STATEMENT 1981-12

AMERICAN ACADEMY OF ACTUARIES

1835 K STREET, N.W. • SUITE 515 • WASHINGTON, D.C. 20006 • (202) 223-8196

June 2, 1981

TO: National Association of Insurance Commissioners' Task Force on Manipulation, Lapsation, Dividend Practices and Annuity Disclosure

FROM: John H. Harding, Chairman - Committee on Dividend Principles and Practices

SUBJECT: Report of the Committee on Dividend Principles and Practices

It is a pleasure to tell you that this Report constitutes our formal presentation to the NAIC of suggested modifications to existing regulations concerning dividend practices. As reported to you in December, the American Academy of Actuaries has formally adopted standards of practice with respect to dividend payment and dividend illustration. The primary focus of these standards, which are formally called *Recommendations Concerning Actuarial Principles and Practices in Connection with Dividend Determination and Illustration*, is on disclosure. The American Academy of Actuaries, by adopting the Recommendations, is requiring that actuaries responsible for the determination of dividend scales disclose to their companies all relevant considerations used in determining their recommended dividend scales. Of course, the Academy of Actuaries cannot compel companies to disclose publicly the relevant content of this report. The NAIC, however, can make such requirements. This presentation to you identifies the form and substance of what the Academy Committee believes should be reported by companies about how they pay and illustrate dividends.

Brief History

In June of 1980, the Committee on Dividend Principles and Practices published its report. This report contained a general historical background, which is summarized here.

It has been traditional in the life insurance industry to illustrate dividends to prospective policyholders. Such illustrations have been called upon to provide an indication of the company's current performance and to give a reasonable indication of the probably relative performance in the future, as dividends were actually paid. It is also been generally accepted that there must be equitable apportionment of dividends among all classes of policyholders, in spite of a temptation for a company to favor more recent policyholders at the expense of others. In the early 1970's, there was concern regarding the apparent proliferation of bases for paying dividends and illustrating them. There was also concern that departure from a close relationship between dividends paid and dividends illustrated may have taken place for some companies.

In the mid-1970's, the Society of Actuaries circulated a questionnaire designed to develop information concerning dividend practices. Analysis of the results showed that there was a much broader range of practices than previously had been thought to exist.

The Society of Actuaries established, in early 1976, the Committee on Dividend Philosophy to explore possible courses of action to deal with this problem. In 1978, this Committee recommended that the best solution would be to establish standards of dividend payment and illustration and that the actuary responsible for recommending a dividend scale provide a written opinion to corporate management.

The Society Committee published Draft 7 of its Recommendations in the fall of 1979. Finally, the Society Committee completed Draft 11 in May of 1980. This Draft covered all participating policies issued by mutual life insurance companies and some participating life policies issued by stock companies. The Society Committee is still working on remaining stock life insurance company issues. In addition, deferred annuities are under consideration.

The American Academy of Actuaries' Committee on Dividend Principles and Practices was formed in late 1978. It has worked closely with the Society Committee since that time. There is a mutual understanding between the Board of Governors of the Society and the Board of Directors of the Academy that the Society should develop the suggested Recommendations and that the Academy use that framework to adopt a formal set of Recommendations, with subsequent interpretations as necessary. In addition, the Academy would develop the appropriate framework for implementation of these Recommendations. This framework is what is being suggested today.

The Academy Committee published a slightly modified version of Draft 11 for comment, as a part of its June, 1980 report. Essentially, the Academy version makes the Recommendations mandatory for mutual companies and optional, at this time, for stock companies. However, stock companies who do not elect to conform should disclose that fact to regulators and to the public. On October 31, 1980, the Academy Board of Directors adopted the Recommendations. The final version was published in February, 1981.

Since that time, the Academy Committee has been developing improved versions of its suggestions to the NAIC. These suggestions include the possible modification of what is now Schedule M of the Annual Statement, modifications in language in the Life Insurance Buyer's Guide and modifications in the language required to be included with dividend illustrations.

Regulatory Disclosure

The Committee believes that the best disclosure for regulatory purposes would be a qualitative extract of the actuary's report. The actuary who signs that report should also sign the statement of opinion and answers to the interrogatories in the proposed modification of Schedule M of the Annual Statement. However, this actuary would not necessarily be the same one who signed the statement of opinion with regard to policy reserves and related items.

