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Update on Life Insurance Illustrations

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Summary: The comments flew during the exposure process. Written, oral, and E-mail expressions were received by the Actuarial Standards Board (ASB), and a standard was, in the end, adopted to provide guidance to the National Association of Insurance Commissioners (NAIC) Life Insurance Illustrations Model Regulation, which assigns major new responsibilities to actuaries involved with illustrations. This session will look at experience with Actuarial Standard of Practice 24 (ASP), "Compliance with the NAIC Life Insurance Illustration Model Regulation." It will include a discussion of the NAIC's possible extension of the model to include annuities and variable life insurance, which would probably require extending the illustration standard as well. The session will also look at possible revisions to ASP 15.

Mr. Edward S. Silins: This panel is composed of four actuaries involved in various aspects of this topic. Bill Koenig is senior vice president of Northwestern Mutual and the incoming chairperson of the Life Committee of the ASB. Bill has served on numerous industry and professional committees throughout his career. Following Bill will be Esther Milnes. She is vice president and actuary in Prudential's individual insurance group. She has recently served on the Board of Governors of the Society of Actuaries (SOA) and has served on numerous professional and industry committees throughout her career.

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She will be followed by Abe Gootzeit, who is a principal in the St. Louis office of Tillinghast. Abe is a frequent speaker at SOA functions and other professional seminars and has also written a number of articles in various publications. I am a principal in the Chicago office of Coopers & Lybrand and I am the outgoing chairperson of the Life Committee of the ASB. The panelists are FSAs and members of the Academy.

We are going to be covering this topic from four different aspects. I will be speaking first about the nonactuarial aspects of the Illustration Regulation, and then Bill will discuss the ASP and other related topics. Following Bill will be Esther who will cover the recently released practice notes on life insurance illustrations. Finally, Abe will cover the results of the survey recently completed by Tillinghast.

I am going to be talking about the nonactuarial aspects of the regulation of illustrations. Actuaries tend to think that there may not be anything quite as important to the other departments in the company, but there are many other departments within an insurance organization that are going to be heavily involved in life insurance illustrations. Those include the compliance, marketing or agency departments, policyholder service, and a number of other areas such as data processing. The goal of the regulation is to promote the understandability of illustrations and to avoid misleading consumers. Group products would be exempted if they are not sold on an individual basis, and other rules would apply for those products. If they are not sold individually, then a quotation would be used that provides general information, not specific to a given individual. There are also some special rules for term with regard to what is shown. Excluded are policies less than or equal to $10,000. That was done as an expediency for certain types of products, primarily what are called burial policies. Credit life is also excluded. That is primarily because they just do not fit into the model; an illustration would not provide any clarifying information to the consumer. Variable life and annuities are currently being worked on with respect to the regulation. We would expect any necessary modification to the ASP to conform with that work.

If a company elects to use an illustration with respect to a specific form, it must always be used. Conversely, it cannot be used if a company elects not to use an illustration with a particular policy form. For those policies that are designated as not being sold with an illustration, the prohibition only applies for the first 12 months after a policy has been in force. An illustration could be used if provided in connection with an annual report.

There are two types of illustrations—basic and supplemental. Basic shows premiums, cash values, and death benefits, and it can be used to show how premiums will be paid. If you use a supplemental illustration, you must also have a basic illustration. A single basic illustration could be used for multiple supplemental illustrations. The information must be consistent between the two. Supplemental illustrations are generally used as concept illustrations for split dollar, deferred compensation, or other special types of policy situations.

There are a few basic requirements contained in the regulation. First, the order is specified. Although the regulation does not specifically say that, it is a natural interpretation of the regulation. The numeric summary must follow the narrative summary. The signature page has to be on the same page as the numeric summary and the tabular detail would follow. Each page has to be properly numbered, such as “three of seven,” and the entire illustration must be dated and labeled as a life insurance illustration. Beyond these basic requirements, companies are free to be as creative and innovative as they like, subject to the requirements of the regulation. So there is a general form that companies need to follow, but there is still room for individuality.

With respect to the narrative summary, a brief description of terms is required. The policy has to be described as a life insurance policy. The narrative summary must also describe features of any riders contained in the illustration, premiums required under the policy, and a definition of the columns used in the tables. Brevity is stressed in the regulation, and the implication is that it needs to be brief in order for it not to be confusing or misleading to the buyer of the insurance. Attention spans being what they are, brevity in making those statements is certainly recommended. For flexible premium products, we have to show and explain any no-lapse premium to the terminal age. We must also disclose what any Section 7702 limits might be in terms of the premiums which could be shown and still comply with the IRS rules. Footnotes and caveats are frowned upon and discouraged in the regulation. That goes back to a long history of small words down at the bottom that were difficult to read and confusing to the customer. The regulation stresses that those should be severely limited. The narrative summary might take anywhere from a half to a full page, although certainly there is no restriction as to how long those could go. Drafts that I have seen have been in that range. Anything greater than one page might also be a marketing hindrance.

The numeric summary that follows must show at least years 5, 10, 20, and at age 70 showing the premiums, death benefits, and cash values under three bases, that is, the guarantees, those that are illustrated, and the midpoint. This stresses the variability of these numbers, that they are not guaranteed, are subject to variation, and that the customer should not get any implication at all that these are guaranteed or contractual benefits. We have to clearly distinguish between what is guaranteed and nonguaranteed, and clearly label any columns and explain them to the customer. Any assumed date of premium payments have to be clearly shown on the illustration as well, and the order is important. Guarantees have to be shown first, followed by any nonguaranteed benefits. The stress and focus would be nonguaranteed first and then we would follow with the other possibilities of the illustration and the potential values.

The signature statement has to come on the same page as the numeric summary. It is a statement stressing the nonguaranteed aspects of the illustration. The agent, in signing, acknowledges that he or she has explained that the nonguaranteed aspects of the illustrations are not guaranteed in any way. The customer is acknowledging that he understands that they are nonguaranteed and that the agent has explained accordingly. This is done at application time and updated on any revisions in case the policy is sold other than as applied for. A copy has to come to the insurance company where it has to be retained if the policy is issued. It does not have to be retained if it is not issued. The retention is three years after the lapse or death of the policyholder. There are some special rules for mail delivery. The company needs to show due diligence that if a revised illustration is sent back to the customer for his or her signature for retention by the company by sending a self-addressed, stamped envelope so that the customer can sign this revised application and send it back to the company. Any revisions have to be submitted prior to the delivery of the policy.

