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Current Issues In Sales Illustrations

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The new National Association of Insurance Commissioners regulations for sales illustrations are rapidly being implemented in most states. As actuaries become more familiar with these new requirements, various technical and operational challenges are now apparent. For those individuals serving as illustration actuaries, developing an effective strategy for fulfilling these new responsibilities is crucial.

Mr. John D. Branscomb: We all know of companies (and I'm sure you don't work for them, but you may know someone who does) that have made major changes in their pricing or product design in order to comply with the new regulation. May we have a show of hands? About 25%. We may come back to that later, and you may want to comment on what the major changes have been.

I will introduce the three speakers now. David Karo has spent the last 20 years working as an actuary dealing with illustration systems and computer software. His initial experience was in the product development area of several life insurance companies. He was responsible for pricing universal life (UL) products and programming in-house illustration systems. He was also very involved with state filings and compliance issues. In 1992, he joined ECTA Corporation, a leading provider of Windows-based life insurance and annuity illustration systems, and Internet and client/server solutions. At ECTA, David has worked on numerous UL and variable life illustration systems and has provided interpretation of pertinent regulations. Earlier this month, ECTA became Navi Sys after merging with Genelco and Beacon Software.

Woody Richen is vice president and financial actuary for individual insurance at Standard Insurance Company in Portland, Oregon where he has worked for 25 years. Before that, he was an assistant professor of math at the University of Michigan. He chairs the Society Task Force on Sales Illustration Practice Notes and develops practice notes for the AAA on the subject of this session.

Hal Phillips became an FSA in 1958 and is celebrating his 40th year as an FSA. The SOA recognizes you at 35 years for longevity, and Hal is eagerly awaiting for the festivities to begin that they must have planned for his 40th year. As a senior life actuary with the California Department of Insurance, he implements regulations and bulletins, and reviews legislation impacting the department, which helps to formulate a department position. He provides input to the NAIC in his development of model regulations and laws. He enforced the yield and net cost comparison measure, which California had for about three years, and now the illustrations law that became effective July 1, 1997. Prior to that, he spent many years in the industry as a product, pricing, and valuation actuary.

Mr. William H. Phillips: I'm going to have you listen for a few minutes. I have a theory that the difficulties the life industry faced with illustrations, including the billions lost in lawsuits, stemmed from the lack of understanding of what a scale of illustrated dividends or nonguaranteed elements is and is not.

I have assumed there was consensus, at least within the actuarial profession, on the definition of an illustration. I'm not even sure of that today. A solution to the illustration difficulties lies, first, at getting at the heart of a problem. The problem, in my opinion, is lack of understanding of the definition of an illustration. The solution lies in educating the actuarial profession, companies, sales force, and the public on what an illustration is and what it is not. I place a large share of the blame for the difficulties in the industry with our profession for not initiating and carrying through such education, but it's not too late.

The only definition in actuarial literature appears in 4.2 of *ASOP No. 24*. A sales illustration is simply an extension of the current scale of non-guaranteed elements into the future assuming current assumptions hold to that point. This says nothing about best estimating, most likely results, guaranteeing results, or creating expectations. I keep running across glaring examples in discussions of illustrations not only among salespeople, but financial writers and even actuaries who are in conflict with this simple definition.

For example, in 1992, the SOA Committee on Illustrations spoke of the two uses of illustrations without ever agreeing on or articulating a definition of an illustration. The type ‘B’ use was to project a likely or best estimate to the future performance and compare cost or performance of different policies. It shocks me. The committee seemed to accept this as legitimate even though "Illustrations inherently do not handle type 'B' requirements as well." The best-estimate concept is at total odds with the definition above. The committee attempts to correct this where it stated, "The second use to compare the cost of performance of different policies is to a considerable extent based on the misperception that the sales illustration projects a likely or best estimate of future performance."

Many writers speak of the risks involved with an illustration stating that they should be understood by the prospect. I have not seen these risks defined, but I assume they include the risk of a company paying less than illustrated. The chances of receiving exactly what was illustrated are close to nil if current interest rates are high. Chances are that you'll receive less than illustrated. If interest rates are low, chances are good that paid will exceed illustrated. There's a mention of risk that actuaries will try to quantify; in this case, probably a fruitless effort. I'm not sure that this aspect of an illustration, discussing the inherent risks and explaining them, helps one to understand the definition of an illustration.

These are examples of a transgression of the definition, as I've defined it. The Academy committee reporting on the work about annuity illustrations lists as the first supportability objective, "Ensure that information provided by the company creates consumer expectations for nonguaranteed elements that are not unreasonable." Now, I could have stated that better: "As does not create unreasonable expectations." But better still, I'm not sure that illustrations should be creating any expectations other than that there will be something above the guarantee. I don't believe an illustration should create any expectation because that will only get you in trouble, and it detracts from the understanding of what an illustration is and is not. An illustration does not show what you can expect.

This is the corker, I think. There was a recent article in *Contingency* called, "Was Leo Tolstoy an illustration actuary?" It was very disappointing to me, although I liked the catchy title. It speaks of an illustration as a picture of how a policy is expected to perform over the next several years. It talks of a ledger predicting miraculous performance. It speaks of assumptions having no relation to the real world. All this in an actuarial journal. I have written to the editor. I haven't heard from him yet. These statements are at odds with our simple definition, and only add to the confusion abounding on the subject.

In summary, I believe the NAIC's model, which we have as a law in California, is helpful, but we still have much to do to get at the heart of the problem. My suggested solution lies in agreeing on a definition and educating all the players, including actuaries, companies, agents, and the public in understanding that definition.

Mr. Branscomb: What changes were made by companies when the regulations came in? What did the regulations change? What were you doing before that you are no longer doing?

From the Floor: Illustrating noncertifiable products.

Mr. Phillips: You're saying that the dividend scales for the nonguaranteed elements just didn't pass the self-or lapse-supported test? That they had to be adjusted? In the case that you're aware of, do you know what was responsible?

From the Floor: I think it was inaccurate pricing at the time of product introduction.

Mr. Branscomb: Anybody else?

