solved-for elements could be based on the concept and then they would be carried over to generate the basic illustration as well.

Producing supplemental illustrations before the basic illustration can cause pagination problems if your program is doing sequential page numbering. When the supplemental illustrations are produced first, they should reference the basic illustration, but not be paginated with it.

The system should be integrated whenever possible. One efficient way to accomplish this is to make your calculation engine a dynamic link library that can be shared with the illustration system and the administrative system. That way your administrative system can produce any model regulation values, if needed. You also could implement integrating your underwriting system to flag cases that are issued differently than applied for. That way you will be guaranteed that revised illustrations can be generated when they need to be.

Internet illustrations are also an exciting new area that might be considered. To comply with the regulation, you really need to know what state a request is coming from. This would best be handled by asking a specific residence question on the Internet rather than infer it from the information available across the Internet about the requester. There is some key Internet formatting and pagination issues that also must be considered. Hypertext mark-up language (HTML) has its limitations. Output appears as one long page and there is no control over where page breaks will occur when it is printed out. This is due to differences in the printer used, not the browser. Netscape Navigator and Microsoft Internet Explorer produce X-of-Y type pagination when the print option is chosen.

There are new standards for HTML that are being implemented, which will allow for more stringent print controls. However, these improvements will not be available until they are incorporated into the next generation of browsers. These browsers will not be available until the first quarter of next year. Even then, you will not be able to fully control printing because an older browser might still be used to generate proposals. HTML is probably best used to show proposals on the screen until they have been fine-tuned enough that the final version is chosen and then you can print that out using a different format. Speed is probably the biggest advantage of HTML.

Portable document format output is a WYSIWYG approach that is much more appropriate for output subject to regulations. Using this format your output would look just like one produced in a more conventional fashion. However, if you use this format, the user would need software like Adobe Acrobat to read and print the final illustrations.

Testing has changed due to the new regulation as well, and there are several things you must be sure to test. Lapse years must be produced and tested for on each basis shown. The output must have the proper markings in the premium outlay column to indicate whether there is zero or no premium. Mid-point values require significant testing, and there is a good chance that your existing tools will not produce the values you need to check. Guaranteed maturity premiums must also be checked when produced.

The regulation has also had an indirect effect on testing due to changes in system architecture. Adding these new functions has led to memory problems in many older computer systems. This has motivated users to rewrite this system and move from a DOS environment to a Windows platform. Validating inputs in a Windows environment is much more difficult than a DOS system because you can enter your information in any order. Therefore, constant cross-checking is needed to make sure that what has been entered is valid information.

There are output considerations because of the regulation requirements as well. There are many additional items required that may not be in your current system. They have included the name and business address of your agent, generic policy name, policy form number, and the preparation date. Companies also may want to implement version control to provide an audit trail. The system would then show a software version number on each illustration. This would allow an illustration to be re-created at a later date if a problem arose.

All pages in the basic illustration must show a page number and its relation to the total number of pages in that basic illustration (i.e., “1 of 2", “2 of 2", etc.). Graphs, charts, and concepts are included in the pagination if they are part of the basic illustration, but they need not be included if they are in the supplemental illustration. Graphs and charts do not need to be shown for all bases, because the values are in the tabular detail for all bases.

The supplemental illustration’s page numbering does not need to be in the pagination of the basic illustration. Guaranteed values need not be shown in the supplemental illustration because they are already in the tabular summary. If one or more illustrated interest rates is to be shown, they should probably be shown in the supplemental illustration. User-selected columns need to be included in the supplemental illustration rather than in the basic illustration because the order in which they are chosen cannot be controlled.

Only those policy features described in the policy form itself can be illustrated. Therefore, if you wish to show a persistency bonus, you can do so as long as the bonus is described in the policy language. The regulation also has its effect on agents. There are compliance standards for laptop illustrations that are included in the latest Q&A document. It states that laptop illustrations may be used if they comply with the regulation. However, if a printed copy is not furnished when the application is taken, an acknowledgment signed by both the applicant and the agent must be submitted with the application. That acknowledgment must include the applicant's name, age, sex, risk class, death benefit, the current date, and signatures. Extra servicing may also be required by the agent to obtain signatures for both the issued policy and revised illustration (if the issued policy differs from that illustrated at the time of application).

