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FTC STUDY OF LIFE INSURANCE COST DISCLOSURE

HEARINGS

BEFORE THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

NINETY-SIXTH CONGRESS

FIRST SESSION

ON

FEDERAL TRADE COMMISSION'S STUDY OF LIFE INSURANCE COST DISCLOSURE

JULY 10 AND OCTOBER 17, 1979

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FTC STUDY OF LIFE INSURANCE COST DISCLOSURE

TUESDAY, JULY 10, 1979

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE,
AND TRANSPORTATION,
Washington, D.C.

The committee met at 10:25 a.m., in room 235, Russell Senate Office Building, Hon. Howard W. Cannon (chairman of the committee) presiding.

OPENING STATEMENT BY THE CHAIRMAN

The CHAIRMAN. The committee will come to order.

Good morning. Today the committee meets to hear the testimony of the Federal Trade Commission on a major staff report to the Commission concerning life insurance cost disclosure. This report is important not only because it represents 2½ years of staff effort on the part of the FTC, but because the life insurance industry is such an important part of the American economy.

The life insurance industry directly affects most of the families in this country. Seventy-two percent of the adult population of the United States and over 90 percent of all husband-and-wife families own some form of life insurance.

Insured families paid an average of over $500 a year in premiums and had approximately $37,000 insurance in force. In 1977, Americans paid $24.2 billion in life insurance premiums representing 1.9 percent of all personal income.

The Federal Trade Commission has examined the currently existing practices and regulations concerning the type of cost disclosure information that is given in connection with the sale of life insurance. They have concluded, as their testimony and final report will indicate, that several improvements and alternatives should be considered regarding the kind of information presented to a consumer.

However, I want to emphasize that this FTC study is only a study. It is not an act of Congress. It is not a trade regulation rule.

The FTC has studied the life insurance cost disclosure issue, and they have come up with recommendations for the States to consider, but the States are not compelled to act.

Hopefully, to the extent that the FTC has been persuasive and offered helpful suggestions on improving cost disclosure, the States will act. But in my view, the McCarran-Ferguson Act would prohibit the Federal Trade Commission from regulating life insurance cost disclosure in any State which adopts some system of regulat-

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ing this activity. The fact that the FTC has issued this study as only a recommendation for consideration by the States, indicates that the FTC was aware of and gave consideration to the limitations on their authority.

On the other hand, I hope that the FTC's recommendations will be met on the merits. I hope that the industry will not simply attack the messenger, the FTC, but will really give thoughtful consideration to those aspects of the FTC's recommendations that may merit adoption.

Finally, I want to say a word about the Federal interest in the insurance industry, both in Congress and in various agencies. Given the size of the industry and the way in which it impacts on almost every citizen as a consumer, this interest is legitimate. But whether it results in Federal action is a different question.

If the industry moves forward and adopts, on its own, or under State regulation, necessary and justified safeguards, then Federal action is unlikely. But, if problems are identified and no action is taken, then pressure for Federal regulation will build.

Today's hearing is the first opportunity of the Commerce Committee to receive a report from the FTC on the numerous insurance studies they have undertaken in the past 2 years. The committee is very interested in these projects and will be monitoring them closely.

The committee is also interested in the FTC's plans for future utilization of these various studies and will want to explore with the Commission what the outer limits of the FTC's authority are under the McCarran-Ferguson Act with respect to the business of insurance.

For all of these reasons, we are very pleased to have as our witness this morning, the former chief counsel and staff director of this committee, and now the Chairman of the Federal Trade Commission, Michael Pertschuk.

Welcome to the committee. Would you please identify for the record those who are accompanying you at the witness table.

STATEMENT OF HON. MICHAEL PERTSCHUK, CHAIRMAN, FEDERAL TRADE COMMISSION; ACCOMPANIED BY ALBERT H. KRAMER, DIRECTOR, BUREAU OF CONSUMER PROTECTION; AND MICHAEL LYNCH, BUREAU OF ECONOMICS

Mr. PERTSCHUK. Thank you very much Mr. Chairman. Also, let me share the sentiments which you addressed in your opening statement.

With me is Al Kramer, to my direct right, the Director of the Bureau of Consumer Protection; and Michael Lynch from the Bureau of Economics, the economist who contributed a great deal to this report.

I thank you for the opportunity to testify before you today. Our topic—life insurance—is a deadly serious one for millions of American consumers. Each year they spend over $30 million on life insurance premium payments. And yet, despite the importance and expense of this purchase, the average consumer buys a life insurance policy without ever being given the information that is absolutely essential for him or her to be able to understand what that policy really costs.

Indeed, I think it fair to say that no other product in our economy that is purchased by so many people for so much money is bought with so little understanding of its actual or comparative value.

A person who buys an ordinary whole life insurance policy, the most popular type of insurance now sold, is in reality buying both protection against dying soon, and protection against not dying soon.

This latter protection takes the form of cash values, which the insured may obtain at will, merely by surrendering his or her policy.

Building up cash values in a life insurance policy is a little different from saving money in any other medium, and one would imagine that one of the first things that many consumers would want to know about their life insurance, like any other savings medium, is "what interest rate will I be getting."

In fact, however, such information is simply not now available either to consumers or to life insurance agents, except perhaps for those few fortunate enough to have mastered courses in both actuarial science and computer programing.

I will elaborate on these observations in a moment, but I would first like to point out that very little of what I have just said or have yet to say is at all original. This committee has had a long-term concern about the fate of the insurance consumer, as its arduous work on no-fault auto insurance attests, which the Commission has undertaken.

The inability of consumers to make knowledgeable decisions when purchasing life insurance has long been a topic of serious, if not sufficiently widespread, concern among insurance industry executives, State regulators and, not least of all, here on Capitol Hill.

In February 1973, the late Senator Philip Hart held extensive hearings on the life insurance industry, with emphasis on the need for life insurance cost disclosure. In Senator Hart's words, the thrust of those hearings was that:

> * * * Consumers couldn't make rational buying decisions at the time of purchase of life insurance because detailed information on costs and benefits wasn't available.

In June 1973, the National Association of Insurance Commissioners adopted an interim model cost disclosure regulation, and a final NAIC model was adopted in May 1976.

The NAIC model law was an important first step in the direction of promoting consumer awareness of insurance costs. However, it contained several major flaws that have since been recognized by other congressional committees, including the Senate Committee on Veterans' Affairs, which in June 1977, postponed action on S. 718, a bill to require adherence to the NAIC model regulation in connection with the sale of life insurance to veterans.

On the House side, counterpart to this committee, the Subcommittee on Oversight and Investigation of the House Committee on Interstate and Foreign Commerce, chaired by Congressman Moss, held hearings on life insurance cost disclosure last August, focusing on the inadequacy of the NAIC model regulation.

It was in the context of this interest among congressional, State, and industry authorities that the Commission began its own inquiry into the problem of life insurance cost disclosure.

In December 1976, the Commission announced that it had authorized its staff to investigate four questions:

One, whether adequate cost information is being provided to prospective life insurance purchasers;

Two, what types of information would be most accurate and most likely to be useful to consumers;

Three, the impact such disclosures would be likely to have upon the industry and upon consumers; and

Four, what would be the most appropriate and feasible course of action for the Commission to take in this area to alleviate any problems found to exist.

The Commission has been, of course, mindful that our ultimate authority to take regulatory action with respect to life insurance may be significantly circumscribed by the McCarran-Ferguson Act.

On the other hand, the Commission's authority to investigate the existence of potential consumer problems, and to report the results of its investigations where they reveal substantial consumer problems, is unimpaired by this act. With this in mind, our staff began their inquiry in late 1976.

They have now produced a report which is being released today. Based on their findings and recommendations, the Commission has proposed a model State regulation on life insurance cost disclosure. The staff report is perhaps the best and most comprehensive exploration of the problems of life insurance cost disclosure undertaken to date.

We thus believe that the report will serve an important educational purpose. By releasing it we hope to prompt careful scrutiny and evaluation of its findings by the expert community.

With that introduction, then let me summarize the findings of the staff report and the Commission's own recommendations.

1. SAVING THROUGH LIFE INSURANCE

The first major conclusion of the report, as I noted, is that ordinary life insurance isn't just insurance. For most consumers, a life insurance policy is also a type of savings account. Only part of the premiums pay for death protection. Another large portion of the premiums consumers pay each year goes toward the policy's cash value, which grows over time and may be obtained simply by surrending the policy.

Industrywide, this savings component of cash value life insurance is extremely significant. Based on industry estimates, our staff puts the total consumer savings held by life insurance companies in 1977 at $140 billion. In other words, consumers save about the same amount through life insurance as through savings and loan passbook accounts.

Let me illustrate the relative importance of the savings component of cash value insurance in two ways.

The first is to examine the cash flow of the life insurance industry in gross dollar terms. Our staff analysis shows that almost $34 billion flowed into life insurance companies in 1977 from premiums

and investment investment earnings. On the other side of this rough balance sheet, only $5 billion were paid out in death benefits. The rest of the revenue went toward savings-related benefits such as dividends, surrender values, and increased holdings, as well as to the cost of doing business.

The other way to look at the savings element of life insurance is to break down each premium dollar into its end uses. How much is used to pay death benefits? About 15 cents. What portion is charged to overhead? Just over 30 cents. And the remaining 55 cents—over half of every dollar paid in premiums? It goes into the savings component, to be used to fund withdrawals and to increase the consumer savings held by the companies.

2. INDUSTRYWIDE RATE OF RETURN

Once we recognize that cash value, life insurance is both death protection plus savings, the logical next question is: What interest rate are consumers receiving on their money? The answer is that, in almost all cases, the average annual rate of return on the savings component of life insurance policies is far below the market value of money.

As one measure of the interest rates paid by life insurance companies, our staff computed the average industrywide rate of return paid on all cash value policies in 1977. After conservatively estimating the portion of the premiums needed to provide death protection, they found that the insurance industry paid consumers an average of between 1 and 2 percent on savings, with the best estimate being 1.3 percent.

This industrywide return rate is a summation of all the rates of return on individual policies. Thus it reflects the fact that the rates vary widely depending on the policy type, and more importantly, on the age of the policy. Because of the uneven way in which cash values grow over the life of a policy, the return rate realized by a consumer is largely dependent on how long the policy is held.

3. PENALTIES FOR EARLY TERMINATION

In the early years, there is actually a negative rate of return—the cash value is less than that part of the premium attributable to the savings element. Most policies have no cash value for the first year, so if the policy is allowed to lapse after only one annual payment, the entire savings is lost, and the rate of return is minus 100 percent. And the fact is that about one in every five new policyholders drops his or her policy in the first 13 months. Using the data gathered in 1973 by the Hart committee, we have estimated total consumer loss from first year lapses to be in excess of $200 million annually.

Due to the slow cash value buildup, whole life policies are rarely a desirable purchase unless held for more than 10 years. When our staff analyzed policies issued in 1973 and 1977, they found that policies terminated in the 5th year had an average return rate of minus 10 percent. At the end of 10 years, those policies would pay approximately 1 percent.

4. INSURANCE VERSUS OTHER INVESTMENTS

From these findings, it is clear that many cash value insurance policies offer rates of return several percentage points below alternatives readily available in the marketplace, even taking into account the fact that interest earnings from insurance are essentially tax free. For example, passbook savings accounts pay 5 percent or more. Time deposit rates for small savers are between 6 and 8 percent. And there have recently been complaints that these rates are artificially low, that they prevent small savers from keeping pace with inflation.

The potential consumer loss makes these rate of return differentials extremely significant. A person who invests $1,000 each year at 3 percent—a rate of return yielded by many whole life policies if they are held for 20 years—will have roughly $47,000 at the end of 30 years. The same amount invested for the same period at 6 percent will yield almost twice as much, about $84,000.

To give us an idea of the aggregate impact, the staff estimated that if the industrywide average return rate in 1977 had been 4 percent rather than 1.3, policyholders would have received an additional $3.7 billion in that year alone.

I should emphasize here that neither the Commission nor our staff is opposed to saving through life insurance. Neither do we favor the purchase of one form of insurance over another. Some available whole life policies offer return rates which are competitive with other savings media. And there are reasons for saving through insurance: it is convenient, some people prefer the forced savings aspect, and tax advantages may exist. In addition, whole life policies have certain attractive features which may not be available through term insurance.

5. THE NEED FOR RATE OF RETURN DISCLOSURE

But we are convinced that consumers cannot make an intelligent judgment about the merits of different insurance and investment packages without rate of return information, because the true cost of a life insurance policy can only be evaluated if one considers the interest rate paid on the savings component. A sizable portion of the premium goes toward savings. If consumers are receiving a lower interest rate on those savings than they could get from other investments, then, in effect, they are paying more for the insurance, something any informed buyer should certainly know.

But of course most consumers are not aware of this, so we come to the pervasive problem with the way ordinary life insurance is marketed today: inadequate cost information. No life insurance company in this country currently discloses a standardized rate of return to its customers. Yet, without such cost information, consumers cannot shop comparatively for the most suitable insurance product at the lowest price. Comparisons between insurance and other types of savings are also impossible.

And, where buyers have no way to distinguish competing products on the basis of their true cost, the forces of competition—which we rely on to eliminate inefficiencies and reward low cost products with larger market shares—cannot operate effectively.

One indication that competition is not working in the life insurance industry is the wide variation in the cost of similar policies. As an example, the 20-year rate of return in 1977 for $25,000 dividend-paying whole life policies, issued to males aged 35, ranged from a high of 7.6 percent to a low of 1.5 percent. For similar non-dividend-paying policies, the scale went from 3.9 to 0.66 percent.

Our staff's analysis of the Hart committee data reveals virtually no correlation between the true costliness of an insurance policy and its market share. They suspect that this variation means that many consumers are paying far more for life insurance than they would choose to pay if they had some way to compare costs.

Without the meaningful disclosure of accurate cost information, we submit, price competition in the life insurance is impossible, and the economic injury to consumers is extraordinarily high.

6. THE COMMISSION'S RECOMMENDATIONS

Mr. Chairman, my testimony so far has been about consumer problems in the life insurance industry and their causes. Now let me turn to the Commission's suggestions as to how those problems can be solved.

The Commission agrees with the Hart and Moss committee reports that an essential first step is to provide insurance consumers with information that will enable them to compare the costs of different policies and to compare saving through life insurance with saving through other means.

As I mentioned, the NAIC adopted model cost disclosure regulations in 1976. The Federal Trade Commission commends the NAIC for its sensitivity to the fundamental need for cost disclosure. However, based on the findings of our staff's investigation, the Commission believes that the NAIC model regulation could be improved. Therefore, we are proposing certain amendments to the NAIC regulation, the major features of which I shall describe. As amended, the NAIC regulation can, we feel, accomplish the goals that were originally set for it.

A. Rate of return information

First, and of greatest importance, prospective purchasers of cash value insurance and annuities should be provided with average annual rate of return information for any cash value insurance or annuity product they are considering purchasing.

Under the NAIC model, the only information consumers receive concerning cash values is a schedule showing what the value will be at the end of selected years. In other words, they are told that after 5 years, the cash value of the policy is, say, $1,000; after 10 years, it is $8,500; and so on. But they are not told whether this sum represents a 1 percent, a 5 percent, or some other rate of return on their investment.

Let me reiterate the serious consequences of this informational void. Without rate of return information, consumers cannot compare the relative merits of saving through the whole life policy with other alternatives such as buying a term policy and investing the difference in another savings medium. Nor are they able to compare the whole life policy's rate of return with anticipated

rates of inflation to judge whether their investment is likely to stay ahead or fall behind inflation rates.

We know that many industry spokespersons object to rate of return disclosures because it requires what to them is an improper separation of whole life insurance into two elements: savings and protection. They assert that life insurance is a unitary contract that, like the law, must be viewed as a seamless web. Cash values are said to be only an incidental byproduct of the level premium nature of whole life policies.

Whether the whole life insurance contract should be characterized as an indivisible whole, insurance purchased on the installment plan or combination of death protection and savings is largely a matter of semantics. The indisputable fact of the matter is that, regardless of how the savings element is described, it is hardly incidental. The savings element accounts for three or four times as much of the premium dollar as does the insurance protection, and this has made the life insurance industry a major repository of consumer savings.

The argument is simply not a persuasive response to the call for rate of return disclosure. The Moss committee considered this same issue and concluded as follows:

> We regard the "inseparable" whole life policy argument as a diversionary ploy. In our view, reliance on it in the future as a defense to rate of return disclosure will cross the line into irresponsibility.

The Commission recognizes that there is more than one disclosure method which can be used to compare different type insurance policies. Based on the available evidence, we selected the rate of return as the one most likely to aid consumers in making informed purchases. The staff report contains a detailed description of the advantages and disadvantages of this and other systems.

B. An appropriate index number

As I have just described, rate of return information is necessary for comparing dissimilar policies and alternate savings mechanisms. Another important part of any cost disclosure system is an index that will enable prospective purchasers to identify and select low cost policies from among an array of similar policies. This need is particularly acute in the case of cash value insurance. For these policies, it is often impossible to ascertain their true cost simply by looking at premiums because in addition to providing death benefits, whole life policies accumulate cash values and, in many cases, pay dividends.

The NAIC model regulation recognizes this problem and requires the provision of three different indices—the surrender index, the payment index, and the equivalent level annual dividend. It also requires that each of these indices be given for the 10th and 20th years.

Providing three different indices, each for 2 different years, for a total of six numbers, has the potential, we believe, to confuse consumers and to defeat the purpose of cost disclosure. The life insurance industry's own Joint Special Committee on Life Insurance Cost recognized this fact in recommending the use of only the the surrender index. The committee warned in its 1970 report, that

to do otherwise would inevitably complicate a subject that greatly needs to be kept straightforward.

Based on the staff's study, we have concluded that the industry Joint Special Committee's early judgment that only the surrender index should be used, was right on target.

We believe that the other two NAIC indices provide little, if any, useful information to consumers. And because the assumptions on which these other indices are based are extremely unlikely to occur, these two indices are potentially misleading.

In addition, to further streamline the disclosure statement, the Commission recommends omitting the 10th year surrender index. Whole life policies are rarely a desirable purchase unless they are held for substantially longer than 10 years. As a consequence, the 10th year indices are of little use to the prospective purchaser.

The focus of the industry joint committee and our own recommendations are consistent with the various studies that have been conducted since 1970. These studies, some of which were done by the industry and some at the FTC staff's request, indicate that consumers have difficulty using and understanding the NAIC six number system.

For this reason, the Commission's suggested regulation would require that consumers be provided with but one index number: the surrender index computed for the 20th year.

C. Timing of disclosure

Finally, the Commission was concerned about the timing of the disclosure. Under the NAIC model regulation, consumers generally received the buyer's guide and policy summary only when the policy is actually delivered, often a week to 10 days after purchase. Our experience indicates that if cost disclosure is to be effective, it must take place before the purchase decision. Consumers are very unlikely to read and use a disclosure package provided after the transaction has been completed.

For this reason, we recommend that a buyer's guide be given at the beginnng of the sales presentation and that a preliminary policy summary be given prior to the time prospective purchasers are provided an application for a policy. The preliminary policy summary would contain the basic information concerning the policy, such as the policy type, premium, surrender index and the rate of return. The proposed preliminary policy summary contains only those limited items of information essential to an informed purchase decision. It would not be impractical for agents to have all of the information needed to fill out the preliminary policy summary with them during the sales presentation.

However, we concur in the NAIC's recommendation that a full policy summary be delivered with the policy. That summary contains more detailed information concerning the cash flow elements of the policy. The Commission believes that this information is important and useful to the consumer. Because the information is more detailed it may not be readily available to the agent during the sales presentation, but it can easily be provided with the policy, as is currently the practice of companies which comply with the NAIC model.

7. CONCLUSION

Mr. Chairman, submitted with this statement are the staff report, the Commission's suggested regulation, and a model buyer's guide and disclosure statement recommended by our staff. While the Commission firmly believes that disclosures of this type are necessary, these latter two documents are not meant to be the definitive solution. Rather, they are provided to illustrate how the necessary elements of a disclosure system can be incorporated into an effective cost disclosure regulation.

We recognize that there are no easy answers when it comes to the question of life insurance cost disclosure; there is room for discussion and disagreement. Undoubtedly, State regulators and others interested in cost disclosure will be able to suggest improvements on these materials. The Commission staff will be available, where called upon, Commission staff will be available, where called upon, to assist the States in what we hope will be serious efforts to consider life insurance cost disclosure regulations.

Mr. Chairman, that concludes my remarks. We would be delighted to respond to whatever questions the committee may have.

The CHAIRMAN. Thank you very much. I want to commend the FTC for presenting a very clear and forceful argument in support of their recommendations.

Of course, we are not going to reach any conclusions today regarding the merits of your recommendations, but it is important that they be presented and that we understand them.

I hope everyone who responds to your report will be as clear and forceful. We will leave the hearing record open for 15 days to receive comments on the report that any interested parties may desire to submit.

Mr. Pertschuk, I would like to ask you a few questions.

In 1968, then Chairman Paul Rand Dixon indicated, and I quote:

> The jurisdiction of the Commission over the business of insurance is limited to the sales of insurance by mail, where such sales are not regulated by state law.

Now, I'd like to ask you this: If a State adopted a disclosure rule along the lines that you proposed, or NAIC has proposed, or some combination of those disclosure rules, would that preclude the FTC from exercising any jurisdiction within that state with respect to policies sold by resident agents?

Mr. PERTSCHUK. I believe so, Mr. Chairman, yes.

The CHAIRMAN. Now one of the things that I think is of great interest to the insurance industry, and to the State insurance commissioners, is whether the cost disclosure regulation that you propose today is just a first step that will lead to a trade regulation rule, or whether the FTC intends to leave the implementation and the determination of what is an appropriate disclosure scheme up to the States and the State regulators.

Could you give us some indications of what your views and the Commission's views are on that issue?

Mr. PERTSCHUK. Yes, Mr. Chairman. As a matter of fact, when I came to the Commission, a trade regulation rule move was one of the potential courses of action to be recommended by the staff and undertaken by the Commission.

But we chose deliberately with a view to the McCarran-Ferguson Act, and even more importantly, to the appropriate separation of activities between the Federal Government and the State to take the course of recommending this model State disclosure recommendation.

That is our entire plan with respect to life insurance cost disclosure. We have no intention of pursuing a trade regulation rule.

The CHAIRMAN. Have you considered the added cost to the insurance industry of these new disclosure requirements?

Mr. PERTSCHUK. Yes, Mr. Chairman, we have. There will be some cost—we believe they are modest—and we believe that they are appropriate. We can either supply some analysis of that in writing, or Mr. Lynch is prepared to describe what they may be.

The CHAIRMAN. Well, I'm thinking in terms of the burden that might be imposed on an agent to provide the policyholder prospective policyholder, the rate of return index prior to the actual sale of the policy.

Mr. PERTSCHUK. Without the computer, this would obviously be a fairly expensive proposition. But with computer programs, some of which we have already begun to develop and will make available, the process of providing this information, which can be done by the companies to the agents, is really not a very terribly complicated or extensive thing.

The CHAIRMAN. It would have to be on a company-wide basis. It couldn't be a burden requiring the agent to carry a little pocket calculator along to make his own computation as he went along in his process of selling a policy.

Mr. PERTSCHUK. No. Just as the surrender indexes are now produced by the companies and carried in the agent's rate book, so too could the rate of return tables be inserted in the rate book. The chief actuary of the Massachusetts Insurance Department, Mr. Hunt, has developed a simple method whereby the agent could interpolate from a table to get the rate of return for specific issue ages and face amounts that would not be in the table, such as male, age 33, $18,700. We believe that rate of return disclosure before sale, can be done about as easily and inexpensively as the currently used surrender index disclosure.

The CHAIRMAN. In your rate of return index calculations, the FTC assumes the standard low cost term policy price. Does that result in unfair cost comparisons?

In other words, are these standard low term policies used to determine the death protection cost for every company, even those companies which insure primarily blue collar workers with higher mortality rates?

Mr. PERTSCHUK. I think they are appropriate. They are appropriate measures, Mr. Chairman. The differences are much more likely to occur between competing policies and competing risks, especially for low cost policies.

Mike, why don't you comment?

Mr. LYNCH. It's a matter of great importance to use a standard set of term rates to make valid comparison between companies. You do need to use the same set of term rates. It's in the nature of a standard that it will not apply to everybody.

Not everybody is a standard risk.

So we have instruction, in our buyer's guide to compare the term rates you are offered with the term rates that are used in computing the rate of return.

For example, those who are in hazardous occupations will not be able to buy term insurance at standard rates. On the other hand, those eligible to buy group term insurance will be able to buy at substantially less than standard rates.

So the benchmark term rates will not be accurate for these individuals.

The main difference in the cost of providing insurance to blue collar workers rather than professionals, is not the difference in mortality rates. Rather the higher expense for blue collar workers is due to the fact that people with lower incomes buy smaller amounts of insurance. Because many of the expenses are independent of the size of the policy, the cost per thousand dollars of coverage is higher for the smaller policies.

This is captured in the term insurance rates that are used in the calculation. Term insurance rates are much higher for smaller amounts of insurance. So the most important reason for the higher costs of insuring blue collar workers is captured in our standard term rates.

The CHAIRMAN. In light of the fact that, on average, the price of life insurance has been decreasing, doesn't this indicate there is adequate competition in the existing market place? Because, based on your statement, as you analyze the study, it seemed to me that the conclusion that I would come to is that there is inadequate competition because of a lack of information.

But, if that is the case, how do you account for the fact that the price of life insurance has been decreasing?

Mr. PERTSCHUK. It should be decreasing greatly because of inflation. The question is whether it is decreasing enough to reflect both the impact of inflation and competition.

In our opinion, the decrease has begun to reflect the high inflationary rate, but by no means reflects a competitive structure in the industry.

Life insurance premiums have been declining and policy dividends rising, but this has much more to do with inflation than with increasing price competition. There is an analogy here with the bond market. When inflation and interest rates rise, bond prices fall. This has nothing to do with increased competition in the bond market. Bond prices fall because a bond is a promise to pay the bondholder a fixed sum of money each year and those fixed dollars are worth less and less as inflation continues. Similarly, as the future dollar benefits promised in a life insurance policy become worth less and less in terms of today's dollars, the premium should fall to reflect this fact. Dividends should increase to reflect the higher interest rates the company is earning on the assets provided by the policyholders' past premium payments. In fact, higher dividends are almost the only way that policyholders can protect the real value of their life insurance protection and savings from inflation.

The real question is not whether premiums have been falling, but whether they have fallen fast enough and far enough to offset the high rates of inflation we have been experiencing in recent

years. Our staff report shows that the answer to this question is "no." An average industrywide rate of return between 1 and 2 percent is hardly sufficient to offset rates of inflation of 10 percent or more.

The CHAIRMAN. The FTC rate of return index takes into account cash values. Now, some analysts say that while you should illustrate this benefit to a consumer or a customer, you should not include it in a cost index because it assumes the policyholders will surrender his policy.

Isn't it more realistic to assume a customer wants to know what the cost will be if he carries that policy out to maturity?

Mr. PERTCHUK. Actually, the vast majority of policyholders do surrender those policies. I think the staff report does expose the figures. But I think that at one point, after 15 years, as I recall, 32 times as many policyholders will have surrendered as terminated through death.

So it is a fair measure.

The CHAIRMAN. Is there a median point that the staff has found? Let's say an average point at which the policies are surrendered?

Mr. PERTSCHUK. Twenty years—Mike, why don't you answer.

Mr. LYNCH. It's return rates that stabilize after about 20 years. As for lapse rates, they peak in the very first year. The very highest lapse rate is in the first 13 months. The next year typically has a higher lapse rate as well. Thereafter, they continually decline.

The CHAIRMAN. So that the first 13 months is the highest?

Mr. LYNCH. The 13-months-lapse rate is typically the highest, and it's about 20 percent or so.

The CHAIRMAN. Now, you indicated, as I understood it, that the disclosure system should not necessarily require both 10-year indexes and 20-year indexes, so as not to confuse the consumer.

Mr. LYNCH. That's right.

The CHAIRMAN. Since the FTC rate of return does not include a correction for taxes, which would vary depending upon the person's income, how does your disclosure plan assist a consumer in evaluating that issue?

Mr. PERTSCHUK. Well, the disclosure, of course, notes that there may be tax advantages to life insurance, as opposed to other investments, and that rates of return should be compared on an after-tax basis.

For many, these life insurance tax benefits are going to be of relatively insignificant value to the low-income consumer, the purchaser of modest amounts of insurance.

The wealthier person with a sizable estate will not only be put on notice by the information and the cost disclosure statement itself, but will also have access generally to financial counseling, and will be able to take into account the consequences and the advantages of the tax benefits.

There are—of course—other investments which have tax benefits.

And finally, even with tax benefits, the differential is between the life insurance rates of the return and alternative investments is often so large that a person would have to be in a very high marginal tax bracket to make the life insurance product attractive

solely on tax grounds. For example, in 1975, 83 percent of all tax returns were in a marginal tax bracket of 25 percent or less. Therefore, a 3-percent tax-free rate would have been equivalent of, at the most, 4 percent taxable.

Mr. KRAMER. Mr. Chairman, one further point on that.

In addition to the information we will be providing to the consumer to look for the other possible benefits of life insurance, there is nothing in our regulation that precludes the insurance company from providing additional information about benefits that are available by purchasing whole life policy.

And, indeed, we would anticipate that companies would begin to sell on the basis of the other benefits available, including tax benefits.

The CHAIRMAN. This might be a competitive tool.

Mr. KRAMER. Yes.

The CHAIRMAN. Are there certain advantages unique to whole life insurance that would support a decision to purchase a whole life policy even if I have found that more accumulation could be achieved by purchasing term insurance?

Mr. PERTSCHUK. Yes, there are some. We note that in our statement. You can borrow against a whole life policy and up until recently, at a 5-percent interest rate, although now it has jumped to 8.

There are certain guaranteed annuity purchase rights and the extended term provision in most such policies.