From the Floor: Hal, do you really think that it's reasonable to get an insurance community to agree on a single definition of an illustration?

Mr. Phillips: I'm very hopeful that we could agree. Actuaries should agree first, of course. If we can't agree and move forward, then I'm really discouraged. Then we're going to have problems forever in the whole business of illustrations.

Mr. Roland R. Rose: I guess one thing that I view as a terrific thing about the illustration actuary certification is the fact that there are many aspects of the certification that will prevent you from developing scales or rates that are just not rational. Most of the time when you go to management about what you're going to do with the dividend scale, you can pay all you want, but nobody is happy unless you can illustrate it. And if you can't illustrate it, people do not see the value of paying that. So there Hal is trying to remove the element of expectation. Basically, it's OK to pay a dividend, but everybody says that's no good unless you can illustrate it. We want other people to see what we are doing and then have them believe that they may be able to achieve the same value with the policy that they buy.

From the Floor: Dave, let me ask you a question. If we adopted the definition that Hal's putting forward or a definition that would say we can't create expectations on an illustration, wouldn't your company be out of business?

Mr. David N. Karo: I'm sure that insurance companies would find some way to market that, but it might make it more difficult.

From the Floor: As far as the NAIC making the rules, all the states adhering to them, and the differences the states are applying, how can you rectify the states branching off from the NAIC model and then expect the companies to turn around the same way?

Mr. Phillips: I'm a state regulator and I guess I'm being paid to support state regulation. But my perception is that our industry in this country can't afford state variations much longer with the globalization of the financial services and so on. They say, "Well, what's better than our current system?" And I say, "I think the NAIC should do it once correctly, and then have all the states comply."

I think our present method is to fight things out. We use the democratic process at the NAIC level and we come up with a model. It's the best that we can get considering things work politically. Well, I never liked the model anyway. I go back to my state and do something different, which I believe is more appropriate. Give the states the right to regulate accounting and valuation, and they will exercise it. It's that simple. And I think we're going beyond the state's rights in that regard.

I think the states should have a word in what the NAIC creates. But when that happens, let's support the position and go on with it so the industry can have one difficult thing to comply with rather than 17 different variations. Of course, we don't always follow this rule. We always agree with the NAIC except when they're wrong. I'll keep saying that.

Mr. Phillips: Can I comment on the previous speaker? I like what you were saying. I think there's a lot of positive in this new illustration era. I think many good things have happened in pricing. Someone said the pricing was all wrong. That's a terrible indictment of our profession. But if pricing is better, that's good. We can pay what we illustrate. That's the hope.

But one of the negatives that I perceive is that in the past, you could illustrate many things and if you paid them, that was a good thing. Under this new regime, you can only illustrate so much under the rules. Why would you ever pay more than you can illustrate? In the past, you could. You could illustrate more and you could pay more. Is any company ever going to pay more? I'm assuming level assumptions. We're not talking about changes in the experience that would justify changes. Assume no change in that. Why would you ever pay more than you could illustrate? You get credit for it at the time of the initial sale. That struck me as a serious negative of the new model, and I don't have an answer for that yet. You're trying to protect the public and the policyholders, and we'd like you to pay what you are willing to pay.

Under the new law in California you can pay whatever you want. It's what you're illustrating that we're concerned about. That's the pie-in-the-sky stuff that evaporates after the sale is made.

Ms. Linda Lankowski: Of course, we have a completely different set of problems because we're regulated by the SEC instead of regulated by the NAIC. One of the things that the insurance department is concerned with is consumer protection, and the fact that actuaries can or cannot agree on what the purpose of an illustration is. Doesn't that mean that what we really ought to be doing is some sort of consumer education? Educate the consumers about what can and cannot be done. All we have now is a regulation that says, "Throw in a million footnotes that tells them that this is what you can and can't do." Everybody ignores the footnotes. So now you change your page numbering to 2 of 14 and 3 of 14 instead of just page 2, page 3, and so on, and you can tear off the footnote.

Has it really helped anything when it comes to having the consumer understand what it is that he or she is getting? I just can't see that as having come out of the new illustrations regulation. It's made it more uniform. Everybody is using the generally recognized expense table (GRET), but nobody is really doing something that they're particularly comfortable with. And I don't see that the consumer is actually helped by this. Would you comment on that?

Mr. Phillips: I agree. I think the regulators were thinking of two or three pages, but those darn things run to 16 pages, and we suspect that if the lawyers got a hold of it, they would make sure every caveat in the world is there so you don't get sued. That was a disaster. I don't know how we can get it back to three pages. I think we should try, but that's what we're stuck with at the moment.

You say the consumer isn't protected. If the illustrations are supportable, then to me a simple answer is where, for example, the current experience continues indefinitely. That's another definition I would put forward. You will be able to pay that scale that you've illustrated. Unless your experience changes, you can, and will, pay that scale. To me, that's a simple definition of supportability. If more of that is happening, I think that's good for the consumer. So there are some negatives. You mentioned one. I mentioned one, and there are probably many others. But there are many positives, too. On the whole, I think it's been a positive development. Others may disagree.

Did somebody say that the negatives are so overwhelming that we shouldn't have bothered? Everyone agreed something had to be done with illustrations. I think the industry agreed as much as we did. You know, this is the product that came out of the legislative method we have in this country. That's how we did it. Could it have been done better? Sure. But that's the best we could accomplish under our procedures.

From the Floor: Do you have any recommendations for consumer education based on your experience?

Ms. Lankowski: I just looked at the company like Mr. Rose referred to that couldn't support their current illustrations; they could not illustrate the higher dividend. The consumer is not necessarily protected against a company that is illustrating different values if the consumer could get a better product that can support a higher dividend because their experience is better. Why shouldn't they have that option of seeing the better illustrations? There are many companies that have had to change their illustrations.

I recognize that there were companies that were having mortality projections, improvement projections in their illustrations and they no longer can have these. For those companies that were competing against those illustrations, that was wonderful.

