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Up-to-the-Minute News Flash on Regulatory Developments

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Summary: This session provides the most current information on the status of those issues in the regulatory area that impact product development. Professional involvement from the NAIC and the AAA is discussed along with other individual state developments of interest. Potential topics include:

- *Guideline XXX adoption by the states*
- *New nonforfeiture law*
- *2000 CSO—Development of a new valuation table*
- *Late-breaking developments*

Ms. Donna R. Claire: I have invited the two regulators who can provide an up-to-the-minute news flash on regulatory developments for actuaries. Sheldon Summers is an actuary with the California Insurance Department, and he heads the Innovative Products Working Group and the Life and Health Actuarial Task Force, which deals with new upcoming products. He also is a member of the Reinsurance Task Force of the Life and Health Actuarial Task Force. He will be discussing both the regulatory Q&A, always a popular subject, and nonforfeiture issues on certain products. Tom Foley is the chairperson of the Life and Health Actuarial Task Force, which means he's in charge of just about everything regulatory on life insurance that affects us. He's also in charge of the Life Insurance Disclosure Working Group, which is currently working on the annuity disclosure issues. Tom is supposed to talk about Guideline XXX disclosure, nonforfeiture, and everything else that you want to hear about.

Mr. Sheldon D. Summers: I'm going to cover two topics that I hope will be of interest to you. The first concerns certain interpretations of the NAIC life and health reinsurance agreements model regulation. Let me give you a little background information. In September 1992, the NAIC adopted the current version of the life and health reinsurance agreements model regulation. This model, which represented a significant revision to the prior one, was developed by a group of regulators representing California, Colorado, Illinois, New York, and Texas.

One of the principles underlying the model provisions is that surplus relief must be of a permanent nature in order to be recognized in the statutory financial statement. This generally means that only actions under the control of the ceding company such as that of recapture may cause a surplus to revert back to the reinsurer. The model includes the following as reasons to deny statement credit. The ceding insurer can be deprived of surplus or assets at the reinsurer's option or automatically upon the occurrence of some event. There was discussion regarding the inclusion of the words "or assets." The industry advisory group had recommended removing them. However, the regulators left these words in because they were concerned that funds withheld by the ceding insurer or the modified coinsurance (MODCO) reserves would be required to be paid over to the reinsurer and converted to straight coinsurance at a time when this was least desirable. Another reason to deny statement credit is that the reinsurance agreement involves payment by the ceding insurer to the reinsurer of amounts other than from income realized from the reinsured policies.

This ties into the principle mentioned previously. Another principle underlying the model regulation is that the reinsurer must follow the fortunes of the ceding insurer. This means that the reinsurer steps into the shoes of the ceding insurer with regard to the reinsured business. If the business is profitable, the reinsurer may realize a gain. If the business is not, the reinsurer will realize a loss. This provision follows the principle of permanent surplus that was up before. It does not allow the ceding insurer to have its surplus reduced to make any payment to the reinsurer. Only amounts from the income of the reinsured policies may be paid to the reinsurer. This also includes any profit and expense charges.

Another reason to deny statement credit is that the treaty does not transfer all significant risk inherent in the reinsured business, or if there is a significant credit quality, reinvestment, or disintermediation risk, the ceding insurer does not either transfer the underlying assets to the reinsurer or legally segregate such assets. The intent of certain language in the model regulation was to clarify that more than just an accounting of the assets was needed to comply with the segregation requirement. Regulators were concerned that if assets were not segregated, the choice of which assets to sell to pay claims would affect the participation by the

reinsurer in the capital gains and losses. Having the assets segregated was clean and helped avoid the possibility of disagreement between the parties as to which assets to sell.

Another reason for denying statement credit is settlements are made less frequently than on a quarterly basis or payments due from the reinsurer are not made in cash within 90 days of the settlement date. This provision intended that the ceding insurer be paid for all receivables within 90 days of the settlement date. In early 1994, a subgroup of the Life and Health Actuarial Task Force was formed to provide guidance in interpreting provisions of the model regulation. The subgroup developed a Q&A document that was adopted by the Life and Health Actuarial Task Force and sent to its parent, the Life Insurance A Committee, in September 1995 with a recommendation that it be exposed for further comment.

The then chairperson of the A Committee, Commissioner Dwight Bartlett, asked the Life and Health Actuarial Task Force to resubmit it as an actuarial guideline. The Life and Health Actuarial Task Force complied and sent the A Committee proposed Guideline JJJ on December 1, 1995, with a recommendation that it be adopted. On December 6, 1995, the A Committee forwarded the document to the Accounting Practices and Procedures Task Force so that it could be considered for codification by the Statutory Accounting Principles Working Group. It should be noted that the Life and Health Actuarial Task Force subgroup that drafted the Q&A included the same states, and, in most cases, the same state representatives (with the addition of New Mexico), that drafted the model regulation.

