ACTUARIAL STANDARDS BOARD

Actuarial Standard
of Practice
No. 24

Compliance with the NAIC
Life Insurance Illustrations Model Regulation

Developed by the
Life Committee of the
Actuarial Standards Board

Adopted by the
Actuarial Standards Board
December 1995

(Doc. No. 050)

T A B L E O F C O N T E N T S

APPENDIX

December 1995

TO: Members of Actuarial Organizations Governed by the Standards of Practice of the Actuarial Standards Board and Other Persons Interested in Life Insurance Illustrations

FROM: Actuarial Standards Board (ASB)

SUBJ: Actuarial Standard of Practice No. 24

This booklet contains the final version of Actuarial Standard of Practice No. 24, *Compliance with the NAIC Life Insurance Illustrations Model Regulation*.

Background

Sales illustrations have been of concern to regulators for some time. Recent developments involving insurance products, policy illustration technology, and the volatility of financial markets, as well as a general concern about misleading illustrations, persuaded the National Association of Insurance Commissioners (NAIC) of the need to develop a model regulation to govern the use of illustrations. At the request of the NAIC, the ASB began work on a new actuarial standard of practice (ASOP) as the NAIC developed its *Life Insurance Illustrations Model Regulation* (hereafter the *Model*).

Developing both documents together was particularly important since the *Model* assigns major new responsibilities to actuaries involved with illustrations. The proposed ASOP was released for exposure and comment in April 1995, with a comment deadline of July 31, 1995.

Responses to Comments on the Exposure Draft

The ASB received sixty-two comment letters and eighteen submissions of confidential data from actuaries and other interested parties. In addition, written and oral comments were addressed by the ASB at a public hearing in May 1995 attended by approximately sixty individuals. Twelve individuals gave oral presentations. All comments and opinions were weighed and considered by the Life Committee as it developed the standard of practice. (A detailed description of the significant issues and questions contained in the comments, as well as the committee's responses to such, is found in the appendix.) In addition to reviewing and considering all of the responses to the exposure draft, the Life Committee also made changes based on changes to the NAIC *Model*, which was amended further after the proposed ASOP was published (and after the comment period had ended). The changes made to the exposure draft were, for the most part, of a clarifying nature, or they flowed directly from changes in the *Model* that were made after the exposure draft was circulated. Therefore, after reviewing the text at the quarterly board meeting, the ASB decided it was not necessary to expose the text for a second time.

The Life Committee and the ASB thank everyone who took the time to comment on the exposure draft—whether by written letter or oral presentation at the May hearing. The ASB voted in December 1995 to adopt the final standard.

Life Committee of the ASB

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ACTUARIAL STANDARD OF PRACTICE NO. 24

COMPLIANCE WITH THE NAIC LIFE INSURANCE ILLUSTRATIONS MODEL REGULATION

PREAMBLE

Section 1. Purpose, Scope, and Effective Date

1.1 Purpose—The purpose of this standard is to provide guidance to actuaries in complying with regulatory requirements governing the preparation of life insurance illustrations (hereafter *illustrations*). This standard does not provide guidance with regard to amounts that are actually credited or charged to policyowners.

1.2 Scope—This standard applies to the work of actuaries who certify compliance with state regulations that are based on the National Association of Insurance Commissioners (NAIC) *Life Insurance Illustrations Model Regulation* (hereafter the *Model*) adopted by the NAIC in December 1995, to the extent that such state regulations are consistent with the *Model*. The *Model* applies to illustrations for life insurance other than variable life insurance, and does not apply to annuities or health insurance. This standard does not apply to compliance with state regulations that differ materially from the *Model* with regard to the issues addressed in this standard. Actuaries involved in the preparation of illustrations subject to a regulation that differs materially from the *Model* may consider the guidance in this standard to the extent that it is applicable and appropriate.

Actuaries involved in the preparation of illustrations in the absence of applicable regulations should consider the guidance in this standard if the illustrations are to be represented as being in accordance with the *Model.*

1.3 Effective Date—This standard is effective March 31, 1996.

Section 2. Definitions

Definitions 2.1, 2.2, 2.5, 2.6, 2.7, and 2.10 below are intended to conform with those contained in the *Model.*

2.1 Currently Payable Scale—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 95 days.

2.2 Disciplined Current Scale—Any scale of non-guaranteed elements that satisfies the required tests set forth herein, using assumptions that are reasonably based on actual recent historical experience.

2.3 Experience Factor Class—A group of policies for which non-guaranteed elements are determined by using common numerical values of a particular experience factor.

