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Moderator: DONNA R. CLAIRE
Panelist: THOMAS C. FOLEY
Recorder: DONNA R. CLAIRE

Summary: This session includes discussion of the latest regulatory topics affecting product development of life, annuities, and health insurance. Topics addressed are currently receiving regulatory attention at the National Association of Insurance Commissioners (NAIC) or at the state level, including equity-indexed products, "XXX," and sales illustrations.

Ms. Donna R. Claire: Tom Foley heads two committees that are very important to this group: the Life and Health Actuarial Task Force (LHATF) and the Life Disclosure Working Group of the NAIC. Both of these task forces affect actuaries. Tom is currently an actuary with the North Dakota Insurance Department. He was formerly the actuary at the Florida Insurance Department.

Mr. Thomas C. Foley: We're going to emphasize talking about nonforfeiture, and the sales illustration model, both the life one and the developing one for annuities.

How many have been following the nonforfeiture re-do? Donna mentioned the LHATF, which is a technical task force that has been around for some 20 years now, and working on a nonforfeiture re-do for at least 15 of those 20 years. Those of you who have been around a while remember that so-called fund-based life insurance policies came into vogue in the late 1970s and early 1980s. Because of the attempt to apply the formula-driven traditional minimum nonforfeiture values to those products, people threw up their hands in the early 1980s and said, "Wait a minute, this isn't going to work. We need to do something else." Immediately (which was in about 1982), the LHATF sprung into action. Up until about three years ago, the modus operandi was to take formula minimum nonforfeiture values that we get

from traditional products, or a nonfund-based product, and apply those to fund-based products. That means we're going to somehow limit charges and credits relative to these products. If you do that, then regulators will immediately be accused of a sin worse than death, and that is rate regulation, and rate regulation is not something that we do in the life insurance business in the U.S. This project limped along. And I was a company actuary for 20 years. In the early 1990s, I got involved as a regulator, primarily because I needed a job. It turns out that it's something I probably should have been doing long before that. In the early 1990s, when I got involved as a regulator, and then a couple of years later, when I got involved with the task force, the task force was still making every effort to apply formula minimums to fund-based products, and it wasn't working.

About three years ago, some of us on the task force called for a vote to go back to basic principles and see if we can't find another way to re-do the nonforfeiture law. Now we're three years into the current re-do, and I would like to be optimistic and tell you that we're very close to having something wrapped up on this, but we're not.

The basic premise that we began with three years ago is that continuing and terminating policyholders should basically be treated the same under a life policy. The Society formed a committee, and Donna has been involved in all of these committees. Bob Wilcox was then Commissioner of the state of Utah and was involved in all these projects. The Society said, "If the basic premise is going to be that continuing and terminating policyholders will be treated the same, then that means we need not only retrospective accumulation to a point in time, but also prospective calculation of values."

Let me back up a minute. Suppose we take the basic premise that, instead of having formula minimums to determine nonforfeiture values, the company is going to make a deal with the applicant. For discussion purposes, let's assume that there aren't any parameters surrounding this deal. So you're the company actuary, putting together the deal, and we're going to put this in what we call a nonforfeiture plan. Somehow you're going to communicate that to policyholders. This deal is going to indicate how nonforfeiture values are going to be given to that applicant who then becomes a policyholder. Let's suppose there are no other requirements.

How do you put together such a deal? At some point in time, suppose somebody buys one of these, it's ten years later, and he or she decides to discontinue paying premiums. A basic premise that we've been using all along is that if somebody buys a life insurance policy, it provides a death benefit. What we will do is continue what are called benefits in kind; in other words, when the policy was

active, and it had a death benefit and money would go to a beneficiary. If the person becomes inactive, whatever that means, he or she will continue to have a death benefit and money will go to a beneficiary. So benefits in kind, either extended term insurance or reduced paid-up insurance, have to be provided.

Another basic premise that we've been stating for the last three years is that there will not be cash as a required nonforfeiture option. When you get to year 10, realizing you made this deal, how are you going to determine the benefits in kind that go to that given insured? One way to do that, of course, is to use some kind of retrospective accumulation. You take premiums paid, benefits provided, and expenses incurred and do a retrospective accumulation to that point in time. Another way to do this is to get to year 10 and to look forward. Suppose we get to year 10 and determine that interest rates are going to go down precipitously. Bill Koenig has often said that we're going to have something comparable to an AIDS epidemic. At year 10, an active policyholder might ask, "What is my value on an ongoing basis? If it turns out that we are going to have a mortality spike, what does that do to my value on a going-forward basis from year 10, everything else being equal? My policy is now more valuable than it was before. The probability of my beneficiary receiving a claim is higher than it was before, so it's more valuable."

Let's go back to the basic premise, which is that the terminating and continuing policyholders are going to get equitable values. That means if I'm going to anticipate, as the actuary, a mortality spike, then I end up with a larger value on a prospective basis than I would have gotten on a retrospective basis. Intuitively, it seems like it goes backwards.

