# Life Insurance Illustrations—A Follow-Up

*by Mark Peavy*

## Introduction

Last April I wrote an article for this publication describing the work in progress on the new Life Insurance Illustrations Model Regulation (Model).[1] Since that time the Life Insurance Disclosure Working Group of the NAIC's Life Insurance (A) Committee has completed the Model, and it was adopted by the NAIC membership at its winter meeting in San Antonio. This article will describe the major actuarial components of the final document, as well as aspects of the related Actuarial Standard of Practice (ASOP) promulgated by the Actuarial Standards Board.[2] Also, some additional key elements of the Model will be briefly mentioned.

## Actuarial Aspects of the Model

As was the case last April, the heart of the new regulation remains the "disciplined current scale" (DCS). As defined in the Model, the DCS is "a scale of non-guaranteed elements constituting a limit on illustrations currently being illustrated by an insurer that is reasonably based on actual recent historical experience." Closely related to the DCS is the "illustrated scale"; no premium, death benefits, cash values, dividends, or any other non-guaranteed values which comprise the "illustrated scale" may be shown in a sales illustration unless they are no more favorable than their DCS counterparts. The "illustrated scale" is further limited by the "currently payable scale," which the Model defines as "a scale of non-guaranteed elements in effect for a policy form as of the preparation date of the illustration or declared to become effective within the next ninety-five days."

Two critical tests remain from the draft of last April; the "illustrated scale" must pass "self-supporting" and "lapse-supported" tests to be used. Essentially, the "self-supporting" test requires that the illustrated values on and after the 15th policy anniversary must be no greater than the accumulated cash flows using the DCS and its underlying assumptions. The intent of the "self-supporting" test is to assure that, under scenarios that are consistent with recent experience, adequate funds will be generated to pay the illustrated values. The "lapse-supported" test is almost identical to the "self-supporting" test, except that lapses after the fifth policy anniversary are assumed to be zero. By making this assumption, the illustration of policy values that depend upon subsidization of persisting policyholders by lapsing policyholders is effectively precluded. While some observers thought the "no lapse" assumption was unduly conservative, the working group took the position that this assumption was an essential component in controlling unduly "optimistic" illustrations.

One additional test included in the April draft, the persistency bonus, was not included in the adopted Model. Initially, the working group was concerned about the illustration of cash values which increase at a rate significantly greater than the underlying accumulated cash flows. However, in attempting to develop a practical definition of what constitutes an inappropriate persistency bonus, the working group became convinced that: 1) there was no definition which would not exclude some reasonable product designs, and 2) the "self-supporting" and "lapse-supporting" tests would sufficiently constrain the illustration of disproportionate annual increases in cash values.

While all of the actuarial aspects of the Model generated considerable discussion, three were particularly difficult to resolve. First, there was ongoing discussion during the development of the Model relative to mandating, after some specified

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policy duration such as five or 10 years, that a specified interest assumption (e.g., 7 percent) be utilized in the DCS instead of the company's recent historical experience. Proponents of a specified interest assumption argued that of all the choices the actuary has to make, the one most subject to fluctuation is the interest rate to be earned by the company. While it is unlikely that either a high or low yield will persist into the indefinite future, the proponents noted that such an assumption is permitted in the development of the DCS. The proponents also contended that use of a specified interest rate would ease concerns regarding the advantage or disadvantage a company crediting portfolio rates would have relative to a company crediting new money rates. In deciding to permit the use of recent historical experience, the working group concluded that technical issues surrounding the designation of a specified interest rate were too challenging to overcome. Among those technical issues was how to develop a single rate that would be appropriate for all companies and could be easily updated to reflect changing economic circumstances. Also, the working group was concerned about the appropriateness of allowing companies with a low DCS interest rate to grade into a higher specified rate. In reaching its decision, the working group noted that the Model requires one set of non-guaranteed values to be shown assuming an interest rate that is the average of the guaranteed rate and the rate contained in the "illustrated scale." It was felt that an illustration incorporating this "middle" interest rate would serve to restrain consumer expectations.

Second, significant concerns were expressed relative to the requirement that companies incorporate fully allocated expenses into the DCS. The working group was concerned that, in the absence of this requirement, adequate provision would not be made for corporate overhead. Critics of this approach maintained that actual pricing of life insurance products is commonly done on a marginal basis, and requiring that expenses reflect a full allocation of overhead was unduly restrictive and particularly burdensome to new companies and product lines. As a compromise, the adopted version of the Model allows companies to illustrate marginal expenses, provided that the total of the marginal expenses for all life insurance products sold by the company is at least as great as that produced by a "Generally Recognized Expense Table" (GRET). The GRET will be developed through the joint efforts of the American Academy of Actuaries and the Society of Actuaries and must be approved by either the NAIC or the commissioner, at the state's discretion. In the absence of the development of a GRET, the company must use fully allocated expenses.

Third, some objections were expressed to the requirement that illustrations for in-force policies be subject to the "self-supporting" and "lapse-supported" tests. Specifically, concerns were raised that it would be administratively burdensome to perform these tests for other than newly issued policies. Also, several commentators noted that in-force illustrations have not been the source of market conduct problems to the same degree as new policies. However, the working group believed it was desirable to take steps to prevent problems from arising relative to in-force illustrations. As a compromise to the various positions, the final version of the ASOP incorporated language that would, in most circumstances, allow the actuary to certify compliance with the Model and the ASOP without retesting in-force illustrations for compliance. Essentially, the actuary is required to perform the two tests only if the currently payable scale has been either increased to a level or maintained at a level higher than is warranted by the changes in experience underlying the DCS.

