Article from:

The Actuary

October 1997 – volume 31 - Issue 8

The expense question
Will life insurers welcome and support the GRET?

by Deanne L. Osgood

Little did I know that I would open a can of worms when I facilitated an SOA workshop last May. The workshop was on the NAIC's "Life Insurance Illustrations Model Regulation." The can of worms was a discussion of the 1998 Generally Recognized Expense Table (GRET).

The existence and use of the GRET to demonstrate compliance with the model regulation has created quite a stir in the life insurance industry. Before discussing some of the concerns, I'll present some background information on the model regulation and the thought process behind the GRET's development.

Broad application led to questions

After three years of debate, discussion, and drafting, the National Association of Insurance Commissioners (NAIC) adopted the "Life Insurance Illustrations Model Regulation" in December 1995 to become effective on Jan. 1, 1997, or when a state's regulation goes into effect.

To define compliance with the model regulation, the Life Committee of the Actuarial Standards Board concurrently drafted Actuarial Standard of Practice (ASOP) No. 24, "Compliance with the NAIC Life Insurance Illustrations Model Regulation." It was adopted in December 1995 and became effective March 31, 1996 — a full nine months before the model regulation's effective date. The intention was to ensure that companies would have the guidance needed to comply with the model regulation on Jan. 1, 1997.

The model regulation and associated ASOP No. 24 were drafted to apply to all illustrated group and individual life insurance policies containing nonguaranteed elements except: variable life insurance; individual and group annuity contracts; credit life insurance; and life insurance policies with no illustrated benefits that exceed $10,000. Other than those exceptions, all life insurance policies are affected by the model regulation and ASOP No. 24, even though the drafters' focus may have been on whole life and universal life policies.

This broad application led to many questions and differences in interpretation when companies applied the requirements to specific product designs and company situations. Many issues have been the subject of lively debate. At the May 1996 workshop, one intensely debated question was:

> Should the model regulation and ASOP No. 24 allow a company to use the expense factors contained in the GRET in lieu of company-specific expense factors based on a full allocation of expenses in order to demonstrate compliance with the model regulation?

To address this question, we first must understand what it means to comply with the model regulation. Second, we need to understand the Generally Recognized Expense Table.

How could insurers comply with the model regulation?

In addition to a variety of format, reporting, and administrative requirements, the model regulation requires that illustrations be "self-supporting" and not "lapse-supported," as defined by both the model regulation and ASOP No. 24. Generally, this means that accumulated policy cash flows (i.e., asset shares) must equal or exceed values available to the policyowner beginning with the 15th policy anniversary for a policy that insures a single life or the 20th policy anniversary for a policy that insures multiple lives. Policy cash flows are to be projected using actual experience factors for mortality rates, investment income, lapse rates, expenses, and other assumptions.

One experience factor that significantly impacts the ability of a particular product to be self-supporting and not lapse-supported is the expense assumption. As with all assumptions, ASOP No. 24 requires the expense assumption to be based on actual experience to the extent it is current, determinable, and credible. However, in some instances — such as for companies with little or no credible fully allocated expense experience — insurers were in a dilemma as to which expense assumptions would assure compliance. The GRET was developed to address this dilemma.

Birth of the GRET

The drafters of the model regulation and ASOP No. 24 nearly reached an impasse regarding the level of expenses required to determine policy cash flows. Generally, insurance company representatives wanted to draft ASOP No. 24 to allow an insurer to use marginal expenses associated with a particular policy to determine policy cash flows. Regulators, however, preferred that ASOP No. 24 require a company to use fully allocated expenses based on a sound expense allocation process.

(continued on page 6)

The expense question (continued from page 3)

After a great deal of discussion, a compromise position was reached — insurers would be allowed to use marginal expenses for a particular policy form provided they are not less than average industry expenses based on a full allocation of expenses. The Society of Actuaries' Committee on Life Insurance Research established a project oversight group (POG) to develop such expenses or to identify an existing table that could represent average industry expenses.

As there was no appropriate expense table, the POG developed the 1997 Generally Recognized Expense Table (GRET) using statutory financial information as reported to the state insurance departments by the 200 largest life insurance companies. The GRET contains expense factors based on a full allocation of expenses. The expense factors vary by four primary distribution channels:

1. Branch office
2. Direct marketing
3. Home service
4. All other

A company choosing to use the GRET to determine policy cash flows can use different GRET expense factors for different distribution channels as appropriate. However, a company cannot use the appropriate GRET expense factors for one distribution channel and company-specific expense factors for another distribution channel.

The Generally Recognized Expense Table was developed to provide a floor below which marginal expenses cannot be used to determine policy cash flows. However, expenses produced using the GRET expense factors cannot be used if they are less than those produced using marginal expense factors for a particular policy form. Therefore, a company using the GRET expense factors must be able to demonstrate that the expenses used to determine policy cash flows are greater than those produced using a particular policy form's marginal expense factors. In addition, a company using marginal expense factors must be able to demonstrate that the expenses used to determine policy cash flows are greater than those produced using the GRET expense factors. In other words, using the GRET does not relieve a company from conducting an expense study to determine, at a minimum, marginal expense factors.

Of course, a company can always use expense factors based on a full allocation of expenses to demonstrate compliance with the model regulation. Many companies have decided to do just that — feeling that it might provide a marketing advantage over companies that use the GRET expense factors or marginal expense factors associated with a particular policy form. Other companies, however, chose to use the GRET for various reasons and had more difficulty implementing it than was anticipated.