Next comes the tabular detail that has got to be consistent with the summary and show the planned contract premium, death benefit and cash values for at least years one through ten and every five years thereafter, as well as on any premium change date. In order to be illustrated, a nonguaranteed element must be described in the contract. I know there are some companies that do not describe some nonguaranteed elements in their contract, so they are going to have to refile those forms unless, of course, they do not want to illustrate those. They are free to pay any nonguaranteed elements, even if they are not in the contract; they just cannot illustrate them. The planned premium has to be shown for flexible premium policies. If you show accumulation values, as for a universal life (UL) contract, it has to be properly named and the cash values, in addition to the accumulated values, have to be shown as well.

General requirements apply to both basic and supplemental illustrations. The same nonguaranteed caveats need to be there. Guaranteed values have to be shown before nonguaranteed values with equal prominence and any identifying information that relates to them—name, age, underwriting class, generic names, and a brief description—has to be shown as well. All of this supports a general theme that illustration are not guarantees and cannot be indicated in that manner. If the credited interest rate is shown, it cannot be any greater than the interest rate that underlies the disciplined current scale. Not all companies indicate what the interest rate is, but if they do, this requirement would apply to both the basic and supplemental illustrations. The supplemental illustration must be accompanied by a basic illustration, contain information that is not more favorable than that shown in the basic, include the same nonguaranteed caveats, and refer to that basic illustration. You could use the multiple supplemental illustrations with one basic illustration.

Annual reports must be provided to the customer if requested. This is a new requirement. Many companies have been sending out policy status reports, but perhaps may not have been sending out revised illustrations. These revised illustrations are now required on request by the customer. For UL, on the annual report, the ins and outs and the current values have to be shown. For fixed premium UL, if the guaranteed amounts will lapse the policy by the end of the policy year, a notice to this effect is required. For flexible premium UL, a notice is needed on what premium would be required to keep the policy in force.

There are several general prohibitions that apply to both basic and supplemental illustrations. The use of "vanishing" or similar policy terms are no longer allowed. Incomplete or misleading statements, as well as unclear labeling with regard to what the illustration is, are also prohibited. It cannot be described as anything other than a life insurance illustration. No other numbers other than the illustrated scale can be used. This is described in the ASP as the lessor of the disciplined current scale or the currently payable scale.

At this point I am going to turn the discussion over to Bill Koenig. He is going to be talking about the ASP and other related topics.

Mr. William C. Koenig: Ed mentioned that there was at least some degree of flexibility and creativity left in the presentation of these illustrations. I think the regulators' view would be that they were trying very definitely to reduce the potential for creativity and flexibility in the presentation of the numbers. My comments by and large, are directed both at the regulation itself and *ASP 24* which were developed concurrently. I think it is fair to say that the regulators recognize that they had a number of problems with the numbers that buyers were originally shown. Ironically enough, one of the major causes of the consumer dissatisfaction, the fact that interest rates have dropped considerably since many of those illustrations were originally presented and proposed, really was not addressed all that well in the regulation or *ASP 24*, although *ASP 24*, such as it is, was really limited in what it could do.

One of my bosses along the way asked me, as chief actuary, to explain why some companies were able to prepare certain competitive illustrations. I described some of the things that I thought were going on in the illustrations and his reaction, as the president, was "When are the actuaries going to do something about that?" I had to explain to him that the actuaries themselves really did not have any authority to do anything about that. There were just as many actuaries going back to their cubicles and designing these sorts of things as there were actuaries who were worried about prohibiting them or improving the situation. But clearly there are a number of things going on and the regulators do have the authority and the power to put some discipline back into numbers and they have done so.

They started out looking at those of us who were trying to work with them and develop a regulation. They tried to focus their attention on current scale. They renamed it currently payable scale. It turns out that the definition of current scale in the regulation is fairly loose. It says current scale is whatever you are paying currently until you decide to change it. There is not much discipline in there. The regulators, at that time, dismissed currently payable scale as a basis for illustrations. Instead, they decided that they wanted to try and impose more discipline and get more credibility in illustrations, even if they had to impose it. They defined something called the disciplined current scale (DCS), which they intended to create as a limit on illustrations. It uses actual recent company historical experience on mortality, expenses, investment earnings, and persistency, and whatever else is important in your pricing. Many current scales are certainly calculated using this as input anyway. So in many cases there is not going to be any difference between a DCS in a company and its current scale. I would hope that would be true in the majority of cases, but I know it will not be true in all cases. At an ASB meeting back in April 1995, while the regulation was being drafted, there was testimony to the effect that there really was not any reason to try to tie the experience of the company, with respect to these elements, to its illustrations, because illustrations were only set on competition anyway. This testimony was not well received by the Commissioner of the state of Utah, who was there and deeply involved in the Illustration Regulation development. I suspect that in cases where there is no link between company experience and its illustrations, there will be more work to be done.

The illustration actuary, once designated by the Board of Directors, has to certify that the illustrations being used by the company are linked to company experience, that there are no projected improvements in experience included in the illustrations, that the illustrations themselves comply with *ASP 24*, and that they pass both the lapse-support and self-support tests. Companies should illustrate the lower of either what it is currently paying or the DCS. If the actuary goes through and looks at the company's experience, they cannot justify the currently payable scale.

One concession that the regulators made that gives companies a fair degree of margin, at least in the opinion of those of us working on this is that, there is no requirement to build in any profit into these illustrations. It may be that you will find that your currently payable scale is, to some extent, less than what you might justify as a DCS, since there is no requirement for profit and your currently payable scale is probably less than the DCS. In that case, there is no need to change your illustrations, and, in that light, you might view the DCS as not all that particularly a stringent discipline.