2.4 Experience Factors—Those elements that reflect actual experience. A particular experience factor reflects actual experience of a specific type. Examples of experience factors are investment income rates, mortality rates, persistency rates, and expense rates.

2.5 Illustrated Scale—A scale of non-guaranteed elements currently being illustrated that is not more favorable to the policyowner than the lesser of the disciplined current scale and the currently payable scale.

2.6 Illustration Actuary—Any actuary who is appointed in accordance with the requirements set forth in the *Model*.

2.7 Lapse-Supported Illustration—An illustration of a policy form using a scale that fails the lapse-support test as defined in section 5.3.5.

2.8 Non-Guaranteed Element—An element within an insurance policy that provides at least as favorable a value to the policyowner as guaranteed at the time of issue of the policy. Examples of non-guaranteed elements include policyowner dividends, excess interest, and a reduction in mortality or other charges from those guaranteed in the contract.

2.9 Recent Historical Experience—Mortality, persistency, interest, and expense experience on an experience factor class that is current, determinable, and credible.

2.10 Self-Supporting Illustration—An illustration of a policy form using a scale for which it can be demonstrated that, when using experience assumptions underlying the disciplined current scale, for all illustrated points in time on or after the fifteenth policy anniversary or the twentieth policy anniversary for second-or-later-to-die policies (or upon policy expiration if sooner), the accumulated value of all policy cash flows equals or exceeds the total policyowner value available. For this purpose, policyowner value will include cash surrender values and any other illustrated benefit amounts available at the policyowner's election.

Section 3. Background and Historical Issues

Sales illustrations have been of concern to regulators for almost a century, going back at least to the Armstrong Commission. Recent developments involving insurance products, illustration technology, and the volatility of financial markets have led to heightened concern, and to the adoption of a model regulation on illustrations by the NAIC.

Actuaries have been involved in the process of establishing scales of dividends and other non-guaranteed elements to be illustrated by insurance companies for decades. Until the 1980s, non-guaranteed elements were essentially synonymous with participating dividends, and the sources of scales of illustrated dividends were tables prepared by the respective insurance companies. More recently, there has been a proliferation of policies with non-guaranteed elements other than dividends. Improving technology has also made possible the development of software that enables insurance agents to produce sales illustrations based on a variety of assumptions, with little or no direct involvement on the part of the insurance company.

In many companies, actuaries have not generally been involved in compliance with illustration regulations. The role of actuaries has often been that of providing information to those responsible for the preparation of illustrations. The *Model* now assigns major responsibilities regarding compliance to an actuary who is appointed by the company.

Section 4. Current Practices and Alternatives

4.1 Regulatory Requirements—Prior to the issuance of the *Model*, many states had certain requirements that applied to sales illustrations. While these requirements varied by state, those that were generally applicable included the following:

a. If dividends or other non-guaranteed elements were illustrated, the illustration generally had to use the insurer's current dividend scale or current interest rate, mortality charges, and expense charges. In some cases, companies were also illustrating less favorable scales.

b. Any reference to dividends or other non-guaranteed elements had to include a statement that such elements were not guaranteed.

c. Illustrations of non-guaranteed values had to display the comparable guaranteed values with equal prominence.

4.2 Uses of Illustrations—There are generally two primary uses of illustrations. The first intends to show the buyer the mechanics of the policy, i.e., how a particular financial design or concept works, and how policy values or premium payments may change over time.

The second use is to compare the cost or performance of different policies, to a considerable extent based on the misperception that the sales illustration projects a likely or best estimate of future performance. Since a sales illustration is simply an extension of the current scale of non-guaranteed elements into the future assuming current assumptions hold to that point, actual non-guaranteed elements will almost certainly vary from those illustrated. Different companies will experience different variances from illustrated values.

4.3 Experience Factors and Assumptions—While illustrations are usually required to reflect the current dividend scale or the current scale of non-guaranteed elements, there has been a great deal of discretion given to companies in the development of these current scales. Other than what has been required by the NAIC Annual Statement, typically there has been no regulation on, or required disclosure of, the degree of risk or contingency associated with these elements.

Actuarial Standard of Practice (ASOP) No. 1, *The Redetermination (or Determination) of Non-Guaranteed Charges and/or Benefits for Life Insurance and Annuity Contracts*, sets a standard of using anticipated experience factors that are based on recent experience. ASOP No. 1 explicitly recognizes that current company experience may be of limited value in projecting future experience. This would be true, for example, when writing new or unique coverages, or when the economic and/or demographic conditions have changed. Thus, ASOP No. 1 allows an actuary to use his or her best judgment in estimating the company's future experience factors to use in setting parameters for determining the illustrative policy values. An actuarial report is required whenever an actuary advises an insurance company on non-guaranteed elements.