At the same time, we should be open to more competition. And if one of the reasons that we use illustrations is to compare one company with another company, the fact that The Guardian is no longer going to be able to illustrate something that looks better than, say, Metropolitan or Mass Mutual or one of the other big companies that it is competing with seems to stifle competition. To me, the consumer is not in a better shape than he was in the past. The company had been illustrating a current scale that was sustainable and now it can't.

Mr. Phillips: Why can't it?

Ms. Lankowski: There are all these different rules about what you can and cannot do for expense assumptions and what is allowed and what is not allowed. If you put that all together, you can't necessarily illustrate as much as you can support. It's not always possible. And unfortunately, nobody looked at realistic examples to say, yes, you can or no, you can't. I think it's stifling competition.

Mr. Phillips: I guess I'm not getting your point. Take the mortality improvement point. Everybody has to follow that rule. If The Guardian looks at its mortality experience every few years and it improves, I assume that will be reflected in the dividend scale, and the dividends will be higher than originally illustrated. Interest rates are another matter. So what is the problem?

Ms. Lankowski: Your expense assumptions are quite rigid about what you can and cannot illustrate for expense assumptions. When you're doing a dividend pricing, there are many formulas that you use and there are certain things that constrain you. And the expense assumption is the biggest thing that's causing problems.

Mr. Phillips: Well, most companies use fully allocated expenses which they would be using anyway. On expenses, small companies with very little credibility may not have even done an expense study. They use the GRET table, which tends to level the playing field for companies that haven't done a sophisticated study. It's the best we came up with. You're fully allocated when you got them. You can compete on those. If you're very efficient, your expense assumptions will be very low, and your product will compete.

From the Floor: I have two questions. First, I'm looking for anybody who has a witty answer to what my product manager calls the Actuarial Full Employment Act when referring to this illustration regulation.

The second question is, I'm aware of a company that's possibly looking to act essentially as a broker with life products manufactured by another company. Not a private label deal, but acting purely as a brokerage. And I'm interested whether there are any kind of side issues from our company's perspective or this other company that we should be concerned about with regard to the illustration regulation even though they would not be the actual underwriting company.

Panelist: My recollection of the regulation is that it assigns responsibilities of compliance to the writing insurance company. If this other company acting in a brokerage capacity is acting like an agent, then there are some responsibilities that fall on the agent, but I can't think of anything beyond the normal distinction between the agent and the underwriting company that would arise. But I also would say that sounds more like a legal question than an actuarial question and that ought to be the final authority.

Panelist: So you can relay that back to the other company.

Mr. Rose: In Session #18PD Market Conduct Issues for Product Development Actuaries, a comment was made about watching out for new money products. And the thing that went off in my head was, "What makes new money any worse than a portfolio?" When you think about portfolio, I think about the interrogatories that say, "Well, is this supportable?" and all this kind of information. I think what goes into a portfolio interest rate and the fact that the portfolio interest rate may contain capital gains, and it may have some sort of a fund that's being taken down. For example, in our case, we had too much surplus one year and so we had to spend our surplus through the dividend scale in a gradual way. There may be many companies that have supportable dividend interest rates in their portfolio rates, and there may be a sizable difference between the new money and the portfolio interest rates. What does the consumer know? How do they have a grasp of that? What do you think of the portfolio interest rate problem?

Panelist: If I understand your question, you're saying that the earned interest rate factor in the test that you ran can't reflect the distribution of some excess surplus that you want to spend on current dividends.

From the Floor: No, it does.

Panelist: You can't illustrate it, that's the problem.

Mr. Phillips: I think that's one of the biggest weaknesses in the regulation. You're not required to disclose that today's portfolio yields 8.5% and new money is 7%. What does that imply as far as declining, future dividend scale? I think that's a problem that has to be addressed.

Mr. David L. Metzler: Hal's comment about illustrations not creating expectations is, I think, perhaps idealistic or naive. Clearly, the point of the disciplined current scale is to see to it that those expectations are reasonable. I think that showing anything is going to create expectations. Even if we only showed guarantees, this will create expectations that the guarantees are close to reality.

Another comment was made about not seeing how the insured was protected at first, and then later how it was in the insured's best interest. I think there's a very clear distinction there because I think the illustration regulation works very well. By the way, we fully support it and have implemented it everywhere. I think the focus is on the protection, and so the regulators viewed that it was a worse violation to create expectations that were too high than to end up having to pay less than you would have been willing to pay if you could have illustrated more. So it may be true that the insured may not be always best served, but I do think the insured is protected.

Finally, a generic question was asked about paying more than what you could illustrate. I don't think anybody's going to do that at the front end. They don't need it to get the sales. It's just hard dollar cost with no benefit. Then again, how sensitive is your paid scale to lapses and things like that? You could very well be in a situation where it may be in your best interest to pay more than what you could illustrate on follow-up illustrations. I don't know whether anybody has done that but, certainly, depending on whether you have a portfolio of new money products and what the competition is doing, it could cause that to evolve.

Panelist: The regulation does permit illustrating distribution surplus after the policy is issued, too. You know, there is a provision for that.

Mr. Roger Wiard-Bauer: I just wanted to comment on this paying more than you're actually illustrating. I would just caution everyone that if you do end up in a situation as an illustration actuary, you may find yourself having to do an in-force illustration certification where your high initial cost ends up lowering your illustrated scale so you can still break even by year 15. There's a leveraging effect you need to watch out for when you do your test.

Panelist: Could you repeat that?

Mr. Wiard-Bauer: When you do your initial test—say your new money interest rate is 5.5%. It's the easiest thing to do. If your company decides to pay 6% the first three years, the actual amount being paid is greater than the illustrated scale. When you read about in-force illustration certifications in *ASOP No. 24*, you'll find out that you have to substitute your actual activity in the equations. Because you paid out more early, it has to come from some place if you're breaking even in year 15. So if you paid out early, you can't illustrate in the later years if you're tight at year 15 because you overpaid in the early years. Does that make sense?

Mr. Henry B. Ramsey: I was going to comment on Roger's comment and say that in the occasion where you explicitly apportion surplus, that leveraging effect doesn't apply if you identify that the excess payments—you paid at 6.5% when you could afford 5%—were an apportionment of surplus, and you may intend to pay 6.5% for the duration of the illustrated amount. When you do the in-force illustration period and you do your calculation and find that you are substantially short of passing the test, you can't identify that shortfall as an apportionment of surplus by going through the exercise of identifying that surplus amount.