The regulators had two more things that they really thought were abusive and so the DCS must also satisfy two other tests. First of all, they were not at all warm to the idea of loss leaders. They thought that companies should not have the ability to illustrate something that was not self supporting. They tried to define *self-supporting* and ended up with "a policy form should have asset shares exceeding cash values after 15 years." They heard about policies that were designed not to recover any expenses over the first ten years so that they had a great ten-year interest adjusted cost index. The company had to recover all its expenses plus interest after ten years, but the company focused its illustrations on ten-year numbers. A compromise was reached that said that a policy form should be breaking even by 15 years, and that is their definition of what is not a loss leader.

The second abuse they noticed that they had strong feelings about was lapse support. In order to measure lapse support, they suggested that we do the same test as the self-support test, but substitute 100% policy persistency after the sixth and later policy years. Now, why was that necessary? They saw things like this article that came from *Life Association News* right about when they were working on this. The president of a company had described his policies as it being like the lottery. The person who buys the winning ticket wins $4 million but everybody else gets nothing. That did not set well with the regulators and then they tried to find, working with the ASB, a way to put in some discipline and reduce the lapse support potential.

Chart 1 shows some accumulations of cash flows as a traditional sort of pricing system where you recover your acquisition expenses first, and then your cash on cash rate of return sort of trend towards whatever crediting rate the company has.

They looked at things like this lapse-support scheme in which the rates of return in the early years are badly depressed, but then on a year-to-year basis increase 30% or more in 15–20 years (Chart 2). The implication is that the company really could not afford to pay those 30–40% annual increases. If there were many people left in those durations, you would get this sort of crossing pattern of cash values over time in the traditional versus the lapse-supported scheme.

CHART 1
RATE OF CASH VALUE INCREASE
TRADITIONAL DESIGN

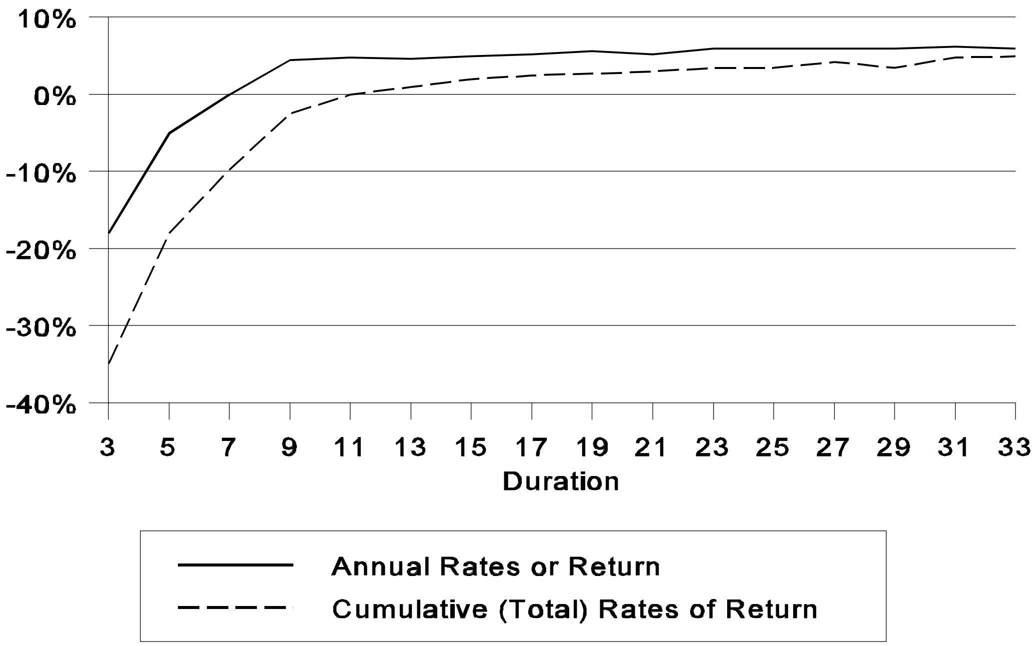
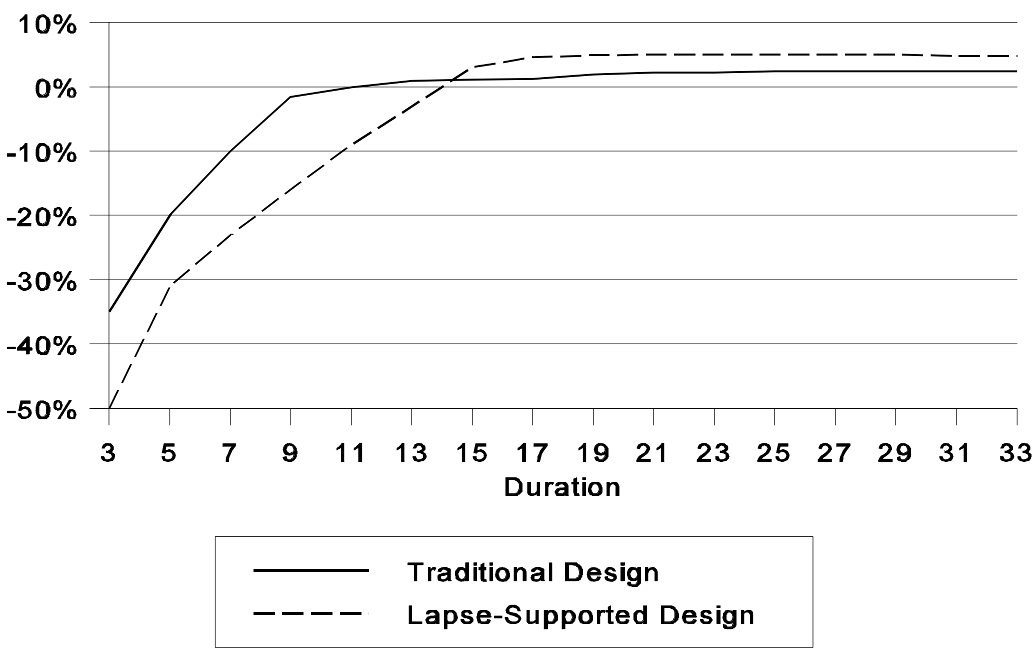


CHART 2
CUMULATIVE (TOTAL) RATES OF RETURN
TRADITIONAL VERSUS LAPSE-SUPPORTED



They want the illustration actuary to test to see whether a company has any element of lapse support in its policies that it is not so egregious that the company would not be able to make the payments that it shows in its illustrations if a greater number of people actually do stick around to collect those amounts. I guess in their view of lapse support, not that they do not want to reward persistent policyowners, companies should be able to find ways to reward persisting policyowners without picking the pockets of terminators, who arguably have been aggrieved enough by paying the higher acquisition expenses and then lapsing.