One other critical element that remained in the adopted Model is the concept of an "illustration actuary." The company must designate an actuary who is responsible for annually certifying that the illustrated scale for a policy form is in compliance with the Model and the ASOP. Furthermore, the actuary is required to disclose: 1) whether a currently payable scale applicable for business issued within the previous five years has been reduced for reasons other than changes in the experience factors underlying the DCS; 2) if non-guaranteed elements illustrated for new policies are not consistent with those illustrated for similar in-force policies; 3) if non-guaranteed elements illustrated for both new and in-force policies are not consistent with the non-guaranteed elements actually being paid, charged or credited to the same or similar forms; and 4) the basis used to allocate overhead expenses. Also, if the actuary is unable to certify a scale of illustrated values, the actuary must notify the board of directors and the commissioner of that inability.

## Other Aspects of the Model

The format of illustrations mandated by the adopted Model is fairly consistent with the April draft. The adopted Model allows companies to choose whether a particular policy form will be marketed with or without an illustration. If the company chooses to market a form without an illustration, then use of an illustration for such a policy prior to the first policy anniversary is prohibited. If a policy form is to be marketed with an illustration, then a "basic illustration" must be provided where the basic illustration consists of:

1) Key information regarding the insurer, agent, insured and policy being illustrated.
2) A brief narrative summary of the policy being illustrated and key terms used in the illustration. The narrative summary must include a statement that notifies the applicant that the non-guaranteed elements actually credited to the policy "may be more or less favorable than those shown."
3) A numeric summary immediately following the narrative summary. The numeric summary must show premiums, death benefits, and values for at least policy years five, 10, 20 and at age 70 (or policy year 30 in the case of a multiple life policy) on three different bases: (a) policy guarantees, (b) the insurer's illustrated scale, and (c) a modified illustrated scale where dividends are 50 percent of those in (b) and non-guaranteed charges and interest credits are the average of those in (a) and (b).
4) A specified tabular detail. For policy years 1-10, every fifth year thereafter until maturity or age 100, and (except for term insurance) every year beyond the 20th in which the premium is to change, the premium, death benefits and values on both a guaranteed and "illustrated scale" basis.

A basic illustration does not have to be provided to individual members of a group unless the coverage is marketed to those individuals; for example, this would probably apply to employees whose employer offered group term insurance on a non-contributory basis. An additional exception is made for non-term group life, where information showing potential policy values for sample ages and policy years which are consistent with the illustrated scale may be shown in lieu of a basic illustration. However, when these potential policy values are shown, a basic illustration must be provided at delivery of the certificate of insurance.

The working group realized that the prescriptive nature of the basic format would result in situations where it did not supply all of the information needed by a particular consumer. Therefore, the concept of a "supplemental illustration" was carried forward from the draft into the adopted Model. The Model imposes few constraints on the supplemental illustration, thereby enabling it to be tailor-made to individual circumstances. The principle constraints imposed include: 1) it must always be accompanied by a basic illustration; 2) the non-guaranteed elements that are illustrated must be no more favorable than the scale illustrated in the basic illustration; and 3) the premium amount used in the supplemental illustration must equal the premium contained in the basic illustration.

The Model also contains detailed requirements for delivery of the illustration. Essentially, if the policy is issued as applied for, a copy of the signed illustration must be submitted to the insurer at the time of policy application, as well as provided to the applicant. If the policy is issued other than as originally illustrated, then a "revised illustration" must be delivered to the policyowner no later than the time the policy is delivered, with signed copies provided to the insurer and the policyowner. If the agent chooses not to use an illustration in the sale, or if the policy is applied for other than as illustrated, the agent and the applicant must certify to that on a form provided by the insurer. If a policy is subsequently issued, a basic illustration must be provided no later than at the time the policy is delivered, and signed copies must be provided to the insurer and the policyowner. If the illustration is provided to the policyowner by mail from the insurer, the insurer is deemed to have satisfied the above requirements if it can demonstrate it made a "diligent effort" to obtain a signed copy of the illustration. A diligent effort can be demonstrated by including in the mailing a self-addressed postage prepaid envelope with instructions for the return of the signed illustration.

## Remaining Tasks

Completion of the Model represents only the end of the first phase of the work on illustrations. One remaining administrative task is to reconcile inconsistencies in other NAIC model laws and regulations to the new Model. As part of that effort, the working group has developed a letter to be sent to all commissioners highlighting the principle differences and recommending steps that can be taken to quickly address them. For the longer term, the working group has as its focus for 1996 the development of appropriate standards for the illustration of variable life and annuity products. Developing standards for these product lines will be made much easier by the research already done on non-variable life illustrations. Also, the working group intends to make itself available in 1996 to address significant questions that arise relative to interpreting the Model. Finally, the working group has been assigned as one of its charges for 1996 the study of cost comparison indices. The adopted Model is silent on the use of cost indices. However, various parties have argued that the development of a rational cost comparison index is essential in enabling consumers to compare the relative value of different policies.

## Conclusion

As pointed out in April, successful implementation of the Model will require careful attention to the feedback that is received. In a project this complicated, it is inevitable that interpretations of the Model will appear that were not intended or anticipated. As these circumstances arise, all parties should do their best to adhere to the spirit of conservatism and consumer protection that guided the development of the Model, yet be flexible to the changes brought about by new insurance products. Unquestionably, the prospects for success will be greatly enhanced if the high level of cooperation between regulators, consumers, representatives of the actuarial profession, and industry representatives that prevailed during the development of the Model persists during its implementation.

## Endnotes

[1] "Life Insurance Illustrations," *NAIC Research Quarterly* Vol I Issue 2, April 1995.

[2] The Actuarial Standards Board is an independent entity within the American Academy of Actuaries. One of its goals is the development of standards of practice for the actuarial profession.