ASOP No. 15, *Dividend Determination and Illustration for Participating Individual Life Insurance Policies and Annuity Contracts*, assumes that the actuary is advising and reporting to the insurance company. It sets forth the recommended practices with respect to (1) the establishment of experience factors, and (2) the requirement of an actuarial report whenever an actuary advises an insurance company on illustrated or current dividends. The standard does not cover other non-guaranteed elements of insurance policies.

In addition, ASOP No. 15 states that if any projection of experience trends is made in determining the experience factors, then such projections should be limited to a relatively short time frame, such as the period for which a dividend scale is likely to remain appropriate. The actuary has a professional responsibility to ensure that illustrated dividends reflect the current financial results of the company and, to that end, should conduct tests to judge whether those illustrated dividends are supportable, i.e., could be paid in the near future. If a substantial probability exists that they may not be supported in the near future, the actuary should disclose this in the actuarial report. Finally, the actuarial report should document the actuary's advice and its basis and disclose, among other items, how the experience factors are reflected in the process of dividend determination.

4.4 Illustration Systems and Software—Varying degrees of flexibility are provided by companies to their agents in customizing sales illustrations, depending somewhat on whether the producers are brokers or career agents. Generally, the tools that companies provide allow flexibility with respect to column selection and formats, variations on non-guaranteed elements, and different premium patterns. Along with this flexibility may be the requirement that the buyer also be given a ledger illustration in a company-approved format.

With respect to varying the non-guaranteed elements, it is more common to allow flexibility in modifying the interest rate assumptions, although some companies allow modifications of the mortality assumptions as well.

STANDARD OF PRACTICE

Section 5. Analysis of Issues and Recommended Compliance

5.1 Regulatory Requirements—The *Model* contains detailed instructions, technical requirements, and prohibitions regarding many aspects of illustrations. The illustration actuary should be familiar with the *Model* and any applicable state variations in illustration requirements. The illustration actuary should be reasonably satisfied that all relevant actuarial requirements have been met.

5.2 Appointment as Illustration Actuary—Before accepting an appointment as an illustration actuary, the actuary should determine that he or she meets the qualifications described in *Qualification Standards for Public Statements of Actuarial Opinion*, adopted by the American Academy of Actuaries. The appointment should be in writing, in accordance with applicable laws or regulations, describing the scope of the illustration actuary's responsibilities, and establishing the effective date. Acceptance of or withdrawal from the position also should be in writing.

5.3 Illustrated Scale—What follows are the detailed requirements for the scales used in illustrating non-guaranteed elements.

5.3.1 Illustrated Scale Requirements—The illustrated scale must not be more favorable to the policyowner than the currently payable scale at any duration. In addition, the illustrated scale must meet the requirements of a disciplined current scale, as set forth in sections 5.3.2 and 5.3.5 below.

5.3.2 Requirement for Self-Support—The *Model* requires the scale for every policy form illustrated by an insurer to be self-supporting according to the assumptions underlying the insurer's disciplined current scale. This test applies to the illustration of policies in force for less than one year. The actuary should not assume that a policy form will be subsidized by another policy form, or by any other source.

As specified by the *Model,* the illustration actuary should use the following self-supporting test: at every illustrated point in time starting with the fifteenth policy anniversary (with the twentieth policy anniversary for second-or-later-to-die policies), the accumulated value of the policy cash flows, using the disciplined current scale and its underlying assumptions, should be equal to or greater than the illustrated policyowner value, i.e., the cash surrender values and any other illustrated benefit amounts available at the policyowner's election. Where policies expire according to their terms prior to 15 years (20 years for second-or-later-to-die policies), the scale illustrated should be self-supporting at the point of expiration.

Each illustration reflects underwriting classification, as well as certain factors that are subject to policyowner choice. The underwriting classification includes factors such as age, sex, and risk class. Policyowner choices reflected in the preparation of an illustration include, but are not limited to, the size of policy, premium payment pattern, dividend option, riders, and policy loans.

In performing the self-supporting test for a policy form, the illustration actuary may test the underwriting classification and policyowner choice factors in aggregate. The assumed distribution between classes should be based on actual experience if available, recognizing shifts in distribution that may be expected to occur toward any portions of the business that do not meet the self-supporting test in their own right.