Two items were quite controversial with respect to the development of both the standard and the regulation itself. First was expenses. There was a controversy on this raised by companies that do not use fully allocated systems of overhead expenses, but rather use marginal techniques or scenario-based testing. The ASB itself suggested a great compromise, "the Great Compromise of Snowbird, Utah," which basically was put into the regulation and the standard which says that fully allocated expenses are always OK in an illustration, but if a company uses a marginal method of allocating overhead, they can do so only if their total expenses are at least as great as the industry average fully allocated. Basically they said it is one thing to talk about how you are going to be lean and mean and all that, but if your fully allocated expenses are not less than the industry average, do not speculate that ultimately they will be.

The greatest weakness in both the standard and the regulation itself, in spite of consuming great amounts of time in the development of both the regulation and the standard, was the interest rate assumption. Either the portfolio average or investment-year method, whichever the company normally uses, can be used without increases. Normal capital gain and loss treatment consistent with actual practice should also be used. Many of us think that there is still work to be done on this. It seems that whoever has the higher number here is perceived to be the great evil.

How can we make this work? Remember the savings and loan ads where you could be a millionaire on pennies a day back when interest rates were 14%? I do not think we are going to see too many millionaires made by putting their pennies in savings and loans. Anyway, no one has articulated, universally, a clean solution to this problem. At a SOA Annual Meeting maybe 15 years ago or more, a speaker challenged anyone in the audience to tell him that a portfolio illustration was exactly comparable to a new money illustration. He wanted to make it clear, then and there, that anyone who was willing to do that was either ignorant or incompetent or both. Now, I am not going to bother doing that because I would guess that everybody here would admit after 15 years of this, that a portfolio and a new money illustration are not comparable. They are both out there, however, and regardless of which system you are on, there is the potential for problems in competition. So those creative types have something to work on. I think both the regulators and the ASB would appreciate a solution.

With respect to in-force illustrations, the regulators had a couple of problems. They did not want an in-force illustration used as a means around the disciplines they had put into new illustrations. They put some safe harbors in and they are outlined in the standard. If the values have not changed much, or if the DCS has not changed, or if it has been lowered more than experience, you should not have to test. If you have lowered your in-force illustrations or if you do not meet any of those safe harbors, then you have to do a test. I dare say nobody has exactly figured out how they would go about doing this test, i.e., reconstructing factors from issue. The scale would have to meet both tests, using actual experience and nonguaranteed elements at issue and the DCS going forward. Nobody really wants to do that, so the best thing to do is to keep your in-force illustrations and payments in line with the DCS. The Larry Gorski Amendment that was adopted says in-force illustrations cannot be less favorable than sales illustrations or the actuary would have to disclose that; the idea is that buyers would be able to find out that a company was utilizing a bait-and-switch strategy in its illustrations.

What do we have? In some ways, it is an industry victory; nonguaranteed elements are still allowed in illustrations. I recall that at one point they were really talking about eliminating all nonguaranteed elements from illustrations. Persistency bonuses are still allowed, as long as they are not lapse-supported. There is not factor-by-factor testing which some regulators would still like to reintroduce, but I think that would be a real can of worms. There's no mandated use of histories. The regulators went down that path once of only permitting historical illustrations. Finally, there are no standardized assumptions.

On balance, I think the standard and the regulation are not bad pieces of work, though no one would claim that they are perfect. Work remains to be done. There are elements in the *ASP 15* that talk about illustrations. There is presently a draft of some changes to *ASP 15* to accommodate the illustration regulation. These would make *ASP 24* applicable where the illustration regulation has been passed and keep *ASP 15* applicable in states where it has not been. Some of us view that there will not be any changes to *ASP 1*, because there is nothing in *ASP 1* dealing with illustrations.

Ms. Esther H. Milnes: I will be reviewing the practice notes that have been developed to help actuaries comply with the requirements that Ed and Bill have summarized for you. It is important for us to understand the role of the practice notes in the regulatory framework, and I will review what the practice notes do and do not do to help you comply with these requirements. I will also tell you how we have gone about writing the practice notes on the Illustration Regulation and how you can help in that process. I will also briefly review the topics that the practice notes cover.

Our latest draft of the practice notes is available. I am not planning to describe all the practices that we put in that 54-page document. I will review, in general, the topics that are covered there, and then in the question-and-answer period, if you do have specific questions, either I will try to take them or ask some of the people on the committee who are here to help me out.

What do the practice notes do? Let me describe some known practices that we anticipate will be used in complying with the regulation and *ASP 24*. These practices are being used by actuaries in accordance with today's code of conduct and existing *ASPs*. That gives them some degree of merit or creditability. However, the regulation and *ASP 24* are new and we would expect practice to evolve over time. The practice notes that we are putting together cover what we think is available in 1996 and we expect it to be updated over the years. The purpose of the practice notes is to help actuaries who have to prepare certifications under the regulation or *ASP 24.* To be most helpful, the practice notes need to cover a broad range of actuarial practice. You will see that we have presented the practices that we have written about as examples, and if there are additional examples that we could include, we would be happy to hear about those. It is important for us to have a broad range of practice in a guidance note like this.

So what do the practice notes not do? They do not describe all practices. That would obviously be impossible. They do not define what is generally accepted practice. They are simply examples and they do not provide a safe harbor. It would sometimes be nice to have one, but that is not what the practice notes do. It is possible that you could apply these practices and still have to defend what you are doing as being consistent with the regulation and *ASP 24.* An important point is that the practice notes do not provide any guidance for what to do when a state enacts a version of this regulation that is different from the model. In fact, *ASP 24* itself applies only to the Model Regulation and not to any state variations. You basically do not have any guidance to rely on when a state does something besides adopt a model. On the other hand, the practice notes do not bind actuaries to any particular practices. Again, they are simply examples, and they are intended to help you, but they do not mandate specific practice. They do not change *ASP 24* in any way. If you have any questions about that later, Lauren Bloom, the Counsel of AAA is here and she is the one who keeps us on the straight and narrow as far as what the practice notes do and what they do not do.