The CHAIRMAN. You say that, until now, it has jumped to 8. That is not necessarily true across the board.

Mr. PERTSCHUK. No, no, it's not. Mike can report on that. But the standard rate of return had been 5 percent. I understand now the standard on new policies is 8. Is that right?

Mr. LYNCH. Yes. But the Senator is correct, that the 8-percent rate is certainly not across the board. Many of the new policies being issued do have policy loan interest rates of about 8 percent. But some States do not permit that.

Also, some companies have been offering their existing policy holders higher dividends, if they will accept a higher policy loan interest rate in their existing policy.

The CHAIRMAN. You stated in your testimony that the commission has no bias against whole life policies. Are there good whole life policies available in the market today?

Mr. PERTSCHUK. Yes.

The CHAIRMAN. Policies that are a good buy for consumers that want that kind of protection?

Mr. PERTSCHUK. Yes.

The CHAIRMAN. Why don't we see more price competition now, under existing conditions, from both within the insurance industry and the other competing forms of assets?

Mr. PERTSCHUK. Well, I think that there are a couple of reasons. One is that there is no existing standard of measurement so that any representations as to the low cost of particular policy is appropriately taken with skepticism.

We have seen claims made by companies which were simply not credible. Perhaps more important, the whole system of life insurance sales discourages cost as a method of selling.

The experience in selling has been, given the present system and the present quality of information available, that cost is considered a negative factor by agents, even for policies with a 4- or 5-percent rate of return, which would be a substantially lower cost policy, the cost is not considered by most life insurance salesmen to be a substantial selling factor.

The CHAIRMAN. How do you account for the fact that, according to your testimony on the study, the amount paid out as a result of death is less than the administrative cost for administering the policy?

Mr. PERTSCHUK. Actually, we did not study the nature of the administrative costs.

The CHAIRMAN. You gave the percentage factor indicating they were higher.

Mr. PERTSCHUK. Well, they were. The figures which I cite do indicate they are substantially higher.

Mr. LYNCH. Yes. These figures come from the annual statements the companies file with the State insurance commission.

And the figures, when aggregated, do show that home office expenses plus general expenses, plus Federal and State taxes are approximately twice the death benefits paid out.

That is the way the business looks.

If you look for a reason, it is the nature of ordinary life insurance that many of them are cash value policies.

And so the premium is high. During the early years of the policy you are paying far more than what it would cost you just to buy death protection alone. That is because, in one sense, you are prepaying for benefits that you would receive in the future.

That's the point of our diagrams, that even though people typically buy life insurance to protect their dependents against loss of their income, the savings features are extremely important.

And this is reflected in the fact that the death benefits paid out in 1977 were substantially less than just the administrative and selling costs of providing insurance.

The CHAIRMAN. You have answered this, I guess, in part but let me ask you anyway: Do individuals who have purchased life insurance accept a lower rate of return on policies rather than investing in other higher return assets because of the lack of market information to make the choice, or are there circumstances peculiar to life insurance so that the rate of return is not of major importance in their decision?

Mr. PERTSCHUK. Mr. Chairman, I think it's the former. Now it's quite possible that many consumers would choose to make the same decisions which they now make. But it is also clear that today those decisions are made without the benefit of essential information. If better information were available, many might make different decisions.

The CHAIRMAN. Can the rate of return and surrender cost indexes be used to compare participating and nonparticipating policies?

Mr. PERTSCHUK. Yes; with the caution that with participating policies, it is technically possible that the dividends will not be paid.

But the actual experience has been, as I understand it, failure to pay those dividends is extremely rare.

I'm sorry. Mr. Kramer indicates that the actual dividends paid have been higher than the illustrated dividends. So that certainly represents a fair comparison.

The CHAIRMAN. The rate of return index differs for the size of the policy, and is higher for lower amount policies. In light of the fact that it's generally understood that buying one policy for $50,000 is better than buying two $25,000 policies, does this indicate any technical weakness in the rate of return method?

Mr. PERTSHUK. It is almost always in the best interest of the policyholder to buy his or her coverage through one large policy rather than a series of smaller ones. The reason is that there are volume discounts on almost all types of insurance policies; that is, the premium per $1,000 is lower, the more you buy. Both the FTC and the Society of Actuaries' calculations show that the rates of return on larger whole life policies are slightly lower than those on smaller policies. The reason is not hard to find. Though there are volume discounts on both whole life and term policies, the discounts are steeper on the term policies. Rather than indicating a technical defect in the rate of return measure, the lower rate of return on the higher face amount policies is correctly alterting the buyer to the fact that the term insurance policy is a relatively better buy at the larger face amounts. Like virtually all other cost indexes, the rate of return should be used to compare policies of the same face amount, after you have decided on the amount of coverage you want.

The CHAIRMAN. Senator Warner?

Senator WARNER. Thank you, Mr. Chairman.

OPENING STATEMENT BY SENATOR WARNER

Mr. CHAIRMAN. These hearings on the proposed FTC model State regulations are very timely. During the past few years the Congress has been made aware of the growing concern on the part of consumers, industry and professional groups with insurance.

This concern is not isolated to a particular line of insurance. We have all received complaints about auto insurance, malpractice insurance and product liability insurance. In many instances the complaints are the same: the cost and availability of insurance and the general lack of understanding on the part of the insurance purchaser on how policies are priced and how to compare policies offered by different companies.

It is interesting to note that businessman who purchase insurance are often as confused as the individual consumer. We all need to have the basic facts upon which we can base intelligent decisions. The purchase of insurance, for whatever purpose, is one of the most important decisions any of us makes in our lifetime. Insurance is not a luxury. For example, most of us consider life and health insurance economic necessities.

The insurance industry is important and yet very unique. It is one of the only major industries to operate without extensive Federal control and is generally exempt from the antitrust laws. This special position is not to be taken lightly. Whenever the Congress reviews the insurance industry, it does so with the highest regard for its historical exemption from Federal regulation.

However, from time to time, issues arise which must be reviewed and policy direction given by the Congress. It has been the responsibility of the Commerce Committee to undertake these reviews. This jurisdiction has covered the breadth of insurance issues: from liability insurance coverage required for motor, water and freight forwarding common carriers to no-fault automobile insurance; from insurance guaranty fund protection to product liability insurance.

It seems to me that there can be no better forum for the discussion of insurance related issues than this committee. Both the Members and the staff are well versed in the subject and are sensitive to the industry and consumer points of view.

It has been reported that life insurance in force in the United States reached a new high of $2,583 billion at the end of 1977, an increase of over $240 million or 10.2 percent over year-end 1976. More than 390 million life insurance policies are in force today. There is no doubt in my mind that this is a significant part of the individual citizens life and we should be very interested in something that attracts so many people.

The Federal Trade Commission has undertaken an important, and maybe, in some quarters, an unpopular study, but, none the less, it is a subject that should see the light of day, should be discussed fully and fairly, and which this committee has an historical obligation to review.

I look forward to the Commission's statement and may have several questions to ask later.

Thank you Mr. Chairman.

Coming from the free enterprise system, I am puzzled as to why—and you touched around the fringes, but I will go directly to my question, as to why one or more companies simply haven't broken away from the industry practice and gone out and made such disclosures as you recited in your testimony; namely, that the average rate of return is 1.3 percent, and say that's the average, here is ours, 5.6, discounting a point or two for our accepting the liability or risk of death before anticipated mortality rate tables.

We've seen examples of the air bus before gaslines came along. People broke away. Self-service stations. This is the dynamics of our free enterprise system. Why is it lacking in this industry?

Mr. PERTSCHUK. That's a fair question.

I think the real answer is the currency of the competition is debased.

By that I mean there is no standard of comparison. There is no standard by which—today—by which that company, that enterprising company can say, here is our rate or return and here is the rate of return of the rest of the industry, or these competing policies.

You know there is an analog, and an interesting one. In the late 1950's, after the cigarette scare, there was a rash of competing claims for filters. Remember that? That was known as the tar repeal. All kinds of wild claims about tar and nicotine. And nobody could make heads nor tails out of them, and the reason nobody could make heads or tails out of them is there was no standard of comparison.

And ultimately—the Federal Trade Commission had to step in and with the industry, develop a standard measure.

Today you get vigorous competition in cigarettes for low tar and nicotine, but they're all measured by the same standard.

I think that's the basic problem, that a company which today says, "we will return a 5-percent rate of return" is competing with other companies who may claim under a different form of measurement, a 7-percent rate of return or claim a mix of services, a mix of aspects of the insurance policy which make that policy non-comparable.

The selling strategies in this industry are designed to say, you can't compare this policy. This policy that I am trying to sell you is unique. It can't be compared with any other policy.

I guess the thrust of our recommendation is that for the essential elements of those policies, they can be compared, but only if you adopt a uniform system.

Senator WARNER. The National Association of Insurance Commissioners undertook their own extensive study of cost disclosure before agreeing on their particular model. Many issues were discussed and either accepted, rejected, or modified.

Now does the FTC study and/or the model rule provide any new information or proposals?

Mr. PERTSCHUK. Certainly new proposals. The NAIC study and proposed rule was, as might be expected, a compromise between competing and conflicting interest and representing on many of these issues a serious compromise, we felt, of the consumer's interest.

Now there are some additional pieces of information in our study. The overall rate of return that we presented to the committee this morning is, I believe, a new piece of information.

But much of what we are recommending is based upon studies of the ineffectiveness of NAIC rules in practice, and much of it is simply building upon information and judgments which have been part of the literature for some time.

The CHAIRMAN. Senator Exon?

Senator EXON. Thank you, Mr. Chairman.

I want to ask a question and start out with a brief statement. I guess of all of the things that come to the attention in my office, I guess we have had more complaints about your Commission—and I assume that's not new. I'm new here.

Mr. PERTSCHUK. I'm not sure that's a bad thing.

Senator EXON. I'm not either, except the fact that I think it is generally understood by those of us not in your agency that you have a high record of complaints, and I suppose maybe that's the nature of the regulating commission. I will try to put that aside.

We keep hearing, though—let's talk about credit life insurance with banks, which is something I think you are into quite heavily at the present time all over the Nation. I don't know if you are familiar with it or not, but I think that you have been having some great difficulties with Nebraska at the present time.

Mr. PERTSCHUK. That, I'm not familiar with, Senator.

Senator EXON. I'm advising you then that you have had.

I guess the problem that comes up here, Mr. Chairman, is that I suspect that the average banker, like the average businessman out there that is regulated by rules, regulations, and redtape that is brought about by the Federal Trade Commission because of laws

passed by the Congress of the United States, are well intended. I think the average banker out there is a man who leans over backwards in an attempt to do what is right and proper.

And I'm not saying that they do not need some rules and regulation. As a former Governor, I know we have a State banking director who looks after the State banks and we have our Federal system over Federal banks and so forth and so on.

The main complaint I get, and I think it's somewhat justified, is that there is too much after the fact regulation. I have had a case brought to my attention where credit life insurance has been sold on balloon type payments on a farm on a contract. The procedures were all approved by your agency, and then 6 or 8 months after that, they come in and say, "Well, regardless of what we said before, this is a fine point of the law." And you attempt to assess all kinds of damages and triple damages and so forth in place, so that it makes it almost impossible for that bank to operate. In fact, some are almost throwing up their hands and are thinking that while credit life insurance is something that can be abused, they are saying, "We just won't handle it," even though I think in many instances it's something that is good for the borrower.

Isn't there some way that we cannot always look to making a penalty retroactive? It seems to me if you go in and someone in good faith has been doing something that they and people from the Federal Trade Commission have said, "This is the way to do it," then you go in retroactively and say, "Oh, yes, but this, and you are therefore penalized for that," rather than giving them the option of saying, "OK, this is the way it has to be from this day forward"—what do you have to say about that? I have received a great number of complaints on that, and I'm not—some of them may not be justified.

Mr. PERTSCHUK. Senator, the situation you have described is one I would be concerned about, too. I'm not really familiar—the Federal Reserve Board actually enforces credit regulations with respect to the banks under the truth in lending law and other credit statutes. We have responsibility over other lenders, and our primary responsibility, our primary role in credit insurance has been to study, investigate, and to make recommendations rather than regulate.

Now perhaps the best way for us to deal with that is to really get in and deal with some of those complaints directly. I would be happy to review those myself and to report back to you exactly what happened and why.

Senator EXON. You work with the Federal Reserve on these things, do you not?

Mr. PERTSCHUK. We do work with the Federal Reserve, and we have a fairly active process of commenting on their rules and regulation and of coordinating with them. Yes, sir.

Senator EXON. How about the investigations that go on back and forth? Do the people with the Federal Trade Commission work with the Federal Reserve people, or are they not included as far as investigations are concerned?

Mr. PERTSCHUK. Collusion?

The responsibility rests with Mr. Kramer.

Mr. KRAMER. In the actual conduct of the investigation, we would not normally work with the Federal Reserve Board and do not do so. They have jurisdiction over banks; we do not. We regulate nonbank creditors. We do not have jurisdiction over, say, for example, savings and loan associations in some areas, but they have their own regulatory body.

In the normal course of events, we would not be conducting joint investigations. As Chairman Pertschuk indicated, there is a good deal of coordination with regard to policies, defaults, to insure all creditors are being subjected to the same sets of rules and regulations so no one is put at a disadvantage.

The Banking Committee is at the present time—in fact, just recently concluded a set of hearings on credit insurance, and a Federal Reserve Board study of the credit insurance was a major topic of those hearings.

And the Federal Reserve Board staff did find that there were indications that about 40 percent of the people who had purchased credit insurance in bank situations had, in essence, purchased it under situations that were regarded as some form of coercion or some indication of coercion.

Senator EXON. Forty percent—in other words, to the extent they couldn't get the loan, let's say, without the insurance?

Mr. KRAMER. The reports—the results reported that of the actual purchasers, about 40 percent felt pressured to purchase the loan—to purchase the credit insurance relating to the loan.

Senator EXON. A followup question to one that I think was brought up earlier. How closely does your agency work, for example, on credit life insurance programs with either the banking commissioners of the States or the insurance commissioners of the individual States?

Mr. PERTSCHUK. Well, on the insurance commissioners, we have tried to work very, very closely on this project. I, myself, met with the committee from NAIC, and I went to a regional conference with the NAIC last year. More important, our staff met directly with more than 20 of the individual State insurance commissioners.

Obviously, this is a matter of sensitivity. I think their primary concern was that we were going to attempt to issue a trade regulation rule and preempt their authority. As early as a year ago—a year and some months ago—I assured them that was not our intention. Our intention is to work with them.

Several members of the NAIC have expressed strong interest in getting the fruits of our study and our recommendation of recommended regulations. And although I have to confess that communications with the NAIC have fallen down from time to time, I think we are committed to doing the best that we can.

Senator EXON. Thank you, Mr. Chairman.

The CHAIRMAN. Do you intend to circulate this study?

Mr. PERTSCHUK. Absolutely.

The CHAIRMAN. I'm sure all of us have had a lot of correspondence with respect to the credit insurance and banks getting into that end of the business. You haven't gotten involved in that?

Mr. PERTSCHUK. Not with the banks.

The CHAIRMAN. Senator Warner?

Senator WARNER. Thank you.

Mr. Chairman, before we depart today, for those who ae following these hearings, particularly the general public are going to be startled with this revelation of 1.3 percent, and it raises the specter that somebody is pulling a ripoff and getting rich, massive profits—they might begin to take this distinguished industry and begin to parallel it with the oil industry.

Do you find any basis, here, for massive profits being made by anybody? Where is the money going?

In other words, 1.3 percent as compared with savings and loans today—5¼—Government bonds, perhaps as high as 9—that range of percent return on dollars?

Mr. PERTSCHUK. The selling expenses of this industry are extremely high. That certainly is one of the directions in which the money is going. I would not characterize what we found in a way in which you have indicated it might be characterized.

Senator WARNER. I didn't declare it. I said I want to make it clear in this hearing that there's no indication that there's any ripoff or massive profits being made by the industry.

Mr. PERTSCHUK. That's correct.

Senator WARNER. Thank you, Mr. Chairman.

Mr. LYNCH. Let me add, if I may, one further point. We were not able, and we did not conduct any detailed study of profitability in the industry. We were able to look at one year—namely, 1975.

The conclusion that is in this study and the discussion as contained in appendix 1 of our report—the conclusion that we reached is that there is no evidence of massive profits being earned by the industry. We were unable to reach a conclusion one way or the other as to whether profits were greater than normal or less than normal.

But most of the discrepancy between, for example, the earning rate of about 7 percent and the rate that we estimate of 1.3 that was paid out—most of that discrepancy is accounted for by high home office expenses, high selling expenses, and rather high taxes.

The CHAIRMAN. Are you through?

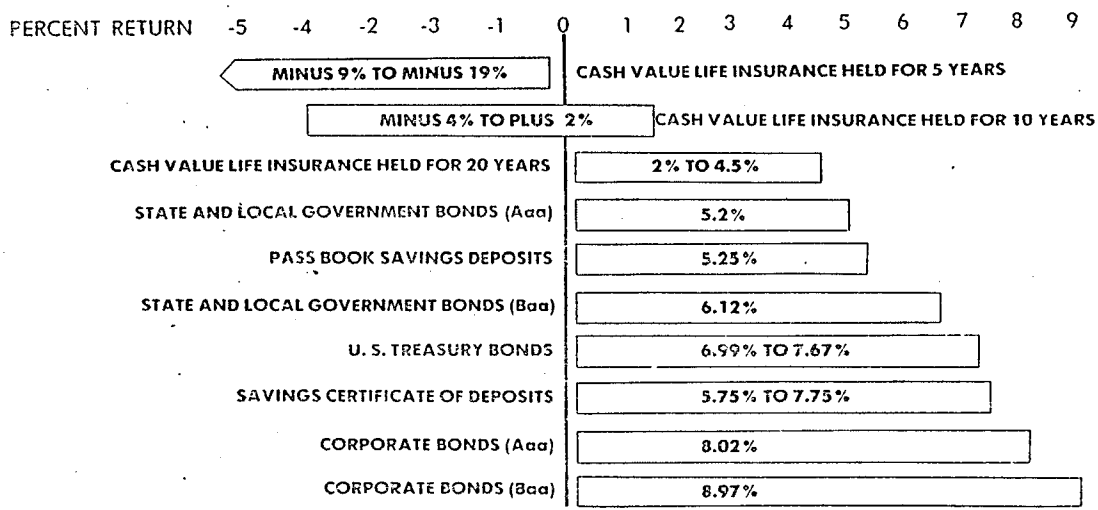
Senator WARNER. I am through, Mr. Chairman.

The CHAIRMAN. Your chart over here (printed below) which is part of the study, indicates certainly that the interest rate on the cash value life insurance held for 20 years is the lowest of any comparable investment type or recognized investment type today. Isn't that correct?

Mr. PERTSCHUK. Yes, that is correct.

[The chart follows:]

RATES OF RETURN ON VARIOUS INVESTMENTS -- 1977



CAVEAT: PURCHASERS SHOULD CONSIDER TAX ADVANTAGES AND DISADVANTAGES OF ALTERNATIVE INVESTMENTS. RETURNS ON CASH VALUE INSURANCE POLICES ARE GENERALLY TAX FREE; SOME BONDS ARE TAX-EXEMPT.

SOURCE: FEDERAL TRADE COMMISSION

The CHAIRMAN. That is, it is lower—you show that at the bottom of less than 2 to 4½ percent and State and local government bonds, at 5.2 percent, passbook savings deposits at 5.25 which, incidentally, is up a little bit now, State and local government bonds at 6.12, U.S. Treasury bonds at 6.99 to 7.67—those I think are up a little—savings certificates of deposit, 5.75 to 7.75— those are up a little now—corporate bonds, 8.02; and Baa bonds, 8.97.

So "whole life" insurance policies are at the bottom of the list insofar as rate of return on money from a savings standpoint——

Mr. PERTSCHUK. That's correct, Mr. Chairman.

Mr. LYNCH. If I may add one more point, the rates that are shown on our chart are average rates, and it should be clear that some life insurance companies and policies are providing very good rates of return—up to 9 percent for example.

The CHAIRMAN. Up to 9 percent?

Mr. LYNCH. Yes. Some products——.

The CHAIRMAN. Furnish me a list of some of those, will you? I'd be very much interested in knowing who they are.

Mr. PERTSCHUK. Mr. Chairman, that does raise a question which I am sure that others will have, and that is the names of the companies who are identified in our study.

And I want to make it clear for the record that we received the information from these companies with the understanding that they would have an opportunity to refute our calculations for accuracy, but that the information and the identity of the companies will be released to the public, once our data has been verified by the companies.

And, of course, we will supply it to this committee as soon as that has happened.

The CHAIRMAN. That was one of the reasons that I said we would leave the record open for 15 days for any industry or interested parties to comment. And I assume that in that period we might even hear from some of these insurance companies.

Mr. PERTSCHUK. It may take us longer, though, to get the formal evaluation of those figures.

The CHAIRMAN. We will be glad to receive the information.

Mr. PERTSCHUK. Thank you very much.

The CHAIRMAN. If there are no further questions, we want to thank you very much again. I think this has been very, very interesting and certainly very helpful to us.

Thank you.

[Whereupon, at 11:10 a.m., the hearing was adjourned.]

[The following information was subsequently received for the record:]

QUESTIONS OF SENATOR WARNER AND THE FTC ANSWERS THERETO

Question 1. The rate of return on a life insurance policy would seem to be an important factor to consider when buying insurance. I understand that the rate of return at 20 years varies from policy to policy. Why don't companies with the better rates of return advertise this fact? Does the FTC report supply information to which a company could compare its rate of return? Would the FTC encourage such communication to consumers from these companies?

Answer 1. (i) We believe the main reasons for the lack of rate of return advertising by the lower cost companies are the lack of a recognized standard method for computing these rates; traditions of the industry which militate against the use of rate of return for the following reasons: (1) cost is a negative element in the sales

presentation and should not be brought up by the company, (2) company advertising tends to be institutional rather than price competitive, (3) once in the home of the customer it would raise an additional variable for the customer to check out, thus delaying the closing of the sale; and finally, even the better companies, offering 4 to 6 percent tax free rates of return do not believe these rates to be sufficiently attractive (relative to alternative investments) to make them effective selling points for their products. With respect to the first reason, a study of so-called deposit term products revealed that although all the companies marketing these products claimed to be providing rates of return between 7 and 10 percent, the actual rates of return varied from minus 9 percent to over plus 9 percent. Potential policyholders should be skeptical, and many apparently are, of claims to high rates of return in the absence of a standardized and objective method for computing them.

(ii) The FTC report contains average rates of return, ranges and standard deviations in rates of return for the two years 1973 and 1977. Companies could therefore compare their rates of return for these years with those in the report.

(iii) The FTC would encourage such comparisons provided that the rates of return were computed using the same method as the staff used and if all comparisons were made using the same set of term insurance rates. Unfortunately even the 1977 data are now somewhat dated, since a number of companies have changed their rates in the last year and a half.

Question 2. The purpose of the FTC study and model rule is to increase consumer awareness through better disclosure of life insurance information so that more intelligent purchasing decisions can be made. Have you evaluated the consumers ability to understand the National Association of Insurance Commissioners (NAIC) model rule and the FTC model rule?

How many consumers do you estimate actually read the material provided? Do you believe that such a small percent will have an effect on the marketing of life insurance?

Answer 2. (i) Consumers ability to understand the NAIC disclosure has been evaluated in studies sponsored by the FTC, the NAIC and the Prudential Life Insurance Co. of America. These are summarized in our staff report on pages 161–165 and in Appendix IX. We believe all of these studies raise fundamental questions concerning the capacity of the NAIC disclosure system to convey even the most basic information about life insurance to most purchasers.

Earlier versions of the FTC system were directly tested against the NAIC system in an experimental setting, in a study run at Purdue University. The FTC groups performed at a statistically significant higher level than the NAIC group in a simulated purchase experiment. Details can be found in Appendix IX. The current FTC system has not been field tested.

(ii) The two field tests for the NAIC system suggest that only 15 to 25 percent of the people receiving the material read all or most of it. The Purdue studies indicated, however, that a "trigger" statement such as the one we recommend that tells people that not all policies cost the same and that they can save hundreds or even thousands of dollars by shopping is effective in getting people to seek and absorb more information.

(iii) Certainly not every buyer needs to be well-informed to keep a market working efficiently. A minority of well-informed buyers is usually enough to keep the whole market relatively honest. How big a fraction the well-informed buyers would need to be unknown. Even if 20 percent were able effectively and easily to compare costs of different types of life insurance policies, we think this would be a substantial improvement over the present situation.

Question 3. On May 31, 1979 a representative of the Commission made the following remarks during a meeting of the Interagency Council on Accident Compensation and Insurance: It would be appropriate for the Commission to: (1) study methods of stimulating cost control efforts by insurers, (2) develop a pilot program to test the effectiveness of information disclosure in helping consumers select appropriate insurance policies, and (3) encourage insurers to provide policies that are responsive to consumers needs.

In view of the above statements by Commission staff and your efforts in this report, what course of action does the Commission plan to take in the insurance area? What has the Commission done to evaluate its authority to promulgate trade regulation rules for life insurance cost information and disclosure?

What plans does the Commission have to increase public awareness of the rate of return or lack of information regarding rate of return?

Answer 3. By way of clarification, while the minutes of the May 31, 1979 meeting of the Interagency Council on Accident Compensation and Insurance reported FTC recommendations for 3 areas of study, the minutes were actually reporting an

earlier written statement regarding areas the FTC staff recommended for study by the Interagency Council. In a letter to Victor Schwartz of January 26, 1979, an FTC staff member had suggested that the Interagency Council might want to study these (and other) issues. The FTC has no immediate plans to pursue these projects. The FTC does have underway (at the request of Senator Kennedy) a study of whether a special antitrust exemption is needed to encourage cost control efforts by health insurers. There are other insurance initiatives underway, for example, in connection with the enforcement of the Fair Credit Reporting Act and the Truth in Lending Act. We would be happy to describe these in more detail.

With respect to your specific questions (1) the Commission has plans only to work with the respective states to put in place our cost disclosure system. Our assistance will be available on request to the states at the convenience of the various insurance departments. (2) We have reviewed the implications of the McCarran-Ferguson Act and are aware of the limitations it places on our jurisdiction. However, the cost disclosure model regulation announced today does not raise those issues, since it involves cooperation with the states. (3) The Commission is quite concerned that the public become aware of rate of return information, but most of our activities will be through and in cooperation with the state insurance departments. As in the past we will speak to consumer and trade groups on request and as our budget allows. We already have a number of requests for speakers on the subject of life insurance cost disclosure and through such groups we hope to increase understanding of the program. We have no consumer education program at this time.

Question 4. The following comments have been made regarding the FTC rate of return proposal:

The net surrender cost is the mirror image of the rate of return.

The rate of return calculation is based on shaky assumptions and cannot be accurate, therein such a disclosure to a consumer would misrepresent the value of a life insurance policy.

The rate of return calculations are difficult to compute and cannot be calculated by the agent at a consumer's home. This compares to the cost indexes which can be calculated by the agency in the consumer's home.

Could you comment on these concerns and explain the reasons the rate of return would provide better information to consumers?

Answer 4. (i) If you compare similar policies (e.g. two whole life policies) of the same face amount, the net surrender cost and the rate of return will almost always rank these policies in the same way. Thus one is the mirror image of the other for similar policy comparisons. The main use of the rate of return measure, however, is to compare dissimilar policies (e.g. term and whole life). The net surrender cost cannot be used for this purpose.

(ii) All cost measures are based on assumptions. The assumptions made for the rate of return calculation are identical to those made for the net surrender index, except the latter assumes that a 5 percent interest rate is appropriate, while the former assumes a certain set of term insurance rates. Since term insurance rates have changed far less rapidly than interest rates, there seems to be less of a problem in deciding on an appropriate set of term rates than an interest rate.

(iii) In practical terms, all of the index numbers are too complicated for the agent to compute from scratch in the consumer's home. However, individual rate of return information can be determined from a rate book or other method provided to the agent by the company.

Question 5. One major FTC concern is the lack of information to consumers on the rate of return on a whole life policy. There are of course other considerations a consumer makes when buying a life insurance policy such as the proper amount of coverage. Have you studied choices a consumer is presently making and made any determination as to whether the policies the consumer selects are providing the appropriate type of coverage?

Answer 5. Aside from how much people pay for a given amount of coverage, the staff also examined the question of how much coverage people buy and how much, on the average, the beneficiary receives when the policyholder dies. While consumers must decide for themselves what is the "right" amount of coverage, our staff estimates that average death benefit received from private life insurance would have amounted to only 10 months of the average personal disposable income per family. Part of the reason why people have such relatively small amounts of death protection may be the consumers lack of understanding of the differences between term and whole life insurance and the bias in the agent commission structure that gives the agent a strong financial incentives to sell policies that provide relatively small initial amounts of protection for the premium dollar.

Question 6. If a State chose to adopt the FTC model rule after having had the NAIC rule in place for a year or two, I would expect there to be some costs to life insurance companies operating in the State. Have you undertaken a cost/benefit analysis of such a change? Do you plan such an analysis?

Answer 6. As indicated previously, there would be some minor additional costs associated with implementing the FTC suggested changes in the NAIC model. One of these will be for computer programming to determine rate of return information. However, to minimize the burden on insurance companies, we have offered to supply our software to any company. We have also made available to the states printed copies of the policy summary and buyer's guide. Some training costs to teach agents the meaning of the rate of return calculation may also be incurred. We believe, though, that the enormous benefits which should accrue to consumers far outweigh the costs of implementing our effective disclosure program.

THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS,
Washington, D.C., July 16, 1979.

Hon. HOWARD W. CANNON,
Chairman, Committee on Commerce, Science and Transportation,
U.S. Senate, Washington, D.C.

DEAR SENATOR CANNON: This relates to your announcement that the July 10 record would remain open for fifteen days to receive the comments of interested parties on the Federal Trade Commission's Staff Report on Life Insurance Cost Disclosure.