The industry has strongly opposed inclusion of the Q&A document and codification. At the request of an ad hoc task force appointed by Commissioner Glenn Pomeroy, a small group of regulators and industry representatives have had further discussions of the issues and in some instances have reached agreement. The Q&A document has been incorporated into *Codification Document Appendix A791*. However, it was removed from the version of A791 that was part of the codification package adopted by the NAIC on March 15, 1998. In taking such action the executive committee directed that the Q&A document be sent back to the Life Insurance A Committee for resolution of four issues that were identified as controversial. The A Committee, in turn, referred it back to the Life and Health Actuarial Task Force.

The first issue deals with the types of treaties to which the model regulation does not apply. One of these treaties is YRT reinsurance. Some regulators believe that the exemption was intended for YRT treaties, which were of one year duration and could be renewed annually. Industry representatives disagree with this view and believe that they are long-term agreements. Why are regulators concerned? It goes

back to the concept that surplus relief must be of a permanent nature if it is to be recognized in the statutory financial statement. If the YRT arrangement can result in a drain of the ceding insurer's surplus, then the surplus is not permanent. How could this happen?

One example would be a YRT treaty with zero first year reinsurance premiums. Upon nonrenewal, or recapture if you view the treaty as long term, the ceding company would be obligated to pay the reinsurer any unamortized surplus relief. If the treaty is kept in force, the seeding insurer may receive less premiums than those it is obligated to pay to the reinsurer. In either case the ceding insurer could be subject to a depletion of surplus. One could argue that there should be no problem as long as the ceding insurer has the ability to charge the policyholder—or the original ceding insurer in the case of a retrocession—a premium as large as the maximum it is obligated to pay the reinsurer.

For example, if the ceding insurer is charging policyholders 70% of the 1980 CSO mortality rates and paying the reinsurer 80% of these rates, it would follow that if the ceding company should have the ability to raise the rates of charges to policyholders up to at least the 80% amount. However, this would still be contrary to what is allowed for other types of reinsurance. It is not a controversial issue that the ceding insurer decides on the cost of insurance rates, and the reinsurer may not charge a higher rate as long as a ceding company is complying with its representation as to how it determines such charges.

The latest proposal to change the Q&A would allow a treaty to be defined as YRT for exemption purposes if it meets one or more of five conditions. I will summarize three of these conditions. One, the maximum reinsurance premium rates are not greater than 80% of the valuation mortality rates. This is a rule-of-thumb condition that would provide some comfort that reinsurance premiums are not excessive. Remember, you only need to meet one of the five conditions in order to get the exemption. Two if the ceding insurer terminates the treaty, it is not obligated to make any payment to the reinsurer. The industry opposes language that allows the ceding insurer to terminate the treaty at any time. Three, the maximum reinsurance premiums are not greater than the premiums charged by the ceding insurer. It should be noted that *Statements of Standard Accounting Practice (SSAP) 74*, as well as Chapter 24 of the *Life and A&H Accounting Practices and Procedures Manual* require that YRT treaties comply with certain provisions of the model regulation. This is even if they're exempt. In California we have used one of these provisions to challenge a company's reserve credit.

The second issue deals with the conversion of MODCO or coinsurance with funds withheld to straight coinsurance. As I mentioned earlier, the group that developed

the amendments to the model regulation did not want to recognize reinsurance credit if a provision existed which allowed the reinsurers to convert a treaty to coinsurance unilaterally or upon the occurrence of some event. However, the proposed change to the Q&A allows such conversion only if the ceding insurer violates a treaty provision or a warranty or representation and refuses to take corrective action. Certain other restrictions also apply. This proposed change is reasonable and should be agreeable to regulators.

The third issue deals with the segregation of assets. The Q&A would not permit assets supporting reinsured policies to be mixed with assets supporting nonreinsured policies. The proposed change would allow such mixing only under very limited conditions. One of these is that the risk characteristics, cash flows, and profitability of the reinsured and nonreinsured business are similar. Another is that assets supporting new issues cannot be included in the segregated asset portfolio if reinsurance does not cover newly issued policies. Although four regulators who discussed this change felt that it did not conform to the language in the model regulation, two of them supported it because they felt it conformed to the spirit of the model regulation.

The last issue deals with the treaty structure known as MODCO with funds withheld. Under this structure the reinsurer withholds the ceding commission from the ceding insurer. The Q&A stated that this form of treaty would violate the model regulation since the amounts withheld would not be paid within 90 days. It rejected the industry argument that such amount was not subject to the 90-day rule because it was not currently due. The proposed change would allow the structure as long as the resulting cash flows were identical to those of a combinable coinsurance/ modified coinsurance treaty. The four regulators are not in agreement with this change because they feel that the receivable is of lower value than having cash in hand. These issues are currently being debated by the Life and Health Actuarial Task Force, which expects to provide a recommendation to the A Committee by the end of 1998.