Our primary concern is that the actuary's report will include proprietary company information with respect to experience factors and how these are translated into product pricing. Such information in great detail would be of little value to regulators, but of substantial value to competitors. The giving away of legitimate techniques of product pricing is unnecessary for appropriate regulation and would diminish, rather than enhance, the price competitive nature of the life insurance industry.

A properly written actuarial report would not enhance a layman's understanding of the dividend process. Further, few state insurance departments could afford to develop the expertise to interpret all such reports in a meaningful manner. Even if such interpretation were made, it is not clear what could be done with the information. The primary role of regulators and the supervision of dividend practices should be directed toward obvious manipulation, solvency questions, general concern about equitable distribution and the avoidance of improper discrimination.

The suggested modifications to Schedule M focus on an extract of the actuary's report. This extract is intended to be helpful to the regulators in their supervisory role. The report requires a summary of practices used, a highlighting of changes in practices, a quantification of changes in dividend scale and a certification by the actuary that the dividends have been determined, except as disclosed, in accordance with the Recommendations Concerning Actuarial Principles and Practices in Connection with Dividend Determination and Illustration.

Consumer Disclosure

The suggested changes to the Buyer's Guide incorporate several new ideas. First, while the current Buyer's Guide describes the concept of cost and identifies the differences between illustrations of cost of participating and nonparticipating policies, the redraft recognizes the existence of cost illustrations of products recently introduced.

Second, the suggested modifications identifies the difference between investment generation and portfolio average methods in the determination of dividends. At the suggestion of the NAIC Advisory Committee on Manipulation, dividends based on investment generation methods are identified as being more sensitive to changes in current interest rates.

Finally, the suggested modifications recognized the existence of the newly adopted Principles and Practices and warns the prospective insured to be aware of any exception language which may be required on the illustration.

Suggested language which should accompany the illustration, must necessarily be brief. We believe, however, that in all cases there should be an identification of the method of investment income allocation used, because of the significantly different illustrative result. In addition, each required exception statement that appears in the suggested Schedule M would also need to be briefly summarized.

The primary focus of dividend illustrations, of course, is on new sales. However, the proposed disclosure language is intended to be used both with illustrations of dividend scales for new policies and also on illustrations for policies currently in-force.

Conclusion

The Academy Committee on Dividend Principles and Practices believes that we have now progressed to a stage where it would be possible and appropriate for the NAIC to make use of our suggestions for modifications which are described above and attached as Exhibits B and C.

Exhibit A has already been distributed. These are the Recommendations which were adopted in October of 1980 and published in February of 1981. Additional copies can be obtained from the American Academy of Actuaries.

We recognize that the process of modification will not necessarily be a speedy one and that the NAIC will need to give serious consideration to not only our proposals, but related proposals from other groups. However, we believe that public disclosure of company practices with regard to dividend illustration and payment is essential. We hope that the NAIC can begin the process of modification as quickly as possible, and we would be happy to work with the NAIC in this process.

JHH:mw

Attachments

EXHIBIT B

POSSIBLE SCHEDULE M DISCLOSURE
Statement Year 1981

Identify the participating ordinary life business which is not subject to the actuarial principles and practices of the American Academy of Actuaries applicable to the determination of dividends paid by mutual companies. Answer the questions and state the opinion below which apply with respect to any other participating business.

Process of Dividend Determination

Describe the general methods and procedures used to determine dividends.

Description of Experience Factors

Describe the basis used in making any distinction in experience factors which underlie the determination of dividends. The description should specifically include:

a. investment income factors;
b. claims factors;
c. expense factors;
d. termination factors;
e. any other factors which have a material effect on the dividends of any group of policies.

Also, describe in a qualitative way any material changes made in the bases used to determine those factors since this Schedule was last filed.

General Interrogatories

1. Has the Contribution Principle been followed in determining dividends?

   If no, describe.

2. Since this Schedule was last filed, has any material change occurred with respect to the determination of policy factors?

   If yes, describe.

3. a. Since this Schedule was last filed, have there been any changes in the scales of dividends on new or existing business authorized for illustration by the company?

   If yes, describe in general the changes that were made.

b. Since this Schedule was last filed, have there been any changes in the scales of dividends apportioned for payment?