The Society's report on the nonforfeiture project basically endorsed the prospective method. Once you get to a point of termination, we're going to calculate value to the policyholder on a prospective basis. As a regulator, we look at that and take the policyholder's side. I would say, when one of my policyholders gets to year 10 ,his or her value is a function of an actuary calculating what's going to happen in the future. In fact, if the actuary thinks mortality is going to spike, then the value is enhanced. If the actuary thinks mortality is not only going to continue its secular trend of improvement, but go down significantly, the policy has a lesser value than it would have otherwise. As a regulator, I don't know if I take great comfort in knowing that there are a lot of companies and actuaries in this country that have the ability to drive that value down. This is an unresolved issue, which we will come back to later.

If we go through what I hope we will go through, you will see that all these things we're talking about—sales illustrations, disclosure, nonforfeiture re-do, and *XXX* ,and

valuation re-do—all meet at the back of the barn. We're talking about the same basic concepts, in different arenas.
The deal that we talked about with nonforfeiture provokes a major question: Should the company be constrained at all in determining this deal? Should we define the de minimis value, for example? What we're talking about now is how somebody pays premiums and gets benefits. Basically, if the premium that's being paid matches the benefits being provided on a duration-by-duration basis, then there is no material prefunding, whatever material means in this concept; therefore, there may not be a requirement for a nonforfeiture value. If there is prefunding, then what's our definition of prefunding? Can you choose what prefunding is for each of you and find that all of them are materially different? This is a question that has not been resolved.

The deal is to be stated in what we call a nonforfeiture plan. As actuaries, we've all thought that any actuary who puts together a policy and prices it has records of how he or she went about doing that. Actuaries document how they developed the assumptions, what assumptions they used, what techniques were used, what they anticipated, and so forth. This is a plan.

What we tried to do, as best we can, is formalize what needs to be in a plan, yet we don't want to formalize what needs to be in a plan. Let me try to explain that to you. I'll ask you to think as a regulator for just a minute. Every time that regulators develop a law or a regulation that you are subjected to, they take great comfort in that, because it means that there are certain activities outside of which, presumably, you can't venture. On the other hand, from your perspective, that same law or regulation gives you a safe harbor. You know that if you don't venture outside of this, at least as far as law or regulation is concerned, you're OK. You don't need to think about it much more. So the compliment of laws and regulations are safe harbors, and there are many regulators and are actuaries in this room and otherwise who are starting to wonder out loud. My actuarial training is basically gathering a collection of safe harbors within which I stay. Am I going to be able to continue to do that? Should I continue to do that? So this is where this dialogue and all these different arenas arise. When we talk about the plan, there's a part of me, as a regulator, that says we need to be very definitive about the plan. There's another part of me that says, I don't want to be definitive at all. I want the company to decide what should go in the plan, given broad general parameters, because I don't want to present a safe harbor. I don't want to say to you, "If you do this, then everything's going to be all right." I'd ask you to think about that.

In addition to the nonforfeiture plan, which lays out how we're going to calculate benefits in kind, how we're going to calculate nonforfeiture values, and there's another plan associated with this, a plan that describes how nonguaranteed

elements in the policy are going to be determined, how credits and charges are going to be applied, or, if it's a participating policy, how dividends are going to be determined.

So from a regulator's viewpoint, we have two plans. One is a nonforfeiture plan, and the other is what I'm going to call a nonguaranteed element plan, and I'll read dividends into that. I also think that dividends may be treated differently from other nonguaranteed elements. In exchange for eliminating formula minimums, in exchange for giving you much more freedom, what we want you to do is disclose to the policyholder how you're going to do what you've been doing for the last 15 years, which you haven't disclosed. There are regulators who talk about dirty tricks that have evolved over the last 10 or 15 years. By dirty tricks, I mean things that appear to give value to policyholders, but really don't. They are totally unknown to policyholders, and therefore they end up taking actions that hurt them. I'm referring to the sales illustration model and the whole concept of lapse support. We've resurrected the tontine concept, which we eliminated well over 100 years ago, primarily so products would illustrate better. The nonguaranteed element plan and the nonforfeiture plan, together, basically would allow the company to go to the world and say, "This is what we're going to do in exchange for you having to meet certain formula minimums." That's the theory.

When we first started talking about the plan, many industry representatives said, "What are we going to do with the plan? Do we have to send it to regulators, and does it have to be approved?" Regulators are not always on the same page on any given topic. Keep in mind that my view may be different from others'. My initial thought was, if the plan will be meaningful, then proprietary information will have to be in it. If proprietary information is going to be in it and if you're going to lay out what you're going to do in the plan, then you don't want to send that a regulator. That isn't going to work. I'm not going to be able to approve it. But there were other regulators that said, "Wait a minute, I want to see it to make sure that the plan was put together, and I want to see what companies are doing." We talked about sending it to state insurance departments, and letting them keep it for 30 days and then send it back. Or we could send it to state insurance departments and eliminate the open record laws for this particular filing. And then there were others who said the elimination of the open record law doesn't work; all we need is a smart attorney and he or she can go get the items.