If you're able to make the payment and you intend to continue to make the payment and there is surplus available to make that payment on an ongoing basis, then there is no leveraging effect. It's just an additional requirement that you state explicitly that you are using surplus in supporting the in-force illustration. Of course, you can't do that on the new business illustration, but the in-force illustration is just spending your bank account. As long as you say so, that's OK.

From the Floor: I'd like to make one comment about the clutter and the footnotes in the illustration, and the fact that the consumers are not well served by that. I'm sure that's true of the footnotes and so forth. That doesn't really lead to the creation of better understanding. I think the numerical summary where you're required to show the midpoint scale does help consumer understanding. In other words, give some idea of the sensitivity of the nonguaranteed elements and the changes in assumptions. You know, there are probably better ways to do it than what's shown in the illustration regulation, but that's a good step forward.

Mr. Forrest A. Richen: I want to spend just a couple of minutes on some illustration actuary issues. Before I do that, how many in the room are illustration actuaries? About a third of the room, I think. Well, this will be a review, and you can probably take me to school on some of these things.

For those of you who didn't put your hands up, how many of you work for illustration actuaries? That's about the rest of you, I guess. Finally, it was mentioned earlier that I have chaired a task force on illustration practice notes in support of the *ASOP No. 24*. Most of our work, or virtually all of our work, has been conducted by telephone.

I know there are a couple of members of the task force in the room, but there are some whom I haven't met. So I'd like to have any members of the task force identify themselves. Hank Ramsey is one and Joan Hinschel is another. So if you have any other questions at the conclusion of the talk, you can ask them as well as me, and we'll try to help.

The key actuarial challenge for the illustration actuary is determining a disciplined current scale. That is a scale that passes the self-support and lapse-support test. Now, these tests are similar to other actuarial pricing or projection activities. You simply determine the policy cash flows using policy values, and carefully chosen experience assumptions. You accumulate these values using the earned interest rate factor that you developed very carefully. You check to see whether the accumulation that you've made exceeds the illustrated policy owner value in years 15 and later, or years 20 and later, in the case of survivor life policies.

Now, this all sounds simple enough, but, of course, the devil is in the details. By practice note, the task force received questions from many sources about these details, and they developed responses. We published one version in 1997, and there will be a revised version published later this year. These questions and answers are intended to be descriptive of current practices. They're not authoritative. They do not extend the standard. But they're supposed to be helpful for actuaries needing to deal with the standard. They're available by mail from the AAA or you can download them from the SOA Web site.

Some issues were raised in *ASOP No. 24*. I'd like to comment on a couple of these that extend from the work with the practice notes or my own experience with my company. They are really three issues that I'd like to mention to try to peak your curiosity or elicit some comments.

The first issue has to do with aggregation or shifts in distribution. The standard says in part, in Section 5.3.2 that "The illustration actuary may test in the aggregate. But the assumed distribution underlying the aggregation should be based on actual experience recognizing that shifts in distribution may occur toward portions of the business that do not meet the self-support test." So any time, you're doing any sort of modeling activity, you need to decide how refined or how coarse your model is going to be, and then try to conduct the test and make sense out of the results.

There are a couple of product features that highlight this problem. Traditional products have gotten flexible enough with the different sorts of dividend options and economatic type dividend options or riders, and dump-in type riders have almost as much flexibility with a traditional product as do UL-type products. So, when you make the decision of the relationship of base policy to rider and how heavily funded it is, you have to think, does it run more like term insurance? Or is it run like a cash accumulation? It means there's really a whole continuum of potential sales that you need to look at that require either an awful lot of time or some shrewd judgment to get that down to a manageable task.

We have a similar problem, of course in a more native fashion, with UL where there's the flexible death benefits and flexible premiums. A product that we sell happens to have a fairly sizable gain for mortality in relationship to the gain for interest. We ask ourselves, "Do we have to test the extreme case of a heavily funded policy where we're sort of minimizing the gain? Or can we aggregate that with policies that are sold more like term insurance?"

Another issue is making commercial software work for you. I'm not going to name any names, but we do use commercial software and, by and large, it's very good. We use pricing software and we can configure it in such a way that it will conduct the self-support and the lapse-support test. It also works well on base policies with dividends paid in cash. There's not much challenge there. But it's true for us, and I expect it's true for most of you, that the marketing department wants you to come up with a super-creative product design so that you can differentiate your product from every other product that's on the street.

Sometimes getting those creative product designs into the software and working reliably can be a challenge. I don't know what your experience is, but ours has been that you can put in what you think is right, and then you can tweak one little assumption and that can change a breakeven year from 15 to 6. Because that's not reasonable for a certain change in assumptions, you're stuck with determining whether it was a software problem, some unintended change in the other assumptions that you made, or whether there's something else in the process that you're using.

The other issue that is a challenge for illustration actuaries is selecting assumptions. Section 5.3.3 of *ASOP No. 24* reads, "Actual experience of an experienced factor class means experienced and past trends to the extent that they are current, determinable and credible." It doesn't really define those three adjectives, but I think we sort of know what they mean.

In Section 5.3.4 it does go on to qualify this a little bit further by saying that "favorable trends may not be assumed to continue beyond the effective date of the disciplined current scale." And similarly, the illustration actuary should recognize unfavorable trends up to the effective date of the scale. So it sounds sort of like projections of any sort, favorable or unfavorable, beyond the effective date of the scale, are forbidden.

In the practice notes there are many questions and answers about selecting assumptions. I think the most interesting ones have to do with dealing with extraordinary events—things that create a blip in the radar, so to speak. If you have the cost of a new computer system, a big administrative system, that may influence your expense levels for two or three years. Or you might have a bad year or the home office could burn down, to cite a ridiculous example. Dealing with those situations and finding ways to smooth them is a real challenge just like setting other sorts of assumptions and projection activities.

From the Floor: Nobody has mentioned two-tier products. How are they meant to be tested?