The major burden of the FTC Staff report, as vocalized by Chairman Pertschuk at the hearing and then reported widely, is that "No other product in our economy that is purchased by so many people for so much money is bought with so little understanding of its actual or comparative value."

In light of this generalization, the enclosed press release from the Office of Public Information at Purdue University is relevant, because it reflects the results of a study conducted for the FTC at a cost of at least $155,000 to the taxpayers, on the precise subject under consideration. The release goes to the heart of the FTC Staff's primary contentions, and rebuts them.

The press release concerns studies done for the FTC by Professor Jacob Jacoby of Purdue; it is headlined "Consumers Do Good Job In Selecting Life Insurance." It reports these studies as concluding that, when it comes to buying life insurance, "consumers may be smarter shoppers than the government thinks."

Commenting on the studies, Professor Jacoby said that "by and large, consumers seem to make decent purchase decisions even without a buyer's guide or cost index. The key question is whether the benefits to be gained from requiring that buyer's guides and cost indexes be made available to the public are worth the ultimate cost to the consumer."

Much time and money was spent by the FTC Staff on these studies, and great emphasis was placed on them, in advance of their completion, as a source of information vital to the Staff's ultimate conclusions. Now that results unfavorable to the FTC Staff's position have been produced, the studies are relegated from a position of earlier prime importance to footnote #116 and Appendix IX of the Staff study, where the FTC Staff attempts unconvincingly to explain the adverse results away.

Also enclosed is essentially the same story, as reported by Clark Bell for the April 3 issue of the Chicago Sun-Times, where the point is noted that the FTC's activity in this area can only result in increasing the cost of insurance.

We find reference to neither the Purdue press release nor to the Chicago Sun-Times story in the 434 pages of material submitted to you on July 10 by the FTC Staff. We would therefore appreciate having them, and this letter, included in the record.

Sincerely,

H. JAMES DOUDS,
Vice President and General Counsel.

Enclosure.

PURDUE UNIVERSITY,
OFFICE OF PUBLIC INFORMATION,
West Lafayette, Ind.

Special report.

From: Ellen Rantz.
Subject: Consumers do good job in selecting life insurance.

West Lafayette, Ind.—When it comes to buying life insurance, consumers may be smarter shoppers than the government thinks, according to the results of studies by a Purdue University consumer psychologist.

Jacob Jacoby, professor of psychological sciences, completed two life-insurance studies which were funded by the Federal Trade Commission. The findings will be use by the FTC to form the basis for regulations about consumer-information requirements in life insurance.

The first study was concerned with how much and what kinds of information consumers use when buying life insurance. The second study was concerned with improving the actual purchase behavior of consumers.

Subjects in the first study were asked to "purchase" one of three life-insurance policies. Some of them had access to buyer's guides, which are pamphlets or brochures given to prospective life-insurance buyers to help them make better choices.

Jacoby found that consumers are selective in the information they use. Of 37 types of information made available, company name and premium were looked at the most frequently.

Other information used frequently by the consumers was cash values, guaranteed insurability, financial rating and waiver of premium. The buyer's guides did increase the extent to which consumers looked at actual cost information, said Jacoby.

Subjects in the second experiment played a series of "shopping games" in which they looked at life-insurance policies that were low, medium and high in cost. The objective was for the consumers, through the use of buyer's guides and cost indexes, to pick the low- and medium-cost policies.

Cost indexes compare relative costs of similar policies.

Six different groups were studied: those with no buyer's guide or cost index (paralleling the situation that now exists for most consumers); those with FTC buyer's guide only; FTC buyer's guide and cost index; FTC cost index only; the National Association of Insurance Commissioners' buyer's guide only; and the Belth buyer's guide only. The Belth guide was developed by Indiana University Prof. Joseph Belth, a nationally prominent insurance expert.

Compared to the other five groups, the consumers who had access to the FTC's cost index and buyer's guide made the "better" purchase decisions, said Jacoby, although the differences were not statistically significant.

The psychologist said that "by and large, consumers seem to make decent purchase decisions even without a buyer's guide or cost index. The key question is whether the benefits to be gained from requiring that buyer's guides and cost indexes be made available to the public are worth the ultimate cost to the consumer."

Jacoby said that although the studies did not examine the life-insurance agent's part in the decision process, the salesperson is nonetheless important.

"You buy a good agent," he remarked. "Perhaps the real key to providing the consumer with good service is upgrading the education of the agent" about other companies and policies, he added.

The life-insurance studies represent one of the first areas in which the FTC has funded consumer research to serve as a basis for drafting regulations, said Jacoby. Normally, the commission has only hearings before drafting consumer regulations.

[From the Chicago Sun-Times, Apr. 3, 1979]

INSURANCE BUYERS NOT HELPLESS

(By Clark W. Bell)

Consumers may not be as helpless as the government believes when it comes to buying life insurance, according to a study commissioned by the Federal Trade Commission.

The FTC is considering the formulation of disclosure requirements for the insurance industry, a development that would have a profound impact on the marketing practices of salesmen. Most insurance companies vehemently oppose such regulation because it will increase paperwork and thus raise the price of coverage. But consum-

er advocates say insurance marketers confuse customers with technical language and a pricing structure that makes it difficult to compare various policies.

The government last year paid Purdue University consumer psychologist Jacob Jacoby $155,000 to study buying habits and make recommendations on how the public can be better informed.

The experiment marks one of the few times the FTC has funded outside consumer research to serve as a base for drafting regulations. Normally, the commission does its own investigations and holds hearings before promulgating rules.

Jacoby asked a sample of 238 Indianans to pinpoint the types of information they would use in selecting an Insurer. Of the 37 types of information surveyed, company name and premium were looked at most frequently. Other statistics eyeballed closely were cash values, guaranteed insurability, financial rating and waiver of premium. Jacoby said consumers provided with buyer's guides did more research on actual cost information.

"By and large, consumers seem to make decent purchase decisions even without a buyer's guide or cost index," he said. "The key question is whether the benefits to be gained from requiring that buyer's guides and cost indexes be made available to the public are worth the ultimate cost to the consumer."

Jacoby said the sales agent may be the most integral part of the transaction. "You buy a good agent. Perhaps the real key to providing the consumer with good service is upgrading the education of the agent about other companies and policies," he said.

FTC STUDY OF LIFE INSURANCE COST DISCLOSURE

WEDNESDAY, OCTOBER 17, 1979

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE,
AND TRANSPORTATION,
Washington, D.C.

The committee met at 10:10 a.m. in room 235, Russell Senate Office Building, Hon. Howard W. Cannon (chairman of the committee) presiding.

OPENING STATEMENT BY THE CHAIRMAN

The CHAIRMAN. The hearing will come to order. I must apologize for the delay, but one of our colleagues was testifying before our Armed Services Committee on the SALT agreement this morning and I was very much interested in what he had to say.

Today the committee continues its oversight hearings on the Federal Trade Commission's life insurance cost disclosure study. On July 10, the Federal Trade Commission presented to this committee a staff report, a provocative and controversial critique of the current system of life insurance cost disclosure.

This morning we will hear from a broad cross section of industry witnesses who will give us the benefit of their views based on their wide experience.

I want to make clear that the committee has not endorsed the FTC staff study. It is only one analysis of the way in which cost disclosure should be treated. The FTC study must be considered along with the NAIC model cost disclosure regulations and other recommendations for cost disclosure.

The decision as to which method of cost disclosure is most appropriate in terms of consumer understanding and simplicity in administration is a decision for each State to make. Given the controversy over the appropriate method of cost disclosure, it would be foolhardy for Congress to consider legislating in this area and, as far as I am personally concerned, the regulations of the business of insurance should remain with the States.

As the witnesses this morning will make unmistakably clear, the FTC cost disclosure proposal is highly controversial and in the view of a large segment of the insurance industry, seriously flawed.

The purpose of the hearing today is to give those in the insurance industry an opportunity to outline their problems with the FTC report and give the committee and public an opportunity to evaluate these criticisms.

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I just want to say that I think the FTC report was wrong in stressing the comparison of life insurance with a savings account. The consumer's goal in buying life insurance is not just the maximum rate of return, but the protection provided by the insurance policy.

This oversight hearing is one of a number of hearings on insurance that this committee has conducted and will continue to conduct in the future. The Commerce Committee has a long history of legislative activity and oversight over the insurance industry, including legislation to establish Federal standards for no-fault auto insurance, legislation to establish insurance guarantee funds, and legislation dealing with product liability insurance.

We are very pleased to have a distinguished panel of witnesses this morning and after I call on my colleagues, we will call first on Mr. John Filer, chairman of the Aetna Life & Casualty Co., who will introduce the other members of the panel.

Senator Warner.

OPENING STATEMENT BY SENATOR WARNER

Senator WARNER. Thank you, Mr. Chairman. I join with you in calling for these hearings and in the observations that you have made this morning.

I participated in the hearing on July 10 and was deeply concerned that the public perception of this industry would likely be distorted as a consequence of the FTC report.

Now, we know that to be a fact. It appears that the Commission was heavyhanded.

I think there is no higher fiduciary responsibility owned by the FTC to the American public than that with reference to this industry. This industry goes deep into the roots of our Republic and I think in the minds of many American citizens. Even if this country were to suffer the misfortune of an impeachment of a President or the Russians came over the ramparts, the insurance policy would still be there as promised.

I am thankful that we have this opportunity now to set the record straight, Mr. Chairman.

The CHAIRMAN. Senator Kassebaum.

OPENING STATEMENT BY SENATOR KASSEBAUM

Senator KASSEBAUM. I think this is a very worthwhile hearing and I am here to welcome Rice Brown, a fellow Kansan, as one of those testifying today. I think he is exemplary of the entire panel's qualifications to speak on this issue which is of importance to us throughout the country. And he is representing the grassroots perspective of one who has worked in every facet of the industry.

He has also served and held offices in the State and National Committees of the National Association of Life Underwriters. In such capacity, he became familiar with the problems raised by consumers and insurance agents, insurance commissioners, and others with regard to the industry and has actively worked to find sensible solutions to the problems.

He has been actively involved in both formulating the National Association of Insurance Commissioners model regulations and worked towards its adoption at the State level. He understands the

problems of this industry and I know the testimony he will offer will be enormously helpful to us all.

It is with pleasure that I welcome Rice Brown as one of the panelists.

The CHAIRMAN. Senator Schmitt.

OPENING STATEMENT BY SENATOR SCHMITT

Senator SCHMITT. Mr. Chairman, I have no formal remarks. I would just say, in addition to the questions you and others have raised I am concerned with the reasons the FTC got involved in the first place? Was there congressional direction of some kind? I believe there was not.

Again, it relates to the broad issue we discussed in other hearings in the last few weeks of what should be—what should the FTC do to initiate activities. In this case, it is not rulemaking activity, but it obviously has had an impact on the industry, on the part of commerce that was, in fact, investigated.

The CHAIRMAN. Well, I want to thank Senator Schmitt and say, as you know, we have been holding oversight hearings on FTC and we have already heard of abuses by FTC committee staff. I am not suggesting there is abuse here, but we were told in our last meeting with the FTC that some of those staff people were no longer there. I don't know whether that applies in this particular instance.

Mr. Filer, we are delighted to welcome you here.

Would you introduce the members of your panel?

STATEMENTS OF JOHN H. FILER, CHAIRMAN, AETNA LIFE & CASUALTY; JOHN R. TAYLOR, EXECUTIVE VICE PRESIDENT, BANKERS LIFE CO.; RICE BROWN, CHAIRMAN, NATIONAL ASSOCIATION OF LIFE UNDERWRITERS FEDERAL LAWS AND LEGISLATIVE COMMITTEE; ACCOMPANIED BY THOMAS J. WOLFF, NATIONAL PRESIDENT; IAN M. ROLLAND, PRESIDENT, LINCOLN NATIONAL LIFE INSURANCE CO.; AND JAMES R. MARTIN, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, MASSACHUSETTS MUTUAL LIFE INSURANCE CO.

Mr. FILER. I am John Filer, chairman of the Aetna Life & Casualty Co. I appear here today as spokesman for the life insurance industry and its major trade association, the American Council of Life Insurance, whose members write about 94 percent of the life insurance business in this country.

I am accompanied by James Martin, chairman of the Massachusetts Mutual Life Insurance Co.; Ian Rolland, president of the Lincoln National Life Insurance Co.; John Taylor, executive vice president of Bankers Life Co. Also with us is Thomas J. Wolff on my right, president of the National Association of Life Underwriters, and Rice E. Brown, chairman of that association's Federal Laws and Legislative Committee.

Let me begin by expressing our appreciation for this opportunity to be heard. I will comment very briefly on our business, our support of cost disclosure in the sale of life insurance, and our position on the recently released Federal Trade Commission staff

report on such cost disclosure. Messrs. Martin, Taylor, Rolland, Brown and Wolff will develop these in detail.

The business of life insurance has played an important role in the social and economic growth of this country for well over 100 years. We have served countless millions of American families in helping to provide an important means of family financial security. We are also a major source of long-term financing to American business and industry. The life insurance business has earned a reputation for integrity, reliability, and service for the good of society.

It, therefore, comes as a shock indeed to find it necessary to have to defend this industry's record and refute the charges recently made to this committee that in effect we have been employing deceptive practices to sell shoddy merchandise. We feel it is important to set the record straight.

We have a concern in all of this which is far broader and deeper than the interest of our own companies and their agents. Our concern is for our many millions of present policyholders who may be misled into lapsing or relacing present policies to their own financial detriment because of the irresponsible allegations of the FTC staff. We are concerned, too, for the many millions of Americans who will be considering the purchase of life insurance and who may be misled in that important decision by those same allegations. This is, in short, an important and serious matter, and our appearance today is an indication that we so regard it.

It is simple to summarize our industry's position on cost disclosure. We are in favor of it. We have supported it for more than 10 years. We have worked diligently to support State regulation to help bring it about on a uniform basis throughout the country.

We specifically support the model cost disclosure regulation of the National Association of Insurance Commissioners. It was produced 4 years ago and has now been adopted by 28 of the States. It is being used voluntarily in all States by companies that account for at least 75 percent of the sales being made today. That figure of 75 percent is an update and correction from the figure that is in our written statement of 60 percent. The system of disclosure and cost comparison required by that regulation is carefully designed to help consumers make good purchase decisions.

The FTC staff report on cost disclosure is another matter entirely. That report, delivered to this committee on July 10, adopts the flawed theory that whole life insurance is a hybrid combination of term insurance and a savings account.

Beginning with this theory and using calculations that are as erroneous as the basic theory, it argues that the "savings account" yielded a rate of return of only 1.3 percent in 1977. That report alleges further that consumers are losing billions of dollars annually because they don't know this. It recommends that the present system of cost disclosure now being adopted by the States be radically changed and that the FTC staff version of the cost disclosure be substituted.

The FTC staff report can be characterized as a reckless misrepresentation of our business. The staff began its investigation with fixed opinions about the nature and value of whole life insurance

and determined to show that term life insurance was the better buy for most people.

The FTC staff report was a result of that hidden agenda to portray whole life insurance as a consumer fraud, to show the States weren't properly regulating the important matter of cost disclosure, and thus to demonstrate the need for Federal intervention.

To put our case directly, the FTC staff set out to make it appear that this industry was hiding its costs and misleading its customers into making poor purchase decisions. To prove this, the FTC staff strained to develop a calculation of interest rates that our business is crediting to its customers' policies so sensationally low that it would shock the public. It rejected analyses by actuaries within our business that would show otherwise, including analyses of how costs are developed. In brief, it rejected facts and pursued its foregone conclusion.

Even before the investigation was well under way, the FTC staff wrote the State insurance regulators, urging them not to adopt the NAIC model regulation, as the FTC was going to find it deficient. At the same time, it was also advising a Member of this Congress that the States were dragging their feet in adopting the NAIC model. Thus, on the one hand, the staff was trying to stop State regulation, and on the other hand it was using the result of its hindrance of State regulation to bolster a case for Federal intervention.

One reason cited by the FTC staff for the States not to act was a study commissioned by the FTC to determine what information would be useful to buyers of life insurance and to test various systems of presenting information to buyers. That study was conducted by Professor Jacob Jacoby of Purdue University. The final results did not support the claims of the FTC staff that the NAIC model regulation was seriously deficient.

If you search the FTC staff report carefully, you will find a lonely footnote reference on page 161 to the Jacoby findings. And if you look still further, you will find a brief description of the results in appendix 9. It survives in the report as an isolated whisper of fact, declaring to the FTC staff, "You were wrong."

The FTC staff report would have our customers believe several things:

First, that our business has misled them and generations before them.

Second, that our business has somehow hoodwinked the State regulators for more than 100 years.

Third, that the rigorous sciences of statistics and probability mathematics which form the base of whole life insurance and dictate its costs were twisted into an enduring deception.

And finally that the respected profession of actuaries for all those years never detected it.

These are the premises which animate this report. Beyond that, it is necessary to accept an offense to reason in order to believe the mathematical findings of the report.

The description of whole life insurance promoted by the FTC staff was publicized so widely and has generated so much confusion

that we find ourselves urgently required to define once again what it is we sell.

Whole life insurance is not partially insurance and partially savings. It is wholly insurance. It is not designed to provide for the possibility of economic gain in return for a risked sum of money. That's an investment. Nor is it designed to accumulate deposits of money building toward an individual or family goal so long as the depositor remains alive to make the deposits. That's a savings account.

Whole life insurance is designed to provide a guaranteed benefit at death, whenever death occurs, in return for a price which is expressed as a fixed periodic premium. That is what it is, and that is what it does. Nothing else in the financial marketplace does this. No combination of financial products does this with an unconditional guarantee.

Our business, of course, also provides life insurance for shorter periods of time. Term insurance is a very useful product, and people buy billions of dollars worth of it every year. At young ages, it requires considerably less outlay than a comparable amount of whole life insurance because relatively few people die at young ages. Because its premium rises with age and eventually reaches a point where most people can't afford it, term insurance does not meet the need for coverage which people can afford throughout life.

The yearly cost of term insurance is not cheap over the length of time most people will live. One can assert that term insurance is cheap—as the FTC staff does—only if one ignores the calendar. Its yearly cost is low when young, higher when middle-aged, and prohibitive when old.

There is an important probability in all this that I would emphasize. Most life insurance is bought by people between ages 25 and 50. About in the middle of that group stands an individual aged 35, examining the prospects and wondering what to do about his life insurance.

The chances are about 8 out of 10 that the "buy term" advice of the FTC staff will leave that person unable to afford to continue life insurance after age 65. If that person needs life insurance after age 65, as many people do, the FTC advice will have been disastrous. This is because for people aged 35, the mathematical prospects of survival beyond retirement age are about 8 out of 10.

It's pertinent to ask the FTC staff a few questions. Who appointed you to advise a nation full of life insurance buyers to take such risks against such well-known odds? What facts support the assertion that the need for insurance vanishes at age 65? How does that advice compare with that of the Veterans' Administration, which has experienced the problems of renewable term insurance for an aging group of World War II veterans?

The most widely publicized charge by the FTC staff was that the industry-wide rate of return on whole life policyholder savings was 1.3 percent. John Taylor will explain how this figure is the figment of the staff's distorted calculations. Let me just say that if you were to apply real-world factors to the formula developed by the FTC staff, the result would be on the order of 5.9 percent instead of 1.3 percent.

Of course. 5.9 percent would not have rated headlines. By releasing its report to the press, but not to the industry, prior to its presentation to this committee, the FTC was successful in orchestrating the news. Its side of the story was the only story the press had to work with. Couple this manipulation with the fact that as a Government agency charged with protecting consumers, the Commission's pronouncements are generally taken at face value, it is little wonder that the initial press accounts were so overwhelmingly one-sided.

This handling of the news release to the media is bad enough. What is worse is that the message communicated violates the standards of truthful advertising that the Commission finds objectionable in others.

If the FTC's Cost Disclosure Report and the press release accompanying it were subjected to the same tests which the FTC generally applies to commercial advertising under section 5 of the FTC Act, they would be properly characterized as "omitting material facts," "unsubstantiated," "false and deceptive," and "having a tendency and capacity to mislead consumers," to borrow just a few phrases from past FTC advertising complaints.

This matter of effective cost disclosure, the ostensible objective of the FTC investigation, is, of course, a valid and important issue. The NAIC model regulation is the best solution yet found and it is working in the interests of consumers. The proposals of the FTC staff to change the model regulation are based on their faulty analysis of what the product is and therefore can only serve a few prospective purchasers. This will be discussed in detail in subsequent testimony. The gentlemen who accompany me will fill in more details of this outline.

[The statement follows:]

STATEMENT OF JOHN H. FILER, CHAIRMAN OF THE BOARD, AETNA LIFE & CASUALTY, HARTFORD, CONN.

THE LIFE INSURANCE INDUSTRY'S POSITION ON COST DISCLOSURE THE RECENT FTC STAFF REPORT

My name is John H. Filer. I am the chairman of the Aetna Life & Casualty Company of Hartford, Connecticut, and I appear here today as a spokesman for the life insurance industry and its major trade association, the American Council of Life Insurance, whose members write about 94 percent of the life insurance business in this country.

I am accompanied by James R. Martin, chairman of Massachusetts Mutual Life Insurance Company, Ian M. Rolland, president of Lincoln National Life Insurance Company, and John R. Taylor, Executive Vice President of Bankers Life Company. Also accompanying me is Thomas J. Wolff, president of the national Association of Life Underwriters and Rice E. Brown, chairman of that Association's Federal Law and Legislation Committee.

Let me begin by thanking the Committee for providing this opportunity to establish the position of the life insurance business on the public record. I will briefly summarize the history of our business, our position in favor of cost disclosure, and our position on the recently released Federal Trade Commission staff report on life insurance cost disclosure. Our other witnesses will develop these positions in greater detail.

The business of life insurance has played an important role in the social and economic growth of this country for well over 100 years. During that long period of time, we have served countless millions of American families in helping to provide an important means of family financial security. We have also become a major source of long-term financing to American business and industry.

Americans are rightfully proud of the kind of society our country has developed over its history, and the life insurance business has played an important role in that

development. We believe it is more than coincidence that the ownership of life insurance is greater in the United States than it is in any other country in the world. And over this long span of years, the life insurance business has earned a reputation for integrity, reliability, and service for the good of society.

It, therefore, comes as somewhat of a shock to find it necessary to have to appear here today to defend this industry's record and to refute the charges recently made to this Committee that we are employing deceptive practices to sell shoddy merchandise. But, because of the wide attention which has been given to those charges, we feel that it is important to set the record straight. We have a concern in all of this which is far broader and deeper than the interest of our companies and their agents. Our concern is also for our many millions of present policyholders who may be misled into lapsing or replacing present policies to their own financial detriment because of the allegations of the FTC staff. We are concerned, too, for the many millions of Americans who will be considering the purchase of life insurance and who may be misled in that important decision by those same allegations. This is, in short, an important and serious matter, and our appearance today is an indication of our concern.

It is simple to summarize our industry's position on cost disclosure. We are in favor of it. We have supported it for more than 10 years. We have worked diligently to support state regulation to help bring it about on a uniform basis throughout the country. We specifically support the model cost disclosure regulation of the National Association of Insurance Commissioners. It was produced four years ago and has already been adopted by 28 of the states. It is being used voluntarily in all states by companies that account for at least 60 percent of the sales being made today. The system of disclosure and cost comparison required by that regulation is carefully designed to help consumers make good purchase decisions.

The FTC staff report on cost disclosure is another matter entirely. That report, which was delivered to this Committee on July 10, adopts the flawed theory that whole life insurance is a hybrid combination of term insurance and a savings account. Beginning with this theory and using calculations that are as erroneous as the basic theory, it argues that the "savings account" yielded a "rate of return" of only 1.3 percent in 1977. It argues further that consumers are losing billions of dollars annually because they do not "know" this. And it recommends that the present system of cost disclosure now being adopted by the states be radically changed and the FTC staff's version of cost disclosure be substituted.

The FTC staff report is reckless misrepresentation of our business. The FTC staff began its investigations with fixed opinions about the nature and value of whole life insurance and determined to show that term life insurance was a better buy for most people. The FTC staff report was the result of a hidden agenda to portray whole life insurance as a consumer fraud, to show that the states were not properly regulating the important matter of cost disclosure and, thus, to demonstrate the need for Federal intervention.

To put our case directly, the FTC staff, in order to justify the intervention of the Federal Government, set out to make it appear that this industry was hiding its costs and misleading its customers into making poor purchase decisions. To "prove" this, the FTC staff adopted an analysis of whole life insurance to support its claims. It developed a distorted calculation of interest rates that our business is crediting to its customers' policies which was so sensationally low that it would shock the public. It rejected analyses by actuaries within our business that would show otherwise, including analyses of how costs are developed and allocated for whole life insurance. In brief, it rejected facts and pursued its foregone conclusion.

Even before its investigation had gotten off the ground, the FTC staff wrote to state insurance regulators, urging them not to adopt the NAIC model regulation, because the FTC was going to find it deficient. At the same time, it was also advising a member of this Congress that the states were dragging their feet in adopting the NAIC model. Thus, on the one hand, the staff was trying to stop state regulation, and on the other hand, to use the result of its hindrance to state regulation to bolster a case for Federal intervention.

One reason cited by the FTC staff for the states not to act was a study commissioned by the FTC to determine what information would be useful to buyers of life insurance and to test various systems of presenting information to buyers. That study was conducted by Professor Jacob Jacoby of Purdue University. The results did not support the claims of the FTC staff that the NAIC model regulation was seriously deficient. If you search the FTC staff report carefully, you will find a lonely footnote reference on page 161 to the Jacoby findings. And if you look still further, you will find a brief description of the results in Appendix Nine. It survives

in the report as an isolated whisper of fact, declaring to the FTC staff; "You are wrong."

The FTC staff report would have our customers believe:

—That our business has misled them and generations before them;

—that our business has somehow hoodwinked its state regulators for more than 100 years;

—that the mathematics of statistics and probability which form the base of whole life insurance and dictate its pricing were twisted into an enduring deception; and

—that the actuaries for all those years never detected it.

These are the premises which animate this report. Beyond that, it is necessary to accept an offense to reason in order to believe the findings of this report.

The description of whole life insurance promoted by the FTC staff was publicized so widely, and has generated so much confusion, we find ourselves urgently required to define once again what we sell.

Whole life insurance is not partially insurance and partially savings. It is wholly insurance. It is not designed to provide for the possibility of economic gain in return for a risked sum of money. That's an investment. Nor is it designed to accumulate deposits of money building toward an individual or family goal as the depositor remains alive to make the deposits. That's a savings account. It is designed to provide a guaranteed benefit at death, whenever death ocours, in return for a price which is expressed as a fixed periodic premium. That is what it is, that is what it does. Nothing else in the financial marketplace does this; and no combination of financial products does this with an unconditional guarantee. A combination of term life insurance plus an investment program might produce such a result—if. A combination of term life insurance plus a savings account might produce such a result—if. But a whole life insurance policy will produce that result with a guarantee as strong as the mind of man and the force of law can devise. That is why people buy it.

Our business also provides life insurance for shorter periods of time. Term insurance is a very useful product and people buy billions of dollars worth of it each year. At young ages, it requires considerably less outlay than a comparable amount of whole life insurance because relatively few people die at young ages. But because its premium must rise with age and eventually reach the point where people cannot afford it, term insurance does not meet the need for coverage which people can afford throughout life.

On the charts here, graphically displayed, is the predicament which the rising prospects of death present to the average individual, the term insurance solution to that predicament at various ages and the whole life insurance solution.

Chart I is a simple line graph, displaying the probabilities of death for males at any adult age. The cost of insuring lives on a year by year basis is rigidly tied to these probabilities. As the probabilities go up each year, so does the cost until that cost exhausts the means of most people and they are required to drop the insurance. In the interest of brevity, the chart shows only male mortality. We acknowledge the need for insurance for women. And while the mortality rates differ, the principle displayed by the chart is the same.

The yearly cost of term insurance is not cheap over the length of time most people will live. One can assert that term insurance is cheap—as the FTC staff does—only if one ignores the calendar. Its yearly cost is low when young, higher when middle aged and prohibitive when old.

Before the late eighteenth century only term life insurance was available and that not beyond age 40. This was the problem that whole life insurance was developed to solve. Conceptually the solution was simple: average out the premium over the expected life of the buyer, accumulate assets in the early years from premiums not needed to pay death claims, and use both the assets and investment earnings to help pay death claims when they exceeded the premiums still coming in from the survivors. (The precises mathematics to achieve that conceptual result are a lot more complex than this and they probably explain why it takes about 8 years of post-graduate schooling to produce an actuary, and another 8 to persuade one to communicate in English.)