Criticisms of the GRET

These implementation problems have led to several criticisms:

- The GRET percent of premium factor currently applies equally to the target premium and any excess premium in universal life products. Critics say this overstates actual expenses because agency expenses allocated as a percent of target premium typically would not apply to any excess premium.
- Products offered on a guaranteed issue or simplified issue basis are subject to the full GRET expense factors. Many say this overstates actual expenses because it doesn't reflect the fact that the company is saving some underwriting expense.
- Some users think that additional distribution channel definitions and associated expense factors are needed.
- By using the GRET, companies whose expenses are higher than the industry average can determine policy cash flows using average industry expenses. Those opposed to the GRET think that a company should be allowed to illustrate a policy form only if it is self-supporting and not lapse-supported as determined using company-specific expense factors.

In an effort to address some of the concerns and provide an updated GRET for use in 1998, the POG attempted to survey the 250 largest life insurance companies to obtain timely data so that a better industry expense table could be developed. The survey requested statutory financial information, expense factors actually used to demonstrate compliance with the model regulation in 1997, expense allocation information, and other company-specific information that affects the level of expenses, such as reinsurance arrangements.

The survey response rate was dismal. Less than half the companies responded. In addition, only about 10 companies supplied any information about universal life excess premiums — not enough to provide sufficient credible data. Although the survey indicated that results would remain confidential, used only by the POG to develop a GRET that would better serve the industry, some companies declined to share actual expense factors used in 1997 and other company-specific information. At least one company said it would not supply data that might lower average industry expenses because competitors might then be able to illustrate more favorable values.

Thus, once again, the proposed 1998 Generally Recognized Expense Table is based on statutory results for the 200 largest life insurance companies. In addition, the poor survey response rate coupled with the lack of industry expense data prevented the POG from including expense factors for universal life excess premiums and for additional distribution channels.

The future of the GRET

After the proposed 1998 GRET is adopted, the POG expects to transfer ongoing responsibility for GRET updates and maintenance to the experience studies area in the SOA's Research Department. This recognizes that the Generally Recognized Expense Table is an experience table, acceptable for use in actuarial practice.

Many companies have relied on the Generally Recognized Expense Table for reasons that may be unique to each company, suggesting that the GRET serves a valid purpose in the current marketplace. Although many companies seem to have embraced the existence and application of the GRET, it has not been universally accepted by the industry. Increased awareness and understanding of the GRET itself and its intended purpose may lead to wider acceptance of the GRET as an average industry expense table. This in turn may result in greater access to expense data and continued refinement and use of the GRET.

Should the model regulation and ASOP No. 24 allow a company to use the expense factors contained in the GRET? Or should a company be required to use company-specific expense factors based on a full allocation of expenses to demonstrate compliance? You make the call.

Deanne Osgood is a consulting actuary with Milliman & Robertson, Inc., Chicago. She can be reached by e-mail at *deanne.osgood@milliman.com.*

Speakers named for Bowles Symposium on genetic testing

Speakers have been announced for the third Thomas P. Bowles Jr. Symposium, focusing on genetic technology's impact on underwriting, to be held at Georgia State University, March 26-27, 1998.

In addition to actuaries, presenters for the two-day program will include lawyers, medical experts, and academics:

- Patrick L. Brockett, Ph.D., third Bowles chairholder and symposium leader, will present actuarial models for using genetic technology in insurance. He is director of the Risk Management and Insurance Program at the University of Texas at Austin.
- Charles S. Jones, Jr., M.D., will provide an overview of genetic technology and explain its possibilities and limitations. He is vice president and medical director, Life of Georgia/Southland Life, and a member of ACLI's AIDS and genetic issues committees.
- Norman Fost, M.D., will speak on ethical and policy issues in mass genetic screening. He is professor of pediatrics and director of the Program in Medical Ethics, University of Wisconsin School of Medicine, and served on Hillary Clinton's Health Care Task Force.
- Karen Rothenberg, J.D., M.P.A., will speak on the social implications of genetic testing. She is a member of the NIH Recombinant DNA Advisory Committee and a professor of law and founding director of the Law & Health Care Program at the University of Maryland School of Law.
- Mark Hall, J.D., will present models of the laws affecting insurers' use of genetic testing to explain the patterns of regulation for life, health, and disability insurance. He is a professor of law and public health at the Wake Forest University School of Law and Bowman Gray School of Medicine.
- J. Alexander Lowden, Ph.D., M.D., will discuss ethical issues surrounding genetic technology. He is vice president and chief medical director of Crown Life Insurance Company, Regina, Saskatchewan.

Additional speakers will include:

- Arnold A. Dicke, executive vice president and product actuary, USLIFE Corporation
- Donald C. Chambers, M.D., senior vice president and chief medical director, Lincoln National Life Insurance Co.
- James C. Hickman, Ph.D., emeritus professor and dean of the School of Business at the University of Wisconsin – Madison
- Angus S. Macdonald, Ph.D., senior lecturer at Heriot-Watt University in Scotland
- Erle E. Peacock, Jr., M.D., J.D., medicolegal consultant at the law firm of Hollowell, Peacock & Myer
- Ellwood Oakley, III, J.D., associate professor of legal studies at Georgia State University
- Derek V. Smith, president and CEO, ChoicePoint Inc.
- John J. Krinik, editor and publisher of *Underwriter ALERT*
- Ray Moseley, Ph.D., associate professor in the Department of Community Health and Family Medicine and director of the Medical Ethics, Law, and Humanities Program at the University of Florida College of Medicine

The symposium is affiliated with the Thomas P. Bowles Jr. Chair of Actuarial Science, established in 1988 to honor Bowles' contributions to the actuarial profession, including a major role in founding the actuarial science program at Georgia State University. The chair's purpose is to address critical issues in the changing environment in which actuaries practice.

For details on the Bowles Symposium, contact Anne Chamberlain, Georgia State University (phone: 404/651-0931; fax: 404/651-4219; e-mail: *achamberlain@gsu.edu*).