Mr. Branscomb: Is there anyone here who has a two-tier product who would care to comment?

Mr. Richen: This was a question that the task force did address, and our answer was published over a year ago in the notes that are official. There was a very critical letter from an actuary who wrote that we missed the point completely. And our answer got into technical issues having to do with conducting a test when there are multiple tracks that a policy might run on, where you might be willing to use accumulation value if benefits are taken in cash, but a different accumulation value if they're annuitized.

The comment from the actuary was that although we may have handled the description of how to conduct a test accurately, the point of the problem was that these products are being sold highlighting the higher accumulation value—the accumulation value that nobody will ever get in cash because you can only get it if you annuitize. So there was a disclosure issue that our answer failed to address. We don't offer a two-tier product, and I don't believe I've actually ever seen an illustration for one. So I think I'm capturing the spirit of the letter properly, but I don't know if it's 100% accurate.

At any rate, our answer to him was that it really ended up not being an actuarial problem. The illustration itself doesn't deal with the disclosure issue adequately. I'm sure there are probably other potential problems like that out there. This is not the last word on how to discipline yourself for illustrations.

From the Floor: Hal, has the California department had any questions on the two-tier problem? Has that come up at any of your meetings?

Mr. Phillips: Yes. I think he has covered our concerns.

Ms. Carolyn J. Eddy: I agree with the comments regarding education and the midpoint scenario. In fact, we would put it in the tabular section if that were ever possible so that when they point to it, they see what can happen if things go up or down. Many situations arose with consumers being unhappy because things aren't serviced. They're sold something. That's the only thing they see. The only time they're contacted is when their policy is about to lapse or they have to pay more premium. So I think in-force illustrations are the key, and I know that the model kind of hints at it with the message. They try to scare customers into requesting an in-force illustration. I think the key is to get automated in-force annual projections. I realize that it's extremely expensive for most people and not that do-able, but it is something that I think the industry has to go towards.

I'm not saying it has to be 16 pages. I think people can understand that things go up and down. But they don't see what happens when it goes up and down until it's down, and then the company is requesting more premium or the values are just too low and it's too late for them to get their policy back on track.

From the Floor: Am I correct? I believe I'm correct that the UL model regulation came out a number of years ago, but had only been adopted by very few states. Didn't that require an in-force projection or an in-force illustration?

Mr. Karo: You're required to offer it.

From the Floor: You're not required to supply it automatically.

Mr. Phillips: You can supply it. Many companies do, but you're required to offer it, and you're also required to inform customers of an adverse change in nonguaranteed elements.

And I've been having quite a discussion with a company. They sent me an in-force illustration, and I had many questions about it. They stated that they had changed their mortality assumptions to be much higher. And my simple question was, "How much and what effect will it have?"

I thought the regulation should require the filing of an illustration for every new form but that didn't go through. On your state variation list, if we're concerned in any way about a company's illustrations, we can ask them for an illustration and how they are handling their notice of adverse changes. You can't just say, we lowered the interest rate. What effect will this have? One of the objectives of the law was to prevent being clobbered when you need to pour money in or you're about to lapse.

Mr. Mark A. Milton: My question is more administrative in nature. The regulation requires that if an illustration is used at the point of sale that illustration should get signed at that point, and if not, a waiver form should be signed. But my company has a program where we'll actually run the illustration for an agent if he or she has a waiver signed initially and sends it in.

Occasionally, we have an agent who just forgets to send in either one. Mr. Phillips, what would you do in that case? Would you send the application back? Would you immediately send out an illustration? Would you fire the agent? What is the current acceptable practice?

Mr. Phillips: I'm not sure that I fully understand your question. They signed a waiver and you're required to provide the illustration, at the latest, when the contract is delivered. If you provide it at that point, don't you comply with everything?

Mr. Milton: This is a case where the home office gets an application, but doesn't get a signed illustration and doesn't get a waiver either. The agent just happened to forget on one particular case. This is hypothetical, by the way.

Mr. Phillips: Call the agent and ask him or her what his or her intention was. If you sent out the illustration with the policy, I think that essentially complies. But I have to study your question a little further, I guess.

Mr. Branscomb: Does anyone else have an issue like that?

From the Floor: If you're not tracking that, maybe you don't even know. We have automated systems that let us know.

Mr. Branscomb: Let's take a poll. How many of you would send the application back? What's your company's practice?

From the Floor: Twenty percent.

Mr. Branscomb: How many of you would immediately send out an illustration? Less.

How many would call the agent and agree to hang on to the application if he or she would run right out and get the waiver signed? How many of you would just go ahead and process the application and deliver the illustration when the policy is delivered, assuming that it's issued, and keep your fingers crossed?

Mr. J. Lynn Peabody: I'd send it to my manager.

This is one of those practical situations where when you combine what we're trying to do with illustration actuary issues and market conduct issues. For instance I think that this may be one of the issues that is going through the Insurance Marketplace Standards Association (IMSA) process when you're coming up with examples of how to certify, or how to answer yes to the question of how you're protecting yourself against certain situations. It may very well be something that has been either addressed or possibly even documented.

Mark's company has gone through the IMSA process. So that's one of the things you can bring up to the certification people because I think that's a practical issue. It's not something you just can answer in every situation. I think that's maybe a way to kind of tie the IMSA process in with the practicalities of being an illustration actuary.

Mr. James R. Thompson: Regarding the issue of credibility, one rule I use is that because most companies review their dividend scale every three years, you take the last three years of average investment income or expenses.

If a company buys a new computer system, does anyone know of an accounting rule for amortizing a system's use? Could that be used as a precedent for what we do?

Mr. Phillips: I certainly don't know the rules, and I can't quote the question that came up in the practice notes, but I believe one of our answers had to do with spreading that expense over the estimated useful lifetime one way or another.

Mr. Phillips: That's, personally, what I would do.

Mr. Robert A. Marks: We purchased a new life and annuity administrative system recently, and we developed a financial model as to how much it would cost us to not only purchase the system, but to implement, convert, and so forth over to the new system. I believe we used a ten-year amortization period for that.