Chart I

Deaths Per 1,000, by Age

U.S. Males, 1976

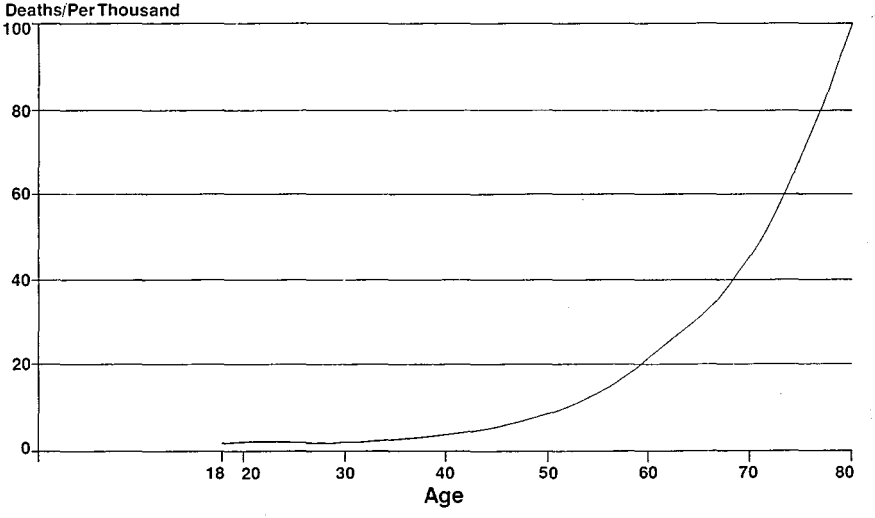
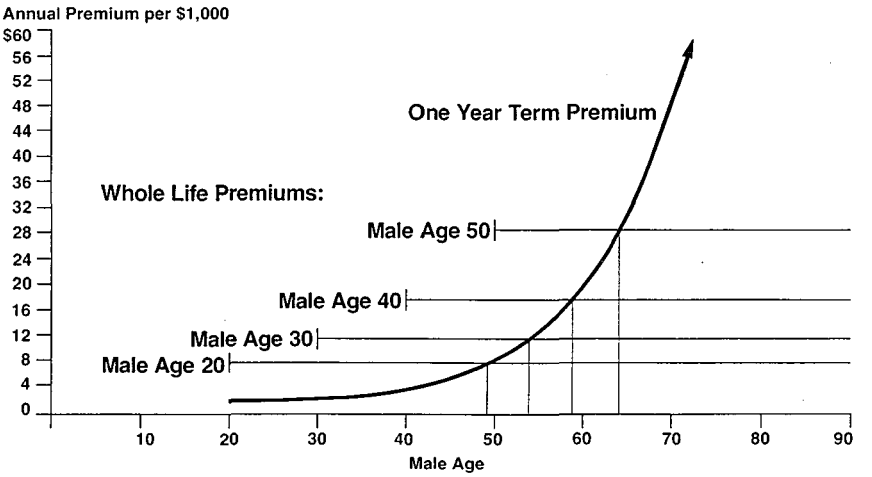


Chart II displays in a rising curve what happens to term insurance premiums as people age. The level cost of whole life insurance is also displayed for various issue ages. The intersections between the level lines and the rising curve are at those ages where the yearly cost of term insurance begins to exceed the cost of level premium whole life insurance at the issue ages we have selected. It is clear from this chart that whole life insurance can be afforded to ages where term insurance cannot.

Chart II

Annual Premiums for 1-year Term Insurance and Whole Life Insurance, At Various Ages

(Net Premiums Assuming 1958 C.S.O. Mortality and 4% Interest)



There is an important probability in all this that I want to emphasize. Most life insurance is bought by people between ages 20 and 50. Right in the middle of that group stands an individual, age 35, examining the prospects and wondering what to do about his life insurance needs.

Even before he gets to the issue of comparing costs, if the FTC staff has its way, he will be advised by its proposed buyer's guide to avoid whole life insurance.

The chances are 8 out of 10 that the buy term advice of the FTC staff will leave a person unable to afford to continue life insurance after age 65. And if a person needs life insurance after age 65—as most people do—the FTC advice will have been disastrous. This is because for people age 35 the mathematical prospects of survival beyond retirement age are 8 out of 10. I think it is pertinent to ask the FTC staff: who appointed you to advise a nation full of life insurance buyers to take such risks against such well-known odds? What facts support your assertion that the need for insurance vanishes at age 65? How does your advice compare with that of the Veteran's Administration—which has experienced the problems of renewable term insurance for an aging group of World War II veterans?

The most widely publicized charge by the FTC staff was that the industrywide rate of return on whole life policyholder "savings" was 1.3 percent. John Taylor will explain how this figure is the figment of the FTC staff's distorted calculations. Let me just say that if you were to apply real-world factors to the formula developed by the FTC staff, the result will be 5.9 percent instead of 1.3 percent.

Of course, 5.9 percent would not have rated headlines. In that vein, by releasing its report to the press—but not to the industry—prior to its presentation to this Committee, the FTC was successful in orchestrating the news. Its side of the story was the only story the press had to work with. Couple this manipulation with the fact that as a government agency charged with protecting consumers, the Commission's pronouncements are generally taken at face value, it is little wonder that the initial press accounts were so overwhelmingly one sided.

This manipulation of the media is bad enough. What's even worse is that the message communicated violates the standards of truthful advertising that the Commission finds objectionable and, indeed, actionable in others.

If the FTC's Cost Disclosure Report and the press release accompanying it were subjected to the same tests which the FTC generally applies to commercial advertising under Section 5 of the FTC Act, they would be properly characterized as "omitting material facts," "unsubstantiated," "false and deceptive," and "having a tendency and capacity to mislead consumers," to borrow just a few phrases from past FTC advertising complaints.

If a private corporation had disseminated such an array of misrepresentations, it would very rapidly find itself looking down the business end of an FTC cease and desist order. In fact, for making less serious misrepresentations than are contained in this cost disclosure report, the FTC has ordered some private companies to engage in corrective advertising "to overcome the public misimpressions created by the earlier advertising." It is indeed a shame that in issuing reports such as this, which may have a tremendous impact on consumers, the Commission is unable to live up to its own standards.

The matter of effective cost disclosure, the ostensible objective of the FTC investigation, is of course a valid and important issue. We are convinced that the NAIC Model Regulation is a sound solution which is working in the interest of consumers. The proposals of the FTC staff to change the model regulation are based on their faulty analysis of what the product is and therefore can only serve to confuse prospective purchasers.

To conclude: the life insurance industry favors cost disclosure and believes the NAIC model serves consumers well in this regard. We reject the contention of the FTC staff that the whole life policy is a form of investment and a poor investment at that. We accordingly also reject the cost disclosure proposals of the FTC staff which are based on that faulty premise.

And finally, we must record our objections to the manner in which the FTC staff has conducted this investigation. The FTC staff undertook this investigation with a bias, a hidden agenda, and a method. The bias was that whole life insurance was a shell game. The hidden agenda was to demonstrate the need for Federal intervention by discrediting state regulation of cost disclosure. The method was distortion of the facts and manipulation of the media. And all of this done in the name of the Federal government. The American people have a right to expect better.

The CHAIRMAN. All right, Mr. Taylor, are you next?

Mr. TAYLOR. I am. Mr. Chairman, members of the committee, I am John Taylor. I am executive vice president of the Bankers Life Co., of Des Moines, Iowa, and by profession I am an actuary.

I wish to thank you for the opportunity to appear before this committee. I would like to comment on the so-called rate-of-return concept upon which the Federal Trade Commission staff entirely built its report, "Life Insurance Cost Disclosure."

I will be using a number of charts which are in the full statement.

In releasing this report to this committee, the Chairman of the Federal Trade Commission gave principal emphasis to what he said was the low average industrywide rate of return that consumers received on their life insurance in 1977. He gave this figure as 1.3 percent.

The figure made headlines and it was quoted in several leading newspaper editorials. But it is absolutely wrong. It is absurd to claim that the interest being credited to policyholders is a mere 1.3 percent.

The rate-of-return calculation made by the FTC staff begins with the erroneous notion that pervades the entire report—namely, that part of the premiums for whole life insurance policies go to buy pure insurance and the rest are put into a savings account, which yields a rate of return that is both very low and undisclosed. In its own support, the FTC staff developed a special calculation that served no other purpose.

The extent of the error can be easily seen by comparing the 1.3 percent rate of return with several obvious benchmarks. The FTC

staff view of the use of premiums is not commonly held by the public. People consistently say they buy whole life insurance policies for protection, not as savings accounts.

Although these policies are valuable assets, they are not perceived by their owners as investments. It is true that investment income is earned by life insurance companies. This permits them to charge lower premiums for life insurance than would otherwise be needed.

Interest rates of 5 or 6 percent—not 1.3 percent—are currently used by life insurance companies in determining premium rates or dividends.

My own company uses a rate in excess of 7½ percent, for example.

Life insurance companies are required by law to maintain reserves that are adequate to meet their obligations to policyholders. It is astonishing to me as an actuary to find that the FTC staff's measure of the rate of return on savings is appreciably lower than the interest actually required for the growth of policy reserves during the year, or the interest actually paid on policy dividends left with companies, which is currently 5 and 6 percent.

Having decided that life insurance policies include savings accounts, the FTC staff then used assumptions of their own selection to prove that the rate of return credited to such accounts was very low.

Here it is possible to choose from a wide range of assumptions. At one extreme the rate-of-return could be minus one-tenth of 1 percent. At the other extreme it could be as high as 9.1 percent. Anyone who is motivated to deprecate whole life insurance would choose assumptions that produce a rate of return close to the bottom of the possible range, say 1.3 percent.

To put this into proper perspective, we need to look at the sources and uses of ordinary life insurance income. This chart, which is designated chart III, shows that life insurance companies received $24.4 billion in 1977 in premiums and $12.4 billion in investment income attributable to ordinary life insurance. Of the $36.6 billion of income, $19.3 billion was either paid in benefits to policyholders or used to support increases in policy reserves; $4.8 billion was used for dividends to policyholders; $10.4 billion was paid in taxes and other insurance expenses; and $2.1 billion was the net gain from operations.

The FTC staff used questionable assumptions to support their contention that the life insurance business credited only 1.3 percent to ordinary policyholders in 1977. One of these was to allocate part of the income of life insurance companies in its calculation in a manner that fits no logical actuarial pattern.

Chart IV shows how the FTC staff arbitrarily allocated premiums and investment income for ordinary life insurance to support their claims. Initially the FTC split premiums and investment income into two parts represented by the two bars on the chart. The first bar on the chart shows that dividends to policyholders of $4.7 billion and benefits other than death benefits of $6.1 billion—which totals $10.8 billion—were matched against premiums.

Of the remaining $13.4 billion in premiums, a figure of $7.4 billion was developed as the cost of pure insurance consisting of

$4.9 billion for death benefits and $2.5 billion for expenses, et cetera. The method of allocation left $6 billion of premiums as a net deposit of savings.

The second bar on the chart shows that the FTC staff matched $10 billion or 80 percent of the total expenses, taxes, and profits against investment income, leaving only $1.8 billion of investment income which they attributed to interest on savings. Since investment income is only one-third of total income, there is obviously no good reason to match it with 80 percent of expenses, taxes, and profits.

A similar distortion took place in the FTC staff's assumption that an appropriate level of ordinary life insurance expenses can be established by simply using an arbitrary percentage of death claims paid during a calendar year. In fact, their assumptions do not reflect the way life insurance is sold, the nature of the product, or the way in which level premiums are determined.

For a block of policies, expenses will usually be much more than claim payments during the first few policy years and will grade down to a small percentage of claims during later policy years. For this reason, the ratio of expenses to claims in a given calendar year will depend on how the amount of business that is still in the first few policy years compares to the amount of business that has been in force for longer periods.

The result of these calculations enables the FTC staff to casually attribute a low rate of return to high expenses and taxes. In a predictable next step, the FTC staff suggests that a reduction of $3.7 billion in expenses would bring the rate of return up to a reasonable 4 percent, and that home office and field expenses should be reduced by nearly half.

As chart V shows, the actual expenses and taxes incurred in 1977 on individual life insurance amounted to $10.4 billion and the insurance companies showed a net gain from operations of $2.1 billion for the year on that line of insurance for a total of $12.5 billion. Thus the amount allocated by the FTC staff to cover expenses, taxes, and profits in calculating the cost of pure insurance amounted to only 20 percent of the amounts actually needed for these purposes.

The notion that current expenses of life insurance companies can be halved is absurd. Life insurance companies have made extensive use of computer technologies to hold home office expenses in check. Commission scales for agents have been stable for more than a quarter of a century. Moreover, State laws regulate the expenses of companies that sell about half the business sold in the United States.

The practical effect is to keep down pricing and expenses of life insurance nationally. An analysis of life insurance company expenses in the decade between 1965 and 1975 shows that the only expense that seems to have grown disproportionately is Federal income taxes.

By any definition, the purpose of cost disclosure in life insurance is to give consumers the tools for comparing the costs of similar life insurance policies. The calculation by the FTC staff of its 1.3 percent rate of return has nothing to do with disclosure or cost comparison. Its sole purpose was propaganda intended to persuade

people that life insurance policies with cash values should be avoided. There is, therefore, no legitimate reason for such a calculation. If nevertheless the FTC staff insists on deriving a rate of return in 1977 on life insurance policies from the annual financial statements of life insurance companies, they could in the consumer's interest obtain a far more accurate depiction than 1.3 percent.

Investment income received by insurance companies is allocated to elements included by the FTC staff in savings. The most important of these are dividends to policyholders and interest needed to maintain policy reserves.

Chart VI compares investment incomes allocated by the FTC staff to savings with investment income actually used for some of the purposes the FTC staff classifies as savings. Just one of these items—the $4.2 billion of investment income required to maintain policyholder reserves—is about 2⅔ times the total amount that the FTC staff claims to be the interest on savings.

All funds received by insurance companies, whether premiums or investment income, are used to pay benefits and expenses. If the FTC staff had allocated premiums and investment income proportionately among the various uses of funds by life insurance companies, as illustrated in chart VII, their allocation would have matched $8.2 billion of investment income with benefits, dividends to policyholders or increases in reserves. If this $8.2 billion had been divided by the FTC estimate of the average savings for the year, $139 billion, their answer would have been 5.9 percent, not 1.3 percent.

However, there is no reason to attempt to develop a rate of return for the business from composite financial statements. Such a rate has nothing to do with disclosure of the price of life insurance policies to individual buyers.

By using unreasonable assumptions, the FTC staff has produced a sensational answer that did great disservice to everyone involved—the public, the press, other members of the Government, and the life insurance business.

Thank you.

[The statement follows:]

STATEMENT OF JOHN R. TAYLOR, EXECUTIVE VICE PRESIDENT, BANKERS LIFE CO., DES MOINES, IOWA

RATE OF RETURN PAID BY LIFE INSURANCE COMPANIES TO ORDINARY POLICYHOLDERS IN 1977

My name is John R. Taylor. I am Executive Vice President of the Bankers Life Company of Des Moines, Iowa, and by profession I am an actuary.

The high point—or rather the low point—of the Report on Life Insurance Cost Disclosure by the staff of the Federal Trade Commission is the calculation of a so-called "Rate of Return Paid by Life Insurance Companies to Ordinary Policyholders in 1977." The answer developed by the FTC staff was 1.3 percent. This figure was highlighted in their release and in the presentation of the report to the Senate Commerce Committee by FTC Chairman Michael Pertschuk.

The calculation made headlines all over the country. It was quoted in editorials in several leading newspapers. But the calculation produces an answer that is absolutely wrong. The FTC staff had created a situation in which the public had to believe either an agency of the Federal government or the life insurance business—which unhesitatingly called it "absurd" to claim that the interest being credited to policyholders is a mere 1.3 percent.

The claim by the FTC staff that whole life insurance—one of the principal products sold by life insurance companies—was a combination of term life insurance

plus a savings account earning 1.3 percent was endorsed by people with a commercial interest in having such a claim accepted by the public. Building on the misleading report, people have cited the 1.3 percent "rate of return" in newspaper advertisements, in television interviews and in promotional pieces. The people involved have products for sale, including combinations of term life insurance and some type of investment which are being promoted as an alternate to or as a replacement for whole life insurance policies.

The calculation made by the FTC staff begins with the erroneous notion that pervades the entire report—namely, that part of each premium for a whole life insurance policy goes to by "pure insurance" and the rest of the premium is put into a savings account, which yields a "rate of return" that is both very low and undisclosed. In order to demonstrate just how low this "rate of return" actually is, the FTC staff developed a special calculation that served no other purpose. In this calculation, the FTC staff used some arbitrary assumptions which were completely different from—but which should have been identical to—assumptions used elsewhere in the report.

The results of the calculation are clearly wrong, and the FTC staff should have known they were wrong. The extent of the error can be easily seen by comparing the 1.3 percent "rate of return" with several obvious benchmarks. The failure of the FTC staff to make such comparisons is an indication of the extent to which they had approached their investigation of life insurance disclosure and cost comparison with fixed opinions that whole life insurance is a bad buy.

Their view of the use of premiums for whole life insurance policies is not commonly held by the public. People consistently say they buy whole life insurance policies for protection. Although these policies are certainly valuable assets, they are not perceived by their owners as being investments. It is true that investment income is earned by life insurance companies, and this permits them to charge lower premiums for life insurance then would otherwise be needed. Interest rates of 5 or 6 percent are currently used by life insurance companies in determining premium rates or dividends. However, this is a long way from crediting interest on a savings account being sold in conjunction with "pure" insurance.

A. *Policyholder savings according to FTC staff*

For this calculation, the FTC staff measures the change in "policyholder savings" which they define as being 90 percent of policy reserves for individual life insurance policies plus 78.6 percent of all policy dividends left by policyholders with insurance companies.

Life insurance policy reserves are one measure of the liabilities of companies to their policyholders. They also are a measure of the value of these contracts to policyholders. Policy reserves held by companies must at least equal the minimum amounts required by state law.

Policy dividends are often left with life insurance companies by policyholders who prefer to receive the interest credited on these funds (currently 5 or 6 percent or more) rather than take these funds in cash.

It is astonishing to find that the FTC staff's measure of the "rate of return" on "savings" is appreciably lower than the interest actually required for the growth of policy reserves during the year or the interest actually paid on policy dividends left with companies. The reasons for this surprising result become clear upon examining the assumptions made by the FTC staff.

B. *Rate of return on policyholder savings*

Having decided that life insurance policies include savings accounts, the FTC staff then proceeded to select assumptions designed to prove that the "rate of return" credited to such accounts was very low.

The results of their calculation depended on the assumptions chosen by the FTC staff from a range available to them. The results of their calculation could have purported to show that life insurance is a poor investment—or a great one. At one extreme, the FTC staff could have taken the $12.4 billion of investment income credited in 1977 by insurance companies to the individual life insurance line and allocated it entirely to the increase in "savings" for that year, or to benefits to policyholders or to dividends. The resulting "rate of return" to policyholders would have been more than 9 percent.

At the other extreme, the FTC staff might have allocated the entire $12.4 billion of investment income to taxes, expenses and gains from operations—with none of it allocated to benefits, dividends or increases in reserves. Under this assumption, the "rate of return" would be slightly less than −0.1 percent.

Thus, the possible "rates of return" open to the FTC staff—depending on the assumptions they used—range from a low of −0.1 percent to a high of 9.1 percent.

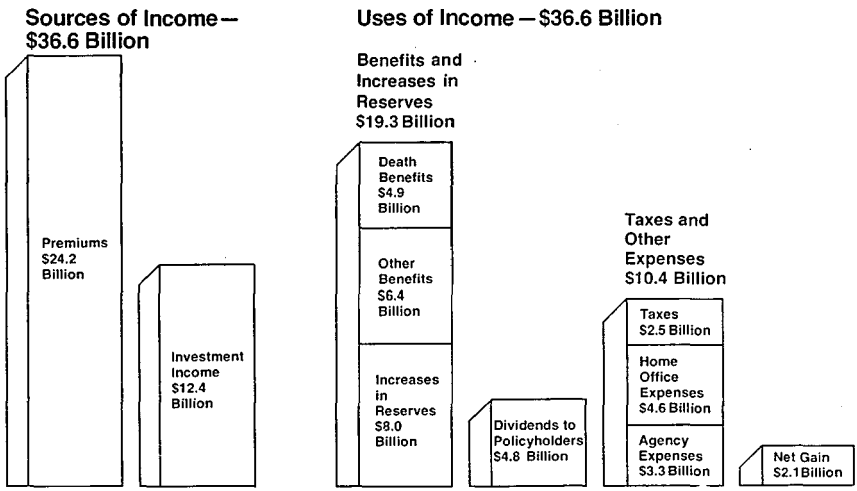
Consistent with an effort to deprecate whole life insurance, the FTC staff chose assumptions that produce a "rate of return" of 1.3 percent that is much closer to the bottom of the possible range than to the middle. A more reasonable set of assumptions that reflect the nature of the products being sold, and the operations of life insurance companies, would result in a figure somewhere above the middle of the range of possible answers.

C. *Arbitrary allocations by FTC staff*

Life insurance companies received $36.6 billion in 1977 from income due to ordinary life insurance. This consisted of $24.2 billion in premiums and $12.4 billion in investment income. Of the $36.6 billion of income, $19.3 billion was either paid in benefits to policyholders or used to support increases in policy reserves; $4.8 billion was used for dividends to policyholders; $10.4 billion was paid in taxes and other insurance expenses; and $2.1 billion was the net gain from operations. (See Chart III.)

Chart III

Ordinary Life Insurance Income*—1977



*Taken from reports made to State Insurance Departments, the same information reviewed by the FTC staff for its report.

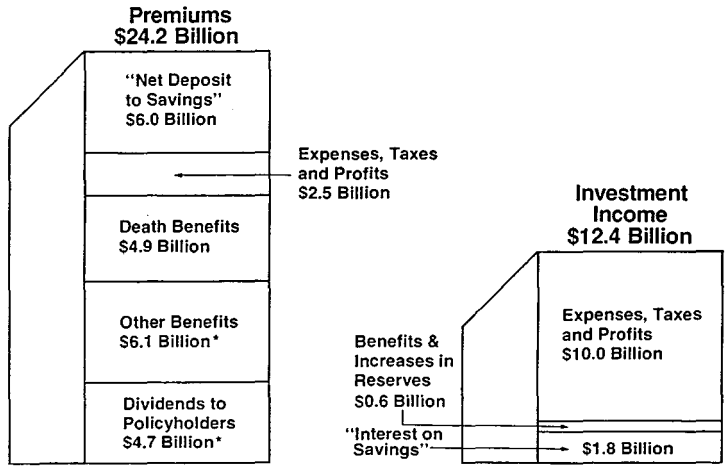
Chart IV shows how the FTC staff arbitrarily allocated premiums and investment income for ordinary life insurance to support their claim that the life insurance business credited only 1.3 percent to ordinary policyholders in 1977.

Dividends to policyholders of $4.7 billion and benefits other than death benefits of $6.1 billion were matched against premiums. Of the remaining $13.4 billion in premiums, a figure of $7.4 billion was developed as the cost of pure insurance representing $4.9 billion for death benefits and $2.5 billion for expenses, etc. This estimate of the "cost of pure insurance" left $6.0 billion of premiums as a "net deposit to savings."

The second bar on Chart IV shows the allocation of investment income that resulted from this allocation of premiums. Since the total increase in "savings" for the year 1977 calculated by the FTC staff amounted to $7.8 billion, their calculation of a $6.0 billion "net deposit to savings" meant that only $1.8 billion of the annual increase in "savings" was attributable to "interest on savings." Nearly all the rest of the $12.4 billion of investment income credited to ordinary life insurance operations was allocated to expenses, taxes and profits—a result that is clearly unreasonable. Since investment income is only one-third of total income, there is obviously no good reason to match it with 80 percent of expenses, taxes and profits.

Chart IV

How FTC Staff Allocated 1977 Income From Ordinary Life Insurance



*Slight differences between these figures and corresponding figures in Chart III result from the use of different data sources by the FTC Staff and the ACLI.

C. *Errors in the FTC staff approach to expense allocation*

The FTC staff allocation of $24.2 billion in premiums into $7.4 billion for "pure insurance" and $16.8 billion as "deposits" has no factual support. Their allocation reflects neither the way life insurance is sold, nor the nature of the product, nor the way in which level premiums are determined.

A major error of the FTC staff results from their assumption that an appropriate level for expenses can be established by simply using an arbitrary percentage of claims paid during a calendar year. This overlooks the facts that (1) the incidence of expenses for a group of policies is quite different from the incidence of claims; (2) level premiums are being charged to cover both benefits and expenses; and (3) sales of life insurance have grown dramatically over the last 30 years.

First-year expenses are generally higher than expenses in renewal years. This is because of (1) acquisition and underwriting costs, including compensation to agents, fees to doctors for medical examination and other underwriting expenses; (2) the cost of issuing and delivering a contract; and (3) the costs of establishing the necessary records to provide future services to the policyholder.

For life insurance policies with level premiums, companies must establish premium rates to cover both this pattern of decreasing expenses and a different pattern of claim costs, which begin at a very low level and increase as policyholders age. Premiums are set high enough so that, together with an assumed investment return, there will be sufficient funds to pay benefits and expenses, including taxes, as they emerge.

For a block of policies, expenses will usually be much more than claim payments during the first few policy years and will grade down to a small percentage of claims during later policy years. For this reason, the ratio of expenses to claims in a given calendar year will depend on how the amount of business that is still in the first few policy years compares to the amount of business that has been in force for longer periods.

The individual life insurance in force during 1977 was heavily concentrated in policies issued during the 1970's. This follows the pattern of sales; nearly three times as much individual life insurance was sold in 1977 as in 1965, eight times as much as in 1955 and 25 times as much as in 1945.[1]

[1] To test the impact of the average period for which policies have been in force on the FTC staff "rate of return" calculation, we applied it to one of our member companies, Metropolitan Life, for (1) industrial insurance, which since it has not sold since 1964, contains only policies that have been in force 15 years or more; and (2) ordinary life insurance, whose sales have been

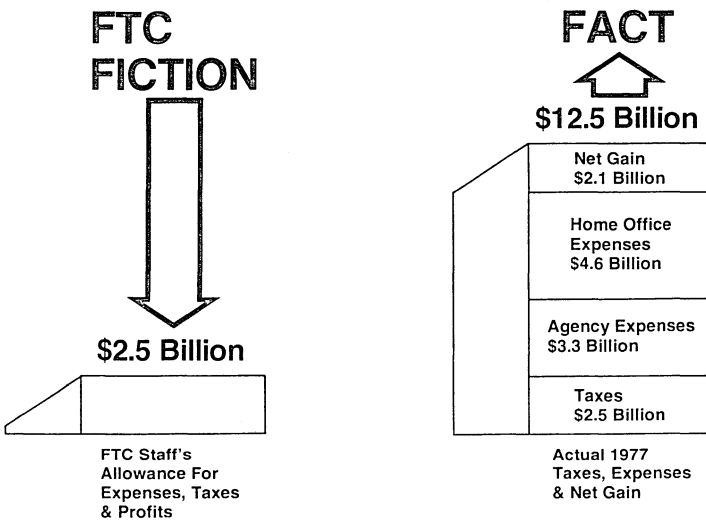
Footnotes continued on next page

To allocate life insurance premiums in 1977 between the costs of "pure insurance" and "deposits in savings account," the FTC staff assumed an allowance for expenses, taxes, and profits equal to 50 percent of death claims. This resulted in an arbitrary provision for expenses and profits of $2.5 billion.

The actual expenses for expenses and taxes incurred in 1977 on individual life insurance amounted to $10.4 billion and the insurance companies showed a net gain from operations of $2.1 billion for the year on that line of insurance. Thus, the amount allocated by the FTC staff to cover expenses, taxes, and profits in calculating the cost of "pure insurance" amounted to only 20 percent of the amounts actually needed for these purposes. (See Chart V.)

Chart V

Taxes, Expenses and Profits, 1977



E. *The FTC staff view of life insurance company expenses*

The FTC staff casually attributes a low "rate of return" to high expenses and taxes rather than to "massive profits." As has been demonstrated above, the low "rate of return" comes purely from the arbitrary assumptions made by the FTC staff for the "cost of pure insurance." The FTC staff suggests that a reduction of $3.7 billion in expenses would bring the "rate of return" up to a reasonable 4 percent, and that home office and field expenses should be reduced by nearly half.

The notion that current expenses of life insurance companies can be halved is absurd. Life insurance companies have made extensive use of computer technologies to hold home office expenses in check. Commission scales for agents have been stable for more than a quarter of a century. Moreover, state laws regulate the expenses of companies that sell about half the business sold in the United States. The practical effect is to keep down pricing and expenses of life insurance nationally.

The following table shows how companies have held expenses in line over the decade 1965 through 1975; it shows, in terms of dollars of constant purchasing power, the increases in (1) individual life insurance in force, (2) individual life insurance premiums, (3) investment income allocated to individual life insurance, (4)

Footnotes continued from last page

steadily increasing. The rates of return, using the FTC staff formula, were 7.2 percent for industrial insurance and 2.5 percent for ordinary. This lopsided and unbelievable result is produced even though both types of insurance are actually being credited by Metropolitan Life with the same after-tax interest earnings.

Why does the FTC staff formula produce dramatically different answers for these two lines of business? Solely because it fails to account for the impact of policy duration.

benefits to policyholders, (5) operating expenses and taxes (other than Federal income taxes), and (6) Federal income taxes.

Increase over the period 1965–75 measured in dollars of constant purchasing power

Individual life insurance:	*Percent*
In force	27
Premiums	2
Investment income	28
Total income	9
Benefits to policyholders	24
Operating expenses and taxes (other than Federal income taxes)	21
Federal income taxes	62

Expenses and taxes (other than Federal income taxes) increased slightly less than business in force but premiums increased by a significantly lower percentage, largely due to (1) reductions in premium rates, and (2) changes in the mixture of sales. The only expense that seems to have grown disproportionately is Federal income taxes.

In short, neither the supposed low "rate of return" calculated by the FTC staff nor the explanation given for that result is supported by fact.

F. *Benchmarks the FTC staff calculation fails to meet*

The results of the calculation performed by the FTC staff can be tested by comparing the resulting allocations of expenses or of investment income to known quantities.

In the sections of the report dealing with "rates of return" by the Linton Yield method, the FTC staff made provision for profits and expenses using a formula developed by a committee of the Society of Actuaries to be representative of the premiums charged for very low cost term insurance. Applying this formula to the insurance in force in 1977 would have produced an amount equal to $4.9 billion. Thus, the calculation performed by the FTC staff resulted in a 50 percent understatement of the necessary provision for expenses and profits when compared to a standard embraced by the FTC staff elsewhere in its report.