So we came up with a concept, which we've labeled a central depository. It is an independent organization to which the company would send its plan. The central depository would be responsible for seeing that the components of the plan are there, and that's all. Then they would send a certification on to the state saying that the company filed a plan with us, and all the pieces are there. If three years later, it turns out that we have some dispute about whether the plan was followed or not,

then, as a regulator in a market conduct mode, we can go look at the company plan and determine that. That would be my strong preference over reviewing filings.

The sales illustration model, which, four states adopted effective January 1, 1997. North Dakota was one of those four states, and we required that companies send a certification to us, both from the illustration actuary and from a responsible officer. All we wanted to see was the certification. I don't want to see a sample of the illustration. We had a few companies that sent illustrations to us because they wanted to get some assurance that they were following the letter and spirit of the law, but that wasn't required. So that's our perspective. I want to know that it's there, and I want to know that the company put the plan together, but I don't need to see it.

There are several other key issues. Let me bring you up-to-date quickly on where we are, and then we can throw this open to anyone on nonforfeiture. We developed a prospective model early in 1997 that has 10 or 12 sections in it. It lays out a description of the nonforfeiture plan, the nonguaranteed element plan, and the central depository and all these things. It comes primarily from a document that was developed by a committee of the American Academy of Actuaries (AAA) led by Walt Rugland. As a regulator, I can't too strongly emphasize how the Society and Academy are both heavily involved in these projects, and we couldn't even come close to doing them without them. This document is reasonably prescriptive. It says thou shalt do this, this, this, and this.

The industry, as generally represented by the American Council of Life Insurance (ACLI), was sitting on the sidelines during the last two or three years as this was developed. That stopped early in 1997 when the ACLI started having regular meetings, and I understand they've had many day-long meetings in this last year. The ACLI came to the working group in mid-1997 and said, "There are a lot of things about the model we like, but there are a whole lot of things about the model we don't like." Basically, the ACLI proposed that we eliminate the following: the central depository, any bright-light tests, any de minimis test, and any definition of de minimis. It said that an Actuarial Standard of Practice (ASOP) does not need to be developed. Bill Koenig, the current chairman of the Life Operating Committee of the Actuarial Standards Board (ASB) and his group have met two or three times to talk about a prospective method for calculating nonforfeiture values. The ACLI said, "We don't need an ASOP. Maybe the only situation where we might need one is in the case of this prospective method for calculating nonforfeiture values." Basically, they're suggesting that we remove many things from the model, and they're also suggesting that cash values be required. So this all came kind of to the head in the mid-1997.

Models developed by the NAIC generally are of two types. In one type, regulators get together and decide what we're going to do, develop a model, and, if the industry accepts it, that model gets adopted in many states and it becomes the law of the land. Generally speaking, if model development does not significantly involve consumer groups and regulator groups, that model dies. A classic example. is a mandated nonforfeiture provision in a model for long-term-care policies that has been on the books for three years. There's not a state in the land that's even close to adopting it, and there won't be.

Ms. Claire: New Mexico is close.

Mr. Foley: Maybe. So the first way regulators develop models is, in essence, to foist them on the public. That generally doesn't work. The other way is to have consumer groups, industry groups, all interested parties, and regulators work together and form a compromise that no one likes. The sales illustration model is a perfect example of that. No one likes that. If you talk to regulators, they can shoot holes in it. I'm sure each one of you can shoot holes in it. But the thing is being adopted and appears to be having some significant effect on behavior.

Let's come back to nonforfeiture. Having been through this process several times now, I realized that, if we're going to develop a nonforfeiture model that has any chance of affecting how we do business in this country, it has to be a compromise. We have to get all interested parties together and forge a compromise. It was in that spirit that, as chairman of this group, I talked to the ACLI, the Academy, the Society, consumer groups, and anybody who would be interested. We thought we were going towards a compromise. We had a fall NAIC meeting and talked about the concept of disclosure relative to the nonforfeiture re-do. Part of this plan concept, and a part of the deal we make with consumers is that we have to tell consumers what the deal is.

We've talked all along about the need for a plan summary corresponding to the detailed plan. If there is a detailed plan in the company archives, then the plan summary goes to the applicant/policyholder. Of course, the devil's in the details, and we've been breaking down in trying to figure out how much of the detailed plan is ultimately going to be given to policyholders.

In the spirit of trying to forge this compromise, I, as chairman, proposed the concept of a "buyer's guide." If we're going to disclose to what's in the plan, there are several ways we could do that. One is to develop a guide to lay out, for life insurance, for example, 30 items that describe how we do business, with a paragraph for each one of those items. If you are familiar with the sales illustration model, think about taking out the narrative summary and putting it in a separate

document. You'll have something very close to what many of us envision for this buyer's guide. This would be an opportunity for regulators, consumer groups, and interested parties to describe nonforfeiture benefits, accumulation values, and all the pieces of a policy. Then, corresponding to each one of those paragraphs, we could have a question that the applicant is to ask the company representative plus the company's response.

When you sell somebody an XYZ kind of policy, 14 paragraphs from this 30-item guide might be pertinent to that particular policy. So you, as a company, put together those 14 items, the corresponding 14 questions, and the company's response. That's the disclosure document or the plan summary, if you will. That describes, for consumers, how you're going to calculate nonforfeiture values, credits, and charges. It made sense to me. But, I could not communicate that at the September meeting, in any one of several different venues.