Many of you are probably wondering whether companies are implementing all this now or waiting for key states to act. Most companies I have contacted have target dates of January 1, 1997, for compliance. That target date has been set whether or not they have actually started into the process yet or not. Some companies are having a great deal of difficulty interpreting the regulation as it applies to themselves and will have much of trouble meeting their self-imposed deadline.

Most companies are implementing the model regulation across the board for all states and will address individual state variations at a later date as things become approved. Some companies are only converting their systems for their biggest selling products; other product lines will be handled on an as-needed basis.

In-force illustrations seem to be another problem area. I have heard comments like, "We do not really need to have a compliant in-force system for another year," but that is very unrealistic. You need it now.

Some companies are moving to the model regulation format in all states before the regulation is passed. That is generally acceptable as long as it does not conflict with current regulations in specific states. However, I have heard that Hawaii and Texas may not allow using illustrations that comply with the model before it is adopted. You may want your legal department to check out these requirements before moving forward.

Companies are doing several things to prevent invalid illustrations. They are installing their new systems over existing systems. This prevents outdated, noncompliant illustrations from being run once the new system is in place. They are also building interest rate limits and rate expiration dates into their systems. You may want to consider running your illustrations solely from an Internet platform. We are currently implementing this approach for one client, and there are some very significant advantages to this. There are reduced software distribution costs. You only have to update one system, not one for each user, and once you make the changes, they are instantly available. Also, you are always guaranteed that everybody is using the current system at a given time.

As a vendor, ECTA is helping clients implement the regulation by presenting different interpretations that we have seen and allowing clients to pick the one with which they feel most comfortable. There are many different interpretations surrounding the guaranteed premium to maturity. For example, companies may choose to always illustrate the initial guideline level premium instead of the guaranteed maturity premium. A shortcoming to this approach is that the guideline level premium may over- or underendow the policy. Some companies solve for a level premium but fail to compare it to the guideline. Others show the guideline level premium and note if it does not support the policy to maturity. Many base their calculations only on the policy at issue and ignore any subsequent policy changes that are being illustrated. I have even seen a few that are ignoring the footnote altogether. This is not something that I would recommend.

Another area of differing interpretations is how to handle vanish-type illustrations. Some companies allow the vanish to be shown in the basic illustration. There the guaranteed values are based on a full pay, but the current and midpoint values are based on the vanish. Numeric summaries that show the year's premiums are paid, and the tabular detail shows how the vanish works on the current scale. This is accomplished by showing a contract premium column that displays the contract premium in all years, a surrender amount column that shows cash value of additions surrendered to pay the premiums, and finally a premium outlay column that shows the net effect of the surrenders. The numeric summary would also include an explanation that nonguaranteed values are used to pay the contract premium.

Another option is to only illustrate full pay scenarios in the basic illustration. Any loans and surrenders would only be shown in the supplemental illustration.

Another interesting situation occurs when vanished illustrations are shown on premium modes other than annual. There the company is showing a switch to annual premium mode at the point in time when the surrenders start. This is done because the surrenders are generally processed on an annual basis, and it would be inconsistent to show modal premiums being paid when the surrenders are actually being taken on an annual basis.

Other issues to keep in mind are that compliant in-force illustrations are needed for any policies more than a year old; the owner/insured must have an illustration signed by the agent that matches the issue policy, which may require more work by the agents to comply; and, that revised illustrations can either be done by the agent or the home office. Remember, additional computer memory is required to run the midpoint illustration values and any potential supplemental illustrations. These additions may cause computers that are working properly now to require more memory.

Mr. Bruce E. Jackson: We work with a few small companies that pay dividends, but they have a specialty market and they usually do not even mention what those dividends are going to be. Up until now, I had thought that there would be nothing to report because there are no nonguaranteed elements in the illustration, but it sounds like some reporting will possibly be required on the anniversary. My questions is, if you do not show any nonguaranteed elements initially, do you still have to send an annual report showing the nonguaranteed elements?

Mr. Bakos: Maybe Commissioner Wilcox could interpret the law better than I, but I think that you may have to offer an annual report or in-force illustration. Is that correct?

Mr. Wilcox: The circumstance that you have described is a perfect one for a company to designate as a policy that will not be illustrated. A summary that does include any nonguaranteed elements is not an illustration as defined in the model, so that still fits, and a product that is not illustrated does not require the in-force illustration.