The second topic I will talk about deals with certain types of policies that can be viewed as having level-premium-term plans embedded within them. These are the same types of policies that are targeted by the NAIC Valuation of Life Insurance Policies Model Regulation, which we all know better as Regulation XXX. The standard nonforfeiture law prescribes minimum nonforfeiture benefits, including cash values which must be available to the owner of a life insurance policy in the case of premium default or policy surrender. Under a level premium structure, a policyholder overpays in the early years when mortality rates are lower in order to avoid paying higher premiums in later years as mortality rates increase. The idea

behind the law is that the defaulting or surrendering policyholder should not forfeit the amount overpaid.

Insurers have designed policies that make them similar to term products but which do not offer the same nonforfeiture benefits; for example, a term product with guaranteed level premiums for 30 years followed by very high premiums. We have encountered policies where the guaranteed premium increases by a multiple of 50 or more times after the initial level premium period. Obviously, most policyholders are not going to pay such high premiums to continue coverage after the initial period. Another example is a universal life policy that has a no-lapse guarantee. If a specified level premium is paid each of the first 30 years, the policy is guaranteed to stay in force during that period. If the policy is considered to end at age 100, the large premiums at the later durations may cause minimum nonforfeiture benefits during the initial 30-year period to become zero. This is a result of the formula for determining statutory minimums.

The California Department of Insurance has taken the position that nonforfeiture benefits for this type of policy must be at least as great as those required for a policy with a term equal to the initial guaranteed period; in this case, 30 years. We have taken the same position with respect to universal life policies with no-lapse guarantees. Because of those guaranteed premiums after the first 30 years, if you apply a unitary approach to determine nonforfeiture values, you get zero cash values for the first 30 years.

We have been and may continue to be criticized for not allowing products to be sold with long-term guarantees. Our response has been that we do not prohibit such products, but, rather, we require that minimum nonforfeiture benefits be provided. In other words, we don't allow companies to circumvent the standard nonforfeiture law through policy design. The Life and Health Actuarial Task Force has been trying to develop a new nonforfeiture law, and I think Tom will talk about that. It is envisioned that such a law would at least initially not replace the existing law but would instead provide an alternative for companies to comply with. Such a new law may relax the cash value requirements that are currently in existence. However, if under the current law companies are allowed to sell policies that not only avoid cash value requirements but also any nonforfeiture requirements, there will be much less incentive for companies to elect to comply with the new law. I will end by quoting our distinguished moderator who in the May 11, 1998 issue of *National Underwriters* in an article on no-lapse universal life policies said: "The controversy is this: Are these allowed under the nonforfeiture law? If an equivalent policy was sold under whole life or term, say a term/life up to age 100, the current nonforfeiture laws would require a cash value. Some would say this is in violation of the spirit, if not the letter, of existing law."

Mr. Thomas C. Foley: We're going to talk about Guideline XXX. Let's talk about the things that have emerged from our the Life and Health Actuarial Task Force and been adopted by the NAIC.

How many of you are aware of Guideline XXX? Does it have a significant effect on your product development activity? You know that Guideline XXX is a valuation standard. In the early 1990s, when it was being adopted, we had what I would call a normal number of risk classes. We recognized age. We recognized gender. We recognized smoking and nonsmoking. Those were the general determinations of class. What has happened now? We have so many classes I can't keep track of them. What's the maximum number of classes that you've heard of from your competitor?

From the Floor: Sixteen.

Mr. Foley: Can anybody top 16? How many of you have heard of ten or above? Eight or above? OK. What's going on? I always thought that insurance involved pooling and that what we do is try to get as many people as we can to pay a premium so that those few who die or incur that contingency get paid. I wrote an article for the *National Underwriter* that came out a week ago. It was primarily on health insurance for senior people, but I also addressed risk classification. As I understand it, and correct me if this is wrong, this is what's driving the current controversy on Guideline XXX. Interestingly enough, there's a person who's involved with a software firm who's been heavily lobbying in every state in the union and spent who knows how much money on paper to try to forestall the adoption of Guideline XXX, and apparently this individual's been successful. However, it appears now that in Wisconsin, Texas, and West Virginia will have an adoption date of January 1, 1999. As it appears that a significant number of companies are licensed in those three states and because of the extraterritorial nature of Guideline XXX, the industry collectively is running around saying wait a minute. We have to fix this. We can't have Guideline XXX adopted as it is as a nationwide standard, the primary reason being risk classification.