Mr. Marks: We also service the payroll deduct market. That's our primary focus. I believe there was a nonterm group life provision in the law. We went ahead and did not try to circumvent our sales practices within that provision because of some of the comments that Tom Foley had made at a session that I was attending about a year ago.

In a simplified issue underwriting environment, how many companies sell individual life products in a payroll-deduction environment where you typically have maybe 15 or 20 minutes to make a sale? How many of you use the nonterm group life provision? Or how many of you actually just go ahead and get any acknowledgement form signed waiving the illustration requirements at the point of sale and only show guaranteed elements? How many of you go ahead and do a full-blown illustration in that type of a sales environment?

From the Floor: My question back to you would be at the point of sale on your sales process, do you actually show a sample age 35, male, nonsmoker type example to each prospect, have him or her sign an acknowledgment form, and then provide a sales illustration with the contract delivery? How do you go about doing that?

From the Floor: You do go ahead and give a sample showing current type values projected based on the current discipline scale, and then you give the full-blown illustration at the contract delivery? I think that's in compliance with that section.

From the Floor: Previous to that meeting (about a year ago) Tom Foley had addressed that issue. He indicated that if you would meet with his people individually, not in a group type session, but individually, that the nonterm group life provision is not intended for that type of a sale. You should be using whatever the provisions would allow not using nonterm group life as being an exception.

From the Floor: Does your company have a rate card that shows ages 21 through 65?

From the Floor: Ages 20–65.

Mr. David N. Karo: I'm first going to go over kind of an up-to-date synopsis of the state-approval process of the illustration model regulation. Twenty-four states have adopted some form of the model regulation as of this date. In that twenty-four, I'm also including Michigan, which I'll discuss a little bit later. Eleven states expect to adopt the regulation by January 1, 1999. The 15 remaining states have taken no action to date, or have no plans to adopt the regulation.

Just in passing, Canada does have an illustration regulation that varies by province. So Canada and the U.S. have taken different approaches. I don't know whether or not anybody here is doing business in Canada.

I'm going to try and go over some of the more significant points, in my opinion, of some of the state variations. These are just some of the highlights. For example, Illinois requires the actuarial certification to be turned in by December 31st of the year that you're certifying, whereas in the model regulation there's no mention of the date when it's due. So Illinois has tightened that up a little bit, but it's something to be aware of.

Michigan is a special situation. Michigan has no plans to adopt the model regulation. However, for traditional products, in Michigan you can use the model regulations format complete with midpoint columns without any problem. For interest-sensitive products, you can meet the requirements of Bulletin 95-04, which is the Michigan Report with the format of the model regulation, but you cannot show midpoint illustrations in Michigan. Michigan is in the process of passing House Bill 5535, which will effectively allow you to illustrate midpoint scenarios in that state.

Missouri excludes single premium products from the regulation. You can illustrate them however you want. You don't have to follow the model regulation.

New Jersey has prepared a draft of its regulation. In New Jersey you can't show certain activity on either the numeric summary or the tabular summary. This activity must be shown in the supplemental illustration.

In New York, persistency bonuses can only be illustrated if they're guaranteed. Any illustration based on suspension of premiums must be presented in conjunction with the full-pay illustration. You can do that using either a combination of the basic and a supplemental illustration, or you can produce a special disclosure document, which is detailed in Attachment A of the handouts.

ATTACHMENT A

New York Regulation 74 Section 53-3.3 Standards for Basic Illustrations

(f) An illustration that shows a contract premium based on current or median policy cost factors or current or median dividend scales which permits a suspension of premium payments prior to the maturity or final expiration date shall be presented only in conjunction with another illustration setting forth a continuous premium payment pattern based on current, median and guaranteed policy cost factors or based on current, median and zero dividend scales for the contract premium. As one alternative, an insurer may utilize a single basic illustration showing a suspension of premium if the numeric summary shows premium payments payable to a specific policy year on a current, median and guaranteed basis. As a second alternative, the insurer may use a single basic illustration depicting the full contract premium being paid for the period required under the policy with both a full pay and abbreviated-pay values included in the numeric summary. As a third alternative, an insurer may elect to use a disclosure document, in conjunction with the supplemental illustration, to be signed by the agent and the applicant, which explains in narrative form that: the requirements to pay policy premiums are not canceled, forgiven or waived; the operation of the suspension of premiums is contingent upon current non-guaranteed factors remaining unchanged, which may or may not occur; a brief description of the factors; and hypothetical examples for issue age 50 with reduction in the current non-guaranteed factors of 25% and 50% as well as an example which shows the need to continue premium payments in order to maintain the policy in force beyond the illustrated premium suspension date.

In addition, the insurer shall provide with any illustration showing a suspension of premium:

(1) a statement displayed in a prominent manner that this illustration is not for a Paid-Up Policy or a Guaranteed Limited Premium Payment Policy;

(2) for a fixed premium policy subject to Section 4232(b) of the Insurance Law, disclosure that the policy, after suspension, continues to require monthly cost of insurance and expense charges, and interest credits, but any changes in current policy cost factors may result in a need to continue premium payments or to resume premium payments, which may be greater than the initial annual premium; or

(3) for a participating policy, disclosure that future dividends may be less than those illustrated which may result in the need to continue premium payments or resume premium payments after an initial suspension of such premium payments.

Just out of curiosity, is anybody's company or a company they know of using this special disclosure document in New York? The Guardian, OK. That's one company that's responding. I don't know whether it's not a well-known fact around here, or just that people have not gotten around to that yet.

People are forever asking me about the Texas regulation because it and its variations have been looming large for so long. There are still a few differences between that regulation and the model regulation. For instance, nonguaranteed rates cannot increase from year to year without a corresponding increase in the guaranteed rates. There is also a fairly obscure proposed amendment to the regulation in Texas called the Proposed Concept Illustration Amendment. It stipulates that if you're illustrating concept illustrations, other than split dollar or executive bonus, and are using a supplemental illustration, a special disclosure document similar to New York's must be used. The entire text of that amendment is very confusing, and some of the allowable methods of disclosure will be chased out by the year 2,000. So I really expect that this amendment is going to evolve over time as people get a chance to read it and make comments on it.