5.3.3 <u>Assumptions Underlying the Insurer's Disciplined Current Scale</u>—As used in this standard, *actual experience of an experience factor class* means experience and past trends in experience to the extent that such experience is current, determinable, and credible. When such suitable data are lacking, experience factors may be derived in a reasonable and appropriate manner from actual experience and past trends in experience of other similar classes of business either in the same company, of other companies, or from other sources, generally in that order of preference. Following is a list of considerations for determining the major experience factors:

a. Interest—The earned interest rate factor underlying the disciplined current scale should be based on the insurer's recent historical experience, to the extent credible, on the assets supporting the policy block. An earned interest rate factor is reasonably based on actual recent historical experience if determined on an entirely retrospective basis considering only assets to be supporting the block. Therefore, the earned interest rate factor underlying the disciplined current scale is assumed to be fixed for all illustrated durations. The earned interest rate factor should be developed using the same method that is used to actually allocate investment income to policies. It may be net of investment expenses, or, alternatively, investment expenses may be treated separately as expenses. The use of either the portfolio average approach or the investment generation approach is acceptable for the allocation of investment income. The detailed procedures for determining the earned interest rate factor should have a sound theoretical basis.

   The manner and extent to which realized and unrealized capital gains and losses are reflected in these assumptions should be consistent with actual company practice for dividends and other non-guaranteed elements. If other lines of business are considered an investment of the illustrated line, gains and losses from such lines may be included consistent with company practice.

b. Mortality—The mortality experience factors should be based on the insurer's recent mortality experience, adjusted for risk class. To the extent that the insurer's recent experience is not fully credible, other credible intercompany mortality experience, appropriately modified to reflect the insurer's underwriting practices, may be used.

c. Taxes—The cash flows used in carrying out the self-supporting test should include cash flows arising from all applicable taxes. All income taxes, except the additional tax associated with the differential earnings rate, should be recognized in accordance with their impact by duration in the self-supporting test. Non-income taxes that may be classified as investment taxes may be treated as a deduction from the earned interest rate or may be treated separately. Other categories of taxes, such as premium taxes or employment taxes, may be handled separately or included in the category of all other expenses, as outlined in (e) below.

d. Direct Sales Costs—Agent commissions, overrides, and other direct compensation that are incurred by formula or as a consequence of sales should be charged directly and excluded from the expense factors given in section 5.3.3(e)(1), (2), and (3) below.

e. All Other Expenses—As described in the *Model*, the minimum expenses to be used in the calculation of the disciplined current scale for all policy forms during the certification year may be (1), (2), or (3) below, subject to the criteria that follow:

   1. Fully Allocated—Unit expenses recently incurred at the company and actually allocated to the policy block. Direct costs should be charged to the groups of policies generating those costs, and indirect costs should be fully allocated using a sound basis of expense allocation. Nonrecurring costs, such as systems development costs, may be spread over a reasonable number of years (e.g., system lifetime) in determining the allocable expenses for a particular year.

   2. Marginally Allocated—Unit expenses calculated in a manner similar to fully allocated except that indirect expenses such as corporate overhead and general advertising are not allocated to the policy block.

   3. Generally Recognized Study—Unit expenses obtained from an intercompany expense study based on fully allocated expenses representing a significant portion of insurance companies and approved for use by the NAIC or by the commissioner.

   Marginal expenses are to be used as the minimum only if they are greater in the aggregate than the generally recognized expense table. Generally recognized expense table expenses may be used as the minimum only if they are not less in the aggregate than marginal expenses. Fully allocated expenses may always be used as the minimum. If no generally recognized expense table is approved by the NAIC or by the commissioner, fully allocated expenses must be used.

The comparison and choice of expense assumptions are to be made in aggregate for all policy forms. Once the unit expense category is selected, that choice should be used for the entire certification year. The average policy size and volume of sales should be appropriate for the policy block for which they apply when the unit costs are being calculated.

f. Persistency—The premium continuation and policy persistency rates used by the insurer should be based on the insurer's recent experience for this or similar policy forms. To the extent that the insurer's recent experience is not fully credible, other credible experience such as that from the Life Insurance Marketing Research Association or other appropriately adjusted intercompany persistency experience may be used.

g. Changes in Methodology—When an insurer changes its methodology in determining non-guaranteed elements (e.g., portfolio to new money interest rates, or blended to smoker/ nonsmoker mortality rates), the assumptions underlying the disciplined current scale should be appropriately modified to reflect the new methodology. This may necessitate reperforming the self-support and lapse-support tests.