Mr. Jackson: If the policyholder were to ask, “What do you intend to pay as dividends?,” would any answer showing a future dividend plan then make it an illustration?

Mr. Wilcox: The model is intended primarily to look at the concerns associated with new business and the sales process. The primary reason for including the in-force illustrations and requirements therein is to deal with those circumstances where replacements may be taking place and ensuring that important additional information is put in front of the policyholder in anticipation of those circumstances. If you are not using anything relative to those dividends at the point of sale, it would probably be relatively uncommon that anyone would ask for that information after the sale. If it has already been declared by the board of directors, which is the information you are more likely to give, I think again, you are outside the scope. It does not sound to me like the circumstance you are dealing with is one that is going to give you much trouble.

Mr. Karo: Keep in mind that in Texas, at least the way things stand now, you are still going to have to provide annual reports, even if you are not marketing with an illustration.

Mr. Joseph C. Higgins: For a state that adopts January 1, 1997, is the first certification due January 1, 1997, or within one year after that?

Mr. Wilcox: Certifications are required before any policy is sold that would require illustrations. Therefore, at the outset, you are going to need to file certifications as you begin. As new products are brought on line, of course, there is a certification required.

Mr. Armand M. de Palo: I want to go a little bit further on the question the first speaker asked. There are nonguaranteed products out there with a universal life design where there are substantial nonguaranteed elements, but the company opts to put in either a 20- or 40-year no-lapse guarantee. So, in effect, it offers a product that if you pay this very low premium for 40 years, the contract will not lapse. The problem with this, and my reading of the regulation says, the company can opt out of the illustration law by saying this product is not to be sold with an illustration. However, unlike a whole life product or a universal life product where the scheduled premium would mature the contract, these premiums will not mature the contract. In fact, at the end of the guarantee period, the contract would actually fall apart or revert to a term product. I strongly suggest that you look at your regulation and not allow these products to opt out and present themselves in the market as term for 40 years. If we do not, we will find companies selling 40-year level guaranteed term at a premium that would be deficient if the term was valued separate and apart from the fact that it is being carried in a universal life contract and being designated as incidental to that contract. This is a big loophole and I expect to see companies using it if it is not closed. I would like Bob Wilcox to comment on this.

Mr. Bakos: Can I make a comment, too? I am not going to disagree with Armand, but I would like to point out that if what you are showing on a piece of paper contains only guarantees, then, technically, it is not an illustration. While there may be some problem with the things you are guaranteeing because you may not be holding reserves adequate to back up those guarantees, that is a problem; however, it is probably not an illustration problem. It is more likely a valuation problem. I think that is the area Armand was getting into.

Mr. Bradley D. Leonard: I want to get some clarification on this basic illustration versus supplemental illustration. I heard a couple of different perspectives. Early in the session, David implied that you would have to run a supplemental illustration using a search to get the premium, and then you must go back and run the basic with that premium. He later on gave examples. Companies are doing it in different ways. Can you do it in different ways? If you can, then how does a consumer get consistency?

Mr. Karo: That is a systems issue, not an illustration issue. I mean, if you are doing a retirement illustration that is a concept illustration and that is going to be a supplemental illustration in terms of the regulation, you are going to be solving for a stream of income. You will want to run that retirement illustration first in your system. Then there may be certain values that are derived from there, like a face amount or a premium stream, that you are then going to capture and use in your basic illustration. It is purely processing order.

Mr. Leonard: But the contract gives you the right to pay premiums forever regardless of the concept. Should the client have that in the basic illustration in all cases? It is what comes out of our mainframe system until that has changed. I have not seen anything that clarifies whether the law states you must do it one way or the other. Is that true? You are saying you should take the solved premium and put it back in the basic? Is that what you are saying?

Mr. Karo: That is one interpretation. That is for ease of computation.

Mr. Leonard: What should the clients get?

Mr. Karo: They are going to solve for this premium, but there are some elements in the concept that could not be included in a basic illustration, so to get to the basic illustration, you are first going to have to run through a supplemental illustration. Just because you are running it first does not mean that it is the first thing the clients are going to see. They are still going to get a basic illustration that is on top.

Mr. Leonard: Should they also get a basic illustration that shows premiums paid to maturity because that is a contract right? Or would you say you do not have to do that?