I'd like to see what kind of experience the audience has had with implementing the illustration regulation. Of course, my first question would be, What are companies doing in states where the model regulation hasn't been approved yet? The most common answer I'm expecting is that they're showing the model regulation whether or not the states have approved it. Let me see a show of hands for the companies that are doing this—showing the model regulation format in all states. It looks like maybe 60% of the room. How many companies are using whatever format they used previous to the model regulation in those states? Maybe 20%. I'm assuming that most of those people who raised their hands may be supporting two systems: one to produce a model regulation format, and then an older system that produces the other format. I see some heads nodding in agreement. Is anybody else taking a different approach? Let's see the hands. So I guess, based on the lack of raised hands, that the rest are unsure.

I have heard comments from clients about the implementation. They're having a hard time understanding all the different state variations. They're finding it very difficult. Because of all those differences, the lawyers are really having a field day, and their compliance departments are just going to town. They are required to produce so much disclosure that it's making the illustrations extremely long and unwieldly.

Also, some people commented to me that for variable universal life they're taking a kind of proactive approach—they're trying to take the philosophy of the model regulation and extend it to their VUL illustrations. When we get into the discussion segment, I'd be interested to hear anybody's particular comments on any individual implementations and what kind of hurdles they've had to go through to get their systems out there.

Is anybody in the audience is illustrating premium taxes that vary by county? That's what I expected, no hands. However, we have a few clients that are doing that, and there are currently four states that I'm aware of—Alabama, Kentucky, Louisiana, and South Carolina—where the premium tax varies by county. It's not a huge difference, about 0 to 15 basis points, but if you find yourself in a large case competitive situation, that could cause a large potential impact. So that's something to think about.

Another hot topic lately has been illustrations—either past maturity or past attained age one hundred. Companies are handling that by not charging any expenses or administrative fees. They're just crediting interest: some on just a guaranteed basis, others on a current basis. They're not allowing any loans, withdrawals, or any other sort of policy changes after that period of time. Let me tell you about a few regulations that are significant. California does not allow cost of insurance deductions past the attained age of one hundred. New Hampshire has a maximum cost of insurance rate of a dollar per dollar of coverage. If any of you have contemplated doing that sort of illustration, I'd like to hear about your particular models and how you plan to illustrate that.

The previous session, at this meeting, 18PD Market Conduct Issues for Product Development Actuaries, discussed IMSA in much more detail than I'm prepared to discuss. But I'd like to see a show of hands of how many people are with companies that are either in the process of or have implemented IMSA. Wow! That's at least 70%, I would say. During the discussion period, I'd like to hear what you think—whether the process is worth it, whether the clients are really going to care about that, or any other kind of comments about IMSA in general.

In Attachment B, I've also included a little bit of information on the draft for the replacement regulation just to get everybody up to speed on that, and to alert you that this is really going to affect every illustration that you put out there. Even if it's not a replacement, there's still a disclosure form that the agent and the applicant will have to sign either stating that it is a replacement or that there's no replacement activity at all going on. So you have to be aware of that regulation. I'd like to open it up to the discussion now.

ATTACHMENT B

Insurance and Annuities Replacement Model Regulation

1. Purpose is to regulate the activities of insurers and their producers with respect to the replacement of existing life insurance and annuity policies.

2. Protects the purchasers through disclosure, it also limits the opportunities for misrepresentation and establishes penalties for non-compliance.

3. Exemptions
   a) Credit Life
   b) Group Life or Group Annuities where there is no direct producer solicitation of individuals.
   c) Contractual changes to existing policies or the exercising of a conversion privilege.
   d) Employer pay-all life insurance coverage.
   e) Existing life insurance that is non-renewable non-convertible term coverage expiring in 5 years or less.
   f) Certain pension plans covered under ERISA.

4. Duties of the Producer
   a) Must submit to the insurer a statement signed by the applicant and the producer, indicating whether the applicant had any existing policies. If there were none then the producer's duties are done.
   b) If there are existing policies, the producer must read a form about replacements to the applicant and leave it with them. The form must be signed by the producer and the applicant, and must list all policies being replaced.
   c) Copies of all sales materials must be left with the applicant. If an on screen presentation is used, printed copies must be given to the applicant no later than at the time of contract delivery.

5. Duties of Insurers Using Producers
   a) Must establish a company policy on replacements and ensure compliance.
   b) Must be able to produce records for each producer, upon request, for the Department of Insurance. Records detail replacements as a percentage of sales.

6. Duties of Replacing Insurers Using Producers
   a) Within 5 business days of receiving an application indicating a replacement, the existing insurer must be notified. The existing insurer may request a copy of the illustration used in the replacement process. That request must be filled within 5 business days.
   b) Must provide a 30 day free look and unconditional refund of all considerations paid on all replacements.
   c) Allow credit for the time elapsed under the replaced policy's incontestability or suicide provisions, up to the face amount of the existing policy. For financed purchases the credit may be limited to the amount the face amount of the existing policy is reduced to fund the new policy. This provision applies to transactions where the replacing and the existing insurers are under common ownership.

7. Duties of the Existing Insurer
   a) Within 5 business days of receiving notice that a policy is being replaced, send a letter to the policy owner telling them that they can request an inforce illustration or a policy summary. That information must be provided within 5 business days of receiving the request from the policy owner.
   b) Upon receipt of a request to borrow, withdraw or surrender any policy values, the applicant must be sent a letter explaining the effect on the non-guaranteed elements, face amount and surrender values of the policy being replaced.

Mr. Branscomb: Do any of the 70% who were involved with IMSA want to give us their thoughts of how that's working? We'd like to hear both the pros and cons.

From the Floor: Regarding IMSA, I'm aware that the downside of it is all the work that is involved. I know from our experience it requires many hours. And I would guess that it's too soon to tell whether there's any advantage out in the marketplace. Does anybody have an anecdote or two that suggests that, at this early stage, there is an advantage or disadvantage?