So we talked about disclosure, but people were muddled. Mark Peavey, an NAIC staffer and I are trying to put some flesh on that. We're going to have a meeting in Seattle in December 1997 and we're going to talk about this again. We're going to put together specific examples of the 30 items, the questions, and so forth.

The other interesting thing that happened in the September 1997 meeting is that the ACLI said basically, let us do whatever we want to. We had the Academy and Society groups that had spent thousands of hours putting together major documents and they said, "Wait a minute, we need to have a few more bright-light tests. We need to have some substance here, and we need an ASOP that limits behavior." So I don't know where we are at this point. We're still trying to forge a compromise, and I thought we were coming close to one, but I don't have a clue about what's going to happen. I don't know whether we are going to come together on these topics or continue to splinter.

Ms. Claire: I just wanted to state that the SOA did endorse a prospective method, but that was solely because the regulators came out and said one of their basic premises was that terminating and persisting policyholders should be treated the same. The only way they could be treated the same is if you know what the persisting policyholder is going to get, so you have to think about all the values that they would have in the future. Therefore, yes, that is true; however, I was chair of the SOA group, and the SOA's position is that there are a number of ways to look at equity or whatever. It's a question of what the basic premises behind the nonforfeiture law are going to be. I was actually the chair of the Product Development Section Council, and I could think of a lot of interesting product designs. Some would benefit those who stay around, and some may benefit those who terminate. If all I have to do is disclose, I am not saying the Society would be

against that. Everybody must understand what the basic rules are that we're working against.

Mr. Foley: Again, there are several issues that will float in and out of this discussion, to the extent that we have bright-light tests, that we have de minimis tests and all these things that give you safe harbors. I'm not sure that really is appropriate for policyholders.

I'd like to switch gears for a few minutes and talk about sales illustrations. We will come back to nonforfeiture and tie all this together before the end. How many are sick of hearing the history of the development of the life disclosure sales illustration model? Everybody in the room. It was adopted by the NAIC in December 1995. Four states adopted it effective January 1, 1997, and it appears that well over half the states are going to adopt if effective January 1, 1998. So it's going along.

The reports that I get generally are very positive about the effect this has had. But there are a couple of issues that we need to talk about. I was in Los Angeles yesterday talking to a group of information services (IS) people, who are primarily the people who develop the software for sales illustrations. They come at this issue with a completely different perspective, and it was very eye-opening to me. I indicated that, in North Dakota, we just required a certification and we want to see illustrations ahead of time. In the fall of 1996, we went around to the agent forums and invited all agents in North Dakota (if they continued to see sales illustrations in 1997 that looked like old-time illustrations) to send them to me at the department. I would follow up with those companies and find out what's going on. I've heard from about 20 agents this year. The vast majority of them want to call and talk about the number of pages

When we developed the sales illustration model, it certainly was my expectation that a typical illustration was going to be five or six pages long. It was going to have a couple of pages for a narrative summary, a page for a numeric summary, two or three pages of tabular detail, and that was it. Right out of the chute, we heard from agents getting 10–5 pages or more. If, as an agent, I go out and talk to a young lady, show her a universal life policy for $100,000, and end up taking an application for the amount that matches the illustration that I have, then I must leave her a copy of the illustration. That would be 15 pages. I need a copy for my records and I send a copy to the home office, and that's the cleanest case we can have. It really gets muddy if I'm going to talk to her about three policies. Then I have three illustrations, 15 pages each, and so on. So the number of pages is killing us.

When I talked to a user's group, they gave me insights that I hadn't heard before. Two or three of them said that they were involved in the meetings where the

actuaries were determining what was going to be in the illustrations. One of them commented that our actuary said we need to provide to policyholders what they need as well as what the model requires that they have and those are different. That's one of the reasons we have so many pages in illustration modeling, which makes me sad. It certainly was not our intention to put together something that wasn't going to be useful to policyholders.

What we were trying to do with the illustration actuary concept was to empower the actuary to have some say in those meetings that we all have. I was the chief actuary in small companies for 10–12 years, and I can't tell you how many times I was in a meeting with the president, the marketing officer, and the accounting officer where we were talking about marketing issues, sales issues, or product issues. I lost every time. Who wins? The marketing officer wins. So what we were trying to do is give the actuary some clout in those meetings rather than having to say, "Yes, but, yes, but, yes, but." It appears that some actuaries have taken that to mean that they now have a tremendous responsibility that they didn't have before, which I think is accurate. And to perform that responsibility, they're literally going to have to cross every *t* and dot every *i*, and that's generating many more pages than any of us ever anticipated. I can't speak for all regulators, but I'm many are really into crossing *t*'s and dotting *i*'s.

I'm into the spirit and essence of this, and I'm delighted with the response I've heard from agents, consumers, and companies saying that a lot of the aggressiveness and dirty tricks that have developed over the last 10 or 15 years are now, if not eliminated, being strongly curtailed because of this model. I'm delighted. I wish I knew what to do about the issue of the number of pages.