Mr. Foley: There currently is a movement in our industry by both small and large companies to fix Guideline XXX. This is driven, as I understand it, by what Wisconsin is doing and what Texas and West Virginia are doing. Are all of you aware of this movement? How many of you are? That's interesting, that many of you would not be. As I said, there's a group of small and large companies that came before the Life and Health Actuarial Task Force in Salt Lake City in March 1998. Basically they said, "The sky is falling. If we adopt Guideline XXX as it is right now, bad things are going to happen to term rates, and, of course, looking at

regulators, since we are the number one consumer advocates of the world, we can't have bad things happen to term rates." They made a preliminary presentation to our group in March about temporary fixes to Guideline XXX, and asked us if we would be interested in putting something together. Basically, we told them because of this meeting we're not having our Life and Health Actuarial Task Force meeting prior to the Boston meeting, which is next week. Anyway, we already had this second quarter's meeting.

I said, "If you want to make a presentation to us in Kansas City in June, two things are necessary. You need to come with a complete program answering all questions, and you need to have universal support for this from all segments of the industry so that if we do adopt it and it gets through the NAIC, there will be support from the insurance industry to get this adopted in states, which has yet to occur." We did get assurances, although they were meek and quiet assurances, that they would come to Kansas City with those two conditions met. As these things go and given the shortness of the time, they didn't meet those two requirements. They talked to us last week. It appears that they still have universal support, but during an hour-long session on Wednesday we said, "There are any number of questions that are going to come up about this redo." We talked about 15-year select factors. It's been determined right now that there's no time to move away from the 1980 CSO Table. We will keep the 1980 CSO in place, but in this case, regulators are going to be the last ones to know what's going on.

We're developing a new 25-year set of select factors. These select factors will still be applied against the 1980 CSO. In order to access these there has to be substantial underwriting. For deficiency reserves, rather than using net premiums, we're going to use illustrated premiums. If I tell you you're going to use illustrated premiums, what does that mean to you? Many people are looking perplexed.

From the Floor: Current assumptions.

Mr. Foley: This gentleman thinks it's current assumption premiums. Any other takers? Illustrated premiums. Don't we have an illustration model in which premiums there are based on the disciplined current scale. Anybody remember that? These are product development actuaries. We're two years into the sales illustration model. There are the discipline current scale premiums. Somebody else said guaranteed premiums. Yes, that's another possibility. We went through in an hour and asked questions about the proposal that the industry was making. They brought back to us the next morning 4 pages with 33 questions that they need to answer about the proposed redo of Guideline XXX.

The timing will get fuzzy. This industry group is going to attempt by August to answer those 33 questions. I know there are many people who are saying, "Wait a minute. The way you've developed these select factors is wrong. We need to develop select factors a different way."

At this point the proposal by the industry is that this redo of Guideline XXX would be prospective only. Their hope is—I have no sense whether this will come about or not—their hope is that in the August–September 1998 time frame of this year they can put together a substantial enough program so that the Life and Health Actuarial Task Force will vote to open up Guideline XXX again at its September 1998 meeting in New York. Then their hope is, by the fact that regulators would be voting to do that, that the individual states (i.e., Wisconsin, Texas, and West Virginia right now, but there may be others in the next few months, that have an effective date of January 1, 1999 on the books) would then say, "Oh, well, if you're going to redo this, then we'll wait till later." Don't go home and say Foley said in Maui that these states were going to wait and adopt this with an effective date of January 1, 2000. I'm not in charge of anything. I don't have any particular influence on the states. If there's anything you should know about the NAIC process versus the state regulatory process, sometimes they're like oil and water. The industry's hope is that by doing this redo and doing everything they can to encourage us to open up Guidelines XXX again, the states will then back off. What we will end up doing is buying ourselves another year, and we will have an effective date, earliest, January 1, 2000. We'll be able to work on select factors and all these things throughout early 1999. Of course, it makes no difference, whether we have Guideline XXX or not because of the year 2000 problem.

From the Floor: I think you described the proposal accurately. You didn't comment, though, on the deficiency reserve proposal, which I think is even more controversial. The deficiency reserve proposal would more or less allow companies to use their own mortality rates to determine deficiency reserve subject to a floor of 40% of these new 25-year select factors. This proposal would probably eliminate deficiency reserves for almost all companies, even those with very aggressive super preferred classes. What do you feel about this proposal, Mr. Foley?

Mr. Foley: There's a real good reason why I didn't bring up that issue. Basically, there continues to be a movement toward allowing actuaries greater freedom and giving them greater responsibility. I espouse that movement significantly. In fact, we will talk about it more in just a few minutes when we review the annuity disclosure and the nonforfeiture redo.