The practice notes were written by a work group that the AAA requested the SOA to form. Those of us on the work group do not really pay too much attention to whether we are a Society group or an Academy group. We are just working on the practice notes. However, the practice notes are to be published by the Academy. Our group is chaired by Woody Richen and I believe he is here also. Several other members of the group are also here. The group included Donna Claire, Bob Conover, John Dinius, Tim Harris, Doug Knowling, John Palmer, Tom Phillips, Chuck Ritzke, David Whittemore and me. Lauren Bloom, Counsel for the Academy and Arnold Dicke, Academy Vice President for Life Practice have also been participating in the work. We started meeting in April, and we have had 1–2 hour conference calls virtually every week since April to work on this document. The work group received questions from many sources and some of these questions related more to regulatory issues than to the actuarial standards. Those were passed on to the NAIC. They are also working on a question-and-answer document. We answered some of the questions just as they were presented. Other questions were modified, sometimes to cover a broader topic or in some cases to give a more specific example. There were a few questions that we actually decided not to answer.

The process for completing the notes is really quite long. Nevertheless, a substantial number of questions have been answered and the practice notes are essentially final. The version I distributed has been through the review process. The draft answers are discussed and reworked by the group, and then submitted to the Academy Counsel. They are exposed for comment. We take the comments into account and sometimes revise the answers. They go again through the review process. Once they have been approved by the Academy counsel and vice president they are ready for publication. The notes that you have are essentially ready for publication. In 1997, the group may refine the work and add additional questions or change some of the answers or add additional examples to some of the answers.

The process of creating the practice notes has been quite an open one. Drafts of the practice notes were distributed at several meetings this year. They have also been published on *Actuaries Online*. *Actuaries Online* has been the site of a lively debate about actuarial practice supporting this regulation. The work group has monitored these discussions and included many ideas from the commenters on *Actuaries Online* in the practice notes. The final version for 1996 will be available both online and in hardcopy. Announcements of its availability will be included in the *Actuarial Update*, as well as the section newsletters. Our target for publishing is early December.

Now, I am going to take you though some of the basic topics that we have covered. The practice notes included a sample certification that the illustration actuary might submit to the insurance commissioner. This is at the beginning. The practice notes also cover topics in these general categories that Bill reviewed: experience assumptions, the disciplined current scale, the self-support and lapse-support tests. There are also some additional topics, such as reinsurance, and we have a few more questions in the draft stage that you do not have that cover two-tiered life contracts, changes in in-force scales, and policy loans from the cash accumulations.

In the general category of experience assumptions, we have questions that cover the time frame for recent historical experience, projecting improvements, treatment of extraordinary events, what to do with similar products in affiliated companies, and how reinsurance affects the experience assumptions. The interest assumption was one of the most frequent subjects that we were asked about. The practice notes include questions on illustrated rates differing from the rates underlying the disciplined current scale, determining the earned interest rate, incorporating ownership in other lines of business, and including investment earnings on surplus in the analysis.

Expense assumption questions and the definition of fully allocated expenses were topics we spent the most time on. Some of the specific aspects of expense assumptions that are covered are the definition of direct and indirect expenses, allocating overhead, inflation, and one-time expenses. There are also several questions dealing with the generally recognized expense table (GRET), which is the compromise that Bill mentioned. That is a table that was developed by the SOA and adopted by the NAIC as a measure of industry expense levels that can be used as an alternative to fully allocated expenses. Federal income taxes were also the subject of a few questions, particularly how to deal with the mutual company add-on tax.

The concept of disciplined current scale is one that is defined for the first time by this regulation and *ASP 24*. The wording of the regulation and the standard do not always seem to be completely consistent, and this has led to many questions. The basic concept of the standard is that any scale of nonguaranteed elements can become a disciplined current scale if it can be demonstrated that the scale passes the self-support and lapse-support tests, using assumptions reasonably based on recent historical experience. Some DCS topics covered in the practice notes are comparing the DCS with the illustrated scale—how to calculate a disciplined current scale, and what happens when the disciplined current scale changes. Various aspects of applying the self-support and lapse-support tests are covered in the practice notes, too. In particular, what results to aggregate and how to aggregate for a policy form raised many questions and you will see a number of questions and answers in that subject,

There are some other resources to help actuaries comply with this regulation and standard. There is a panel discussion at this meeting entitled “Implementing the Illustration Regulation: the Clock Is Ticking”, that will feature some of the regulators and it will focus on gearing up for compliance. Also, the NAIC Life Disclosure Working Group is publishing its own set of questions and answers. Many of these questions and answers deal with the regulatory aspects rather than the actuarial aspects of the whole framework and many of them are essentially in final form now and are available from the NAIC on its website.

Finally, I would like to ask for your help in completing this project. We want to publish a 1996 version in early December. There is still time to include additional examples of practice or to reflect your comments. The deadline is November 15, 1996. Please send your comments to Bob Conover at the SOA office or on *Actuaries Online*. I do want to point out that while we monitor comments on *Actuaries Online*, we do not consider those to be official. If you want us to specifically consider some point, please send it directly to Bob Conover.

Mr. Abraham S. Gootzeit: This presentation is on a survey that Tillinghast has conducted on responses from companies regarding the actuarial tests in the Illustration Regulation.

I will be talking from a copy of the survey. I will be trying to go through the survey to identify a few items that I believe are of interest. In the survey we tried to cover the methods, progress and conclusions, basically covering the tests of economic viability, although we did cover a few other things as well. We did send out the survey to approximately 200 companies. We only got 48 responses, which was a little disappointing. However, the time frame was that we wanted the responses back in by September 6, which was a little early, so I think many companies have not yet coalesced their thoughts regarding how they were going to respond. As we are going through these numbers, keep in mind this is actual activity through September 6, 1996, or slightly thereafter for the stragglers.