One of the things we're talking about doing at the working group level is taking the narrative summary and pulling it outside the document or inviting companies to pull as much as they can outside the illustration itself and just printing that once. We're going to start looking at that early in 1998.

What we've been doing since 1995 is basically working on the annuity companion to the life sales illustration model. In 1996, we took the life model and replaced life with annuity and said, “Well, here it is. This is going to be the annuity illustration model.” As you might have guessed, there was significant input from the industry, saying, “That's not needed, not appropriate, and not right.” It's my sense that we're within a few meetings of adopting a model, and that model is going to emphasize disclosure and allow illustrations on a sale-by-sale basis. That means, if I have a particular fixed annuity, and I talk to this young lady, I can use an illustration with her, and then go talk to a gentleman the next day about the same product and not

use an illustration. So it appears that illustrations are going to be optional on a sale-by-sale basis.

The primary rationale behind that is that illustrations aren't greatly used for annuities and aren't nearly as complicated. It does not appear that the dirty tricks relative to annuities have developed for life products. So illustrations are going to be curtailed. We don't know at this point what the format of illustrations will be. We anticipate having a major discussion about that at the December 1997 meeting.

A few things are clear, though, about the disclosure aspect of annuities. When we put the life model together, the insurance industry didn't have many competitors, at least, many competitors outside the insurance industry selling life products. That may be changing very rapidly. Annuity products and annuity-type products are sold not only by insurance companies, but by every financial institution around. So that is a consideration in developing a disclosure document that we didn't have before. If we develop a 15-page disclosure document that insurance companies have to use to sell annuities, they will be screaming at us that they're not going to be able to compete because other institutions sell similar products and do not have 15-page disclosure requirements. So we're limited in that we need to have relatively few pages in a relatively simple disclosure document. That same concept that I talked about—having a guide that lists some concepts and asks a series of questions—is also going to be applicable to disclosure for annuities.

There are three or four key issues with regard to annuity disclosure that we need to talk about. One is the concept of sustainable rate. Except for TIAA-CREF, the annuitization rate of annuities in this country is almost nonexistent. TIAA-CREF does not allow anything other than annuitization, and it works very well. It enhances their investment capabilities and they have performed very well for the last 15 years. Unfortunately, most fixed annuities sold today are not annuitized, and all too often, they're used because of the tax advantage in what I call "put and take" accounts. Let's assume that somebody would buy an annuity for the classic reason, to set aside money now and turn it into income to enhance retirement. If this person doesn't need the money now, then he or she generally doesn't care about surrender charges or liquidity. It's a moot point. However, if you were to buy a declared-rate fixed annuity with a 3% minimum interest rate and a first-year rate of 7%, how many people would ask the following question, "What's my rate going to be in year 2?" How many people would not be concerned with that? Every one of us would be concerned with that.

How many people who buy annuities today even ask the question? How many companies would give them any comfort if they did ask the question? We know that there are companies whose intention it is to have the renewal crediting rates

follow the development of the financial marketplace. If it goes up, they go up; if it goes down, they go down. There also are companies at the other end of the spectrum whose intention is to take that crediting rate to the guaranteed rate just as soon as they can get it there.

As a consumer, how can I tell the difference? If I buy a declared-rate annuity for the right reasons, and it turns out that I buy from one of those companies that takes my 7% to 3% in three years, what am I going to do? I'm going to be unhappy and probably going to pull my money out. I put in $1,000 and now I have $850 and I'm upset and discouraged. As a regulator, I don't much care for that. Somehow, we need to find some way to get consumers to ask companies, what is your intention with regard to renewal crediting rates? The minute we use the word intention, industry reps say, "Wait a minute, what about class-action lawsuits? The minute I put down what my intention is, and if it turns out something is different from what I intended, then aren't I liable in a way that I wouldn't have been otherwise?" It's not an easy issue to grapple with, but we must indicate to people who have a declared-rate annuity what the company's intention is for crediting renewal rates.

We need to explain the pluses and minuses of lapse support. We continue to hear arguments put forth by company representatives that lapse support is a legitimate concept, as long as the consumer knows about it. As long as the consumer knows that they're going to forgo value in early years in exchange for greater value in later years, that's a fair deal. Talking about fairness is a very difficult thing to do. From my perspective, a little bit of that may be fair, but much of it quickly becomes unfair.

The bigger issue is whether or not this concept permeates the way we do business. Then what assurance do we have that lapse supports aren't going to be so low that the support turns out to be nonexistent and we can't pay those values? The president of a major U.S. company makes the analogy, in writing, between the kind of business that we're talking about and a lottery. That is, if you get to year 20 or 25, you get a bonanza, but you don't get much if you get out before then. That's not my idea of what we should be about. We need to explain this to the world so everyone understands the consequences of lapse support.

If people buy an annuity for the right reason, that is, they want to annuitize to enhance retirement values, then we have to play fair. There are companies today that are providing pitifully low settlement option rates years into the policy. We need to disclose that. We need to have history and we need to have people understand that their monthly income is a function not only of the fund that they have out there, but the factors. The only thing that makes me optimistic at all is that

Ithink because of all the baby boomers, there's going to be a lot more focus placed in the next 10 or 15 years on keeping monthly income current, whatever that means. I'm sure there are people in this room who know a whole lot more about that than I do.