If there's the potential for actuarial review of that work, then I would be generally willing to sign off on that. If actuaries are going to choose 40%, they will have to

justify using that 40%, and their underwriting standards and their monitoring should be such that an appropriate percentage is used, but I'm not 100% willing to let them do that in a vacuum. I want there to be the ability for peer review. We've talked about all kinds of ways that we could have peer review. There's a project to completely redo valuation of life insurance and health insurance and annuities.

In that potential valuation redo we're talking about various ways that there can be oversight of an individual actuary's work. We've talked about a central depository. In fact, they have one of these in the U.K., and they may have them in other places where there is not a government collection of actuaries. It's like a consulting firm, but it isn't a consulting firm. They're independent, and they're available to anyone. They're available to the company. They're available to government actuaries. They're available to all kinds of entities. They're kind of like hired guns. A CEO could say I'm not sure whether we're doing the right thing or not in this given area. Go hire this independent agency that doesn't have any axe to grind to come in and see if we're doing the right thing.

If we could develop such an organization, then I think there would be more impetus for there to be a movement toward giving more responsibility and more freedom to the individual actuary. We've all experienced this—we're sitting at our desk in front of our PC with our pencil and paper, and we're making a decision about product, valuation, or whatever. Every actuary in the world, I hope, has to have going through the back of his or her mind, "If the actuarial God up in the sky could see what I'm doing right now, would he or she approve? Am I doing the right thing? Am I thinking of all the things that I should be?" If we could only have that kind of peer review. Is that a reasonable answer to your question?

From the Floor: Yes. Do you think we should discuss why there has been a big controversy about this proposal?

Mr. Foley: Sure. At this point, it's ironic that the industry knows a whole lot more about this Guideline XXX redo than we do. I've heard 45 minutes on one time and an hour on another. That's all I know.

From the Floor: The industry controversy arose because by using these new mortality tables many of the large permanent insurance writers were afraid these tables may become prevalent tables for tax purposes and would therefore result in the inability to continue selling permanent insurance and the failure of the 7702 test. Some proposals have been made to try to avoid this problem. So far, nothing has been satisfactory to everyone, which is a problem. Anybody who has some ideas on how a new regulation could be formulated in such a way that it would not affect permanent insurance should talk with Jim Reiskytl of Northwestern Mutual.

Mr. Foley: I understand this is a potential stumbling block, and the definition of insurance in the tax code will be violated. We continue to see this happening, and it seems to happen more and more with the tax code, but with regulation in general we can't go where we want to because of some silly thing we set up to keep companies from going this way. This continues to happen, and this is one reason why there are those who say that the Comptroller of the Currency should be the big regulator for all of life insurance or, as Governor Campbell said, the Federal Reserve.

Enough of Guideline XXX. Annuity disclosure illustration had an out-of-body experience a while ago when it asked about the definition of illustration premium, and no one thought of the disciplined current scale. You are all aware that we adopted a life illustration model a couple years ago? Yes? Good. Since that was adopted, the Life Disclosure Working Group has been attempting to put together a corresponding model for annuity. On the degree of complexity, if life insurance is a ten, a fixed annuity is a two, and if you could do a life insurance illustration model, why couldn't you in a month do an annuity illustration model? I asked myself that same question. It's two-and-a-half years later, people. We haven't done it yet, and there's a really good reason why—which speaks to not only the annuity illustration model but the nonforfeiture redo that we're going to talk about later.

We, as an industry, at least for the last 20 years, since the Federal Trade Commission report in the late 1970s—

From the Floor: 1979.

Mr. Foley: We've been embarrassed as an industry at the low return that we've had in our policies. In reaction to that, interest-sensitive universal life, all these new products, were developed. Before that date we had participating policies, some of which really were participating; that is, company boards at the end of the year really would look at divisible surplus, and there would be dividend formulas that would equitably allocate that divisible surplus to policy owners. We had participating policies that really weren't participating; that is, they were just guaranteed policies in disguise. We also had guaranteed cost policies that basically said, "Here it is. Everything's fixed. If things go better than this, we, the life insurance company, gain. If things go worse than this, then you, the policyholder, gain." All that went out of the window when these new products arrived in the early 1980s. I remember I was a chief actuary at a small company at this point in time, and I can distinctly remember believing that with the interest-sensitive products I had to file a guaranteed scale with the state, and I thought I had to send what my current scale is today, and if that ever changed, I was going to have to send it and get approval

again, not unlike what happens with premium rates under health insurance. It turns out, as far as I know, there are two states, New York and New Jersey, that have any kind of after-the-fact filing requirement for interest-sensitive products. Are there other states that do?

From the Floor: Mainly for information.