Why don't we just go through the survey itself. Question A1 was: "What is the approximate number of life insurance policies your company issues annually?" We got 48 responding companies who issue life insurance policies and we separated them into three size categories. We call them large, medium, and small because we are very clever in the way we characterize these, and we try to segment them by number of policies issued, as opposed to any other measure, comparable groups. So the large companies were the ones that issued 50,000 policies or more per year, and we had 14 of those. There were 17 medium companies issued (between 10,000 and 50,000 policies) and 17 small that had less than 10,000 policies per year. We will be looking at responses in those categories.

Question A2: “Does your company issue life insurance policies in any state that has adopted or is likely to adopt the NAIC Life Insurance Illustration Model Regulation as of January 1, 1997?” Of course, you needed to be clairvoyant back in late August to know which states would be likely to adopt by that time, but 47 of the 48 said yes, and one probably did not understand the question.

Question A3 is an interesting question. “Has your company made use of the practice notes drafted by the SOA task force for interpretation of the Model Regulation?” Forty-one of the 48 companies were, in fact, familiar with the Practice Notes, which I thought was actually quite good. So you were successful at least in getting the respondents to be familiar with your work.

Question A4: “Have you and your company taken any special steps to minimize potential legal liability to the illustration actuary?" I think it has become clear that there is no special restriction on legal liability in the Model Regulation. Eight of the companies said that they had taken steps. The responses are not particularly meaningful. Some said they were going to be really careful and do peer review and make sure that they did good work. There are some illustration actuaries that are holding out hope that their companies will prevent them from being sued.

Now we get to Section B which concerns itself with illustration capabilities and methodologies. Question B1: “Has your company decided to issue any policy forms without an illustration in states that have adopted the regulation?" Fifteen have said yes. We said, if yes, please describe. They are generally small policies, or policies that contain nonguaranteed elements, or policies in states that have adopted the Model Regulation, so there's not much in there, but 15 did say yes.

Question B2: “Has your company decided to use the Illustration Model Regulation format in all states, including those states that have not adopted the Model Regulation? As of January 1, 1997, 26 said yes. There were ones that were going to go ahead and make these changes and will go ahead and use them widely, even in states that have not adopted. Another 11 companies have not yet made their decisions.

Question B3: “If your company has policy forms that failed the tests, which decision has your company made regarding illustrated values?" Thirteen of the companies said that it does not apply because all of them have passed, and seven of them said they will illustrate the lower values that passed the tests in all states. So some will be restricted in what they can illustrate and they will illustrate these lower values in all states. Four of them said they were going to split the illustrations and use the lower values only in the states that they are required to do so because of the Illustration Regulation passage. Of course, 21 have not decided because this is a kind of esoteric question. Of the large companies, only three have not decided and in the small companies 12 have not decided. In this particular question, the smaller companies may have not given these issues as much thought.

Question B4 talks about in-force illustrations. "Does your company currently have the capability to provide in-force illustrations and are they available to policyholders?" Thirty-six said that they have the capability, and they are available if requested by the policyholder. They were available, but were only going to send them out if somebody asks, as opposed to sending them out to everybody. Ten cannot do that yet.

Section C questions are concerned with the actuarial testing methodology. It is really related to what Bill was talking about earlier regarding the economic viability testing. Question C1 just says, "Have you conducted these tests?" Only nine companies of the 48 had conducted the tests for all of the policy forms that they issue. Twenty-one others were partially through, and 17 have not started yet. Even at that late date, that larger percentage has not started yet.

Question C2: "Which expense method did you use or have you decided to use?" The totals for this question are larger than 48 because some companies decided to answer more than once, but 32 of the 48 companies will be using the fully allocated expense method, including 12 of the 14 large companies, which is exactly what you would expect. Conversely, of the small companies, only eight of the 17 are using fully allocated. That is a larger percentage of the small companies than I thought. Actually, half of the small companies are using fully allocated and the other half are using either marginal or GRET expenses, which in my mind is almost the same thing.

C3 asks: "Did you use different sets of expense assumptions for various policy forms?" This is kind of an interesting question. It is not entirely clear that you can do this, but 28 companies will be, in fact, using different sets of expense assumptions for various policy forms. That is permitted as long as the expense is an aggregate coverage expense method that you have selected from the previous question. So you are, in fact, allowed to recognize different expense parameters for various policy forms and distribution methods and so on. That does leave a little flexibility for various companies to do things.

Then we get into the kind of boring assumptions, C4, C5, C6, and those kinds of questions. C4: "Which best describes the mortality assumptions you used?" Twenty-five of the companies are going to use recent company experience for mortality, and again, the large companies are going to use their own experience and the medium and small companies will use combinations of their own experience or something else, which is exactly what you would expect.

C5 is a truly boring question: "Which best describes the lapse assumption you used?" Nearly everybody is using their own experience, especially the large companies. C6: "Which best describes the premium persistency assumptions you used?" This is for flexible premium contracts. Generally they used their own assumptions, particularly for the larger companies.

C7: "How did you handle riders and supplemental benefits?" We have split out those riders that have nonguaranteed elements and those that are fully guaranteed. For the ones that have nonguaranteed elements, it is split in thirds between tested separately, tested with the base policy, or not tested. I don't really understand the "not tested" category. On the fully guaranteed side, we're not testing riders and supplemental benefits that are fully guaranteed. An interpretation here might be in order. I think that you are permitted or possibly required to do so. To the extent that you have fully guaranteed riders and supplemental benefits that are profitable in the lapse-support and self-support kind of definition, this may be helpful. So the fact that 33 companies aren't testing those is surprising.

Sections D, E and F are similar. D looks at UL, E looks at participating life; and F looks at term life insurance. Question D1 is, "How many of them actually issue UL policies?" Forty-four said yes, we do, and there are many policy forms there. D2: "For how many UL policy forms have you actually conducted tests of economic viability?" Twenty-six of the companies had conducted tests.