5.3.4 <u>Relationship of Recent Historical Experience to Disciplined Current Scale</u>—The assumptions underlying an insurer's disciplined current scale should be logically and reasonably related to recent historical experience. Changes in experience should be reflected promptly once they have been determined to be significant and continuing. When incorporating recent historical experience into the assumptions, the actuary should comply with the following guidelines:

a. Historical experience may exhibit improvements from year to year. Such trends in improvement may not be assumed to continue into the future beyond the effective date of the scale underlying the illustration.

b. Similarly, if trends indicate that significant and continuing deterioration in an experience factor has occurred or, in the actuary's judgment is likely to occur between the date of the historical experience and the effective date of the scale underlying the illustration, the actuary should recognize such deterioration in determining the assumptions to be used.

c. When an insurer introduces a change in underwriting practice (e.g., blended to smoker/nonsmoker), the actuary should divide the historical experience into the new underwriting classes in such a way that historical experience is reproduced in the aggregate.

5.3.5 <u>Lapse-Supported Illustrations</u>—The *Model* prohibits illustration of non-guaranteed elements in policies that are deemed to be lapse-supported, and establishes an additional test to demonstrate compliance with this requirement. This additional test requires that the policy form in question be self-supporting under the same assumptions and with the same level of aggregation as described in section 5.3.2, changing only the persistency assumption. The modified persistency rate assumption will use persistency rates underlying the disciplined current scale for the first 5 policy years and 100% policy persistency thereafter. Where benefits are conditional upon policy continuation or certain premium payment patterns, the lapse-support test should be constructed under the assumption that all policies in force at the end of year five and surviving to the date of such benefits will qualify for these benefits.

As allowed for in the *Model*, policy forms that have no guaranteed or non-guaranteed nonforfeiture values at any duration, such as certain term coverages, are exempt from the lapse-support test. These forms must still pass the self-support requirement, however.

5.3.6 <u>Annual Certification for Illustrations on Policies In Force One Year or More</u>—The illustration actuary may certify that a scale used to produce an illustration for a policy in force one year or more is in compliance with the *Model* and this standard if the following apply:

a. the currently payable scale has not been changed since the last certification and the illustration actuary determines that experience since the last certification does not warrant changes in the disciplined current scale that would make it significantly less favorable to the policyowner, or

b. the currently payable scale has been changed since issue only to the extent that changes are reasonably consistent with changes in experience assumptions underlying the disciplined current scale, or

c. the currently payable scale has been made less favorable to the policyowner since the last certification and the change is more than current experience would necessitate.

If none of the conditions in (a), (b), or (c) above is met, the illustration actuary should review and revise as necessary the experience factors underlying the disciplined current scale to a new disciplined current scale for this policy form. The illustrated scale must meet the self-support and lapse-support tests (as described in sections 5.3.2 and 5.3.5), using actual experience and actual paid scales of non-guaranteed elements from the date of issue to the present and a scale not greater than the disciplined current scale from the present forward.

In the context of inforce illustrations, distributions of accumulated surplus or prior gains to an inforce policy block may be included in the disciplined current scale and in non-guaranteed elements to be illustrated to the extent that such distributions are (1) currently being paid to the policyowners by the insurer, and

(2) there is the intent and ability to continue to do so. Such distributions may be used in conducting the tests for self-support and lapse-support.

5.4 Changes in Practice—An insurer may introduce certain changes in the way it conducts its business, which will have a significant positive or negative effect on future experience. If the action has already occurred, but not enough time has elapsed for it to be reflected in the insurer's actual experience, it may nevertheless be reflected in the assumptions underlying the disciplined current scale. As prescribed by the *Model*, any trends in improvement may not be assumed to continue into the future beyond the effective date of the scale underlying the illustrations. The changes should be *real* in order to be reflected in the disciplined current scale. An action leading to an expected change in experience should actually have taken place, and not simply be planned for in the future. Examples of actions that may be recognized are as follows:

a. Changing Underwriting Standards—Introducing preferred risk, guaranteed issue, or simplified underwriting may impact the mortality assumption.

b. Varying Commission Levels—Changing commission levels (either decreasing or increasing) will have a known effect on policy expenses.

c. Reducing Staff—If the actual staff reductions have been implemented, a conservative estimate of net cost savings can be reflected in the disciplined current scale.

Section 6. Communications and Disclosures

6.1 Required Communications—The illustration actuary should certify annually, as required by the *Model*, stating that the scales used in illustrating non-guaranteed elements are in compliance with the requirements as set forth in the *Model*. Certifications should also be made for newly introduced forms before a new policy form is illustrated.

The certification should contain the following disclosures:

a. for business issued in the last 5 years, a statement as to whether the currently payable scale has been reduced since the last certification for reasons unrelated to experience changes;

b. a statement as to whether there are any inconsistencies between illustrated non-guaranteed elements for new policies and similar inforce policies;

c. a statement as to whether illustrated non-guaranteed elements for new and inforce policies are consistent with the non-guaranteed element amounts actually credited or charged to the same or similar forms; and

d. a statement of the choice of expense assumptions as discussed in section 5.3.3(e).