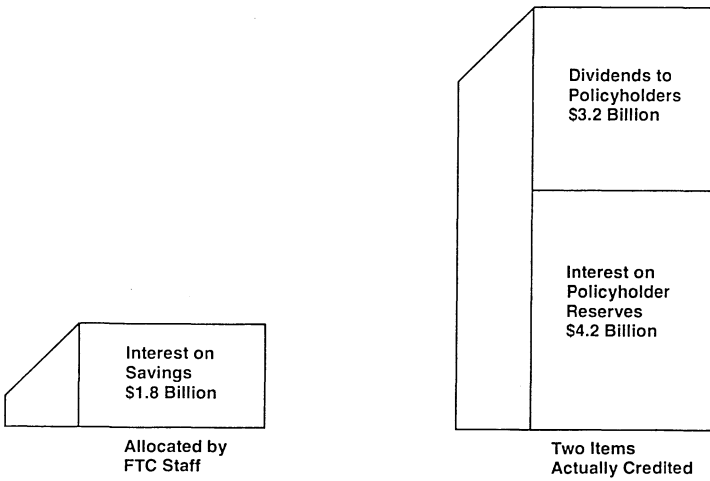
It would have made some sense for the FTC staff to separate dividends left on deposit with life insurance companies from life insurance reserves. Superficially at least, these dividends on deposit can be compared to savings accounts, since specific interest is credited to them, currently 5 percent or higher. This interest is currently taxable. Thus, the 1.3 percent produced by the FTC staff calculation is far below the interest actually being paid on the only element included in "savings" by the FTC staff on which interest is directly credited by companies.

Investment returns are applied by insurance companies to other elements included by the FTC staff in savings. The most important of these items are dividends to policyholders and interest needed to maintain policy reserves. Of the $4.8 billion actually paid as dividends to policyholders in 1977, about two-thirds ($3.2 billion) was due to investment earnings. The policy reserves amounted to something more than $140 billion in 1977. These reserves were calculated with an average interest rate of about 3 percent. This means that about $4.2 billion of their increase during the year had to be met by investment income.

Chart VI compares investment income allocated by the FTC staff to "savings" with investment income actually used for some of the purposes the FTC staff classifies as "savings." Just one of these items—the $4.2 billion of investment income required to maintain policyholder reserves—is about two and one-third times the total amount that the FTC staff claims to be the "interest on savings."

Chart VI

Allocation of Investment Income to "Savings," 1977



G. *A reasonable estimate of the rate of return on life insurance*

The calculation by the FTC staff of the "Rate of Return Paid by Life Insurance Companies to Ordinary Policyholders in 1977" had nothing to do with disclosure or cost comparison, both of which deal with individual policies sold by individual companies. Its sole purpose was propaganda intended to persuade people that life insurance policies with cash values should be avoided. There is, therefore, no legitimate reason for such a calculation to be made. If, nevertheless, the FTC staff insisted on deriving a "rate of return" in 1977 on life insurance policies from the annual financial statements of life insurance companies, they could have obtained a far more reasonable answer than 1.3 percent.

All funds received by insurance companies, whether premiums or investment income, are used to pay benefits and expenses. If the FTC staff had allocated premiums and investment income proportionately among the various uses of funds by life insurance companies, their calculation would have matched $3.5 billion of investment income with taxes and expenses and $0.7 billion of investment income with net gain from operations. Proportional allocation would match $8.2 billion of investment income with benefits, dividends to policyholders or increases in reserves.

If this $8.2 billion matched with items which the FTC staff classifies as additions to or withdrawals from savings had been divided by their estimate of the average "savings" for the year ($139 billion),[2] the "rate of return" shown for the year would have been 5.9 percent, not 1.3 percent. (See Chart VII.)

CONCLUSIONS

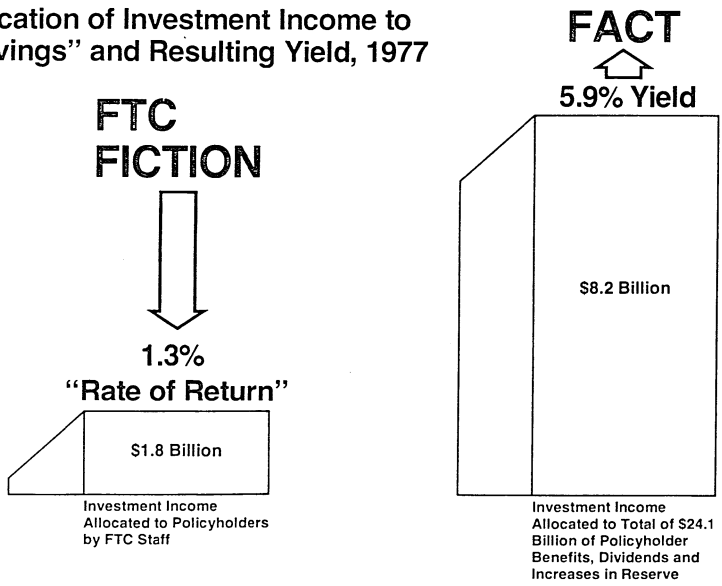
The basic idea permeating the FTC staff report that the premiums paid for life insurance constitute a combination of premiums for "pure" insurance and "deposits" in a savings account is wrong and has led to a "rate of return" that has nothing to do with reality.

The only interest rates that have an impact on the price of life insurance are those used by the companies in setting premiums and in determining dividends to policyholders. Those rates are currently in the area of 5 or 6 percent, and, of course, vary from company to company.

[2] P. 17 FTC staff report.

Chart VII

Allocation of Investment Income to "Savings" and Resulting Yield, 1977



There is no reason to attempt to develop a "rate of return" for the industry from composite financial statements. Such a rate has nothing to do with disclosure of the price of life insurance policies to individual buyers. However, if the FTC staff had made their calculation with reasonable assumptions, they would have produced a reasonable "rate of return." By instead using unreasonable assumptions, they produced a sensational answer that did great disservice to everyone involved—the public, the press, other members of the government and the life insurance business.

The CHAIRMAN. Who is next?

Mr. MARTIN. I am. I am Jim Martin, chairman of the Massachusetts Mutual Life Insurance Co. My professional background is in marketing and I, too, represent the American Council of Life Insurance here today.

First, let me say that the Federal Trade Commission challenge to the whole life product—and the advocacy of "buy term and invest the rest"—is not a new one. These views have been expressed before—as early as 1875—have been given careful consideration by experts—and have been rejected. Yet today the "buy term and invest the rest" bunch are at it once again.

What is different now, and why we are here today, is that the group leading the attack on our industry this time is a Federal regulatory agency using taxpayers' dollars, attempting, without the authority to do so, to usurp the powers of the insurance commissioners of our 50 States, and to extend its authority into areas of regulation where it currently has little or no legal jurisdiction.

According to the FTC staff report, their sole interest is to make the American consumer better informed. They would have you believe that all consumers—if they were better informed or as well informed as the more sophisiticated insurance buyer—would purchase only term insurance. That is pure rubbish, but if the average consumer were to accept this contention without first learning the

real facts—he or she could well be doing themselves and their families grievous disservice.

Let's look at our company, Massachusetts Mutual. We sell a market that consists primarily of the most sophisticated insurance buyers in America. During the last 12 months, we received 520 applications to purchase life insurance policies, each of $1 million or more. It is both interesting and relevant to note that over 60 percent of these were for some form of whole life insurance. These 520 customers were ones who, before making their decision, were able to afford expert advice from independent legal, accounting, and financial advisers, and 63 percent concluded that whole life best filled their insurance needs. Incidentally, this ratio of approximately 60-percent whole life to 40-percent term is presently the same for all of our life business.

I believe that a whole life contract must be viewed as a unique bundle of indivisible rights. I think back to my high school biology teacher explaining—that while a human being is of inestimable value and utility—the human body itself is a combination of over 50 percent water plus various chemicals.

In other words, considered separately—our parts represent a pail of water and a bucket of bones with little value and little use. Much in the same way that human beings represent a unique combination of water and chemicals—the whole life product is a combination of rights whose value and utility are significant—only when they are properly combined together.

In attempting to make its case, the FTC report focuses for the most part on what it would have you believe is the life insurance industry's reluctance to provide meaningful cost disclosure information to the public. This was true a decade ago—but is patently untrue today.

We as an industry strongly support meaningful cost disclosure. Where we disagree with the FTC—is that we support a different method of cost disclosure—one that we believe best serves the consumer in its clarity and its objectivity.

We support the cost disclosure system of the National Association of Insurance Commissioners (NAIC) one already in place in more than half the States.

Life insurance companies want their customers to receive the buying information they need—and to the maximum extent possible, to get reliable cost indexes to compare prices. Toward this end, the companies which sell most of the life insurance in America—have spent considerable time, effort, and money to put into effect the cost disclosure system prescribed by the NAIC model regulation of life insurance solicitation.

The NAIC system was developed by experienced insurance regulators who held extensive hearings to consider various means of disclosure and cost indexes—drawing on the experience and judgment of many expert witnesses.

The NAIC committee on cost comparison considered and rejected Linton Yield—the method now proposed by the FTC—primarily because the committee believed that any system that attempted to separate the insurance and savings elements of a life insurance contract would create more misunderstanding than enlightenment for consumers.

The current NAIC model regulation, or a comparable earlier version, has already been adopted in 28 States. Our company and many others now make this information available to consumers in virtually every State—including those which do not yet require it.

The NAIC model regulation has two main requirements. First, prospective purchasers must receive a specified "Buyer's Guide" and a "Policy Summary" as basic disclosure tools. Our staff people have these documents available here today. Second, consumers must receive two cost indexes.

The policy summary gives the salient financial facts about a policy. The Buyer's Guide is a plain-language booklet to help people shop for life insurance. It explains the two cost indexes—one showing what the relative cost of a policy might be if it is kept until the policyholder dies—the other showing the relative cost if the policyholder turns in the policy for its cash value. The NAIC cost indexes show how prices of similar policies of competing companies can be related to one another.

So where does the American life insurance consumer stand today? Thanks to the NAIC and the cooperation of many life companies—most consumers, at time of purchase, receive a plain-language booklet on the various types of policies and a means of comparing them with one another—and with similar policies of other companies. Further—the cost indexes we now give to the consumer can be computed in our field offices or the consumer's home—and do not require an actuary and a computer for preparation.

Twenty-eight States require this system—with others considering it. Now enters the FTC—like an accident in frantic search for a place to happen. The FTC has vigorously sought to persuade other States to delay adoption of the NAIC regulation—through personal visits and a full-blown publicity barrage—all financed with our taxpayer dollars.

The FTC staff report wants—"disclosure of the average annual rate of return of cash value insurance and annuity products." Rate of return has nothing to do with disclosure—which means telling consumers about premiums, illustrated dividends and benefits. The FTC staff's rate of return or Linton Yield method—relies on the flawed concept that whole life insurance is a combination of pure insurance and "a savings account."

The FTC staff report claims its rate of return cost index will help buyers "to evaluate cash value insurance as a savings vehicle"—meaning that the Linton Yield Index numbers for whole life insurance should be compared with interest currently being paid on savings accounts, or on a variety of investments. This is an economic nonsense and using a rate of return index to depict cash values as savings accounts is utterly misleading since the term policy plus a savings account is not the same as a whole life policy.

The FTC staff report conveniently fails to mention that Linton Yield Indexes produce price rankings that are remarkably similar to the NAIC indexes. Since this is so, and since 28 States have already adopted the NAIC method— it seems to me that using the Linton Yield Index would add nothing of significance but confusion and a waste of time and money.

Lest my comments sound like sour grapes—let me say that, under any measurement or form of cost disclosure, our Massachusetts Mutual whole life product has proven to be an excellent low-cost purchase for the consumer, one of the most competitive in the market. You would think, therefore, that my company would willingly embrace the FTC's Linton Yield Index, especially when, using average term rates and surrender after 20 years, a Massachusetts Mutual whole life policy purchased by a 35-year-old man produces, even under that FTC Linton Yield system, a so-called rate of return in excess of 6.5 percent. This is more than five times greater than the 1.3 percent illustrated by the FTC staff. But we do not embrace it, because, as already stated, it is misleading and it is wrong to use it.

The FTC staff Buyer's Guide also belittles the services of life insurance agents. I am offended by the FTC's unwarranted criticism of the people who sell life insurance. This brings to mind a weakness which exists under any form of cost disclosure which requires the use of an index—including the NAIC model. The disclosure process implies that the index is in itself a complete measure of the work of the product. It is not, because the index necessarily ignores the reputation and performance of the life insurance company and the essential service provided to the consumer by the life insurance agent.

In concluding, I would like to add that I recently read that the Chairman of the Federal Trade Commission—in an appearance before a subcommittee of this committee— complained that many industries were spreading what he labeled "myths and half truths" about his agency.

Though our industry was not among those singled out in the story—I would suggest that he review the FTC's own irresponsible handling of its life insurance study—and its own use of myths and half truths.

I would like to thank you for this opportunity to discuss our commitment to a sound system of cost disclosure and consumer information—both of which can be of great benefit to the American consumer, Massachusetts Mutual and to the life insurance industry.

[The statement follows:]

STATEMENT OF JAMES R. MARTIN, CHAIRMAN OF THE BOARD, MASSACHUSETTS MUTUAL LIFE INSURANCE CO., SPRINGFIELD, MASS.

LIFE INSURANCE DISCLOSURE AND COST COMPARISON

My name is James R. Martin. I am chairman and chief executive officer of Massachusetts Mutual Life Insurance Company of Springfield, Massachusetts. Mass. Mutual, which is nearly 130 years old, is the tenth largest among the 1800 life insurance companies in the United States. I have been chief executive officer of my Company for eleven years and my professional background is in marketing. I, too, represent the American Council of Life Insurance here today.

First, let me say that the Federal Trade Commission challenge to the whole life product—and the advocacy of "Buy Term and Invest the Rest"—is not a new one. These views have been expressed before—as early as 1875—have been given careful consideration by experts and have been rejected. A classic refutation of this argument appears in a book called "The Tired Tirade," written a dozen years ago by Halsey Josephson, a man with 40 years of experience in life insurance. Yet today the "Buy Term and Invest the Rest" bunch are at it once again.

What is different now, and why we are here today, is that the group leading the attack on our industry this time is a Federal regulatory agency attempting, without

the authority to do so, to usurp the powers of the insurance commissioners of our fifty states, and to extend its authority into areas of regulation where it currently has little or no legal jurisdiction.

According to the FTC staff report, their sole interest is to make the American consumer better informed. They would have you believe that all consumers—if they were better informed or as well informed as the more sophisticated insurance buyer—would purchase only term insurance. Not only is that pure rubbish, but if the average consumer were to accept this contention without first learning the real facts, he or she could well be doing themselves and their families grievous disservice.

Let's look at our Company—Mass Mutual. We sell a market that consists primarily of the most sophisticated insurance buyers in America. During the last twelve months we received 520 applications to purchase life insurance policies of one million dollars or more. It is both interesting and relevant to note that over 60 percent of these were for some form of whole life insurance. These 520 consumers were ones who, before making their decision, could certainly afford expert advice from independent legal, accounting and financial advisers—and over 60 percent, 63 percent to be precise, concluded that whole life best filled their insurance needs. Incidentally, this ratio of approximately 60 percent whole life to 40 percent term is presently the same for all of our ordinary life business.

Reading the FTC report and its conclusions, one has to wonder how much of the report's distortions and inaccuracies stem from lack of even basic understanding of the life insurance product or from a preconceived attempt to extend the agency's authority.

The fact is that the argument against the whole life product is based on two assumptions—that (1) whole life insurance is simply term insurance plus a separate savings plan and (2) since we wouldn't think of attaching a savings plan to our fire insurance, therefore, we shouldn't do it with life insurance. Both assumptions sound logical—but only to someone who knows nothing about life insurance.

In the first place, life and fire insurance are totally different products—based on fundamentally different concepts. Fire insurance covers the possibility of a specific event—one that may or may not even occur. Life insurance deals with the certainty of the insured's death—the only question is when.

Fire insurance is a static, constant risk. It remains the same whether you have a fire or not. Life insurance, on the other hand, has to deal with an ever-increasing risk. Term insurance, where there is no cash value, copes with this definite risk by increasing the premium in stages as the insured ages. For older people, the cost of such coverage becomes prohibitive. That's probably why at the Mass. Mutual only 6 percent of all death benefits are paid by term insurance. A lot of people buy it in early years for temporary maximum protection, but relatively few die with it.

Term insurance can be just right for people whose needs require maximum coverage for a limited period of time—for a termporary risk—but it is not—and never should be sold as a low-cost substitute for whole life—or permanent—insurance.

That is because whole life insurance, unlike term, has a device for keeping the premium level—despite the ever-increasing risk—for the whole of life. That device is the reserve.

Historical fact, actuarial teaching and practice, court decisions and consumers themselves amply verify that whole life insurance is a contract to provide life-time protection for the same annual premium, or a level premium. It is not a combination of decreasing insurance and an increasing savings account as the FTC staff would have you believe. Cash values are a by-product of the level premium feature; they are not savings accounts separate from the insurance.

For that reason, it is totally meaningless to compare the "return" on the whole life contract with investment vehicles, such as savings accounts and securities which do not have insurance protection, availability of paid-up and extended insurance, settlement options, a right to borrow at fixed rates—all features that are part of the whole life contract.

I believe that a whole life contract must be viewed as a unique bundle of indivisible rights. I think back to my high school biology teacher explaining that while a human being is of inestimable value and utility, the human body itself is a combinatin of 57 percent water plus various chemicals. In other words, considered separately, our parts represent a pail of water and a bucket of bones with little value and little use. Much in the same way that a human being represents a unique combination of water and chemicals, the whole life product is a combination of rights, whose value and utility are significant only when they are properly combined together.

In attempting to make its case, the FTC report focuses for the most part on what it would have you believe is the life insurance industry's reluctance to provide meaningful cost disclosure information to the public. This is patently untrue. We as a company and we as an industry strongly support the provision of meaningful cost disclosure. Where we disagree with the FTC is that we support a different method of cost disclosure—one that we believe best serves the consumer in its clarity and its objectivity.

We support the cost disclosure system of the NAIC, the National Association of Insurance Commissioners, one already in place in more than half the states.

Life insurance companies have a self-evident interest in seeing that their customers receive the buying information they need, including the features of policies they will want to consider. The companies also want to make sure that buyers are furnished with reliable cost indexes to measure the prices of policies they may wish to compare. For these reasons, companies have spent a great deal of time, effort and money to put into effect a system of disclosure and cost comparison developed by the National Association of Insurance Commissioners. This is the NAIC Model Life Insurance Solicitation Regulation.

We have carefully reviewed what the Federal Trade Commission staff in its report on life insurance cost disclosure describes as "deficiencies" in the NAIC model regulation. We have also reviewed the FTC staff's suggestions for changes in the model regulation. Their criticism is largely without merit. Their suggestions, if adopted, would make it difficult for consumers to arrive at sound decisions about life insurance.

BACKGROUND

Over the last dozen years, people inside and outside the life insurance business have debated the merits of different disclosure systems and different cost indexes for comparing the prices of life insurance policies. The National Association of Insurance Commissioners Model Life Insurance Solicitation Regulation, adopted in 1976, requires information to be furnished to "improve the buyer's ability to select the most appropriate plan of insurance for his needs, improve the buyer's understanding of the basic features of the policy which has been purchased or which is under consideration and improve the ability of the buyer to evaluate the relative costs of similar plans of life insurance."

The NAIC model regulation was developed by a task force of experienced insurance regulators. The task force first held extensive hearings to consider various means of disclosure and cost indexes. There were several public hearings. The task force thus drew on the experience and judgment of its members, the testimony of many expert witnesses, experience in states that had adopted an interim version of a model solicitation regulation, and information provided by a dozen related research projects that the NAIC had set in motion.

The current NAIC model regulation or a comparable earlier version has been adopted in 28 states. Beyond that, life insurance companies have developed procedures for producing and delivering to policyholders the information required by the model regulation. A recent survey showed that companies writing the majority of life insurance sold in the United States are giving this information to all their new policyholders—not merely to those in the states that have adopted the NAIC model regulation. We are rapidly approaching the time when everyone buying a life insurance policy in the United States will receive the information required by the NAIC model regulation.

Today an NAIC task force is studying the effectiveness of the model regulation with an eye to whether it needs improvement. While this has been taking place, the FTC staff has vigorously sought to persuade other states to delay adoption of the NAIC model regulation. Their objections were delivered in person by FTC staff members or sent to insurance departments in many states and more recently were made public by means of the staff report released to the Senate Commerce Committee on July 10, 1979.

THE NAIC MODEL REGULATION AND DISCLOSURE

The NAIC model regulation requires life insurance companies to give all prospective purchasers a specific "Buyer's Guide" and a "Policy Summary" as basic disclosure tools. Cost comparison is covered separately by the NAIC model regulation and will be discussed in the pages that follow.

The Policy Summary must show separately for the basic policy and each rider for each of the first five policy years and representative years thereafter: (1) premiums, (2) death benefits, (3) cash surrender values, (4) illustrated dividends and (5) endow-

ment amounts. These must be given for a sufficient number of years to illustrate clearly the patterns of premiums and benefits.

This is a good selection from all the financial facts that might be reported about a policy. For example, if figures for each possible policy duration were required, the display would become impossibly large and only confuse the prospective buyer. The Policy Summary requires the same information that many companies have long supplied to policyholders in the form of year-by-year "ledger statements." It is a useful and tested method of informing prospective buyers about the cash flows of a policy, its benefits and options.

The NAIC Buyer's Guide is a booklet to help people shop for life insurance. It discusses how much life insurance to buy, what kind to buy and how to compare the prices of similar policies. There are brief, straightforward descriptions of term insurance, whole life insurance and the endowments—the three basic types of policies. It explains the NAIC cost indexes and concludes with this advice:

"The first decision you must make when buying a life insurance policy is choosing a policy whose benefits and premiums most closely meet your needs and ability to pay. Next, find a policy which is also a relatively good buy. If you compare Surrender Cost Indexes and Net Payment Cost Indexes of similar competing policies, your chances of finding a relatively good buy will be better than if you do not shop. Remember, look for policies with lower cost index numbers. A good life insurance agent can help you to choose the amount of life insurance and kind of policy you want and will give you cost indexes so that you can make cost comparisons of similar policies.

"Don't buy life insurance unless you intend to stick with it. A policy which is a good buy when held for 20 years can be very costly if you quit during the early years of the policy. If you surrender such a policy during the first few years, you may get little or nothing back and much of your premium may have been used for company expenses.

"Read your new policy carefully, and ask the agent or company for an explanation of anything you do not understand. Whatever you decide now, it is important to review your life insurance program every few years to keep up with changes in your income and responsibilities."

THE NAIC MODEL REGULATION AND COST COMPARISON

The NAIC model regulation requires the use of two cost indexes—the "surrender cost index" and the "net payment cost index." They are the means by the means by which consumers can compare the prices of life insurance policies.

No cost index measures the "true cost" of a life insurance policy to an individual. The "true cost" to a buyer cannot be determined when a policy is bought—only after it has terminated because of death, surrender or maturity (of an endowment). Only then can one compare out-of-pocket costs—premiums minus any dividends—with the benefits actually received.

While the "true cost" of a policy to an individual cannot be measured at time of purchase, the cost indexes in the NAIC Buyer's Guide do show how the prices of policies relate to one another. Even so, these measures are not absolute. This is because certain assumptions are made in calculating these indexes, and relative rankings of policies change if a different set of assumptions is used.

In spite of the appearance of complexity, the cost indexes in the NAIC model regulation do answer two simple and key questions. First: "If a policy is kept in force for a given number of years, how much will a buyer have paid for it?" Second: "How does the amount the buyer will have paid compare with the cash surrender value of the policy?"

The first question is answered by the NAIC's net payment cost index and the second by the surrender cost index. In each case an interest rate has to be assumed to complete the calculation. The NAIC model regulation specifies 5 percent for this purpose.

There is good reason for incorporating an interest factor. Even though two policies may be closely comparable, they are not likely to have the same cash values and dividends from year to year. The differences in cash values and dividends are smoothed out through a formula that includes the interest rate mentioned, and the result is the index figures which the NAIC regulation advises consumers to use in shopping for life insurance.

The net payment cost index is a measure of the price the company has put on the policy. The net payment index is meant to indicate the level of cost in the event that a policy ends due to the death of the policyholder and the payment of the proceeds to a beneficiary. It is not an attempt to predict the actual cost of a policy to a particular buyer.

The surrender cost index is a second measure of the price a company has put on a policy. It differs from the net payment cost index in that it reflects the fact that a policyholder will not only receive protection for a future period but will also own a valuable asset at the end of that period. The surrender cost index is meant to indicate the level of cost in the event that a policy is cashed in. It is not an attempt to predict the actual cost of a policy to a particular buyer.

To summarize, the NAIC model regulation requires the use of two cost indexes to give the prospective buyer information about relative prices of policies if they are (a) kept until death or (b) surrendered for their cash values. Both indexes are needed to give an adequate basis to compare the prices of policies.

FTC STAFF CRITICISMS OF NAIC MODEL REGULATION AND THEIR PROPOSED CHANGES

The FTC staff report criticizes some of the disclosure requirements of the NAIC model regulation and some of the cost indexes it requires for price comparison. The FTC staff recommends deleting one cost index and replacing it with another of its own selection. They would also add a minor item to the policy summary and revise the NAIC Buyer's Guide considerably. Most of these suggestions in the Council's view are without merit and would make the consumer's selection of a policy more difficult—not easier.

A. *Cost comparison—A rate of return cost index*

The FTC staff report says: "* * * the most important improvement that can be made in the NAIC model regulation is to require disclosure of the average annual rate of return on cash value insurance and annuity products." The "rate of return" proposed by the FTC staff has nothing to do with disclosure, which really deals with items such as premiums, illustrated dividends and benefits. The "rate of return" proposed by the FTC staff is simply another cost comparison index calculated by what is called the Linton Yield method.

The Linton Yield calculation relies on a flawed concept of the nature of the whole life contract, which assumes that it is a combination of "pure insurance" and a "savings account." The calculation produces an index that purports to be an interest rate that insurance companies are presumed to credit to the "savings account."

The American Council of Life Insurance takes the position—which is amply validated by historical fact, actuarial teaching and practice, and by court decisions—that the whole life policy is a contract providing lifetime protection for a level premium and not a combination of decreasing insurance and an increasing savings account. Cash values are alternative benefits available, at the policyholder's option, in lieu of performance of the original contract rather than being savings accounts separate from the insurance provided.

The FTC staff report ignores the origin of the whole life contract, numerous legal interpretations, and the reason that consumers theselves typically give for buying whole life insurance, which is for protection.

The FTC staff report suggests that their wrong idea should be accepted because: "Debate should not focus on whether a particular definition is correct, but rather on whether the definitions are useful in helping to understand different aspects of the whole life contract." This is remarkable reasoning. It says that accuracy is beside the point and that an inaccurate definition is acceptable as long as it supports the argument to which it is applied. Incorrect definitions can, and in this case do, lead to misunderstandings.

Although the FTC staff report suggests that the Linton Yield calculation measures an interest rate earned on life insurance policy "savings," it does no such thing. Rather it addresses the purely hypothetical question: "What interest rate, after taxes, would I have to earn over time for the difference between the premiums for a given policy and the premiums for an imaginary term insurance policy to accumulate a mythical savings account equal to the cash value of the policy at the end of the period?"

If a policyholder were able to follow this reasoning—after all, the buyer's main goal is to protect his family, not to engage in economic theorizing—he should be warned that the calculation involved is based on assumptions that could either be right or wrong. For example, the FTC staff report includes Linton Yields that use different hypothetical premiums for term insurance from those in their accompanying proposed model regulation.

1. *Advantages claimed for rate of return cost index by FTC staff.*—The FTC staff report claims several advantages for the Linton Yield cost index as a basis for price comparison. None stand up to examination. The FTC staff report says the Linton Yield method is useful for comparing dissimilar policies. But it does not produce cost indexes for term insurance, which currently constitutes over 50 percent of

individual life insurance purchases. A system that applies to whole life insurance but does not apply to term insurance is of no help when comparing the prices of these two dissimilar policies.

The FTC staff report suggests at one point that the prices of actual term insurance policies be compared with the hypothetical rates used in the Linton Yield calculations. It is impossible with the information given in the FTC staff report for a consumer to tell if the premiums actually charged for a real term insurance policy are higher or lower than the few premium rates shown in the buyer's guide developed by the FTC staff.

The FTC staff report claims its "rate of return" cost index will help buyers "to evaluate cash value insurance as a savings vehicle," meaning that the Linton Yield index numbers for life insurance should be compared with interest currently being paid on savings accounts or on a variety of investments. This is economic nonsense. It suggests that the interest rate produced by the calculation will be credited by the company for a period of, say, 20 years. Or that interest currently paid on savings or investments will continue unchanged over the next 20 years. Or that after-tax interest rates will be available over the next 20 years on investments with a very high degree of safety and liquidity. Or that a particular individual will remain in the same tax bracket all during that period. Or that term insurance coverage at rates used is deriving the interest rate will be available over the next 20 years.

Using a "rate of return" index to depict cash values as savings accounts is utterly misleading. A term policy and a savings account are not the same as a whole life policy, even if the savings account after 20 years happens to equal the 20th-year cash value. A whole life policy has far greater utility than any term insurance-bank account combination.

To illustrate, if a policyholder's health deteriorates, a whole life policy offers the option of paying no more premiums and taking fully paid-up insurance.[1] Even for someone in good health, the right to continue the insurance in force for an indefinite period at a level premium is extremely valuable. In short, Linton Yield rates cannot help a buyer to decide between buying a whole life insurance policy or opening a savings account.

2. *Objections to rate of return cost indexes.*—There are serious objections to the use of Linton Yield cost indexes.

First, Linton Yield indexes produce price rankings that are remarkably similar to the NAIC surrender cost indexes. Both indexes are calculated from the same premiums, illustrated dividends and cash values. Both reflect the importance of when money is paid by the policyholder or by the company. Thereofre, using Linton Yield indexes in addition to surrender cost indexes would waste time and moey. In the few cases where the "rate of return" index differs from the NAIC surrender index, confusion would arise in the consumer's mind as to which policy is the better buy.