D3: "How many UL policy forms have failed the actuarial tests of economic viability?" Here we have ten companies that have products that have failed, and that's a total of 29 policy forms. Of the 26 companies that have tested UL policies, ten of them have policies that have failed; that is 38%, plus or minus 1% or 2%. Earlier in the year, Tillinghast tried to predict, especially for the UL database that we maintain, what percentage of those policy forms were likely to fail. We came up with about 50%, and that was before the GRET and some of the other methodologies that evolved during the year. We now have some evidence, at least on this small sample that 38% of the companies that have performed the test have at least one form that has failed. It's a reasonable confirmation.

I'm not going to go through question D4. We're looking at actual features that may have caused difficulty, and I don't discern any particular pattern here. It's kind of a laundry list of things. D5: “Have you changed, modified, or withdrawn any UL insurance policy forms in anticipation of the Model Regulation?" We have seven who have said yes, for a total of nine policy forms, and we have some answers on why they have done this. What we were trying to ascertain from this question is whether companies were making changes in advance of doing the testing, either because they had more policy forms than they wanted to support or they had known problems. We received answers here which I’m not sure have much utility.

Section E gave a similar treatment to participating life insurance policies—the Northwestern Mutual and Guardian brand. We had 21 of the 48 responding companies issue participating life forms.

Question E2: “For how many participating life policy forms have you conducted the actuarial tests of economic viability (self-support and lapse-support tests)?” Eleven of those companies had conducted tests for some of their forms and of those 11 companies, seven of them have at least one form that has failed. I’m not sure if that percentage is meaningful, because it is based on a very small sample, but it is more than half. Again, companies are showing some difficulty in passing all their forms.

Question E4: “For policy forms that have failed the actuarial tests of economic viability, please indicate product features and so on that have caused particular difficulties, or where you have made changes.”

Table 1 shows product features such as dividend scale and that kind of thing. The one point that I think actually is useful is the size of the policy. Three companies said that small-sized policies are giving them trouble. I think that is more prevalent in the industry than this survey would indicate, i.e., small-sized policies are giving many companies difficulty. Small size is defined as being in the $10,000–25,000 range. And that’s depending on how you allocate expenses.

We’re going to skip question E5.

TABLE 1
TILLINGHAST SURVEY—QUESTION E4

	Caused Difficulty	Have Made Changes
Dividend Scale		
Mortality element	2	1
Interest element	4	2
Expense element	3	1
Other	1	1
Paid-up additions	1	0
Paid-up additions rider	1	0
Term rider	1	0
Small policies	3	0
Large policies	1	0
Branch office sales	1	1
General agent sales	1	0
Other	2	1

The last section F, is on term insurance, Question F1 indicates that 43 of the 48 responding companies, in fact, issue term life insurance. Of those 43, 19 companies had conducted some tests of the economic viability and of those 19, seven have at least one policy form that failed these tests. That's about 37%.

Let’s turn away from the survey. I think that insurers are modifying their portfolios in response to this Illustration Regulation. One trend we're going to see and already have seen, is a smaller product portfolio. There are policy forms that don't pass and it's just too difficult to make them pass. So the companies are merging those forms together or just deleting those forms entirely. Certainly, there will be a narrowing of competitive variation. We expect to see those companies that are making egregious use of illustrations to be brought in line and those companies that have been illustrating with integrity should see their competitive position improve. There should be room for niche markets and/or benefits as people are looking for preferred access to distribution. In 1996, there is a renewed interest in living benefit riders, i.e., long-term-care riders, critical illness riders and the kinds of things we did five years ago and didn't find successful. Now, we're trying again because we're trying to differentiate ourselves. Certainly the product features will be arranged so that profits will be front-ended so they can pass these economic tests.

Back in Chicago on February 13, 1996, there was an ACLI meeting where Bob Wilcox, who is the Commissioner of Insurance in Utah, said that there were four guiding principles to the entire illustration actuary movement. He said the process has been going on for several years at the NAIC level to, first of all, prevent the sales miscommunications that may have occurred in the past. Second, he wanted to empower the actuary whom he called the insurance engineer who understands the details and builds the buildings. Thirdly, the industry must present clear, understandable information to the consumer (that's the disclosure point). Finally, the NAIC is trying to regulate only at the level needed to achieve the desired result. In other words, the value you get back must exceed the cost.

This is what he said back in February and here we are now. Everybody is busy doing this stuff, and has it worked? I think that the Illustration Regulation is beneficial to our industry. It is a consensus regulation; the Model Regulation and *ASP 24* are consensus documents that have been prepared with participation from regulators and insurers. Many issues required compromise, and I think that's the hallmark of a successful process. Certainly, we should have much more integrity when dealing with the public. We can no longer say the word "vanish," which should give many companies solace. The industry should be able to eliminate most of the more egregious abuses; hopefully, they will not be replaced by others. Those companies that have been illustrating life policies with integrity should see a more even playing field.

The cost for this will be temporary dislocation. There are a number of changes that insurers are making in administration systems, product pricing, experience studies, and really whole aspects of their business. I think the net impact of cost versus benefit will, in fact, be overwhelmingly positive so that Bob Wilcox's fourth principle will be realized.

Mr. Robert H. Dreyer: One issue that seems to be getting us the widest divergence of opinion deals with indeterminate term premiums. For years, we have illustrated both the current and the guaranteed premium. Our software vendor proposes that we simply switch the position and put the guaranteed term premium first and add a mid-point premium, but the NAIC question-and-answer paper that went out this summer says that this is inappropriate because you have to illustrate the premium that the insured intends to pay, and that after the first year you have to show a zero-death benefit. I confirmed this interpretation with the ACLI. It was supposed to have been discussed in Anchorage. I have not seen anything in publication yet; can anybody enlighten us on what is the intent for an indeterminate premium term product?

Mr. Silins: We're playing Stump the Panel, and I think you won.

Mr. Koenig: I would speculate that common sense is going to prevail in some of these issues that I know the regulators didn't anticipate and where they didn't think through every one of these situations. If that, in fact, is their answer, then I guess that's an indication of their thinking and maybe they need a dose of common sense.

That doesn't strike me as the most logical answer, but I sort of like your answer, Bob. I think that, in the long run, those things will all get worked out in the way that makes the most sense to the buyers, if not the regulators.