6.2 Inability to Certify—As required by the *Model*, if an illustration actuary is unable to certify any policy form scale the insurer intends to use, the actuary shall notify the board of directors of the insurer and the commissioner promptly of his or her inability to certify.

6.3 Documentation—The illustration actuary should maintain documentation that supports the actuarial certification with respect to the construction of the disciplined current scales, which should include the following:

a. description of, and rationale for, the mortality, persistency, expense, and tax assumptions;

b. description of, and rationale for, the interest rate assumption and description of the method used to allocate interest credits to policies;

c. description of, and rationale for, any other calculation methods and assumptions used to carry out the tests and demonstrations described herein; and

d. demonstration that the self-support and lapse-support tests have been met.

6.4 Reliance on Data Supplied by Others—The actuary may rely on data supplied by another. In doing so, the actuary should disclose such reliance in the certification. The accuracy and comprehensiveness of data supplied by others are the responsibility of those who supply the data. However, the actuary should, when practicable, review the data for reasonableness and consistency.

6.5 Notice of Error in Certification—As required by the *Model*, if an error in a previous certification is discovered, the illustration actuary shall promptly notify the board of directors of the insurer and the commissioner. The certification should be considered in error if the certification would not have been issued or would have been materially altered had the correct data or other information been used. The certification should not be considered to be in error if it would have been materially altered or not issued solely because of data or information concerning events that occurred subsequent to the certification date.

The actuary should notify the board of directors or the board's designee of any such determination made between the issuance of the most recent certification and the next certification date. The notification should include a summary of such findings and an amended certification.

6.6 Deviation from Standard—An actuary must be prepared to justify the use of any procedures that depart materially from those set forth in this standard and must include, in any actuarial communication disclosing the results of the procedures, an appropriate statement with respect to the nature, rationale, and effect of such departures.

Appendix

Comments on the Exposure Draft
and Committee Responses

The proposed standard of practice was exposed for review in April 1995, with a comment deadline of July 31, 1995. Seventy-four letters of comment and oral presentations were received. In addition, eighteen submissions of confidential data (providing numerical examples) were received. Summaries of substantive issues and questions contained in the comments (whether written or oral) are in lightface, and committee responses in **boldface.**

<u>Title</u>

Questions were raised as to why this standard was not designated as a compliance guideline. **The Actuarial Standards Board recently decided to phase out the series of separately numbered compliance guidelines, because of concern about the implication that compliance guidelines might be considered to have lesser standing than "regular" standards. The fact that an actuarial standard of practice such as this one is motivated by the need to provide guidance in complying with directives from a non-actuarial body, and may not be entirely consistent with generally accepted actuarial practices, is still clearly signaled by the use of the word *compliance* in the title and by appropriate wording in section 1.**

<u>Section 1. Purpose, Scope, and Effective Date</u>

Section 1.2, Scope—The failure to include annuity and variable life illustrations was questioned. **The decision of the NAIC not to include these other coverages in the *Model* at this time eliminated the need for standards on compliance.**

Section 1.3, Effective Date—It was suggested that the effective date of the standard should be the same as that of the *Model*. **Actuaries preparing illustrations will need this standard some months ahead of the effective date of the *Model*, and some companies may wish to comply with the *Model* prior to its adoption by a particular state. Wording was added to section 1.2 to clarify the applicability in such cases.**

<u>Section 2. Definitions</u>

Section 2.2, Disciplined Current Scale—It was argued that since the currently illustrated scale should be the less favorable of the disciplined current scale and the currently payable scale, the definition should not imply that the disciplined current scale is necessarily the illustrated scale. **The suggested change was made to the text, here and elsewhere (e.g., in sections 5.3.3 and 5.4 of this text).**

Section 2.4, Experience Factors—Suggestions were received that this definition and several others should be made more specific, encompassing more of the precise meaning given to these terms in later sections. **This suggestion was considered, but it was felt that the definitions should be left general where possible, with further development of the meaning of these terms in, for example, section 5.3.3.**

<u>Section 3, Background and Historical Issues; and Section 4, Current Practices and Alternatives</u>

The changes that were suggested for these two sections were relatively minor. All were considered and some were adopted. In some cases, suggestions were not adopted because they were based on the assumption that the purpose of these sections is to advise actuaries on acceptable practice. However, these sections are intended to be purely descriptive.