Second, where the NAIC surrender cost index relies on fairly simple and straightforward arithmetic, "rate of return" indexes are based on the roots of 5th and 10th degree polynomial equations, using a repetitive trial and error process which requires a high speed computer. Since life insurance premiums vary with policy size, all cost indexes differ depending on the amount of insurance being purchased. Any variations in the NAIC surrender and net payment indexes needed to reflect changes in premiums according to policy size are simple to calculate, and agents can make them in the client's home or office. With Linton Yield indexes, separate and lengthy calculations are required for accurate results for each size policy. Calculations of this complexity would have to be done in the offices of a company rather than by an agent in the client's home, and would delay the issue of life insurance coverage. There are documented cases of deaths that have occurred in circumstances like this, with consequent loss to survivors.

Third, Linton Yield calculations as proposed by the FTC staff result in lower "rates of return" (and apparently higher prices) for larger policies than smaller ones. This is obvious nonsense, since the price per thousand dollars of life insurance drops as policy size increases. Taking the hypothetical term insurance rates given by the FTC staff, we have found that the so-called "rates of return" for a $1,000 whole life insurance policy issued at age 25 ranged from somewhat more than 8 percent to over 12 percent, depending on when the policy was surrendered. These "rates of return" turn out to be higher than for any $25,000 whole life insurance policy issued by any company surveyed by the staff of the FTC in 1978.

This preposterous result makes it clear that Linton Yield calculations, like all other cost indexes, must be carefully interpreted when comparing the prices of unlike policies. In addition, it shows that Linton Yield indexes, unlike the NAIC cost indexes, give wrong answers when policies of different size are compared.

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[1] If the individual is disabled, premiums may be waived under the terms of the policy.

Fourth, "rate of return" indexes are based on conditions that simply do not exist in the real world—namely, that one can make an immediate and timely investment of each small additional increment of funds into the indefinite future at an assumed after-tax rate of return, and that reducing amounts of term insurance will be continually available at the prices that are assumed by the FTC staff.

To spell this out, a buyer might be shown a Linton Yield of 5 percent for a $20,000 whole life policy for 20 years. To produce a savings account equal to the 20th-year cash value, the buyer would have to find a savings institution paying more than 5 percent interest plus an amount to cover income taxes over the next 20 years on deposits of fractions of the annual premiums (of, say, $300 a year) for the whole life insurance policy.

The buyer would have to find a life insurance company willing to sell renewable term insurance starting at $20,000 and decreasing to $10,000 or $12,000 at the premiums shown in the FTC staff report. These premium rates supposedly represent low rates that companies currently charge for renewable term insurance. Actually, such policies are sold in minimums of $25,000, $50,000 and higher. Using a Linton Yield calculation to decide whether to buy a life insurance policy or to open a savings account is not likely to help the buyer to the right decision.

Even if all the problems associated with Linton Yield could be solved, the resulting cost indexes would give no different information to the consumer about relative prices of policies than does the NAIC surrender cost index—which is already well established. Since the FTC staff report recommends continued use of the NAIC surrender cost index, it is fair to ask why anyone would want to add another cost index to give the same information.

Lest my comments sound like sour grapes—let me say that, under any measurement or form of cost disclosure, our Mass. Mutual whole life product has proven to be an excellent low-cost purchase for the consumer, one of the most competitive in the market. You would think therefore that my company would willingly embrace the FTC's Linton Yield Index, especially when (using average term rates and surrender after twenty years) a Mass. Mutual whole life policy purchased by a 35-year-old man produces, under that system, a so-called "rate of return" in excess of 6.5 percent. This is more than 5 times greater than the 1.3 percent illustrated by the FTC staff. But we do not embrace it, because, as already stated, it is misleading and it is wrong to use it.

B. *Cost comparison—Other changes proposed by FTC staff*

(1) The FTC staff report recommends deletion of the net payment cost index from the NAIC model regulation. This would be a serious mistake. It would deprive the buyer of a means of evaluating the relative prices of life insurance policies which reflect the premiums for all benefits provided by the policies—adjusted for illustrated dividends. The NAIC net payment index gives buyers an indication of the relative costs of different policies if kept until the death of the policyholder results in a claim—which is, after all, the purpose for life insurance.

The use of both cost indexes required by the NAIC model regulation to compare prices of two policies can result in the surrender cost index indicating one policy to be cheaper and the net payment index indicating the other policy to be cheaper. Such an outcome accurately reflects a real problem in comparing the prices of two or more life insurance policies.

Take the prospective buyer who is considering two non-participating whole life insurance policies, the first with lower premiums and the second with much higher cash values. His decision must be based on whether he regards higher cash values as more important than lower premiums. Under the FTC staff approach, which would furnish a surrender cost index and a Linton Yield cost index, the policy with high cash values may appear to be cheaper according to both indexes. In fact, the net payment index (eliminated by the FTC staff) may give a better indication of relative prices of the two policies, and it certainly will if the policies are kept until death.

(2) The FTC staff recommends deleting from policy summaries the "equivalent level annual dividends" used to calculate the NAIC net payment and surrender cost indexes. This would be a mistake. Dividends cannot be calculated until a company has determined its annual expenses—death claims, operating costs and investment income. Consequently, dividends can only be illustrated, or based on the amounts payable under the current scale, and future dividends can neither be guaranteed nor estimated. The equivalent level annual dividend is a measurement of the effect of illustrated dividends on a cost index. By comparing it to the net payment and surrender cost indexes, the buyer can determine which part of each cost index is attributable to guaranteed values, and how the illustrated dividends influence the

index. It can be used to distinguish the prices of participating policies with different levels of guarantees.

The FTC staff says that the equivalent level annual dividend is "potentially deceptive" because it suggests that no dividends may be payable. We disagree with this argument. In any case, it fails to recognize that the equivalent level annual dividend can be used to explain a significant element of both the net payment and surrender cost indexes and to give buyers a useful measure of the extent to which prices are guaranteed.

(3) The FTC staff wants to prohibit the NAIC net payment and surrender cost indexes (currently shown at both 10 and 20 years) except for the 20th year. But they recommend that their "rate of return" cost indexes be shown for 5, 10, 20 and 30 years, on the basis that there are different rates of return depending on when a policy is surrendered for cash.

The same reasoning, of course, applies to the NAIC net payment and surrender cost indexes. The annual cost per thousand dollars of life insurance changes substantially, depending on when a policyholder dies or surrenders a policy. The NAIC model regulation balances the desire to illustrate these differences and the desire to use as few figures as possible for cost comparison purposes, with the use of two indexes for 10 and 20 years as the best available compromise in the consumer's interest.

C. *Disclosure—Buyer's guide*

The FTC staff report proposes to change substantially the tone and purpose of the NAIC Buyer's Guide. The report states: "One of the most important decisions consumers have to make is whether to base their insurance program on primarily term or whole life insurance. Other than providing a brief narrative description of the difference between term and whole life insurance, the NAIC Buyer's Guide contains little to help the consumer make this decision." However, the changes proposed by the FTC staff are clearly intended to guide the consumer into choosing between term insurance and whole life insurance, regardless of actual family protection requirements and goals.

In contrast, the NAIC Buyer's Guide giver well-balanced consumer buying information. It alerts the buyer to differences in prices among policies and explains how prices can be compared. There is information on choosing the amount and kind of insurance, the importance of selecting a financially sound company and on the kind of assistance a good life insurance agent can give.

The changes proposed by the FTC staff would destroy this balanced consumer guidance. Significant cost comparison data would be eliminated. The importance of selecting a good company and a good agent is played down. Simple statements of fact in the NAIC Buyer's Guide would be replaced by the opinions of individuals on the FTC staff. The changes they recommend would, for the most part, replace a useful Buyer's Guide with one that is both confusing and misleading.

1. *Bias shown in FTC staff's buyer's guide.*—The FTC staff argues that the most important decision in buying life insurance is to choose between term or whole life insurance. Term insurance is portrayed as being a better buy than whole life insurance in most instances by statements such as: "* * * term insurance gives you three to five times more protection for your premium dollar than whole life. For example, a 25 year old person who can afford to spend $300 a year on life insurance could buy either $20,000 worth of whole life or $100,000 worth of term insurance." This statement fails to warn the consumer that term insurance for a level $300 a year will diminish as the buyer grows older, and will eventually disappear. It disregards long-term needs and speaks of current coverage as if it were the only consideration.

The bias in favor of term insurance crops up in the proposed changes where whole life insurance is discussed. The FTC staff says: "During the early years of a whole life policy, the premiums are *much* more than the amount needed to buy term insurance for a person of the same age" (emphasis added). Contrast this with the NAIC Buyer's Guide, which accurately states that whole life insurance premiums "* * * can be *several* times higher than you would pay initially for the same amount of term insurance. *But they are smaller than the premiums you would eventually pay if you were to keep renewing a term insurance policy until your later years.*" (emphasis added)

The message intended by the FTC staff comes through in the following quotations:

"At the time of purchase, term insurance generally provides the largest death protection for your premium dollar."

"When you're young and your insurance needs are generally greatest, term insurance gives you three to five times more protection for your premium dollar than whole life."

"Many people, especially those with young children—can get the amount of insurance they need only by buying a term policy."

"* * * when a person approaches retirement, the need for life insurance may diminish."

"If you think you'll want some insurance after age 65 * * * there are serveral things you can do. One is to buy a renewable term policy that is also 'convertible' * * * you can also buy a *combination* of term and whole life insurance. * * *"

"If you want protection for your family while you're young and a source of money as you grow older, * * * you can buy a whole life policy * * * or you can buy a term policy and each year invest the difference. * * * If you buy a term policy, * * * you'll build up a sizeable sum of money by the time you're 65."

"Try not to leave yourself underinsured."

"Remember * * * term insurance will provide you with several times more insurance protection than whole life for the same premium dollar."

Actually, people buy large amounts of both term insurance and whole life insurance each year. Companies price both products on a fair basis. Both products are designed to meet specific family and business needs. To conclude that everyone needs only term insurance or for that matter, only whole life insurance, is preposterous. For the FTC staff to propose a buyer's guide strongly endorsing only one type of policy is misuse of regulatory resources.

2. *The FTC staff view of the life insurance agent.*—The FTC staff buyer's guide almost totally ignores the role of life insurance agents in (1) helping buyers to determine suitable types of policies; (2) explaining the special features or benefits of particular policies; (3) comparing prices; and (4) informing consumers about matters that cost indexes do *not* measure, including the nature of the agent's service and the reputation of the company represented.

In fact, the FTC staff buyer's guide belittles the services and reputation of life insurance agents through sweeping generalizations about their lack of detailed knowledge about their companies policies and cost comparison, and the influence of the commission structure on insurance pruchase recommendations.

The FTC staff report would stuff the NAIC Buyer's Guide with information about group term insurance; charts showing yearly renewable term insurance rates at four ages; accumulations of $500 per year for 30 years at five different interest rates; surrender cost indexes for two plans of insurance at three ages and two amounts of insurance. Some of this information might be useful to some buyers in some circumstances, but there is a serious question as to whether making the NAIC Buyer's Guide longer and more complex will serve consumers better—or will make it less useful to the average buyer.

D. *Disclosure—Preliminary policy summaries*

The FTC staff recommends a preliminary policy summary in addition to the summary required by the NAIC model regulation. As proposed, a preliminary policy summary would include Linton Yield indexes for 5, 10, 20 and 30 years. Since these indexes vary by policy size and require extensive calculations on high speed computers, a preliminary policy summary would unnecessarily complicate the purchase of whole life and endowment contracts. No such indexes would be required by the FTC staff in the preliminary policy summary for term insurance policies.

The preliminary policy summary proposed by the FTC staff for term insurance policies would include only a surrender cost index. As previously stated, this would provide an incomplete basis for price comparison.

CONCLUSION

The NAIC model regulation requires (1) disclosure to improve people's understanding of life insurance policies and (2) cost indexes for evaluating the relative prices of life insurance policies. There are two disclosure documents: a policy summary, showing premiums, dividends and benefits for a sufficient period to illustrate premium and benefit patterns, and a buyer's guide. The buyer's guide has factual descriptions of different kinds of policies and basic advice about shopping for life insurance.

Two cost indexes are used to evaluate prices: a net payment cost index (which reflects out-of-pocket costs in the form of premiums less illustrated dividends for a specific period such as 10 or 20 years), and a surrender cost index, adjusted to reflect the value of a policy given up at the end of the period shown.

The FTC staff report suggests replacing the net payment cost index by a "rate of return" cost index. It also would make many changes in the NAIC Buyer's Guide. Their suggestions are based on the flawed assumption that whole life insurance is a

combination of low cost "pure insurance" and a savings account that yields a low "rate of return."

The FTC staff proposals would change the NAIC Buyer's Guide from a well-balanced consumer aid to a tract that praises term insurance and advises that the difference in premiums (between term and whole life insurance) should be invested in some financial vehicle.

The Linton Yield cost indexes proposed by the FTC staff give substantially the same rankings to policies as the NAIC surrender cost index. However, the Linton Yield index is expressed in terms of an interest rate, and the FTC staff erroneously claims that it can be used to compare dissimilar policies and to help the consumer to decide between buying whole life insurance and term insurance.

Any contention that term insurance is better than whole life insurance, or vice versa, is erroneous. Both contracts serve useful purposes, and the public buys both in approximately equal amounts each year. The proposals by the FTC staff—overemphasizing cost indexes and endorsing term insurance—would, if adopted, reduce the value to the consumer of the NAIC model regulation that is now firmly in place. The FTC staff began with an inaccurate premise about the nature of life insurance policies and ended with a set of misleading recommendations. The consumer would be hurt rather than helped if their recommendations were to be followed.

The CHAIRMAN. Thank you, Mr. Martin.

Next? Mr. Rolland.

Mr. ROLLAND. Mr. Chairman, members of the committee, my name is Ian M. Rolland. I am president and CEO of the Lincoln National Life Insurance Co. of Fort Wayne, Ind., and I am an actuary by background, and I am here today representing the American Council of Life Insurance.

I appreciate the opportunity to appear before you and will address my remarks to the conduct of the FTC staff in its study of life insurance cost disclosure and cost comparison.

The results of the FTC staff study were made public exactly 3 months ago but its conclusions apparently were reached nearly 3 years ago, even before the December 1976 announcement that an investigation would be held.

If one were to carefully orchestrate a program designed to discredit the life insurance business and State regulation, and to point out the need for Federal intervention, it would closely resemble what the FTC staff has done prior to and coincident with the release of its life insurance report.

The report was drafted and issued in a way to suggest that it is the product of an objective staff whose goal is to benefit consumers. However, the evidence is clear that issues have been prejudged; life insurance experts ignored; data buried when it is unfavorable to the FTC staff's assumptions; statistics manipulated and distorted so as to seriously mislead consumers; and extensive attempts made on a national scale to interfere with adoption of the National Association of Insurance Commissioner's own model regulation on life insurance disclosure and cost comparison.

I. FTC STAFF ACTIONS

In May 1976, after 6 years of study and 3 years of experience with an interim regulation, the NAIC adopted a model life insurance solicitation regulation.

Without waiting to see how effective the NAIC model might prove to be, the Federal Trade Commission in December 1976 announced an investigation of cost disclosure. After only the most preliminary of inquiries, it was announced that the FTC staff had

concluded that one of the best ways to compare policy costs was to calculate a rate of return on the savings portion of whole life policies.

Despite this obvious prejudgment, data and expertise of the council and many of its member companies were made available to the FTC staff. Life insurance representatives repeatedly explained the problems inherent in a rate-of-return index. Concern was expressed that the investigation was losing objectivity because of FTC staff views favoring routine use of term insurance plus some sort of investment rather than whole life insurance. However, the FTC staff stood fast behind the conclusions it had drawn before the investigation even began.

The strategy of the FTC staff then emerged: to push for Federal regulation of life insurance, using the issue of cost disclosure as the initial tactic. State insurance departments were asked by the FTC staff to suspend consideration of the NAIC model until investigation was completed. In correspondence with Representative Robin Beard of Tennessee, the goal of the FTC staff was more clearly revealed: to seek to influence a majority of the States to reject the NAIC model. If this goal were attained, the FTC could argue that, since cost disclosure was not being regulated by the States, the McCarran Act would be no bar to the issuance of an FTC trade regulation rule occupying this field.

This view appeared again in a draft of a letter from FTC Chairman Pertschuk to Senator Alan Cranston regarding S. 718, which would have mandated the use of the NAIC model for veterans' insurance programs, but was defeated by FTC pressure.

In April 1978, Michael Lynch, a staff economist with the FTC, in an interview in the Newark Star-Ledger was quoted as saying that the result of the cost disclosure study might ultimately be "to recommend to the Congress Federal regulation over life insurance." No other options were mentioned. Mr. Lynch was further quoted as expressing fears that State regulation in life insurance is so weak it "could be resulting in widespread deceptions by certain companies."

II. ABSENCE OF POLICYHOLDER COMPLAINTS

The Council was concerned about whether FTC scrutiny of the life insurance field was justified by a convincing number of consumer complaints. In January 1979 the council filed several Freedom of Information Act requests with the FTC about the nature and quantity of consumer complaints on insurance, but was obliged eventually to use the Freedom of Information appeals process to compel the FTC to release much of the information.

Out of some 3,700 documents received from the FTC, more than half were merely FTC routine acknowledgements and transmittal slips. Consumer complaints had been received in only 11 of the 29 areas in which the FTC staff had begun inquiries, the majority concerned with health insurance and automobile insurance. The largest number of complaints against an individual life insurance company was only four.

There is, in short, no evidence that the FTC is responding to substantial consumer complaints about life insurance, and there is

minimal evidence of public satisfaction with the cost disclosure practices of the life insurance business. The FTC staff dismisses this with the offhand comment that "consumers don't know enough to complain."

III. STUDIES FUNDED BY FEDERAL TRADE COMMISSION

The FTC staff's patronizing attitude about the intelligence of life insurance policyholders is not justified by the FTC's own studies.

In early 1977, with much fanfare, the FTC staff announced that it had contracted at a cost of $155,000 with Prof. Jacob Jacoby of Purdue University to determine what kind of information consumers use to make life insurance purchase decisions, and how various cost disclosure materials can help them.

After studying disclosure systems, including some developed by the FTC staff, Professor Jacoby concluded that "consumers exposed to any one of the six different disclosure systems used in this investigation were, by and large, able to make good purchase decisions."

He also stated that:

> Our subjects reported that the various disclosure systems, especially buyer's guides, used in this study were, in general, helpful and easy to understand, and tests of knowledge seem to confirm these reports.

Concerning the NAIC Buyer's Guide, the research showed, "The NAIC Buyer's Guide alone was sufficient to generate a substantial increase in the attention paid to these cost indices."

Reference to the Jacoby research was limited by the FTC staff to a footnote in its lengthy report, and to a small summary in an appendix.

The FTC also retained Prof. Roger Formisano of the University of Wisconsin to survey recent life insurance purchasers in New Jersey. Of the 194 people interviewed in the Formisano study, only 3.1 percent had any dissatisfaction with the life insurance policy purchased. Also, 80.8 percent said the agent's presentation did not confuse them; 84.5 percent said the agent was not aggressive; 78.9 percent said the agent did not urge them to make a decision in a short period of time; and 84.5 percent said they would call the same agent if they needed more life insurance.

Desite the results of the research, the staff of the FTC strongly recommends several changes to the NAIC model regulation covering disclosure and cost comparison.

IV. THE FTC STAFF AND THE NEWS MEDIA

As a Federal agency, the FTC never has had difficulty in obtaining media coverage, all the more so when it tops its statements with such false and inflammatory headlines as, "Life Insurance Consumers Losing Billions Yearly."

The manner in which the FTC engages in trial by media is worth reviewing. Despite efforts by the council and its member companies to cooperate with the FTC staff, when we sought an advance copy of the final report we were told: "No copies will be released until the day the report is presented to the Commerce Committee."

The press, however, received its copies in advance, and reporters immediately began writing their stories. Several called the council for its reaction.

We then asked to see the report in order to respond to specific charges. News people told us flatly that they had been told by the FTC staff not to share the report with anyone at the risk of being denied advance copies in the future. Consequently, we were forced to respond to attacks made in a report we had never seen.

This is extremely unfair, but it is not unusual for the FTC staff. They followed an identical procedure in releasing their study of debit insurance in January 1979.

V. THE FTC STAFF AND TERM INSURANCE VERSUS WHOLE LIFE INSURANCE

The FTC staff advocates extensive revision of the NAIC Buyer's Guide so that consumers will be led to purchase term insurance and virtually ignore whole life insurance.

Unlike the FTC staff, the life insurance business believes both whole life and term are valuable products. They serve different needs of people at different times in their lives. People buy the two in almost equal amounts.

Although term insurance is extremely useful, it has its shortcomings, the major being that it cannot effectively protect a policyholder for the whole of life. This has been proven time and again.

One recent example is the term insurance coverage provided by the Government to men and women in uniform in World War II. Veterans had the option of keeping their term insurance after being discharged and renewing it at higher rates at 5-year intervals, or converting it to a whole life or endowment policy at a level annual premium. Many veterans who selected term because the initial premium rates were quite low have reached an age today where the premiums have increased to the point that it is difficult for them to afford coverage. The Veterans' Administration from the first has campaigned to persuade these policyholders to convert their term insurance to whole life insurance with its level premiums. Now veterans groups are asking Congress for help for veterans who need life insurance and can no longer afford the rising premiums for their term insurance.

The "buy term and invest the difference" philosophy inherent in the FTC staff report is not new. It has been advocated for decades, usually by salesmen with investments to offer, who seek to have people use cash values on existing policies to buy these investments. It is wrong for an agency of the Federal Government to lend support to what, in many cases, is a consumer ripoff.

The publicity so vigorously generated by the FTC staff in announcing its report will only confuse some buyers of life insurance, leading them to purchase new policies that do not serve their long-term financial needs. Some policyholders may be encouraged to drop their insurance, to the detriment of their long-run interests. The FTC staff report on life insurance cost disclosure is so misleading and tainted that it should be filed and forgotten.

[The statement follows:]

STATEMENT OF IAN M. ROLLAND, PRESIDENT, LINCOLN NATIONAL LIFE INSURANCE CO., FORT WAYNE, IND.

THE FEDERAL TRADE COMMISSION STAFF STUDY OF LIFE INSURANCE DISCLOSURE AND COST COMPARISON

My name is Ian M. Rolland. I am president of Lincoln National Life Insurance Company of Fort Wayne, Indiana, and I am here today representing the American Council of Life Insurance.

The FTC staff report on Life Insurance Cost Disclosure was presented July 10, 1979, but its conclusions were apparently reached even before December 1976, when the first announcement was made of a life insurance cost comparison investigation.

If one were to carefully orchestrate a program designed to discredit the life insurance business and state regulation, and to point out the need for Federal intervention, it would closely resemble what the FTC staff has done prior to and coincident with the release of its life insurance report. The climax of this Washington drama was the release of the FTC staff report, which is filled with inaccuracies, distortions, and misleading and biased statements.

The report was drafted and issued in a way to suggest that it is the product of an objective staff whose goal is to benefit consumers. However, the evidence is clear that issues have been prejudged; life insurance experts ignored; data buried when it is unfavorable to the FTC staff's assumptions; statistics manipulated and distorted so as to seriously mislead consumers; and extensive attempts made on a national scale to interfere with adoption of the NAIC's own model regulation on life insurance disclosure and cost comparison.

I. FTC STAFF ACTIONS

In May 1976, after six years of study and three years of experience with an interim regulation, the National Association of Insurance Commissioners, representing the insurance commissioners in all 50 states and the District of Columbia, adopted a Model Life Insurance Solicitation Regulation. It embodied the best thinking and experience on disclosure and cost comparison of state insurance regulators and of authorities in the life insurance business who were asked to serve in an advisory capacity.

Without waiting to see how effective the NAIC model might prove to be, the Federal Trade Commission in December 1976 announced an investigation of cost disclosure through a press release that indicated in advance its likely conclusions. The nature of the investigation was scarcely revealed when after only the most preliminary of inquiries, it was announced that the FTC staff had concluded that to calculate a "rate of return" on the "savings" portion of a whole life policy was one of the best ways to compare policy costs.

Despite this obvious prejudgment, data and expertise of the Council and many of its member companies were made available to the FTC staff over the next few months. In discussions with the FTC staff, life insurance representatives repeatedly explained the problems inherent in a "rate of return" index. Concern was expressed that the investigation was losing objectivity because of staff views favoring routine use of term insurance plus some sort of investment rather than whole life insurance.[1] However, the FTC staff stood fast behind the conclusions it had drawn before the investigation even began.

The strategy of the FTC staff then emerged to push to for Federal regulation of life insurance, using the issue of cost disclosure as the initial tactic. State insurance departments were asked by the FTC staff to suspend consideration of the NAIC model until the investigation was completed (Attachment A). The tone of these communications was one of cooperation, as if to say "we are developing a better cost disclosure package which you may want to consider adopting." The goal of the FTC staff was more clearly revealed in correspondence with Rep. Robin Beard of Tennes-

[1] In a 6/23/77 letter from FTC Chairman Pertschuk to Senator Alan Cranston, Mr. Pertschuk wrote: "* * * At age 25, the annual premium on a whole life policy is often 3 to 4 times higher than the annual premium on an individual term policy. For many, if not most young veterans * * * an individual term policy rather than a whole life policy represents the best insurance buy * * *. For most young veterans, the only way to purchase the needed amount of insurance at an affordable price is to purchase term insurance * * *. Since group term insurance * * * is an even better buy than individual term insurance, the Veterans' Administration should encourage the purchase of group term insurance by those veterans eligible to do so * * * the consumer has to know at what rate of interest his savings will increase if invested in a whole life policy. If the rate of return is extremely low, as is often the case with whole life policies, the consumer may safely conclude that he would be better off buying term insurance and investing the money he saves in some other savings medium."

see (Attachment B); it was to seek to influence a majority of the states to reject the NAIC model. If this goal were attained, the FTC could argue that, since cost disclosure was not being "regulated by the states," the McCarran Act [2] would be no bar to the issuance of an FTC Trade Regulation Rule occupying this field.

This view appeared again in a draft of a letter from FTC Chairman Pertschuk to Sen. Alan Cranston regarding S.718, which would have mandated the use of the NAIC model for veterans' insurance programs, but was defeated by FTC pressure. The next-to-last paragraph in the draft letter (although it does not appear in the version that was sent) reads:

"Finally, passage of S.718 now, in its present form, may seriously prejudice the results of the Commission's newly-launched life insurance investigation. Passage of S. 718 would constitute the first federal endorsement of both the interest-adjusted method in general and the NAIC disclosure package in particular. Such an endorsement would come just as the Federal Trade Commission has begun to design and test various alternative disclosure packages which consumers may well find far more understandable than the NAIC package. If S. 718 is enacted, it is reasonable to assume that many of the forty-four states currently without cost disclosure regulations may soon follow suit and promulgate the NAIC model. Such a move would, under the McCarran-Ferguson Act, deprive the Commission of jurisdiction to enact a meaningful cost disclosure regulation that works."

In April 1978, Michael Lynch, a staff economist with the FTC in an interview in the Newark Star-Ledger was quoted as saying that the result of the cost disclosure study might ultimately be "to recommend (to the Congress) Federal regulation over life insurance." No other options were mentioned. Mr. Lynch was further quoted as expressing fears that state regulation in life insurance is so weak it "could be resulting in widespread deceptions by certain companies."

In its fiscal year 1979 budget request, the FTC asked for $252,000 for life insurance cost disclosure, a portion of which was to be used to begin Trade Regulation Rule proceedings. Both the House and Senate Appropriations Committees quickly registered disapproval of this course of action, cautioning the FTC not to undermine state efforts to adopt the NAIC Model Life Insurance Solicitation Regulation.

The House Committee said: "It is the understanding of the Committee that the Federal Trade Commission may consider some action to regulate the solicitation of life insurance even though the subject matter of insurance regulation has been traditionally left to the states. It has come to the Committee's attention that several of the states have adopted the model life insurance solicitation regulation of the National Association of Insurance Commissioners, and the additional states may adopt the regulation in the near future. Because of this action on the part of the NAIC and the states to regulate the industry, the Committee strongly recommends that the Commission not take any final action during fiscal year 1979 which might be inconsistent with the model regulation of the National Association of Insurance Commissioners. Such a course will provide time for appropriate committees of Congress to consider the matter."

The Senate Committee said: "Being aware that the McCarran-Ferguson Act, 15 U.S.C 1011-1015, declares the continued regulation by the states of the business of insurance to be in the public interest, the Committee is concerned about the recent activities of the FTC relating to the possible Federal regulation of the life insurance business with respect to cost disclosure. By letter of July 13, 1978, the Chairman of the FTC advised the Chairman of this Committee that contrary to its earlier plans the FTC no longer contemplated initiation of Trade Regulation Rule proceedings on the subject of life insurance cost disclosure in fiscal year 1979, but rather would seek to encourage meaningful regulation of this area at the state level. The Committee does not disagree with the efforts of the Commission to work with the states, but directs that in no event should the Commission nor its staff attempt to impede or thwart the adoption by the states of the Model Life Insurance Cost Solicitation Regulation supported by the National Association of Insurance Commissioners."

The life insurance cost disclosure investigation is not the only insurance matter being investigated by the FTC. So extensive is its insurance inquiry that a special Project Unit on Insurance was created within the agency and 32 professional members assigned to oversee 29 separate investigations and studies of the insurance business that were either begun or contemplated. This has since been reduced to 19 ongoing investigations.

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[2] The McCarran-Ferguson Act, 15 U.S.C. 1011-1015 was enacted in 1945 for the purpose of leaving the regulation and taxation of the business of insurance with the states rather than the Federal government. Except for cases involving boycott, coercion or intimidation, Federal laws apply to the business of insurance only in instances in which the states have failed to regulate or where the laws are specifically applicable to insurance.