Mr. G. Thomas Mitchell: In response to that one I'd ask, is the insured intending to pay less or more than is billed by the insurance company? I have no answer to that. Next question. Suppose I chose a July 1 testing date. Does that mean that I wait until July 1 rolls around and see what the situation is and then busily work in the next couple of months to prepare a certification, perhaps in September, or does it mean that I better have my certification in by July 1?

Mr. Silins: I'll take a stab at that. I think you need to have your certification in by July 1. That's the date of the certification that's required. Incidentally, in those states that have adopted the Model Regulation, before you start selling, for example, on January 1, 1997, you need to have your certification in prior to the time you sell policies in those states.

Ms. Milnes: Let me add a little bit to that. The regulators have said that they do want a certification before the effective date in a particular state. Then if you wanted to change your certification date after that, you would just have to refile some time during the subsequent year on a new date. The regulation doesn't specify the exact date that your certification has to be in. You, as a company, get to choose that after round one, essentially. So, if you wanted to, for example, do all your work in November for November certification, you could do that now and continue to do it in November. If you like April better, you could do a certification now and then switch to April during 1997.

Mr. Melvin J. Feinberg: A question for anyone up on the panel relates to the effective date of the regulation. How would you see the regulation applying to a situation where you have an in-force policy that's many years old, let's say? Certainly you don't intend to do any DCS testing on it. Now, let's say there is a rider with the same policy date that offers a new policy, as a conversion option. In order to sell that exercise of rider, in a sense you have to show an illustration. So this is not in the sense a new issue illustration; it's an in-force illustration, but it's for a policy that is just being issued now. Any idea how that might work?

Mr. Silins: I'll try that and see if anybody agrees or disagrees with me. I think you might get a different answer for the two types of policy changes that you talked about. In the first case, the customer has his old policy form and he's exercising a provision under that policy form. It would be my opinion, and again you would want to get legal agreement or disagreement with this, that an illustration would not be required to meet the definition. In other words, the regulation only applies to policies sold after the effective date of the regulation.

In the second case where the policy is converted to a new policy form, I think I'd reach the other conclusion—that the policy would have to conform. Again, I'd want some legal advice to make sure I've interpreted that right. Would anybody on the panel agree with that?

Ms. Milnes: Yes.

Ms. Randi M. Sterrn: A few months ago there was talk about extending this to variable life illustrations, and then it all seemed to die. I didn't hear anything further. Has anybody on the panel heard anything?

Mr. Silins: What I've heard is that there is a committee that's taking a look at that and trying to develop a regulation for variable products, but I think that's going to come after annuities, which are next, and they are not as far along on annuities as we thought they might be at this point. I'm guessing that we won't get a revised regulation on annuities until some time next year followed by a revision for variable products thereafter.

Mr. Roger M. Winans: A question on whether you have any advice or opinion in terms of who should be appointed to be this illustration actuary. Should it be somebody who is perhaps involved in pricing and knows the products well, but might not be as independent in their judgment, or should it be a different actuary in the company?

Mr. Silins: I'll try that and then we can have others talk about it. My personal preference would be to have somebody in marketing do it—somebody who's familiar with the pricing and changes, tweaking that might have to be done to the products, but that's a personal preference. There certainly are no requirements or stipulations or other advice given by the NAIC or the ASB. It is just a matter of preference.

Ms. Milnes: I would say that you do have some guidance in the qualification standards of the Academy and that you have to look to the Code of Professional Conduct and the Qualification Standards to see whether you are qualified to do the work. Every person who becomes the illustration actuary should meet those qualification standards, which would require at least some rather thorough familiarity with the work. I think it would be very difficult for an actuary who is not familiar with the company's pricing and experience analysis to step into this.

Mr. Gootzeit: I have sometimes thought that the regulators were misguided in looking for actuaries to sign all these things anyway. Perhaps they ought to get the presidents to sign some of these things. The thought is that a president who has to sign himself is going to make sure he finds an actuary who does good work, but that's just a personal preference of mine.

Ms. Karen K. Backhaus: I'd like one of the panelists to give their comments on a situation whereby an insurance company is illustrating a product and ceding that block of business entirely to a reinsurer. The reinsurer has told this ceding company that their illustration actuary must sign the certification and perform all the testing, when, in fact, the reinsurer has control over all nonguaranteed elements at the date of testing and any changes to those nonguaranteed elements. They also have control over the illustration software. Can you please comment on how you would advise this illustration actuary?

Ms. Milnes: We do have a question and answer on reinsurance. It's a very difficult issue. That doesn't directly answer the question you asked, but it does give some guidance that might be helpful.

Mr. Gootzeit: I was just going to say, it's extremely dangerous and this particular situation is much more common than has been in the past with many companies doing turnkey operations and fronting operations and so on. I would say a high percentage of the life insurance business that is sold in the U.S. falls under categories similar to that and one that requires much care.

Mr. Silins: I think the front writing company's actuary would be on the hook for the illustrations. We'd then get into reliances and so forth. The illustration actuary who is for the direct writing company might need to get more reliances than otherwise would be necessary, but still is on the hook for the certification, in my opinion.

Mr. Armand M. de Palo: This is more of just a comment than a question. As many of you know, New York State does intend to adopt regulations quite like the Model law. In New York State, Regulation 74 governs illustrations. Rick Moss is committed to come out with the regulation on illustrations for New York licensed companies in the State of New York by the summer of 1997. He has agreed to comply, where possible, with the NAIC Model law, but the scope of Regulation 74 goes to annuities and variable life. He is committed to have a regulation that will incorporate both annuities and variable life by that date. John Hurley, on my staff, will be working with him to draft such regulation. If the NAIC’s Model law does not pick up annuities and variable life by that date, he is going to do his own thing. Anyone who has any input who wants to give it to New York should either contact Rick Moss directly or contact John Hurley in my law department because the last thing we can afford is to have great variation by state. This is not a question, but I really wanted input from people as they get down the road to communicate it through someone, like the Life Insurance Council of New York (LICONY), which is the life insurance representative in New York State. John Hurley will be the lead on that task force.

Mr. Silins: One possibility is that there will not be an ASP for compliance with that regulation in New York and that was something that the ASB was trying to avoid because we didn't want to have a compliance ASP for states that differs from the model.