Mr. Karo: Yes, it is a contract right, but your basic illustration is supposed to show what the person intends to do. If the person intends to pay less to maturity, then your first interpretation would be correct.

Mr. Leonard: That is an opinion. It sounds like it is an opinion opposed to part of the law. That is what I am trying to get at.

Mr. Robert H. Dreyer: I raised an issue at another session and if there were any regulators in that group, they were either unable or unwilling to answer it. Now that we have a captive regulator, I am going to throw the issue out again. I am talking about products like indeterminate premium term. The Q&A document that came out from the NAIC and the ACLI in August, I believe, suggested that if you have an indeterminate premium term plan, you must show a zero death benefit after the first year because the premium that the insured intended to pay would not support the policy on a guaranteed basis. It is my feeling that to show both the guaranteed maximum premium schedule followed by the current premium schedule is much more enlightening to the prospect than to just show his or her first year of coverage and ignore everything thereafter.

Mr. Wilcox: Let me acknowledge, Bob, at the outset that I do not think we gave adequate consideration to the indeterminate premium product in the initial design. However, I think that there are a couple of different directions that we can go, and we are in the process of deciding what we want to put into the Q & A document in that regard. You recall that in the narrative summary there is a requirement that the premium necessary to keep the product in force be shown, so the policyholder will get that amount shown there.

In the numeric summary, the expectation is that the premium to be shown would be the amount that the policyholder intends to pay, as you discussed. That means in the subsequent years, if the premium is increased and the policyholder does not pay that increased premium, then the death benefit goes to zero, as you suggest. I think that is one answer that would definitely comply with the regulation. I am suggesting (this has not gone to the working group yet, so this is only my idea and the working group may not buy into it ultimately) that it would be possible to show the premium that the policyholder intends to pay and then as a nonguaranteed element the additional premium required so that on a guaranteed basis there would be the additional premium necessary to bring it up to the guaranteed level, whereas the current scale level would be the full guaranteed element, and still be consistent with the regulation. I think that complies with the spirit of the regulation if not the letter of the law. I am going to try to persuade the working group that here is a way to deal with it. It is not quite what you suggested, but it is very close to it.

Mr. Thomas P. McArdle: I was wondering whether there are any plans to modify the GRET to reflect expense factors by product type such as term or universal life. It seems to me that the table hits those products rather hard, especially the way the current expense factors are structured.

Mr. Wilcox: Let me comment relative to the GRET. First of all, the way the regulation is drafted, there can be multiple tables. At the present time there is the table that has been prepared by the SOA that has been adopted by the NAIC and is valid for use. That table already breaks things out by the marketing methodology. My guess is there might be some reluctance to do too much breakout on the GRET. The original position of the working group was that everyone should use fully allocated expenses and everyone can still use fully allocated expenses. That is permitted in every circumstance. The use of the GRET was a compromise position. There was a time where it looked like the GRET could run into some real difficulty, and we might have a hard time coming up with a GRET that worked at all. As it turned out, it appears that the work product is at least usable and has some usefulness associated with it. There may be a new table in the future, and that will have to be reviewed and adopted before it can be used, but I doubt that there will be much more flexibility than you have in the current version.

Mr. Henry B. Ramsey, III: I have a question primarily for David Karo. The regulation requires the display of the mode the policyholder plans to pay, but many universal life systems have historically used the annual premium payment and then month-through-month calculations and shown other equivalent semiannual, quarterly, or monthly premiums with the knowledge that the values might be slightly different because of rounding or other interest pieces. What have you seen people trying to do to deal with this requirement to calculate values using the exact modal premium payment? Is this a problem similar to the one you described earlier with the midpoint calculation?

Mr. Karo: In all honestly, all our universal life clients use real modal premiums, so if they want to pay monthly, it is a monthly amount. They are not doing moralization calculations like you are suggesting, so they are really paying $100 a month rather than some sort of modal factor being applied to an annual premium amount. Therefore, what you are seeing in the premium column is the annual sum of what they have paid on a modal basis. That's generally what I have seen.

Mr. Bakos: Of course, the Guardian does not have the universal life-type policy, so we have taken a literal interpretation of the wording because, for a traditional participating policy, obviously the values will not change. It depends on what mode you pay, and the regulation says mode, not modal premium. So it is our intention to illustrate values based on an annual premium payment, and to indicate in the illustration, based on the requested mode of the applicant, what that premium would be.