From the Floor: Yes. When the model regulation started coming out, it seemed as though one of the things that our company took pride in was the fact that we wouldn't need to change any product development practices with respect to the new model illustration regulation. So that was viewed as a positive.

From what I see of the description of IMSA, it still seems like it's basically what a good and successful company should have been taking pride in doing all along. I think if you're not certified yet, you should do so now, because if you're not going to be certified, it's going to be just a step backwards for you.

Mr. Karo: That may or may not be true. I guess my feeling on that is it just depends on the consumer's awareness. Consumers may have no idea whatsoever what IMSA is or what it stands for. If so, then they're really not going to be all that impressed by that Good Housekeeping Seal of Approval sort of thing.

From the Floor: Regarding IMSA, within the last couple of months, I've heard, I guess, what I would call a rumor, regarding rating agencies view on IMSA certification. Specifically, if you aren't certified, it could be a couple of negative notches against you. I was wondering whether anybody here might be from a rating agency or whether anybody else has heard anything like that.

From the Floor: It would be viewed as a negative if they weren't certified rather than a positive if they were certified.

From the Floor: That's kind of raising the bar.

From the Floor: Right.

From the Floor: This is a separate comment. I think many times the value that we see from some of the things that are done is a retrospective value, as opposed to being able to really see any value in a short amount of time. I think, at this point, companies have spent many, many dollars implementing illustration actuary compliance, and they've spent many, many dollars implementing IMSA certification. And it's going to be a while before we know whether it's been really valuable or not valuable. But having worked with a number of companies who have gone through the process of defending and settling or considering the settlement of market conduct suits, I personally think that if both the illustration actuary and IMSA had been in place ten years ago, some of those suits may have been more defensible than what they are now.

Furthermore, insurance companies have gone under. We have wondered whether they would have gone under if we would have had the investment regulations. The answer is, yes. If we would have had valuation actuary regulations, would they have gone under? The answer is, yes.

Personally, I think that if we would have had illustration actuary issues and IMSA issues to deal with ten years ago, we may not have seen the hundreds of millions of dollars involved in the kind of lawsuits that we've been seeing over the last five years, or three years, and that we will continue to see over the next couple of years. So maybe that's one thing that we'll be able to point to at some point ten years down the road and say, "Maybe we've saved some of those particular situations." That might be a hard-dollar comparison.

From the Floor: Along that vein, I think if they amended the IMSA requirements to put a little bit of enforcement in there, which is one of the things that's been talked about, I think that will also go a long way towards making it a little weightier and helping to defend the company's position a little bit better.

From the Floor: Has anybody had any experience with maturity extension riders? Do you have many people asking you about them?

Mr. Karo: During the last six months, every client that I've talked to has mentioned it. Not all of them have actually gone through with it, but it seems, at least in the marketing community, that it was a hot topic. It poses many potential administrative and systems problems just because many things on the systems end are set up to stop at 100. And then when you start having to go to 120, well, basically everything is broken.

Ms. Lankowski: We just converted an old system from a mainframe to a micro platform. That was one of the things that we did have to look at. It turns out that the company that we bought the business from had done a 16-year age-rate-up on a case. So we had people who were really only 84 and were looking for illustrations, and we had problems with illustrating and administering them.

So it's actually something that we've had to look at seriously from an administration point, too. What do we do with these policies? There is no maturity date that's actually listed in the policy form. We didn't need a maturity extension rider. It just doesn't say anything about maturities in there. And then the question is, how do you charge for that? Do you charge for that? What kind of guarantees do you have after the end of the period? Do you increase the face amount as cash values increase or what? It's quite a complicated issue. I'd love to talk to anybody who has also dealt with that issue to come up with some solutions.

Mr. Branscomb: Hal, do you have anything on the status of the annuity model?

Mr. Phillips: An AAA committee prepared a report dated December 1997. It was verbally updated at the February 2, 1998, Dallas meeting. The Academy is trying to answer the question, how should a company prove by testing that it can support by ability and intent to pay what is illustrated?

Listed under the annuity supportability objectives were the risks that should be addressed: lapse rates too high or too low, disintermediation, credit, hedging, expense, mortality, antiselection, and risk-based capital requirements.

They've identified four methods of testing. At the company level, it's dynamic. At the product level, it's static simplified bright-line testing. This is what we have in life insurance now. There is supportability disclosure. This was an excellent report with many, many hours of volunteer work. They've run a number of tests on three products: vanilla, single premium deferred annuity (SPDA), a first-year bonus SPDA, and a two-tier annuity.

No simple answers jumped out so they have work to do. I talked to both chairpersons, Steve Preston and Barb Lautzenheiser, and they welcome any and all comments and input to the process. Steve encouraged me to make this announcement.

Mr. Wiard-Bauer: I'm involved in the Academy disclosure working group. Hal did a great job summarizing it. There is a report that is being written right now. It has the final touches going on in some places between here and the mainland. But the report will be out next week at the NAIC meeting. There will be updated interim reports from this group, and we hope to make our first recommendations at the September 1998 NAIC meeting.

From the Floor: Does anybody know whether the NAIC will regulate illustrations on separate account products any time soon? Anybody heard rumors? I heard they were going to work on those issues next.

Panelist: I think that's still being discussed. The SEC is starting to do some activity on variable life and annuities. It's still in the very early stages. I haven't really followed it enough to tell you much more. George Coleman of Prudential probably could tell you a lot more. He's not an actuary. He's a lawyer who is involved and who has been following it. And we expect it to come out more at the NAIC meeting because the NAIC life disclosure group is starting to talk with the SEC more about it again.

Mr. Donald E. Fritz: A follow-up question on the potential annuity illustration rule. Any feeling in there yet about when you might be seeing the potential effective dates?

Panelist: That's really a hard one, actually. The negotiations between the industry and the regulators really have focused around buyers guides and disclosure documents. So they have not looked at the format for illustrations, nor have they looked at supportability tests because the Academy is still working on the research for it.

The other thing is the NAIC is very much aware of the year 2000 problem that companies are facing. So certain things are being postponed. The NAIC is pushing back effective dates on things already for other regulations. So I can't give you a date, but I can say that it will happen in the future.