Let me end on annuity disclosure with something that just makes my blood boil. I would hope that it makes your blood boil, too. I continue to see ads in agent and nationwide publications from companies offering to the public annuity products that are similar, except on one, the commission in year 1 is 10% and the client gets 5% credited to their account, while on the other, the commission is 4% and the client gets 8%. The commission is inversely proportional to the interest rate that's credited. I don't know how a company can, in clear conscience, put together products like that and say to agents, "If you have competition, sell this one, and you take 4% or 5% percent, but if you're not in competition, sell this one and we'll pay you 10%." Perhaps, we need to switch to equity-indexed annuities (EIAs).

Ms. Claire: What do you think the timeline is on the replacement regulation?

Mr. Foley: I have not been involved with the replacement regulation at all. The A Committee is the life insurance committee at the NAIC, and a lot of the committees that we're talking about now ultimately end up reporting to the A Committee. I sat next to a regulator from a northeastern state who was on the replacement committee, and I get the sense that they're rapidly coming close to something, but I don't know anything about it.

Ms. Claire: New York State intends to replace Regulation 60 by the end of the year. It has some interesting provisions that you may want to look at. They're going down one path with annuities, and I actually agree with their path. The replacement regulation requires annuity illustrations in a certain format. It also requires a 60-day free look on both sides. The replacing company has to give 60 days, and the other company has to take them back at the end of 60 days. So there are some interesting provisions. It's something that I think people should watch very closely because New York does intend to adopt this by the end of the year for January 1, 1998.

Mr. James N. Van Elsen: It is moving very quickly in the working group. At this point, the replacement regulation has virtually no industry support, so I don't know what that's going to do. In its current form, there are very significant items that all the trades have difficulties with, and I just don't know what that's going to do to the progress. Again, as you know, without compromises, we end up with regulations that occupy shelf space.

Ms. Claire: Yes, other states may take the New York approach, and go off on their own. Anyone working in New York does have to comply with those laws.

Mr. Howard M. Callif: I'm kind of confused. You don't want to give people a safe harbor and you don't want people the illustrations indicating that they have done something within the spirit of the law. I'm not sure I understand that.

Mr. Foley: I apologize. It is fine if somebody wants to send that to me. It's just not a requirement that illustrations be sent.

Mr. Callif: Would you respond to them?

Mr. Foley: Sure. I responded to those that sent them in.

Mr. Callif: The other question I have is on the number of pages. I think that the idea of disclosure was followed fairly explicitly in most of our customers' illustrations. They basically explained every feature of the policy that was available and ended up with 13 pages of illustrations because these are complex products. It just takes a lot of doing.

Mr. Foley: So if we pulled the narrative summary out, would that help significantly?

From the Floor: **Y**es, but our customers would say no. The problem is, how do you explain it if you have a sheet that's explaining it in general. You haven't really explained specifically what the person's buying so you haven't solved the problem of giving them disclosure and something that they can use to make a decision.

Mr. Foley: It may be that we're just going to have to live with many pages, if we're really going to disclose.

Mr. William C. Koenig: Will you entertain some comments now, before you move on to equity-indexed products?

Mr. Foley: Sure.
Mr. Koenig: I'm speaking on behalf of the ASB. With respect to the proposed nonforfeiture law, you said that there were some people who thought that a standard of practice would be necessary to "limit behavior."

Mr. Foley: Did I say that?

Mr. Koenig: Yes. This, of course, is a dicey prospect. The ASB does not have the antitrust immunity that the regulatory community does. I think the illustration

regulation and standard of practice work was an excellent example of the cooperation between regulators and the actuaries. It was a package that had all the regulatory sanction that the actuaries needed to write a standard of practice. I think you will have to be careful, going along in the nonforfeiture law work, not to leave too many details to the standard of practice, because it will be very difficult for the actuaries, if not impossible, to do much limiting of behavior. Most of that is going to have to be done in the law.

I have a couple other comments on things you said. One of the possibilities that you've talked about with respect to the nonforfeiture law, is anything goes. Let me make it clear that I'm speaking on my own behalf, and in no way for the ASB. These are just my own opinions. The idea that anything goes, with adequate disclosure, puts way too much burden on disclosure, and way too much faith in companies' ability to lay things out in a way that buyers will really understand. I think there is a role for regulation beyond just saying, anything goes. That sort of approach makes me very nervous. I think lapse support is an excellent example of that. There is no way that lapse support can be adequately disclosed because of the things you said. It is not a lottery, because there will not be a big payoff. No one's going to win if the companies get the good persistency because the money won't be there. This whole marketing strategy was tried 100 years ago. It didn't work then and it won't work now. Lapse support, in my opinion, is simply a way to get inflated values into illustrations, and it is simply a sales tool that is not meant to encourage good persistency. If it got it, it would be self-defeating. And I don't think that can be adequately disclosed.