Mr. Foley: But generally the industry has been able to file guaranteed rates and do whatever they wanted with current rates to the point where, as a regulatory actuary whose primary goal in life is consumer protection we continue to see horror stories. We have a bank in Bismarck in which the bank officers in 1988 bought a bunch of interest-sensitive life products. I'm sure you could tell me what tax reason they had for buying those, but I'm sure they had a good reason. The current interest rate in 1988 was 8%. Last year the president of the bank sent me a letter and laid out the interest-rate history behind these policies. Generally the interest-rate history was 8%, 7.75%, 7.5%, 7.75%, bouncing between 7.5% and 8% from 1988 through 1992. Between 1992 and 1994 the current interest rate went from that general area to 4.25%, and it's been 4.25% ever since.

For well over six months I've been trying to find out what happened with these bank policies. It turns out that the original writing company sold this line of business to somebody else who sold it to somebody else, and I've yet to get to the bottom of the story. Interest rates have gone down since 1988. Have they gone down from 8% to a guaranteed minimum? Probably not. Would that same company be using 4.25% for their current interest rate on new sales today? Probably not. Would there be an actuary who could justify the expense amortization on those old blocks versus this new block as different? Probably. Is that a right thing to do for all policyholders? There are a few companies in our industry who seem to have as their overriding philosophy that they treat all policyholders that we have in a fair, equitable manner. Maybe all companies do this, but it's clear to me that there are a few who do it because they go out of their way when they interact with the department, the regulatory actuaries, to tell us we're making such-and-such change. They don't have to do this. We're making this change for this reason, and we're making this available to all policyholders.

Because I don't hear from the vast majority of companies when this kind of activity takes place, I don't know what your philosophy is, but by examples like the one that I just went through I think you can see that there may be some kind of bait-and-switch activity taking place. This is the primary reason why the annuity disclosure illustration redo has taken so long because we've been trying to get a handle on how can we get information to a consumer about what their expectation should be in renewal years for the crediting interest rate. We have precious little fixed annuity

or even variable annuity business that's sold and purchased in this country to supplement retirement. I'm not sure why that is. I have a bunch of deferred annuities, to supplement retirement. I don't have any intention of doing anything else with them. But I think there are many people who buy deferred annuities in the U.S. today to buy boats put kids through school, or all kinds of tax-deferred reasons where the instruments don't work very well. We've been struggling. If we were to go back two-and-a-half years and say two-and-a-half years from now we're still not going to have an annuity disclosure/illustration model, I'd have said you're nuts. There's no way that's not going to happen. That hasn't happened yet.

Where are we now? We've developed a buyer's guide for equity-indexed products. This was finalized by our task force in March in Salt Lake City. Any of you who sell equity-indexed annuities today, we are asking you to please—and all the industry support groups are doing the same thing—to adopt and use the *Equity-Indexed Annuity Buyer's Guide* with all sales. It's my strong belief that a consumer is best served by getting this Buyer's Guide before the initial sales contact. That leads to lots of logistic problems unless the insurance departments, for example, become actively involved in distributing this, which they may.

We now have a *Fixed Annuity Buyer's Guide,* of which ultimately the *Equity-Indexed Guide* we just talked about is going to be an appendix. That is nearing final shape. In fact, next week in Boston at the NAIC meeting I'm hopeful that we will finally bring that to closure, and it turns out that the Buyer's Guide is going to be the essence of disclosure for annuities. There's going to be a one- or two-page companion document that companies will have to provide that will answer questions that are in the Buyer's Guide. What's the guaranteed interest rate? What are surrender charges? There will be a list of six to ten items for deferred annuities. Illustrations, it appears, will be completely optional for annuities on a sale-by-sale basis. For instance, you can take Annuity A and sell it to Bill and not use an illustration, and then show it to Sally and show whatever illustration you want.

With regard to nonguaranteed elements at this point, the working group's position is to show somebody the guaranteed interest rate, which is guaranteed for all years. You show them the first-year guaranteed interest rate, which generally is higher, and you can show them the interest rate that you would be paying in renewal years, as long as that interest rate is supportable. You might ask what does it mean for it to be supportable? We don't know yet. There's an Academy group that's working on that. Is supportable going to mean the same thing that supportable means in the life insurance model? I don't know. Probably something analogous to that but I don't know. You can show a nonguaranteed element, that is the interest rate that we would pay today in renewal years, without showing an illustration, but if you want to show any other nonguaranteed element, then you have to show an illustration,

and generally the illustration will follow the same guidelines as for the life model, only it's going to be simplified, and I hope we can find a way so that we won't end up with 15–20 page documents as we have with the life model.

Ms. Claire: Could you explain where we are in the supportability?

Mr. Foley: Yes, this will be new to me.