<u>Section 5. Analysis of Issues and Recommended Compliance</u>

Section 5.1, Regulatory Requirements—The actuary should not be responsible for state variations that are not relevant to the company's operations. **The committee changed the text in response to this comment.**

Section 5.2, Appointment as Illustration Actuary—The need to cite laws and regulations in the appointment letter was questioned. **The committee changed the text in response to this comment.**

Section 5.3, Illustration of Guaranteed Elements—**As a result of comments questioning the necessity or intent of this section, this section was eliminated. The remaining sections were renumbered.**

Section 5.4, Illustration of Non-Guaranteed Elements (now section 5.3 and titled Illustrated Scale)—Some letters pointed out that the standard does not address the practice whereby companies present attractive illustrations and then cut back their scales after issue. **By providing a test of self-support, the standard ought to reduce the ability of companies to use illustrations that cannot be supported. To reach further, into the realm of promises not kept, was beyond the scope of the standard. The actuary should consult ASOP Nos. 1 and 15 in this regard. Certain disclosures in this respect are now required of the actuary, as required by the *Model*.**

Section 5.4.1, Disciplined Current Scale (now section 5.3.1 and titled Illustrated Scale Requirements)—Some felt that the description of the relation of the illustrated scale to the disciplined current scale was ambiguous. **Some wording changes were made to clarify the text.**

Section 5.4.2, Self-Supporting Requirement (now section 5.3.2 and titled Requirement for Self-Support)—Several respondents felt that the self-support test should not require an asset share, or "unit based," approach, and that other methods should be allowed. On the other hand, one respondent felt that the standard should be more explicit that an asset share approach is what is really intended. **The self-support test is prescribed by the *Model*. Section 5.4.2 (now section 5.3.2) specifies that the test may be applied to a policy form in aggregate, and the committee feels that this wording is broad enough to permit methods that are more aggregative than asset shares, although obviously the asset share method is the primary method. At one point in the section, wording was changed to emphasize that testing for a policy form as a whole is permitted.**

Some felt that illustrations based on subsidies between policy forms should be allowed, and that in general the choice of pricing level is a matter of management prerogative and strategy. **The choice to subsidize a particular policy form might well be legitimate, but in order to avoid a situation in which the company adopts an illustration approach unsupported by recent experience, there would have to be restrictions on pricing subsequent to issue. This goes beyond the intent of this standard, which applies to illustrations only, and not to actual pricing. The basic self-support and lapse-support tests were retained in the *Model*, and hence in this standard.**

Comments were made that aggregation should include riders, dividend options, and policy loans. **The committee changed the text in response to this comment.**

Several objections were made to the sentence on incidental subsidies, such as it might require much detailed testing to apply, it is vague, and it could create uncertainties in application. Another comment was that it might encourage a practice of "correcting" subsidies by after-issue pricing action. **The sentence was eliminated due to vagueness and the extra work that this statement might require. As far as the subject of pricing actions after issue is concerned, that is beyond the scope of the standard.**

The 15-year limit was objected to, mainly on behalf of "second-or-later-to-die" products, for which the emergence of profit tends to be very late because of the pattern of mortality margins. **The *Model* was changed to allow for a 20-year period for second-or-later-to-die policies. The standard reflects this change.**

Another objection to the 15-year test was that it should not be cumulative; early gains should not be allowed to offset late losses. **To some extent, the lapse-support test will prevent such practices. The standard was made consistent with the *Model*.**

Various suggestions were made about anticipating shifts in distribution within the aggregate. **The committee did not determine that the text should be changed.**

Some felt that much work was required to test each age and/or dividend option. **The committee believes that this comment stems from a misreading. These items may be tested in the aggregate.**

An objection was made to the use of policyowner dividends but not stockholder dividends in the test. **No change was made to the text, since stockholder dividends are not a policy benefit.**

Some felt that the standard mandated aggregate testing. **A wording change was made to avoid this misunderstanding.**

Section 5.4.3(a), Interest Assumptions (now section 5.3.3(a))—Many comments were received about the portfolio versus new money rate problem. Some suggested that portfolio rates be graded into new money rates. **Both methods are in general use and it was not considered appropriate to preclude either. The grading method is inconsistent with the actual recent historical experience requirement in the *Model*.**

Several commentators objected to the apparent mandated use of recent interest experience when rates are falling. **The company may always illustrate less favorable scales.**

Section 5.4.3(b), Mortality Assumptions (now section 5.3.3(b))—Objections were made that the wording did not permit partial credibility approaches. **Wording changes ("To the extent that...") were made to permit partial credibility for mortality and for persistency as well.**

Section 5.4.3(c), Expense Assumptions (now section 5.3.3(e) and titled All Other Expenses)—Many objected that the "fully allocated" provision did not allow room for newer companies, companies with temporarily high expenses, or companies that consistently use marginal expense approaches. **A provision was added to the *Model* so that an assumption, not below industry averages nor below marginal costs, could be used. The standard reflects this change in the *Model*.**