As far as nonforfeiture goes, nonforfeiture laws were meant to protect terminating policyholders. That is a noble goal. But your global proposal, which affects not only nonforfeiture benefits, but nonguaranteed elements of all sorts, is a much more global effort. Perhaps part of the problem that regulators are having is the expansion of this project beyond trying to protect terminating policyholders to one of much greater scope.

To the extent that there is a problem with nonforfeiture values (which I would guess there is, if you've been wrestling with this for 15 years), then providing an alternative law that companies may use does not solve the problem for the rest of those products that don't avail themselves of this new option. If there are products that, in your opinion, are not providing adequate nonforfeiture benefits, then those products and companies would, presumably, be free simply to stay with the old law, and not provide adequate nonforfeiture benefits. To the extent this is just an option, companies will still have the current law to work with, which I believe you and your regulatory compatriots feel is inadequate. I think that would be a problem.

Most of the problems that I have seen in lawsuits have been on the nonguaranteed element side of the ledger. We certainly haven't been sued, and I can't remember reading about a lawsuit that involved someone saying, "I had a $1,000 guaranteed cash value, and the company didn't pay me $1,000." All the lawsuits are on the nonguaranteed side. I would submit that making guaranteed cash values be one more nonguaranteed element might be a step backward.

There is a big problem in the proposal that you referred to, and that is the auditing of the plan over time, how you know whether a plan is really being complied with. That is one of the most difficult things that the Life Operating Committee of the ASB wrestled with as it has tried to be useful in your work. It has been very hard for us to resolve the two opposing ends of this. If a plan is so specific that the company has absolutely no management flexibility to deal with a block of business, you are basically selling some business and putting it on autopilot, and saying that if interest rates go up, the crediting rate will go up by so much, and if mortality changes, you'll reflect that, and so on. So a second auditing actuary coming in would have no question that the plan was being fulfilled because there was no flexibility in it in the first place. That's likely to be unacceptable. If you try and introduce some element of company flexibility and ability to manage the business, then it is hard for us to see how that can be reconciled with your legitimate regulatory goal of having some idea of what the future will be for this block of business. In my company, we have a pretty good idea of what our plan is; however, among actuaries who, understand the plan, there is a pretty wide range of legitimate differences of opinion as to how we should go about fulfilling our plan, which is reflecting experience in our dividend scale and the timing of that. There's a wide range of acceptable answers to what really fulfills that plan. Having an independent person come in and say some of those are right and some of those are wrong would be very difficult.

Finally, with respect to the illustration regulation, I will say that if it wasn't a home run, it was probably an extra base hit. The tests of economic viability, both the lapse-support and self-support tests, were important. I think those were excellent concepts. The discipline and tie to the real world was a great step forward. At the ASB hearing in New York in 1994, there was some testimony to the effect that you regulators were barking up the wrong tree because you were assuming that the dividends and the nonguaranteed elements illustrated had no relationship at all to a company's underlying fundamentals and experience, and that those things were just set by competition. We don't know why you were worrying about that. I remember Bob Wilcox wasn't favorably impressed by that testimony, but I think a good deal of that went on. Having a company do some tests of economic viability, with respect to the things they sell, was an excellent concept that should be brought

forward onto the annuity work. Those concepts are equally valid and applicable to annuities as life insurance and should be carried forward.

Finally, with respect to sustainable rates, the question isn't really what the company's intent is; however, companies should be able to say what the rate will be if nothing changes in year 2. That's not an impossible thing. Frankly, as far as the plan goes, if you can't make it work on what is a fairly simple laboratory example here for nonforfeiture work, and if a company can't disclose what its second-year rate will be if nothing changes, then it's hard for me to imagine the plan concept ever working on more complicated products or even products not yet imagined.

Mr. Robert H. Dreyer: One problem that we're running into with illustrations is the expense of matching the original illustration with the policy that's issued. We're a small company, and we'll probably issue 30,000 policies this year. Roughly half of them won't require an illustration. Right now we've had to add four or five temporaries who do nothing but compare the illustration that the agent submits with the policy as issued and prepare revised illustrations. My question is for you, Tom, as a regulator. The law permits the agent to get a signed statement saying, "I was not shown an illustration, I understand I will receive one when the policy is delivered." At what point does the agent's sales talk become an illustration?

Mr. Foley: That's one of the few questions I can answer. The minute they talk about nonguaranteed elements, then an illustration is required. You certainly are free to decide that no agents are going to use illustrations, and you will present the basic illustration for those policy forms that you're going to illustrate at the time of delivery, as long as only guaranteed elements are talked about in the sales process.

Mr. Dreyer: Do you mean at the original sale, when the application is being taken?

Mr. Foley: Right.

Mr. Dreyer: So if the agent were to say, "Our current interest rate is 6%, but it's not guaranteed, and we'll reset it every year," this constitutes an illustration, and we have to get the applicant to sign an illustration and submit it. If you go out with an illustration of a $50,000 policy, and the applicant wants a $100,000 policy, he can't sign a statement saying, "I was not shown an illustration of the policy as applied for?" This is where the problem comes in. Every time an illustration comes in with an application, it has to be matched on the other end with the policy as issued.

Mr. Foley: So what you're saying is the policy is not issued as applied for.