If yes, describe in general the changes that were made.

c. For each major block of business, indicate when the dividend scale was last changed (including changes described in b. above) and indicate the extent of such change in terms of the percentage by which dividends payable under the new scale exceeded or were less than those which would have been paid in the year of change had the scale not been changed.

4. Does the dividend scale incorporate the use of projections or forecasts of experience factors for any period in excess of two years beyond the effective date of the scale?

If yes, describe.

5. In the basis of determining investment income experience factors, state whether the company uses (a) a portfolio average approach, (b) an investment generation approach, or (c) a combination of the two approaches.

If (b) and (c), describe the general basis used, including the issue year groupings.

6. With respect to policy loan provisions,

a. Describe how differences in such provisions affect dividends.

b. Does the dividend scale contain any provision for varying the amount of dividend in accordance with the extent to which an individual policy's loan provision is utilized?

If yes, indicate the blocks of business where this treatment pertains, and describe the basis of variation used.

7. Does the company pay termination dividends on its policies? If yes:

a. Are they payable on death, surrender and maturity?

b. Are they payable or credited either upon the commencement of non-forfeiture insurance or upon termination thereof by death, surrender or maturity?

c. Do they reflect the incidence, size and growth of amounts which may be attributed to the policies in question?

If the answer to a., b., or c. is no, describe the basis used.

8. Does the undersigned believe dividends illustrated on new or existing business can be paid if current experience continues?

   If no, explain why.

9. Does the undersigned believe there is a substantial probability that because of the expected deterioration of experience, the dividends illustrated on new or existing business cannot be maintained for at least two years?

   If yes, explain why.

10. Describe any aspects of the determination of the dividend scale not covered above which involve material departures from the actuarial principles and practices of the American Academy of Actuaries applicable to the determination of dividends paid by mutual companies.

11. Describe any material changes in the basis of determination of the dividend scale which were made since this Schedule was last filed and which are not covered above.

Actuarial Opinion

I, (name, title), am (relationship to company) and a member of the American Academy of Actuaries. I have examined the actuarial assumptions and methods used in determining dividends under the dividend scale for the individual participating life insurance policies of the company issued for delivery in the United States. The dividends encompassed by this scale are both:

i) those apportioned for payment during 1982; and

ii) *those in effect* as of January 1, 1982 which are illustrated for payment on new or existing business in 1983 and later and which are authorized for illustration by the company.

My examination included such review of the actuarial assumptions and methods of the underlying basic records and such tests of the actuarial calculations as I considered necessary. In my opinion, these dividends have been determined in accordance with actuarial principles and practices of the American Academy of Actuaries applicable to the determination of dividends paid by mutual companies, except as described above.

Date Name and Title

EXHIBIT C

POSSIBLE CHANGES IN SOME SECTIONS OF THE LIFE INSURANCE BUYER'S GUIDE

(The Committee believes that the "What is Cost?" and "How Do I Use Cost Indexes?" sections of the Buyer's Guide could be enhanced by the following.)

What is Cost?

"Cost" is the difference between what you pay and what you get back. If you pay a premium for life insurance and get nothing back, your cost for the death protection is the premium. If you pay a premium and get something back later on, such as cash value, your cost is smaller than the premium.

The cost of some policies is guaranteed at time of issue. These policies are called "guaranteed cost -- nonparticipating" policies. These policies do not pay dividends, but every feature is fixed at the time of purchase so that you know in advance what your future cost will be.

Listed below are some examples of policies that contain cost elements that are not guaranteed when you buy the policy. The actual cost of these policies will depend on the future actions of the company selling the policy and your actual cost can be lower or higher than that illustrated at time of purchase.

- Participating Policies

  These policies have their cost reduced by dividends. Their premiums, cash values and death benefits are guaranteed, but the dividends are not. A dividend is a refund or return of part of the premiums paid. Each company pays those dividends which it believes to be appropriate, based on its current experience as to the factors affecting the cost of the insurance it provides -- primarily claims, expenses, investment earnings and taxes.

  There are certain standards that have been endorsed for mutual companies as generally acceptable for use in determining dividend scales, including illustrations of dividends that may be paid in the future. Companies are required to indicate whether or not their illustrated dividends, and cost indexes reflecting them, were determined in conformance with these standards.

  The future dividends illustrated by companies conforming with these standards are based on current levels of experience. The extent to which actual dividends will differ from those illustrated will depend on the extent to which actual future experience differs from that underlying the scale of illustrated dividends.