Mr. Roger K. Wiard-Bauer: We're still working on the report, and I've been involved in some of the conference calls. I think they had a marathon four-and-a-half hour conference call to try to get the report done. I'm a member of the Academy Disclosure Working Group, the Academy's Committee on State Life Insurance Issues, and of the Academy's Life Practice Council. I also serve as the liaison between the Actuarial Standards Board (ASB) Life Operating Committee and the Academy Disclosure Working Group, so I'm plugged into the middle of everything. The Academy's been working very hard on this issue, and Tom's described it well. It's a real tough nut to crack. There is a wonderful variety of annuity products for consumers in the marketplace. When you try to start figuring out how to test these products to see if the interest rates are reasonable, it gets to be challenging. We recognize that companies want to and should be able to recognize in their interest rates being illustrated the variations in how they manage things, and the Academy's done extensive testing on this to benchmark work and has literally put in thousands of hours in the past few months to try to identify how to reflect these variations. The key in all this is asset/liability (A/L) matching. For those of you who have worked with the life illustration regulation, you know that there is A/L matching in that regulation. We believe the annuity form of this will need to take on a different twist.

The Academy is preparing an extensive interim report. It will be finished in the next couple of days and released at the NAIC meeting in Boston next week. We've designated these key issues, done a lot of the background benchmark-type work, and identified about six options running from very rigorous, complex, almost valuation-actuary-type concepts to some very simplified methods. They'll streamline tests and give you an easier way to do things more frequently. We're trying to outline those options. The next three months will be a continuation of that work to pin things down to the point where the report in September will have the Academy's recommendations.

We are very interested in people's input, so I would encourage everyone to get a copy of the report. Like I said, it's not quite finished. If you contact the Academy's office next week, I'm sure you can get a copy sent to you. We will be very interested in hearing everyone's input on it. And, again, the Academy is

recognizing the sensitivity of the issues this is touching on because it does get into the A/L matching issue, and it does recognize the different cost of capital. We've looked at the risk-based capital charges, and other things that companies are faced with. Those are reflected in a number of the annuity designs because of the rich variety that's out there in the marketplace.

Mr. Foley: Another key concept that has been developed in the last six or eight months about disclosure is something called balancing language. We talked earlier about actuary freedom/actuary responsibility and company freedom/company responsibility. There are some regulatory people who want to curtail your ability to develop Product X or Concept Y. Fewer and fewer are in that camp. More and more regulators are starting to understand that you're well served and our consumers are much better served if you're able to innovate. What is the price you have to pay to innovate? You have to tell the applicant and a consumer what you're all about. That's where this concept of balancing language comes into play, and I'm going to read you a few examples from an equity-indexed annuity disclosure piece that was submitted in North Dakota to give you a flavor of this. I strongly encourage you to pick up on this when you're interacting with regulators. We don't want to curtail activity with regard to current crediting rates. We don't want to do rate regulation, but we have to find some way that consumers can be alerted to what a company's general modus operandi is because there are some companies that are just out for their own bottom line, and consumers are not well-served. That's our dilemma.

Let's review some examples of balancing language. This again is a fixed equity-indexed annuity. If you anticipate needing any of your money before the end of the seven-year period, we recommend you consider a different product with more liquidity for some or all of your money. If your product doesn't have liquidity, that's fine. There are many times when I'd like to buy a product, and I'm not concerned about liquidity. In fact, if we really are going to get to the point where we're going to provide retirement products for people, liquidity often fights that. You need to tell people, "Don't buy this thing if you're interested in liquidity." Between the end-points of the seven-year period, your annuities value will not be tied if it's a point-to-point product. You take the value of the index at time zero and at time seven. You then compare the two. Basically there's indexing between zero to seven. You just get the guaranteed surrender value.

During the seven-year index period, your annuities value will not be tied to the growth of the Standard & Poor's 500. That crediting will happen at the end of the seven-year period. During the seven-year period your annuity will be credited with the minimum interest rate of 3% compounded each year. This minimum rate of interest times 90% of the single premium, minus any partial surrenders, doesn't

have liquidity. It's tied to the index only at the end of the period. If your original single premium was $10,000, at the end of seven years you would have a minimum surrender value of $11,069. Thus 90% accumulated at 3% takes $10,000 to $11,069. If you surrender your certificate at the end of year 3, you receive $9,835, which is less than the original single premium. It's not a sin to have surrender values be less than what you put in. It is a sin if you don't tell people about it. Balancing language is absolutely critical. This document is full of averaging, and, again, I apologize if you don't know much about what's going on with equity-indexed annuities.

With this point-to-point concept, you can take the value of the index at day zero and at the end of seven years. However, if you take the value of an index on a given day, you run the risk of being in one of those troughs or a daily or weekly steep decline or a spurt. In order to get around that, companies have developed the concept of averaging. Instead of taking the value of the index at the end of the seventh year, you take the average of the index for the last 90 days of the period.