Mr. Dreyer: It is not applied for as illustrated. I know that if it's issued other than applied for, you have to do a re-illustration. But what if it is applied for differently than was illustrated to them at the time?

Mr. Foley: Then I think you have to have a conforming illustration delivered with that policy in time.

From the Floor: Delivered with the policy is no problem, because we can set up our issue system so that it automatically creates the illustration. It can be delivered with the policy and signed at that time. What I'm saying is, if we do that, how little do we have to do at the time of application, because if we still have to get a signed illustration at the time of application, we're still stuck with the problem of matching or having two signed illustrations.

Mr. Foley: I'm not following the question. What am I missing?

Ms. Nancy A. Behrens: I think the point is that, if customers took one illustration, and that's not what they end up applying for, that is part of the certification that an illustration that matches the application wasn't used. So they would sign that certification that says, "I didn't get an illustration that matched what I applied for," and they'll just get one at issue.

Mr. Foley: Right. Yes, that's OK.

From the Floor: I just wanted to clarify if that practice was accepted.

Mr. Foley: It is for me.

Mr. Dreyer: At an earlier workshop, it was suggested that the minute you even talk about a nonguaranteed element while taking the application, you need to get a signed illustration and that causes a whole lot of problems.

Mr. Foley: This gives you some indication of the divergence of opinion out there, which isn't going to get us to a nonforfeiture re-do anytime soon. Bill represents one camp, and there are a number of people who would represent significantly different viewpoints. There are several things, as Bill indicated, that we didn't even talk about at this session with regard to nonforfeiture.

From the Floor: I just wanted to make a comment or two relative to the discussion on annuities because of some concerns that have surfaced in that regard. Some pertain to compliance with the Insurance Marketplace Standards Association (IMSA). Some of you may recall that there's a question in the IMSA questions

having to do with determining what appropriate product and parameters associated with that product are being sold to the consumer. People have a pretty good idea of how to deal with that with regard to life insurance, but one of the things that we've discovered on annuities is that companies, in general, are doing almost nothing to determine the appropriateness of what is sold to a consumer when an annuity is purchased. The general concept is, if someone's willing to buy it, it must be OK. And that's something I think we're going to have to take a good look at.

You mentioned replacements, and replacements on annuities is an issue that, as far as I can tell, no one is looking at. When an individual has a product and they outlive the surrender charge, and now an agent encourages them to discontinue that policy and purchase a new product with a new surrender charge, that raises some significant issues that we're going to have to look at.

You raised an issue about things that make your blood boil, specifically the companies that are offering different products with different compensation levels and different outputs as a result of that. One of the real concerns I have about our industry is that there are still too many instances in which companies do not view the policyholder as the customer, but view the agent or the producer as the customer. That's what that product reflects. The company is looking at the agent as the customer, and the policyholder as simply the vehicle by which to accomplish those purposes. We won't turn around the overall attitudes and approach to the products that we sell until we turn around that particular viewpoint on who we're there to serve. As soon as we look at the policyholder as the customer, I think that will change.

Mr. Foley: Replacing annuities after the surrender charges have gone to zero, I understand, has a major effect on company profitability, and more than one actuary has said that that makes selling annuities nonviable, so there are all kinds of reasons to look at that.

I started talking in January 1996 about disclosure of EIAs. Declared-rate fixed annuities and variable annuities are relatively simple to understand, relative to EIAs. As for EIAs, if you've seen one of them, you've seen one of them. So they're tremendously difficult to understand, from a consumer viewpoint. I know any of you who have worked with those wrestle, just like I do, and try to figure out all of the nuances and all of the new designs that are going on out there. First, think about a consumer having any chance of understanding how the products work. Second, the recent activity on the market is a prime example of this. Think about most small investors in this country today, and what their thoughts are. They need to sell, right? That may be absolutely the worst thing to do if they have an equity-indexed product. So the products are very difficult to understand, and it's very

important that they do understand how they work in order to make them work for them. Agents don't understand them, many companies don't understand them, and consumers don't understand them. Outside of that, we're doing all right.

We, in North Dakota, have been trying to raise the bar on disclosure of these products. We have not approved any since March 1996. There were three companies that got in before we discontinued that, and two of those, and maybe the third one, have now withdrawn their products from North Dakota. Bulletin 97–2 that was distributed August 1, 1997, lays out what a company has to file with our department for us to even consider these products. We may have one that's close to meeting those requirements. Class-action attorneys have told me that they are now making long lists of reasons why, two or three years from now, this product is going to be at the top of their lists. Based on the market conduct activity that we've had in the last five years in this industry, I don't know why we wouldn't be doing everything we can to go out of our way to make sure that consumers understand these products. I just can't understand it at all. The disclosure documents that are sent to our state for these products are woefully inadequate. I gave a talk several months ago to an agents' group in Bismarck, and at the end of the talk, an agent in the back of the room raised his hand and said that he talked to a potential consumer the day before who had just bought an EIA. He asked this consumer what the agent told her. She said, "He told me that, for sure, I was going to earn 3%, and I'd probably earn 14%." That's the disclosure that we have going on out there for EIAs.