II. ABSENCE OF POLICYHOLDER COMPLAINTS

The Council was concerned about whether the accelerating FTC scrutiny of the life insurance field was justified by a convincing number of consumer complaints. In January 1979 the Council filed several Freedom of Information Act requests with the FTC about the nature and quantity of consumer complaints on insurance. Responses were delayed. Only after we had been obliged to use the Freedom of Information appeals process did the FTC release a fraction of the information requested.

The Council received a large carton from the FTC and a bill for $1,300. Out of some 3,700 documents, more than half were merely FTC routine acknowledgements and transmittal slips. Consumer complaints had been received in only 11 of the 29 areas in which the FTC staff had begun inquiries, the majority were concerned with health insurance and automobile insurance.

A number of our member companies also sought information from the FTC about consumer complaints filed against them but these requests were withdrawn or substantially amended when the agency estimated search costs would be $500 per company. Notwithstanding these estimates, several companies went ahead and were charged no more than $25. The largest number of life insurance complaints against an individual company was four.

There is, in short, no evidence that the FTC is responding to a substantial number of consumer complaints about life insurance, and there is minimal evidence of public dissatisfaction with the cost disclosure practices of the life insurance business. The FTC staff dismisses this with the offhand comment that "consumers don't know enough to complain."

Such arrogance about the intelligence of the American citizens who own life insurance is chilling in its implications. This attitude is all the more distressing because the FTC staff appears to have concluded that they know enough about life insurance, and what is best for the life insurance buyer, to ignore the views of those who have either operated or regulated a business that has successfully served the public interest for well over a century.

III. STUDIES FUNDED BY FEDERAL TRADE COMMISSION

The FTC staff's patronizing attitude about the intelligence of life insurance policyholders is not justified by the FTC's own studies.

In early 1977, with much fanfare, the FTC staff announced that it had contracted with Professor Jacob Jacoby of Purdue University to determine what kind of information consumers use to make life insurance purchase decisions, and how various cost disclosure materials can help them.

We cautioned the Commission that we did not believe that the format of the Jacoby studies would give an accurate representation of consumer behavior in the real world due to the fact that agents would not be involved, the experimental nature of the research, sampling problems and other difficulties.

The FTC staff, however, must have had great confidence that this research would provide data to support their point of view, for they were willing to spend $155,000 on it. It is curious, therefore, that the results of Professor Jacoby's studies were relegated to a single footnote in their lengthy staff report and a small summary in the appendix. The reason: the results of the study did not support the preconceived notions of the FTC staff about cost disclosure.

From studies intended to measure the usefulness of various disclosure systems, including some developed by the FTC staff, Professor Jacoby concluded that "consumers exposed to any one of the six different disclosure systems used in this investigation were, by and large, able to make good purchase decisions."

He also stated that "Our subjects reported that the various disclosure systems (specifically, buyer's guides) used in this study were, in general, helpful and easy to understand, and tests of knowledge seem to confirm these reports."

Concerning the NAIC Buyer's Guide, the research showed "The NAIC Buyer's Guide alone was sufficient to generate a substantial increase in the attention paid to these cost indices." Professor Jacoby concluded that differences in knowledge among those exposed to the various buyer's guides was negligible.

What this FTC-sponsored research shows is that consumers can make good purchase decisions and are reasonably knowledgeable about life insurance. It does not show any need to replace the NAIC form of disclosure in current use throughout the country.

The FTC also retained Professor Roger Formisano of the University of Wisconsin to survey recent life insurance purchasers in New Jersey.

Professor Formisano did not question many of the consumers in his survey until up to six months after their purchase, so their recollection about the specific events of the day of purchase is understandably hazy. Nevertheless, the life insurance buyers expressed overall satisfaction with their policies and the agent they dealt with. Of the 194 people interviewed in the study, only 3.1 percent had any dissatisfaction with the life insurance policy purchased. Not one was extremely dissatisfied. An overwhelming 83.3 percent expressed satisfaction, including 41.7 percent who said they were "very satisfied" and 15.6 percent who said they were "extremely satisfied."

Also, 80.8 percent said the agent's presentation did not confuse them; 84.5 percent said the agent was not aggressive; 78.9 percent said the agent did not urge them to make a decision in a short period of time; and 84.5 percent said they would call the same agent if they needed more life insurance.

The Formisano report did not state the proportion of respondents with whom agents thoroughly discussed both term and whole life insurance. But the responses indicate that a large majority of agents did speak about the relative advantages of both products.

The message of the consumer research sponsored by the FTC is clear:

(1) Consumers can make good purchase decisions and they are satisfied with their own purchases and with the agents they deal with.

(2) The NAIC Buyer's Guide was successful in generating interest in cost criteria. Participants in the research were positive in their response to the NAIC Buyer's Guide.

(3) There were only small differences in performance of participants using the various disclosure packages; these might be attributed largely to the way the material was presented, not to the material itself.

Despite the results of the research, the FTC staff report strongly recommends several changes to the NAIC model regulation covering disclosure and cost comparison.

IV. THE FTC STAFF AND THE NEWS MEDIA

As a Federal agency the FTC never has had difficulty in obtaining media coverage, all the more so when its statements generate misleading and inflammatory headlines such as "Life Insurance Consumers Losing Billions Yearly."

The manner in which the FTC engages in trial by media is worth reviewing. As noted earlier, the Council and its member companies made every reasonable effort to cooperate with the FTC staff starting at the outset of their cost disclosure investigation. There were many joint meetings. Countless documents were provided to the FTC staff. We stood ready at all times to answer questions. However, when we quite reasonably sought an advance copy of the final report we were told "No copies will be released until the day the report is presented to the Commerce Committee." The press received its copies early, and as is customary, reporters immediately began writing their stories to dispatch to client newspapers in advance of the Commerce Committee hearing. Several called the Council for its reaction. We then asked to see the report in order to respond to specific charges. News people told us flatly that they had been told again by the FTC staff not to share the report with anyone. Again, efforts to get the report from the FTC failed, and we were forced to respond to attacks made in a report we had never seen.

This is extremely unfair but, unfortunately, it is not unusual for the FTC staff. They followed an identical procedure in releasing their study of debit insurance in January 1979.

The FTC staff has been going to some lengths to depict its recommendations merely as suggestions for the states to consider. The fact is, the FTC staff has been trying to promote its particular form of cost disclosure to state insurance departments for more than a year. It has almost uniformly been rejected.

We believe that the FTC staff now hopes that media reactions to its strawman of 1.3 percent interest may help to create pressures leading to legislation mandating the use of its cost disclosure system, thus accomplishing indirectly what it has been unable to achieve directly—regulation of the life insurance business from Washington. This is the message between the lines of the Federal Trade Commission staff report "Life Insurance Cost Disclosure."

V. THE FTC STAFF AND TERM INSURANCE VERSUS WHOLE LIFE INSURANCE

Having evidently concluded that most people would be better off with term insurance than whole life insurance, the FTC staff advocates extensive revision of the NAIC Buyer's Guide in favor of this point of view. This would be supported by

adoption of the Linton Yield cost indices measuring the so-called "rate of return" on whole life insurance policies and on endowments. According to the FTC staff, Linton Yield indices enable a comparison between whole life insurance policies and term insurance policies, even though these indices are not calculated for term insurance.

Criticism of whole life insurance does not end there. Both the FTC staff report and the press release that announced it refer at length to the low "rate of return" on whole life insurance policies. Solely to achieve headlines—a strategy that proved to be quite successful—the FTC staff devised a meaningless calculation purporting to show that life insurance companies, in the aggregate, credited only 1.3 percent interest on the "savings element" of individual life insurance policies during 1977. This was represented by the FTC staff as a form of consumer fraud foisted on unsuspecting and trusting policyholders through inadequate disclosure and buyer confusion.

The simple fact is that a whole life insurance policy is a promise by a life insurance company to pay a specified benefit upon the death of the policyholder and to make other benefits available in other circumstances. For this, the policyholder agrees to pay an annual premium that remains the same each year for as long as he chooses to keep the policy in force. This "level" premium solves the problem that had forced generations of earlier consumers to drop their life insurance because they had reached an age at which life insurance was no longer available. Whole life insurance guarantees that a benefit will be paid no matter at what age the policyholder dies.

Term insurance is an extremely useful type of life insurance, but it cannot effectively protect a policyholder for the whole of life. This has been proven time and again. One recent example is the term insurance coverage provided by the government to men and women in uniform in World War II. Veterans had the option of keeping their term insurance after being discharged and renewing it at higher rates at five-year intervals. They also had the option of converting their term insurance to a whole life or endowment policy at a level annual premium. Many veterans selected renewable term insurance because the premium rates were quite low. Today these veterans have reached an age where the premiums are increasing to the point that it is difficult for many of them to afford coverage, and they are faced with even higher future increases. The Veterans Administration from the first has vigorously campaigned to persuade these policyholders to convert their term insurance to whole life insurance with its level premiums. Now Veterans' groups are asking Congress for help for veterans who need life insurance and can no longer afford the rising premiums for their term insurance.

Years ago, similar problems for citizens buying individual term insurance policies led the insurance department in one of the most heavily populated states to refuse to permit term life insurance policies to be sold beyond age 70. The advice of the FTC staff about reliance on term insurance will, if followed, lead to the same problems for today's consumers.

Advice from any source to "buy-term-and-invest-the-difference" must be considered with the greatest of caution, even if such advice has the stamp of approval of an official agency of the United States government.

Neither the Linton Yield indices nor the spurious "average industrywide rate of return" in the FTC staff report have any relationship with the investment income actually earned by life insurance companies or the cost of insurance to policyholders. These costs are affected only by the interest rates used by the companies to establish premiums actually being charged and policy dividends actually being paid. These interest rates are typically at levels of 5 and 6 percent, or higher.

The Linton Yield cost indices cited by the FTC staff show averages of from 4 to 5 percent for participating policies sold in 1977. Using the same calculation, however, some policies sold that year had actual Linton Yield indices of between 8 and 9 percent. Even if a consumer were able to find term insurance both at the very low, unrealistic premium rates and in the reducing amounts assumed by the FTC staff, he would have to earn 8 or 9 percent after taxes on an investment over the next 20 years to accumulate a fund equal to the cash value of a whole life insurance policy at the end of that period. Thus, their own cost indices argue against the FTC staff conclusion that whole life insurance policies have very low "rates of return."

VI. CONCLUSIONS

The investigation by the FTC staff of life insurance disclosure duplicated matters that had already been carefully studies by the National Association of Insurance Commissioners. The two academic projects sponsored at taxpayer expense by the FTC did not produce results to justify drastic changes sought in the disclosure and cost comparison system of the NAIC model regulation.

The FTC staff report recommends the adoption of a new cost index to be shown at durations of 5, 10, 20 and 30 years, and substantial revision of the NAIC Buyer's Guide—changes that are clearly meant to direct consumers into choosing term insurance over whole life insurance.

Whether term insurance is better than whole life insurance is up to the buyer to decide, not government agencies. Both products are useful, as experience has shown, with most people requiring term insurance for current protection and whole life insurance for protection into the indefinite future.

"Buy term and invest the difference" is not new. It has been advocated for decades, usually by salesmen with investments to offer, who seek to have people use cash values on existing policies to buy these investments. It is wrong for an agency of the Federal Government to lend support to what, in many cases, is a consumer ripoff.

The publicity deliberately concocted by the FTC chairman in announcing the FTC staff report will only confuse some buyers of life insurance, leading them to purchase new policies that do not serve their long-term financial needs. Some policyholders may be encouraged to drop their insurance, to the detriment of their long-run interests. The FTC staff report on life insurance cost disclosure is so misleading and tainted that it should be filed and forgotten.

ATTACHMENT A—BUREAU OF CONSUMER PROTECTION

Mr. ROBERT C. WARREN, Jr.,
FLMI, New Hampshire Insurance Department,
Concord, N.H.

DEAR MR. WARREN: Thank you for your letter of June 16, 1977, informing me of the hearing to be held on New Hampshire's proposed Life Insurance Solicitation Regulation. As you are aware, the staff of the Federal Trade Commission is currently studying the problem of life insurance cost disclosure. Although the investigation is not finished, the staff conducting the investigation has developed very serious reservations concerning the usefulness to life insurance purchasers of the Model NAIC Life Insurance Solicitation Regulation. A description of some of the inadequacies which we see in the NAIC model regulation is contained in a letter dated June 24, 1977 from the Commission to Senator Alan Cranston, Chairman of the Senate Committee on Veterans' Affairs. This letter was sent in response to Senator Cranston's request that the Commission comment on S. 718, a bill introduced to provide veterans with certain cost information relating to the conversion of government supervised insurance to individual life insurance policies. Although some of the issues raised by S. 718 are unique to the veteran's insurance program, the cost disclosure system proposed, like the proposed New Hampshire system, very closely follows the NAIC model regulation. Thus, we think that many of the comments contained in the Commission's letter to Senator Cranston are directly relevant to your proposed regulation. I have enclosed for your information a copy of S. 718 and the Commission's letter to Senator Cranston.

During the hearings which were held on S. 718 on June 28 and June 30, 1977, both the Veterans Administration and the Veterans of Foreign Wars testified in opposition to S. 718. In many respects their opposition was similar to the Commission's position set forth in its letter to Senator Cranston. I have also enclosed a copy of the written comments on S. 718 submitted by the Veterans Administration.

I hope that the enclosed material will be of use to you in considering New Hampshire's proposed Life Insurance Cost Disclosure Regulation. If you have any questions concerning the enclosed material, or if we can be of any further assistance to you, please contact me.

Sincerely,

DAVID C. FIX,
Attorney, Division of Marketing Practices.

Enclosures.

ATTACHMENT B

Hon. ROBIN BEARD,
House of Representatives, Washington, D.C.

DEAR CONGRESSMAN BEARD: This is in response to a letter from one of your constituents, dated February 9, 1977.

is mistaken as to the focus of the FTC's current life insurance investigation. The FTC is not principally concerned with the language of life insurance policies; as correctly notes, in most states the state

insurance commissioner must approve the exact language used in all policies before those policies can be marketed. What the FTC is concerned about is the fact that identical policies differ in cost by substantial amounts and that consumers are not currently able to comparison shop effectively for a low-cost policy. The FTC investigation will attempt to determine why costs of similar policies differ so substantially; why consumers don't shop around more for low-cost policies; and what measures the FTC can take to remedy these problems.

Assuming the Commission's staff can document the problems mentioned above, it may propose several different remedies, one of which might be a trade regulation rule requiring life insurance agents to disclose the costs of their policies to consumers in some sort of standardized form. This is only one of many possible remedies, however. The Commission's investigation is in its preliminary fact-finding stage and the choice of the proper remedy will remain an open one for quite some time.

If the Commission's staff does, in fact, recommend a trade regulation rule, hearings will be held across the country and individuals such as will be given ample opportunity to comment on any proposed rules. In addition, as the Commission's investigation progresses, the Commission's staff will be in touch with such trade organizations as the American Council for Life Insurance and the National Association of Life Underwriters and will actively solicit their comments.

The staff of the Commission respectfully disagrees with comments regarding the unconstitutionality of the FTC's actions in the life insurance field. Article I of the federal constitution grants Congress the authority to regulate interstate commerce and Congress, in turn, has delegated part of that authority to the Federal Trade Commission. company probably does business in all fifty states. Certainly, he is in constant touch with his company's home office regarding business matters involving his company's policyholders. There is, therefore, no doubt whatsoever that as a m atter of constitutional law the Commission has the authority to regulate the matter of life insurance cost disclosure.

Finally, the staff disagrees with as to the current performance of most state insurance commissioners. State, insurance commission offices are grossly understaffed; many do not even have an actuary on the staff. Only six states currently have any form of life insurance cost disclosure regulation to benefit consumers. And this is in spite of the fact that the National Association of State Insurance Commissioners recommended nearly two years ago that each commissioner promulgate such a cost disclosure regulation for his state as soon as possible.

If you have further questions with regard to this matter, please do not hesitate to contact the undersigned.

Sincerely,

MICHAEL C. MCCAREY,
Deputy Assistant Director for Marketing Practices.

The CHAIRMAN. Thank you. Who is next?

Mr. BROWN. I'm next.

Chairman Cannon and Senators, I first want to thank you, Senator Kassebaum, for your nice introduction and tell you that Kansas is awfully proud you are representing us.

I want to let you know I am the chairman of the Federal Law and Legislation Committee of the National Association of Life Underwriters. I am also the trustee of that same organization. As an organization we represent 140,000 life insurance salesmen throughout the United States. As an individual, I am an agent in the city of Topeka, Kans., and I serve two Kansas companies in the sale of life insurance. The members of our organization sell virtually all the life insurance sold in the country. We have to meet the client and discuss with him the FTC report. At a time when mistrust of all government is rampant, this report only adds to that.

The FTC says if you want protection for your family while young and a source of money as you grow older, there are two things you can do: Buy a whole life policy with a built-in savings program, or a term policy, and each year invest the difference between the whole life and term premium. If you buy a term policy and you are the kind of person who can save regularly—and they say many

people are—you will build up a sizable sum of money by the time you're 65. You can use this for the same purpose as the cash value of a whole life policy. If you are considering whole life as a way of saving, you should compare its features with other types of savings programs, especially savings accounts.

On the other hand, another strong institution, known as the VA, with over 30 years in the insurance business, says term insurance is not designed for lifetime protection. Premiums increase every 5 years and can become burdensome if not prohibitive in later stages of life. You should seriously consider converting the term policy to whole life.

I am a life insurance agent representing the largest agents' organization in the world. I am especially disturbed FTC implies I don't know what I'm doing when in its own report, which Ian Rolland just quoted, they have pointed out after people purchased and held a policy for over a year and had that interview fresh in their minds, that only 3.1 percent were dissatisfied with what they bought—83.3 percent were satisfied. Included in those figures, 84.5 percent would buy from the same person they bought it from before because they were satisfied with what he said, satisfied with what he did, satisfied with how he presented it, and happy to have him or her as their agent.

I think a point that is important for me to state to all of you is that my business is the development of a clientele, not the sale of the policy. When I go out and hang my shingle up in a town, it's there to stay. When I develop a clientele, they are people I hope to serve and work with for all of my life. I am not a fly-by-night operator. I am an individual who wants to develop a clientele like any other professional so I can work with that clientele for the whole of my life.

Thousands of my agent colleagues hand out prior to even meeting their client or prospective client in person the NAIC Buyer's Guide. As a matter of fact, thousands of my colleagues send out the NAIC Buyer's Guide to their already existing policyholders so they can read and review it. Thousands of my colleagues are insuring that before they see the client he understands and is knowledgeable about what it is we will discuss. Because we are in the business of building clients, as much as in the business of selling policies. We know that our clients will probably purchase from us seven or eight times. To build a clientele and serve them well—that's the business we try to be in.

The NAIC Buyer's Guide, we have discovered, is one of the finest third-party influences on what we do. We want our clients to know and in general they do know. When we meet with a client we are stressing life insurance purchasing for a period of time, based on the knowledge and depth and concerns of that client. To say that we put our emphasis on the largest commission product is a slander on the education and the time we have spent trying to be professionals in this business.

When it comes to the FTC staff report, now heralded as fact in many cases, I think you should know the kind of thing we are faced with. From the Washington Post, Wednesday, July 11, 1979, headline: "Whole Life Policy Faulted for Low Interest Yields."

And from the Chicago Sun Times on August 21, "The family lawyer says it's sickening that savings are so low in life insurance policies."

From the Dayton Daily News, it says, "Nonparticipating Insurance Bad Deal for Most, the Study Says."

From the New York Times, a report on whole life insurance says, "Buyers Lose Billions Yearly."

From the Maine Sunday Telegram, an article says, "Is Your Insurance Agent Trustworthy Anymore?"

Then also a huge, gigantic ad suggesting that you should cash in your life insurance policies and replace them because consumers are losing billions yearly, according to the latest FTC report.

From the Minneapolis Tribune on Wednesday, July 11, an article stating that the FTC finds whole life policy a bad buy.

Senator WARNER. Who put the full-page ad in?

Mr. BROWN. An organization called Bates and Doyle, an agency in Maine.

Senator WARNER. They suggest term life?

Mr. BROWN. Yes, buy term life and cash in your whole life, is what they suggest.

In Shawnee Mission, Kans., in the windshield wipers of automobiles is a picture of a dollar bill that says, "The U.S.A. will provide you with a booklet telling you about the $2.5 million consumer ripoff."

From the Phoenix Gazette, "A federal survey blasts life insurance returns."

From the Arizona Republic, "Insurance plans yield low returns, a U.S. study states."

A quote from a newspaper stating that the Federal Trade Commission wants life insurance companies to tell you what you pay for and what you get, enclosing a brochure that says that the U.S. Congress says that most life insurance sold in America is deceptive, consumer fraud, misrepresentation, gross overcharges, planned confusion, and a national scandal. Dr. Mike Lynch, a Ph. D. with the Federal Trade Commission, is traveling throughout the country giving seminars on what you should know about your life insurance, according to an ad placed in the Oregon Sunday Times.

To put all these things together, one stock brokerage firm prepared an entire brochure where they list all the various headlines that have been shown throughout the United States, and on the inside suggests you should come to them to replace your life insurance and cash it in and invest with them.

The Business and Farm says that whole life insurance is a bad buy and has a further quote here by several Senators on the committee.

In the Engineering Quarterly they say, "Buying life insurance cheaper can be a bad buy."

My point is that thousands of insurance agents, after the FTC report came out, lost insurance policies. One was mine. I had a friend I grew up with; we lived together side by side in McPherson, Kans., for years. He is a banker in a small community. He called me up the day after the FTC report and said, "Rice, I don't want to discuss it with you, but the point is I think what you sold me was wrong."

I said, "Don't you remember why you bought it?"

He said, "That's not the point now. I think what you did is wrong. I want to cash my policy in."

He did cash his policy in. Senators, the policy that he owned was being paid for almost entirely by the dividends that it was producing. What he did hurt him much more than I could ever have hurt him in my life.

There is an organization in my town that has been in the business of replacing life insurance for years. When the FTC report came out, they gathered up all the headlines and prepared them in a brochure and gave it to their sales agents and told them, "If you will use this particular brochure, one out of every two families will give you their life insurance policies for you to review; and if you give those policies to us, we will prepare an in-depth brochure as to why they should cash their life insurance policies in. To help this along a bit, if you get five families to give you their policies, we will give you a free weekend at the Crown Center in Kansas City as a prize."

Maybe the most touching of all was a man in Colorado who approached me at a meeting of the Colorado Association of Life Underwriters and said, "I don't understand it. After spending 25 years in the insurance business trying to be a good agent and trying to be a man who did the right kind of job, my daughter came home from college and quoted the FTC report and said she was shocked to find out that I had spent my life ripping off her friends' parents."

Senators, we believe as it now stands this FTC staff report, especially the more scandalous statements contained in it or fairly to be derived from it, will be misused for years to come to cause dissatisfaction with existing life insurance, to cause its ill-advised replacement, and to prevent the sale of much of the kind of life insurance that has represented a high-quality purchase for millions of consumers for so long a time.

Thank you very much.

[The statement follows:]

STATEMENT OF RICE E. BROWN, CLU, OF THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

Mr. Chairman, members of the Committee, my name is Rice E. Brown. I am in the business of life insurance sales in Topeka, Kansas, and I appear here today as Chairman of the Committee on Federal Law and Legislation of The National Association of Life Underwriters, an organization representing the interests of 140,000 life insurance field sales people who do business in virtually every community in the United States.

First of all, let me say that we subscribe to the testimony of the witnesses for the American Council of Life Insurance and endorse their characterization of much of the FTC Staff Report and its coincident press release as misleading and erroneous. We would add that the issuance of this FTC Staff Report, especially with that sensational press release, has clearly resulted in misunderstanding and even misuse, as illustrated later in this statement.

When the FTC Staff Report to the Federal Trade Commission on Life Insurance Cost Disclosure was made public, we said that one of the major problems with it is that the FTC persists in making comparisons between whole life and other thrift media that are invalid. Because of the additional contractual rights in a whole life policy, which are not present in these other media, direct comparisons are inappropriate and invidious, if not misleading.

Moreover, we were—and are—particularly concerned with the seeming preoccupation of the FTC Staff with the concept that term insurance is superior and more

suitable for most people than whole life insurance, and the contention that consumers are generally uninformed about life insurance and unable to evaluate its cost.

The FTC Staff's preference for term insurance, as well as their insistence that whole life can reasonably be compared to savings accounts, both seem illustrated by "saving through life insurance," on page 9 of the suggested FTC Buyer's Guide, contained as Appendix X of the Staff Report, where consumers are advised that: "If you want protection for your family while you're young and a source of money as you grow older, there are two things you can do. You can buy a whole life policy with its built-in savings program. Or you can buy a term policy and each year invest the difference between the whole life premium and the term premium * * *. If you buy a term policy and you're the kind of person who can save regularly, and many people are, you'll build up a sizeable sum of money by the time you're 65. You can use this for the same purposes as the cash value of a whole life policy * * *. If you are considering whole life as a way of saving, you should *compare its features with other types of savings programs, especially savings accounts.*" (ital. added).

We question whether it is the legitimate or justifiable role of a government agency to appear to "take sides" as between two legitimate and worthwhile products, and undertake to lead the consumer to a preference for one of them over the other. One problem is that, to the extent that FTC, as one government entity, may succeed in doing this, this will work at cross-purposes with the efforts of at least one other government agency—the Veterans Administration—which has consistently advised VA policyholders that: " * * * term insurance is not designed for lifetime protection * * *. The premiums increase every five years and premiums can become burdensome, if not prohibitive, in the later ages of life. You should seriously consider converting your term policy to a permanent plan."

We also take issue with the FTC Staff conclusion that consumers are uninformed and unable to evaluate cost. This conclusion is simply unfounded. We would refer to the FTC's own studies in this regard. In preparation of the Staff Report now under criticism, the FTC commissioned two separate surveys of its own, with much fanfare and at great expense to the taxpayers. One of these was conducted at Purdue University, to determine what information consumers use in making life insurance purchase decisions and how various cost disclosure materials help them. The FTC also retained a professor at the University of Wisconsin to survey life insurance buyers in New Jersey regarding their recent purchases of life insurance.

The first study, which cost the taxpayer at least $155,000, concluded that: " * * * consumers exposed to any one of the six different disclosure systems used in this investigation were by and large able to make good purchase decisions." Reference to the results of this research was confined to a footnote in the FTC Staff Report and a small summary buried in Appendix IX.

The other survey concerned 194 life insurance buyers in New Jersey. Only 3.1 percent expressed dissatisfaction with the life insurance policies they had purchased. On the other hand, 83.3 percent were satisfied with their purchases.

Furthermore, 80.8 percent maintained that the sales presentation made by the agent was not confusing; 84.5 percent said the sales person was not unduly aggressive; 78.9 percent claimed that the sales person did not urge them to make a decision too quickly; 84.5 percent said they would contact the same agent for more life insurance.

On the whole, therefore, the FTC's own research indicates quite clearly that people make good purchase decisions and are satisfied with their purchases and the agents with whom they deal.

In the face of these contradictions by their own studies, one might wonder why the FTC Staff has insisted on assuming a Big Brother role for the consumer, especially in an area traditionally regulated by the states and not by the federal government. We also wonder why the FTC seems to be working a cross-purposes with highly respected government agencies such as the Veterans Administration.

Another of our chief concerns with the FTC Staff study, Mr. Chairman, is for the confusion and misinterpretation this report will surely cause—has already caused—in the life insurance marketplace. The release of a quasi-governmental report to the accompaniment of a flaming FTC-authored headline: "Consumers Losing Billions Yearly By 'Ill-Informed and Inappropriate' Life Insurance Choices," is not calculated to inspire public confidence in the life insurance business or its products. On the contrary, government-generated declamation such as was contained in the FTC release provides the very fodder on which market unrest can feed.

I would like to cite some examples, Mr. Chairman, of the market confusion and misuse that the FTC Staff Report has caused. These examples were sent to me from representatives of our associations around the country:

In Springfield, Illinois, an October 11 newspaper advertisement contains a "Notice to the public," which asks, "Did You read the 2½ year result of the investigation of Whole Life Insurance by the F.T.C. in the July 11, 1979 State Journal-Register? Conclusion—American Consumers are losing billions of dollars annually by owning whole life cash value life insurance that pays an average 1.3 percent per year." The ad solicited business for a "Consumer Advisory Service" whose market specialty is stocks, bonds and mutual funds, in addition to insurance and seems clearly designed to use the FTC's unfortunate pronouncements as a vehicle for the replacement of existing life insurance.

In Wausau, Wisconsin, on October 1st an ad appeared in the Daily Herald, stating "According to a recent Federal Trade Commission Report on Life Insurance, the consensus is that Term Life Insurance Is a Good Buy!" The individual who sent this to me said that the he was doing so because the ad seemed contrary to a statement by an FTC spokesman at our annual convention in September that the FTC did not endorse any particular kind of insurance.

On September 30 even the New York Times seems to have been misled by the phrasing and presentation of the FTC report, stating that "the FTC charged," and "according to the FTC," rather than correctly attributing the so-called charges to the FTC Staff.

In Houston, Texas, a member of the life underwriters association received a letter from an investment builder saying that since he believed in the accuracy of the reports of the Federal Government, he would hardly be interested in converting term life insurance to ordinary life insurance until it was absolutely necessary to do so.

In Appleton, Wisconsin, an ad in the August 26 Post Crescent, placed by an organization that "redirects" people's insurance programs, says that the "FTC finds 'whole life' policy bad buy," and "FTC says whole-life insurance bad as investment at 1.3 percent." This ad in turn cited similar headlines in The Wall Street Journal, the Wisconsin State Journal and the Chicago Tribune.

One of the most glaring examples of the way the FTC report lends itself to misuse in the marketplace appeared in the August 5 Maine Sunday Telegram, in Portland. There, the full-page ad, virtually urges replacement of life insurance and proclaims the FTC report as saying "Whole life is a bad buy," based on the 1.3 percent figure the FTC Staff had used. This ad proceeds to urge that readers "Buy term and invest the difference," advice that we believe has been spawned by the FTC Report.