Why do we average? There are advantages and disadvantages to averaging the index values of the last three months. If there's a large downturn in the index at the end of the period, averaging protects you from participating fully in the loss. Conversely, if there's a large upturn in the index during the last three months in the index period, averaging will not allow you to fully capture the gain. So if you're going to tell them the good news, tell them the bad news as well. That's what balancing language means, and I strongly encourage you when you developing marketing and advertising material interact with regulators, policyholders, and marketing people.

Mr. Summers: I just wanted to reiterate what Tom was saying about the balancing language being important. One of the pieces the Academy's Report on Annuity Disclosure and Supportability is looking at is the use of disclosure language either as a substitute for or an addition to supportability testing. That's a different concept, using disclosure for supportability type issues, but the Academy is working on it. It will be in the interim report to a certain extent and will be worked on in the next few months. Disclosure is becoming very important.

Mr. Foley: Speaking of disclosure, for 15 years the Life and Health Actuarial Task Force has been trying to redo the life nonforfeiture law. Why do we need to redo it? Well, these new products that emerged in the 1980s are all formula-driven. Literally, since 1983 the task force has been trying to redo it, and for the longest time that redo involved rate regulation, and rate regulation of the life insurance business is not good.

About three years ago we thought we'd take a fresh approach to this. Many of us that thought that good things were going to happen, but we were wrong. We're still struggling. For the last three years, we have been saying that we have the determination of a nonforfeiture value. We want to give you as a company actuary as much freedom as possible in how you determine that nonforfeiture value. You figure out what is an appropriate ongoing value to a terminating policyholder. Once you do that, you have to explain to the applicant what it is you're going to do, and that explanation comes by way of a plan. This has been our path for three years. And wouldn't you know it? What do you think has been our biggest problem?

From the Floor: Taxes.

Mr. Foley: Taxes have been a big problem because one of the things we've been talking about is that cash values would be optional, and instead of having formula-driven nonforfeiture values, now we have company-driven nonforfeiture values, and cash values are optional. The tax code being nice and flexible speaks to that well, doesn't it? Wrong. There are many people who would contend that the arrangement that the industry has with the Treasury is so flimsy that institute such a system, that inside buildup might be in jeopardy. That's one problem, but that wasn't the problem that I was thinking about.

We can't figure out the plan. We can't figure out how we're going to disclose to policyholders what it is we're going to do. It seems as if the same mantra or the same theme keeps coming up, doesn't it? Not only in the determination of nonforfeiture values have we been concerned with disclosure to policyholders, but also how we're going to credit and charge, and determine current values. That brings us back to the annuity disclosure issue that we talked about. Think about when you design a product, and you determine what you're going to credit and charge. What are ways that you can go about doing that? I compiled a list of six ways that you can go about doing this. We're talking about the general procedure now for charges and credits and nonforfeiture values. One, the company can have complete discretion about how it does that and have no guarantees. I'm not saying you can do that by law today. I'm saying that at one end of the spectrum you can have complete discretion about how you're going to set charges with no guarantees. Second, you can have discretion with guarantees. You can have complete discretion, although mortality charges won't be greater than this. Interest won't be less than that and so forth.

You can also have 4 variations of autopilot. You can put those values on autopilot with discretion—interest rates will be 200 basis points below this index, but I can change the index given these conditions. Or, you can put those charges and credits

on autopilot, but the company still has some discretion about changing things. You can have discretion limited by regulation—I'm going to credit an interest rate, but it can't be less than 4%. Mortality charges can't be greater than x. Discretion is limited by prior approval. I can do anything I want with regard to credits and charges as long as I get approval from my friend, the regulator. Finally, autopilot without discretion—you completely take everything out of your hands. All the credits and charges will not be set at issue, but the procedure for determining them is set at issue. You can have six levels of discretion. We talked about this last week. We are starting to see more of a movement toward autopilot determination. The crediting rate is set based on an index, and if you guarantee the participation rate for a full term, it's out of the company's hands, whatever happens. We're starting to see cash values and nonforfeiture values determined by various subset instruments from the general account where there's a bond fund or this kind of fund. I don't know whether that's autopilot or not because so far we can't find how those various funds are monitored. But there's starting to be more and more of a movement.

What we determined last week at the Life and Health Actuarial Task Force is that the regulators are interested in what New York and New Jersey are both doing with regard to having prior approval and ongoing oversight of companies' rate regulation, if you will. I don't know where that's going. I know that for the September meeting of the task force we're going to put together a model that mimics the New York model. Regulators are increasingly concerned when they see companies apparently take advantage of policyholders with crediting rates. That's very sobering. I would strongly encourage you to counter this movement with complete disclosure—honest, open, aboveboard—and as you sit at your desks determining what the company's strategy is going to be or your contribution to what the company strategy is going to be, I would strongly encourage you to have your equity hat on and say that all policyholders must be treated fairly.