  There are two main ways in which dividends may reflect investment earnings. One method involves reflection of such earnings on funds attributable to all policies, regardless of when they were issued. The other method involves reflection of such earnings on funds attributable to policies issued in specified years. Usually, dividends based on this method are more sensitive to changes in current interest rates than are dividends based on earnings on funds attributable to all policies.

A description of the method used must accompany any figures presented which involve dividends.

- Nonparticipating Policies with Nonguaranteed Cost

While "nonparticipating" policies do not pay dividends, some of them have costs that are not guaranteed at time of purchase. Some examples are:

-- Nonguaranteed Premium Policies

Cash values and death benefits under these policies are guaranteed, but their premiums are not. These policies contain a guaranteed "maximum premium", but the company anticipates charging a lower premium. The company will illustrate the cost based on the premium it currently expects to charge. Your actual cost will be lower or higher than this, depending on the premiums you are actually charged.

-- Policies with Nonguaranteed Cash Values

Premiums and death benefits under these policies are guaranteed, but their cash values are not. These policies contain a guaranteed minimum interest rate for accumulation of cash values, but the company anticipates using a higher rate. The company will illustrate the cost based on the interest rate they currently use to accumulate cash values. Your actual cost will be higher or lower than this, depending on the interest rate actually used.

-- Policies with Nonguaranteed Death Benefits and Cash Values Under These Policies

These policies do not require a specific level of premium payments, but guarantee a minimum level of death benefit and cash value for any particular amount of premium the insured chooses. The company will also illustrate higher cash values and death benefits based on the interest rates and insurance cost it currently uses. Your actual cost under these policies, in relation to the benefits provided, will be higher or lower than that illustrated depending on the interest rate and insurance cost actually used.

-- Reunderwritten Policies

Some policies permit the insured to have lower premiums throughout the duration of the policy, if the insured can periodically meet specified health qualifications.

The actual cost of these policies will depend on whether or not the insured can meet the prescribed standards.

Cost illustrations for all policies with costs that are nonguaranteed are required to disclose the part of the cost that is not guaranteed.

POSSIBLE MODIFICATION OF EXISTING STATE
REGULATIONS WHICH DEAL WITH
DIVIDEND DISCLOSURE

The Committee has not addressed itself to each possible regulation where the following modifications might apply. However, most of the regulations involved deal with solicitation and advertising. In principle, information relevant to the comparability of dividend scales could be added to the normal dividend caveats:

A. For those policies which are specified in Schedule M as not subject to the actuarial standards which apply to the determination of dividends paid by mutual companies, it would be appropriate to include a statement in the dividend caveat that "the dividends illustrated for this policy are determined according to standards which are different from those applicable to a mutual company."

B. For all other policies, the method of allocation of investment earnings should be identified.

1) If a company is more than 10 years old, and states in Schedule M that it uses a portfolio average approach, it would be appropriate to state:

"Illustrated dividends are based upon the dividend scale applicable to currently issued policies, which reflects current investment earnings on funds attributable to all policies. Dividends are neither guarantees nor estimates and future dividends which you actually receive will differ from those illustrated to the extent that future expense, claim and investment experience differs from current experience."

2) For other companies it would be appropriate to state:

"Illustrated dividends are based upon the dividend scale applicable to currently issued policies, which reflects current investment earnings on funds attributable to all policies issued since 19 *. Dividends are neither guarantees nor estimates and future dividends which you actually receive will differ from those illustrated to the extent that future expense, claims and investment experience differs from current experience."

*(The earliest year of the issue year grouping used to determine the investment earnings on current issued policies.)

C. Under the conditions defined below, with regard to the answers to the Interrogatories in Schedule M, disclosure of areas of specific concern would be appropriate.

Interrogatory 1 - A negative answer should be disclosed.

Interrogatory 4 - An affirmative answer would require a description of the period of projection.

Interrogatory 6 - An affirmative answer to question 6.b. should be disclosed.

Interrogatory 7 - A negative answer to question 7.a. or 7.b. would require disclosure of the types of transactions on which termination dividends are not paid, once they are available. A negative answer to question 7.c. should be disclosed together with a statement that termination dividends are not in conformance with the standards of practice for payment of such dividends.

Interrogatory 8 - A negative answer should be disclosed.

Interrogatory 9 - A positive answer should be disclosed.