Objections were raised that the unit expenses could be affected by temporary decreases in sales. **A sentence was added to provide for "appropriate" assumptions with respect to levels of sales.**

Section 5.4.3(d) (now section 5.3.3(c) and titled Taxes)—There were several comments that taxes were not properly recognized. **In response, a new subsection on taxes was created.**

Section 5.4.4, Relationship of Recent Historical Experience to Disciplined Current Scale (now section 5.3.4)—Several respondents said the text seemed to require that deteriorating trends needed to be projected to a later date than improving trends. **Changes in wording and organization were introduced to make the subsections more nearly parallel.**

Some said that projection over the life of the policy should be permitted, and in some cases it was claimed that ASOP No. 15 allows such a practice**. The regulation does not allow for the projection of improvements into the future.**

It was said that using the "date of the illustration" as the end point of any projected experience could lead to problems or ambiguity. **The phrase "effective date of the scale" was substituted.**

Simply projecting trends is not enough, said some. Discontinuous changes may occur as a result of changes in staffing, changes in commission scales, or changes in underwriting practice. **Section 5.5, Changes in Practice (now section 5.4), was intended to address this.**

Section 5.4.5, Lapse-Supported Illustrations (now section 5.3.5)—Suggestions were received that modifications in mortality and expense could occur if persistency were actually to be 100%, and that such experience modifications should be incorporated in the lapse-support test or, alternatively, that some less extreme test, such as 97% persistency, should be used. **One hundred percent persistency is mandated in the *Model*. The language in the standard was modified slightly to make clear the nature of the assumptions underlying the test.**

An unexpected impact on certain term policies was evidenced. **The Model was changed to exempt certain term policies from the lapse-support requirement. A corresponding change was made to the standard.**

Section 5.4.6, Illustrations for Policies In Force Longer Than One Year (now section 5.3.6 and titled Annual Certification for Illustrations on Policies In Force One Year or More)—Several respondents pointed out that paragraphs (a) and (b) were not consistent, and that (a) incorrectly referred to "originally illustrated" scales. **Changes were made to correct these problems.**

There was some concern that section 5.4.6 (now section 5.3.6) might be interpreted as calling for a complete reworking of the self-support and lapse-support tests (including, perhaps, a historical accumulation of experience) each time that an inforce illustration is made for a particular policy form and issue year. One respondent, however, thought that the text should more explicitly require such a reworking. It was pointed out that even where the conditions of (a) are not met, there might not be a need for a change in the disciplined current scale**. Inforce illustrations are not perceived to cause market conduct problems to the same extent as those for new sales. Accordingly, provision for the safe harbor of continued use of the prior illustration was provided for in the revised sections (a), (b), and new section (c). Where recalculation is required, clearer guidance was provided for the choice of assumptions in the new disciplined current scale. The entire section was clarified.**

A number of comments were received about the last paragraph of 5.4.6 (now section 5.3.6), including the observation that the insurer may only plan to pay the extra distribution for a short period. One comment called for allowing the illustration of such distributions only if reserved for. **Wording was added to ensure that such distributions should only be illustrated to the extent the insurer has the ability and intent to continue to do so. It was not felt that such distributions necessarily need be reserved for.**

Section 5.5, Changes in Practice (now section 5.4)—A number of comments indicated that in certain relatively minor respects this section was inconsistent with other sections. **In response, the committee made a number of wording changes.**

Section 5.5, Consistency—Some felt that this section was unclear or that it trespassed too far into setting standards for payable scales rather than illustrations. **This section was eliminated after the NAIC amended the *Model* to require a disclosure in the certification.**

<u>Section 6. Communications and Disclosures</u>

Section 6.1, Required Communications—**Changes were made to reflect the language of the *Model* and the required disclosures.**

Section 6.2, Inability to Certify—**An unnecessary sentence (the third sentence of this section), duplicating that of formerly numbered section 6.7, was eliminated.**

Section 6.3, Additional Disclosures—Comments indicated that this section may unnecessarily require disclosure of sensitive materials. **Upon review, the committee decided that this section should be eliminated.**

Section 6.4, Documentation (now section 6.3)—Comments included questions about "other sources" and also a note that in several of the items there should be more than mere "description." **Changes were made to respond to these comments, and the section was reformatted.**

Section 6.6, Notice of Error in Certification (now section 6.5)—**Changes were made to follow the language of the *Model* more closely.**

The committee thanks everyone who took the time and made the effort to write comment letters, submit confidential data, and provide testimony at the hearing.