SOCIETY OF ACTUARIES

Article from:

The Actuary

January 1995 – Volume 29, No. 1

OPINION

Insurance illustrations: a possible solution

by Lloyd Foster

The credibility of permanent life insurance has suffered serious damage because of insurance proposals, or illustrations, with unrealistic projections of future earnings.

Attempts to rectify the situation through regulation have bogged down. (See sidebar article, "NAIC pushes back illustration guidelines issue date," on this page.) Part of the delay is differences of opinion about what is "reasonable" in terms of future investment returns. Can any actuary pontificate with any degree of seriousness about what is a "reasonable" future earnings rate expectation?

The debate is far from academic. The 1980s demonstrate how unpredictable interest rates can be. During the 1970s, it was very tempting to assume that interest rates would never climb above certain thresholds. The double-digit rates that emerged during the '80s were a devastating blow to those comfortable assumptions.

Just when the industry was beginning to feel at home with a high interest rate environment (and designing policies as if the high rates were here to stay), along came the '90s, and the rates came tumbling down. With them tumbled many an interest-sensitive product that had depended on high interest rate projections for marketing success.

When it comes to the interest return on insurance policies, no one can see into the future. Most people find it difficult enough to see the current trends.

Yet, the prospective buyer needs some indication of what the future holds for a new interest-sensitive policy. The moment we enter the arena of cash value policies with non-guaranteed investment benefits, we feel compelled to illustrate what the results could be. And illustrate we do.

According to many concerned members of our profession, we illustrate only too well, and that is the problem.

I believe the emphasis on investment crediting rates ignores the real information needs of the prospect. The real issue is not outrageously high, unrealistically low, or even "reasonable" middle-of-the-road projections. We know that emerging realities invariably render these illustrations meaningless.

The prospect, however, is keenly interested in the efficient handling of policyholder funds: Is too much used to cover administrative and other expenses? Are sales loads and other costs eating up too much of the premium dollars? These issues are easily masked by the focus on investment returns.

I believe attention should be redirected to the central issue: the proper handling of our clients' money. Here are some ways this could be done:

- Allow insurance companies to use whatever interest rate projections they choose.
- Project all future premiums at the same interest rate used in the projection of cash values.
- Create an index, the Cash Value Percentage Index (CVPI), which will be the ratio of the projected cash values to the projected premium at any particular date. The CVPI will give the prospect a good indication of who pockets what share of the insurance returns. For example, if $CVPI_{20} = 20\%$, the prospect would know that 80% of the projected premiums are to be used up by the insurance company, suggesting either inefficient expense controls, exorbitant sales loads, or unconscionable profit margins. It would not matter whether the projected cash value at the end of year 20 amounted to millions.

This is a healthy new direction of benefit to both sides. The emphasis would shift from interest rates to equitable treatment of the policyholder, and the insurance companies that insist on using high interest rate projections could continue to do so.

Lloyd Foster is president of Foster Mathematical Solutions, Austin, Texas.

NAIC pushes back illustration guidelines issue date

The National Association of Insurance Commissioners (NAIC) has been working for the past year to develop illustration guidelines for life, variable, and annuity products. It recently announced that the date to introduce those guidelines has been pushed back to March or June of 1995 for the life insurance product illustrations, with variable and annuity products to follow later. The deadlines for implementation, once the guidelines are issued, however, are expected to be short.

According to an article in the November 28, 1994 issue of *National Underwriter*, the NAIC's Life Disclosure Working Group's technical advisory group will recommend a three-part format for illustrations that includes:

- A narrative explaining the product, the guaranteed credit rate and cash value, and the death benefit
- The actual illustration in the form of ledger pages
- A notes section that replaces the much-criticized footnotes