From Lancaster, Ohio, an agent wrote that the FTC Report and its publicity have caused an average of one termination by his policyholders every two weeks since then.

A similar story is told by an agent in Logan, Utah, who says that since the FTC Report was issued, many of his clients have approached him with the idea of changing their whole life insurance to term insurance because of the 1.3 percent figure used by the FTC.

An agent in Amherst, Ohio write to me to the effect that, solely because of the FTC Report, a client of his concluded that it would be to his advantage to surrender four whole life policies and replace them, with annual renewable term insurance.

An agent in Cherry Hill, New Jersey wrote to me to the effect that, based on the FTC Report, several of his clients who had purchased whole life insurance advised him that they were going to replace it with term insurance.

In my personal experience with the FTC Report in Kansas, a life-long friend of mine who is an officer in a bank in Meriden, Kansas, called me the day after the FTC Report to cancel his two permanent life insurance policies. The major thrust was that he felt he had been deceived and that I as his agent had deceived him. Even though we were close friends I was not able to convince him to retain these policies, in the face of what appeared to be government criticism of them.

And, while I was attending a recent insurance meeting in Colorado as a representative of our national association, a life insurance agent from a small community in Colorado made an emotional appeal that something be done regarding the FTC Report. He had served as a life insurance agent for a leading life insurance company for years in his community and had suffered the embarrassment of the FTC Report classifying him as one who took advantage of the ill-informed. His own daughter, a college student, came home and accused her father of cheating her friends for his own gain. He wanted to know "What right does the FTC have to cause me that kind of embarrassment?"

In Topeka, Kansas, a firm which has specialized in the field of replacement of life insurance for years began, the day after the FTC Report was released, to develop large ads and brochures emphasizing the 1.3 percent rate of return statement made by the FTC Staff. They informed their sales people that by using this brochure they

should be able to convince 5 out of every 10 people they talked to to let the agent have their insurance policies "to review them" so that they could be cashed in and new term insurance purchased. To further make this attractive they offered a free week-end in Kansas City at the Crown Center to anyone who would, in fact, make these sales calls and turn in insurance policies for what they called a "replacement review."

We believe these things illustrate that the FTC Staff Report is being interpreted and misused in such a way as to cause members of the public to question the life insurance purchases they have made, and in many cases to terminate protection that they need.

We believe that, as it now stands, this FTC Staff Report, and especially the more scandalous statements contained in or fairly to be derived from it, will be misused for years to come to cause dissatisfaction with existing life insurance, to cause its ill-advised replacement, and to prevent the sale of much of the kind of life insurance that has represented a high-quality purchase for millions of consumers for so long a time.

Mr. Chairman, I appreciate the opportunity to appear before your Committee on this important matter.

The CHAIRMAN. Mr. Brown, let me say as a member of Congress I can say, "Welcome to the club."

Simply by reason of some of the things you mentioned there attributed to Congress—Congress never did have any part in that kind of a finding. But because of the attribution to us as Members of Congress, I saw a recent survey that said we are held in lower esteem by the American public than used car dealers.

So I would say you can join us in that group.

Senator SCHMITT. If the Chairman would yield on that point, it's just another example, as I indicated earlier, of how indirect and tenuous is the FTC justification for many of the things they have undertaken, such as the issuance of this report, such as several of the rulemaking activities that they have undertaken. I hope that as a result of this fall's activity by this committee, for which you and Senator Ford and others are to be commended, that the FTC will realize they have to clean up their act. They just can't go out indiscriminately, in contrast to their own mandate, and tag on a particular segment of commerce without a clearer mandate from Congress than they had in almost every one of the cases dealt with.

The CHAIRMAN. All right, Mr. Wolff.

Mr. WOLFF. Mr. Chairman, I am Thomas J. Wolff of Vernon, Conn. I am here representing our 140,000 members of the National Association of Life Underwriters. I would like to augment Mr. Brown's testimony by citing how the FTC staff report has already been used on national television in such a way as to cause the very confusion and misunderstanding that we were afraid would in fact occur.

On August 18, on WGN-TV in Chicago, and subsequently on approximately 150 other television stations throughout the United States, the Phil Donahue Show devoted its entire hour of television time to life insurance, with particular reference to the FTC staff report and its allegation that life insurance companies pay 1.3 percent on life insurance "savings."

Numerous statements were made on this telecast to encourage and advise viewers to buy term insurance and invest the difference. Further, there were disparaging comments on the show with respect to traditional life insurance, as well as those who sell it.

Newspaper clippings displayed on the television screen during the show proclaimed that the FTC says life insurance is a poor

investment, and that the FTC says policyowners are losing money by purchasing whole life insurance.

How many of the 8 million Americans watching that show will not buy whole life which may be in their best interests and may cash in insurance they have because of the headlines attributed to the FTC.

Understandably this nationwide telecast generated a storm of protest. Mr. Donahue said he never saw such a response. He graciously agreed to do a second show. This was taped on September 28. It has been and will subsequently be shown on approximately 150 outlets.

It was my privilege on behalf of The National Association of Life Underwriters as president to appear on this program along with Robert Beck, chairman of the board and chief executive officer of the Prudential Insurance Co. of America. Phil Donahue gave us the opportunity to respond to some of the unfortunate points. We will submit a transcript of both of these programs, because I believe they forcefully illustrate the confusion and doubt that has been caused.

More particularly, they clearly demonstrate a need for clarification of the FTC report and perhaps even the press releases that went with it. On that show it was pointed out that at our annuual convention in September, a representative of the FTC who was on our program had indicated that the problem and uproar was not really due to the FTC report but rather by the interpretation that the press had given to this particular report.

A member of the audience stood up and said Mr. Wolff, if that is correct, why does the FTC not simply issue a clarifying statement to their press release to clear up the confusion?" You would think that would be a simple enough request.

The FTC says the problem was misconstruction and confusion about their release. They should clarify it. We asked the FTC representative at our convention about issuing such a clarification and he indicated the FTC would not do that.

Just last week the FTC told the general oversight committee of the House Committee on Small Business that the rate of return on whole life policies is more like 4 or 5 percent. I believe, Senator, you referred to that earlier. FTC witnesses admitted under questioning by your committee in July, Mr. Chairman, that the rate could be as high as 8 or 9 percent.

In view of the foregoing, we believe that the erroneous 1.3 percent figure should be and must be retracted by the FTC. Great damage has been done by the FTC press release but there is a potentially more invidious and harmful effect. Because of how the FTC material is being used in the marketplace, to either improperly replace existing life insurance or thwart the purchase of new whole life policies, this could and will in my view seriously interfere not only with the orderly marketing of a valuable and necessary product, but could also result in severe adverse ramifications for our country.

I would like to illustrate this point just a little bit further. The life insurance industry has historically been known as one of the cornerstones of the free enterprise system. There are many reasons

for this. I won't take the committee's time to elaborate them all, but I would like to touch on just two.

First, one of the basic tenets of a free society is that the citizens of that society should do whatever they possibly can for themselves under their own initiative without help from the Government. Whole life insurance is a unique product designed to help people do just that, to provide for their families future security in the event of death, disability, old age, or future emergencies.

No other product in the marketplace offers that type of combination for people to take care of themselves without the help of the Government.

Second, an adequate flow of long-term capital is a critical need of a free society. Indeed, many of the problems this country is experiencing at the present time are reportedly due to the fact that we don't have an adequate flow of long-term capital.

Whole life for over 100 years has been a major factor making it possible for the insurance industry to provide that long-term capital to this country. That a Government agency at this critical point in time should espouse and recommend to the American people that this time-proven vehicle for the creation of long-term capital which served those same people so well should be abandoned in favor of term insurance is hard to believe.

If you and the members of this committee agree that whole life is valuable property and that the 1.3 figure was an affront to the life insurance industry, please help us to set the record straight by asking the FTC to retract or clarify those statements.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you very much.

Senator SCHMITT. Mr. Filer, if you or your counsels have made any study of the FTC authority under current law to investigate life insurance in the manner that they have and to issue regulations with respect to life insurance—I realize they have not done that, but there does seem to be in the comments of the Chairman and other members of the Commission and its staff an inclination to try to create a situation where they could step in with FTC regulations. Have your counsels in any way examined this issue in a systematic, legal way?

Mr. FILER. Yes, we have. I am reluctant to summarize legal opinions.

Senator SCHMITT. Would you provide us with a statement as you see the legal situation?

Mr. FILER. Yes. I understand reasonable legal minds differ but we will address that in writing for you. It is a significant issue.

[The following information was subsequently received for the record:]

MEMORANDUM

REMOVAL OF THE FTC'S FACT-FINDING AND REPORTING POWERS BY THE McCARRAN-FERGUSON ACT

In unambiguous terms, the McCarran-Ferguson Act states that the Federal Trade Commission Act is not applicable to the "business of insurance" to the extent that such business is "regulated by State law." Nevertheless, in recent years the FTC has argued that the McCarran Act prohibits the Commission only from taking enforcement action under §§ 5 and 18 of the FTC Act (through such means as administrative adjudication or issuance of trade regulation rules). In the FTC's view, McCarran

does not prevent the Commission from "investigating the insurance industry, preparing consumer education materials, intervening in other agency proceedings, or publishing reports" under the investigatory authority contained in § 6 of the FTC Act.[1]

Simply put, this interpretation of McCarran-Ferguson is directly contrary to the plain language of the Act and to its legislative history.

I. THE LANGUAGE OF THE ACT

As the Supreme Court has noted in a recent decision construing the McCarran-Ferguson Act, the "starting point in any case involving construction of a statute is the language itself." *St. Paul Fire & Marine Ins. Co.* v. *Barry,* 438 U.S. 531, 541 (1978). The wording of the McCarran Act can leave no doubt as to the intent of Congress. The entire FTC Act—including the provisions in § 6 for investigating and issuing reports—was made inapplicable to activities comprising the "business of insurance" where the states were engaged in regulation. No distinction was made in McCarran between § 5 and § 6 of the FTC Act. In the words of Senator Ferguson, where a state "has specifically legislated on the subject, the three acts [Sherman, Clayton, and FTC] shall not apply." 91 Cong. Rec. 1443 (1945).

Congress' choice of wording must also be read in the context the Congress' understanding of the dual functions of the Federal Trade Commission. The Federal Trade Commission Act, passed in 1914, vested the FTC with powers in two general areas. With regard to the FTC's fact-finding and reporting power, the FTC is the direct successor to the Bureau of Corporations, formed in 1903. The Bureau had no law enforcement function, but instead was intended as a research or investigating agency with authority to gather information and to publish such information as the President directed. One purpose of the FTC Act was to enlarge these fact-finding powers of the Bureau and to vest them in an independent agency. This investigative authority was incorporated in § 6. Second, the FTC Act conferred on the Commission a quasi-judicial function to prosecute and try, before an administrative tribunal, cases involving anticompetitive, unfair or deceptive conduct. This adjudicative authority was incorporated in § 5.

After having given the FTC these different functions, Congress could have chosen, in the McCarran-Ferguson Act, to exempt the insurance industry only from the FTC's enforcement function but not from the fact-finding function. Congress has, in fact, made precisely this choice in the case of other industries. In the past, Congress has amended § 5 of the FTC Act to preclude FTC enforcement jurisdiction over air carriers and persons subject to the Packers and Stockyards Act but did not touch § 6, thereby leaving the FTC free to conduct investigations for fact-finding purposes.

With regard to the insurance industry, however, it is notable that Congress chose neither to limit the exemption to § 5 of the FTC Act nor to work within the four corners of the FTC Act at all. Instead, Congress selected language in the McCarran Act which, in blanket terms, removed all FTC jurisdiction where the subject matter standards of the Act (i.e., the "business of insurance" and "state regulation" criteria) were met. Phrased differently, Congress adopted a "reverse preemption" standard under which the FTC lacks jurisdiction when the states have enacted regulatory legislation. Where they have, it is the states—and the states alone—which are responsible for regulating, issuing reports and determining policy. Indeed, both individual states and the National Association of Insurance Commissioners (NAIC) have, over the years, issued numerous studies on competition and consumer problems in the insurance industry.

II. THE LEGISLATIVE HISTORY

Because Congress chose to use unambiguous language in the McCarran Act, resort to the McCarran Act's legislative history is unnecessary in order to ascertain the extent of the FTC's jurisdiction. Nevertheless, that history and Congress' basic purpose behind the McCarran Act unequivocally demonstrate that Congress did not intend for the FTC to have investigational jurisdiction where it did not have enforcement jurisdiction.

Analysis of the legislative history must begin with the historical reasons for passage of the McCarran Act. In *Paul* v. *Virginia,* 75 U.S. (8 Wall.) 168 (1869), the

[1] "Staff Briefing Book For Commission Insurance Policy Session" (June 1978) at 4. The Commission has adopted the staff view. Chairman Pertschuk has stated that "McCarran-Ferguson does not limit the Commission's authority under § 6 of its Act to investigate the business of insurance and make its findings public." Written answer to question propounded by the House Subcommittee on Consumer Protection and Finance of the House Committee on Interstate and Foreign Commerce.

Supreme Court held that insurance transactions were not in interstate commerce within the meaning of the Constitution's commerce clause and, therefore, were not subject to regulation by Congress. Seventy-five years later, however, in *United States* v. *South-Eastern Underwriters Association,* 322 U.S. 533 (1944), the Court overruled the *Paul* line of decisions and determined that the insurance business was part of interstate commerce. As such, it was fully subject to the federal antitrust laws, including the Sherman Act criminal prosecution which the Justice Department had brought in *South-Eastern Underwriters.* The Supreme Court's decision created widespread concern in Congress and among the states that application of the federal antitrust laws, and other existing or future federal statutes, would preempt or impair the extensive system of state regulation and taxation of insurance.

Consequently, Congress began considering means of preserving state regulation and taxation. The course of the debates and the contents of the bills demonstrate that Congress selected explicit, precise language where it intended to permit limited Federal jurisdiction as an exception to the general rule of deference to the states. In contrast, at no point during the debates is there any discussion, or implicit indication, that Congress intended to permit the FTC to perform its reporting function even though it was prohibited from enforcement.

The initial bills, introduced in 1943, would have totally exempted the "business of insurance" from the Sherman and Clayton Acts despite the absence of state regulation. The FTC Act was not mentioned. S. 1362, H.R. 3269 and H.R. 3270, 78th Cong., 1st Sess. (1943). These bills did not become law for two principal reasons. First, they were not supported by the NAIC, which instead favored an exemption only to the extent necessary to permit continued regulation and taxation. The NAIC, then in the process of drafting a bill, requested that the Congress postpone action until the state proposal could be offered. Second, many, including the President and the Department of Justice, opposed an unconditional exemption.

On August 29, 1944, the NAIC issued a report containing four specific legislative recommendations. One of these was that the FTC Act be amended to eliminate any jurisdiction over the business of insurance.[2] On November 16, 1944, the NAIC released its proposed bill, which, in § 3, stated that "[*n*]*othing* contained in the Federal Trade Commission Act . . . shall apply to the business of insurance or to acts in the conduct of that business." [3]

Senators McCarran and Ferguson modified the NAIC bill to substitute the general phrase "business of insurance" for specific enumeration of exempt practices and introduced the bill as S. 340 on January 18, 1945.[4] The McCarran-Ferguson bill incorporated, in § 3, the NAIC proposal that "[n]othing contained" in the FTC Act "shall apply to the business of insurance or to acts in the conduct of that business." It was S. 340, as subsequently amended, that President Roosevelt signed into law on March 9, 1945. Thus, it is clear, at the outset of the Congressional debates, that the authors of the McCarran Act intended for "[n]othing" in the FTC Act to apply to the insurance business. While S. 340 underwent important changes, to confine antitrust immunity further, this significant delimitation of the FTC's powers was never lessened or modified.

During the House debates, several members expressed their concern over exempting the business of insurance from the FTC Act where the states did not regulate. 91 Cong. Rec. 1027-28, 1086, 1089, 1092-93 (1945). At the urging of his colleagues, Representative Sumners, one of the three members representing the House in Conference, agreed to support "an amendment which would make the Federal Trade Commission Act applicable to the same extent as the Sherman and Clayton Acts." *FTC* v. *Travelers Health Association,* 362 U.S. 293, 300 (1960) (citing 91 Cong. Rec. 1093 (1945)). As a result, the present § 2(b) of the McCarran Act was adopted as a recommendation of the House-Senate conference.[5] In short, the jurisdiction of the FTC was placed on a par with that of the Justice Department—it could act only where an activity was not the "business of insurance" or was not regulated by the states.[6]

What these debates reveal is that Congress used explicit and precise language where it intended to confer limited jurisdiction on the federal antitrust agencies.

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[2] The NAIC Report is reprinted at 90 Cong. Rec. A4403-06 (1944).

[3] Emphasis added. The NAIC bill is reprinted at 90 Cong. Rec. A4406 (1944). The NAIC bill also contained the first proposal that the Sherman Act remain applicable "to any act of boycott, coercion, or intimidation."

[4] The bill had been introduced the previous December near the end of the 78th Congress but no action was taken.

[5] H.R. Conf. Rep. No. 213, 79th Cong., 1st Sess. (1945).

[6] Additionally, the three-year moratorium on application of the antitrust laws, in order to permit the states time to enact regulatory legislation, was expanded to include the FTC Act.

While at first Congress considered an absolute exemption from the FTC Act, it later specifically permitted FTC jurisdiction where a state had not passed regulatory legislation. Congress took special care to use exact wording when it intended to make an exception to the "pre-emptive role of state regulation." *St. Paul Fire & Marine Ins. Co.* v. *Barry,* 438 U.S. 531, 546 (1978). The "boycott, coercion, or intimidation" proviso in § 3(b) is the prime example. It is inconceivable that Congress would not have been similarly explicit had it intended to distinguish between § 5 and § 6 of the FTC Act and to allow the FTC to wield its fact-finding powers despite state regulation.

Viewed more broadly, the idea that the FTC has jurisdiction under § 6 notwithstanding state regulation is inconsistent with the basic Congressional intent behind the McCarran Act: "Congress' purpose was broadly to give support to existing and future state systems for regulating and taxing the business of insurance" and "to throw the whole weight of [the Congress'] power behind the state systems," notwithstanding the fact that "they differ greatly in [their] scope and character." *Prudential Ins. Co.* v. *Benjamin,* 328 U.S. 408, 429-30 (1946). In short, Congress acted to prevent impairment of state regulation. As recent events have demonstrated, highly-publicized FTC investigations and reports can thwart the states in exercising their regulatory function. Indeed, when in 1914 it vested the FTC with power to publicize facts, it was Congress' purpose that publicity serve a quasi-enforcement or deterrent function. Congress' specific refusal, in the McCarran Act, to permit exercise of this power in regard to the insurance industry reflects its awareness of the potential for federal-state conflict which it was the purpose of the McCarran Act to prevent.

In sum, the McCarren Act precludes FTC jurisdiction, under any provision of the FTC Act, where an activity is part of the "business of insurance" and is "regulated by State law." [7] Where both of these criteria are met, the FTC lacks jurisdiction either to issue reports under § 6 or take enforcement action under § 5. Indeed, it borders on the absured to argue that the FTC has some sort of "inherent" power to investigate subjects over which it lacks general regulatory jurisdiction. This remarkable assertion of agency power violates the most fundamental precept of administrative law, that agency jurisdiction is limited to those powers specifically delegated by Congress.

III. THE M'CARRAN ACT PRECLUDES THE FTC'S ONGOING INSURANCE INVESTIGATIONS

Because the McCarran Act does not impose an absolute ban on FTC jurisdiction, the Commission does have "jurisdiction to determine its jurisdiction," that is, to determine whether an activity is within the "business of insurance" and whether it is regulated by the States. Only upon a negative finding in either case may the FTC then engage in its enforcement or reporting role.

In conducting its recent investigations, however, the FTC has bootstrapped this right of preliminary inquiry into a far broader, self-asserted right to investigate and issue reports even though the facts demonstrate a total absence of jurisdiction. The FTC has: (1) claimed jurisdiction where it is quite apparent, under established judicial precedent, that the matter under investigation is the business of insurance and is regulated by the states; (2) has continued investigations even though it has uncovered evidence proving a lack of jurisdiction; and (3) has prepared and issued public reports even though it never had, or even determined that it had, jurisdiction. Several recent proceedings serve to illustrate this jurisdictional overreaching.

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[7] With regard to the Sherman Act, the Justice Department retains jurisdiction to bring actions against conduct involving "boycott, coercion or intimidation" even though such conduct is the "business of insurance" and is regulated by the states. But the "boycott" exception makes absolutely no reference to the Federal Trade Commission Act. The legislative history indicates that this omission was intentional. It was the Justice Department which had moved against the exclusionary practices which were the subject of the *South-Eastern Underwriters* case, and it is reasonable to infer that Congress intended for it alone to retain jurisdiction in this area. Congress was also specific where it intended to permit FTC jurisdiction. As a result, the legislature's failure to use similarly express language in the boycott proviso of the McCarran Act strongly indicates that only the Justice Department was intended to have jurisdiction in that limited area. The Department has, indeed, been active in this field after passage of McCarran. See, e.g., United States v. New Orleans Ins. Exchange, 148 F. Supp. 915 (E.D. La.), aff'd per curiam, 355 U.S. 22 (1957); United States v. Ins. Board of Cleveland, 144 F. Supp. 684 (N.D. Ohio 1956), 188 F. Supp. 949 (N.D. Ohio 1960); United States v. Cincinnati Ins. Board, 1963 Trade Cas. (CCH) ¶ 70,945 (S.D. Ohio 1963); United States v. Baton Rouge Ins. Exchange, 1958 Trade Cas. (CCH) ¶ 69.068 (E.D. La. 1958); United States v. Associated Aviation Underwriters, 1967 Trade Cas. (CCH) ¶ 72,260 (S.D.N.Y. 1967); United States v. United States Aviation Underwriters, Inc., 1968 Trade Cas. (CCH) ¶ 75,571 (S.D.N.Y. 1968). In contrast, the FTC has never litigated in court a case relying upon the boycott provision, let alone won one.

Early in 1979, the Commission contracted with a group of MIT consultants to study insurance discrimination in risk classification and ratemaking for private passenger automobile policies. This project is intended to develop the analytical basis for yet further FTC investigations in the ratemaking field. But as the Supreme Court's decisions made clear, ratemaking, and such underlying activities as analysis of loss experience and risk classification, are at the core of the "business of insurance" that Congress intended to be regulated solely by the states. The Court's words in *SEC* v. *National Securities, Inc.,* 393 U.S. 453, 460 (1969), are emphatic: "Certainly the fixing of rates is part of this business; that is what *South-Eastern Underwriters* was all about." Just months ago, the Supreme Court reaffirmed that the McCarran Act covers ratemaking and reiterated its definition of insurance as the spreading and underwriting of risk, a process that necessarily entails classification of those risks. *Group Life & Health Ins. Co.* v. *Royal Drug Co.,* 99 S. Ct. 1067 (1979).

There is equally little doubt about the existence of state regulation. Indeed, private passenger automobile insurance is the most heavily regulated line of insurance. Every state prohibits unfairly discriminatory rates, and requires that risks be classified on the basis of objective, actuarially-sound data. And, over the past few years, the states have been active in holding hearings on rating classifications. The NAIC presently is conducting a thorough study of the same questions which the FTC is considering.

Revealingly, the FTC did not even attempt to assert a basis for jurisdiction prior to undertaking the MIT study. What is most troubling about the MIT study, however, is that it is designed to develop a ratemaking model which could be used "to achieve specific policy objectives," including "the objective of subsidizing specific subgroups of individuals in the provision of insurance." In short, with no expertise let alone jurisdiction, the FTC is seeking to supplant the social and economic policymaking role of the states—exactly the result which it was the purpose of the McCarran Act to prevent.

Also in 1979, the FTC commenced an investigation of rating territories in Los Angeles and requested documents from insurers doing business there. As with the MIT study, the use of territorial classifications for ratemaking purposes is without doubt the "business of insurance." Moreover, the California Insurance Department has specific authority, under statutes prohibiting unreasonable geographic discrimination or discrimination on the basis of race or national origin, to prohibit any violations which may exist. Cal. Ins. Code § 11628. Not only has the Rate Regulation Division of the California Department considered the same issues being investigated by the FTC but it has concluded that, with minor adjustments, existing rating territories are fully justified by significant geographical differences in motorists' driving and accident records. Even assuming that the FTC might have had jurisdiction despite state regulation because of a "boycott," the staff attorney in charge of the investigation has stated that the Commission has unearthed no evidence of exclusionary conduct. Evidently, the Commission hopes to publish a report on its investigation even though there is no colorable basis for the Commission's jurisdiction.

To justify jurisdiction over these and other insurance investigations, the FTC relies upon a line of judicial decisions enforcing administrative subpoenas as against claims that the issuing agency was without jurisdiction. Chief among these cases is *FTC* v. *Crafts,* 355, U.S. 9 (1957). These decisions, however, definitely do not stand for the proposition that the FTC can issue reports on subjects over which it has no jurisdiction.

Crafts involved FTC enforcement action, not the FTC's reporting and fact-finding function. The Commission sued to obtain judicial enforcement of subpoenas issued to a California-based company allegedly engaged in deceptive interstate mail advertising of its policies. The question before the Court, then, was whether the FTC had a right initially to determine its jurisdiction by subpoenaing and examing relevant documents. An arguable basis for such jurisdiction existed, since it was unclear whether the states to which circulars had been mailed regulated deceptive insurance advertising. The fact that the Commission had a reasonable basis upon which to assert jurisdiction is demonstrated by the subsequent Supreme Court decision in *FTC* v. *Travelers Health Association, 362 U.S. 293 (1960), where the FTC was found to have power to prohibit deceptive advertising directed at states which did not regulate.*

In *Crafts,* the Supreme Court enforced the FTC's subpoena on the basis of earlier cases upholding enforcement subpoenas where the investigation was for a lawfully authorized purpose and the documents sought were relevant to the inquiry.[8] Subject

[8] Endicott Johnson Corp. v. Perkins, 317 U.S. 501 (1943); Oklahoma Press Publishing Co. v. Walling, 327 U.S. 186 (1946).

to those requisites, the courts permit an agency to determine initially whether particular conduct is within their jurisdiction. But under no stretch of the imagination can *Crafts* be read as permitting the FTC to gather information for reporting purposes and issue reports where it has no jurisdiction or before it has determined whether it has jurisdiction.

There is another important distinction between *Crafts* and instances where the FTC is gathering information for preparation of a public report. In the context of an enforcement proceeding, the courts have created a presumption against interlocutory judicial review because the subpoenaed party can challenge the agency's authority at a latter date when it issues a final cease and desist order or trade regulation rule. The remedy will then be effective since, absent jurisdiction, the agency can impose no sanctions.

This same opportunity is not present where the FTC never intends to issue a complaint or rule. Then, insurance companies affected by a report are caught in a "Catch-22" situation. They cannot obtain judicial review until the FTC issues a complaint or regulation, but the Commission cannot issue a complaint or regulation because of the McCarran Act. Appeal to the Commission is a futile course, since it is the same Commissioners who authorized the investigation who must pass judgement on their own actions. Further, in the unlikely event of judicial review after a report has issued, there is no effective remedy since the damage has already been done and the controversy is moot. Because court review thus is unavailable or cannot be obtained in timely fashion, insurers are left with no remedy and must shoulder the heavy burden of attempting to rebut misleading and widely-disseminated FTC information.

IV. CONCLUSION

The futility of recourse to the courts points to the need for Congressional action. In the final analysis, it is only through reiteration of Congress' long-established policy of deference to the states and through legislative clarification of the FTC's jurisdiction that the states and the insurance industry can obtain a remedy to effectuate their rights under the McCarran-Ferguson Act.

Senator SCHMITT. I asked that because in the committee we have been struggling with how does FTC determine that there is a mandate for them to investigate a particular area. Obviously, they should consider themselves an arm of the Congress. There is some indication they may rather think of themselves as a Congress.

It is this Senator's opinion, at any rate, that we must deal with that, either in the change of their basic authorization or in the establishment of a concept commonly referred to as a legislative veto, where, at least at the end of the pipeline on regulations, we have some control. But that would not solve this problem.

I am not sure we could advocate a legislative veto over the issuance of the FTC reports, though the idea does have some attraction.

Mr. FILER. If I might respond briefly, I think you are absolutely right. The damage from this report would not be cured by anything like a legislative veto. The damage is in the doing, and I think the significant part is that it was perfectly apparent that the FTC staff was in fact hindering the spread of State regulation—and you raised the legal question—so that they could assert jurisdiction by claiming the States weren't properly regulating the area. It is a very significant question.

Senator SCHMITT. I was being a bit facetious about legislative veto on the issuance of a report. Obviously that wouldn't have too much meaning.

But I do think that your information about your view of the legal ramifications and the legal justification or nonjustification for what they have done in the report area is important.

Our previous hearings, we had 6 days of them, focused much more, almost entirely, on the question of rulemaking procedings.

Here we have another aspect of FTC activity where they can have as much impact economically on the consumer and on commerce in general as if they had promulgated a rule.

So it may be in our consideration of changes to the basic organic laws that govern, to some degree, the FTC activities, that we must not only look at how do they initiate a rulemaking process and what justification must they have for doing that, but how do they initiate an investigative process and what justification must they have before they do that.

If nothing else, I think your appearance here today has brought to my attention and to the attention of the committee that the issue is somewhat broader even than the question of rulemaking procedings.

I thank you for that and I would appreciate those answers for the record.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Warner?

Senator WARNER. Thank you, Mr. Chairman. I want to make it clear whom I represent in this hearing. That is, what I categorize as the innocent people.

We have, on the one hand, the FTC firing a volley across the bow. You are back today, and I think very effectively, firing another volley across the bow. The American public is sitting there somewhat bewildered as to who is right and who is wrong.

Mr. Wolff has asked if we, the Congress, would compel the FTC to retract their report, so then there would be a third story that the Congress fired back.

I am wondering if we can, as responsible individuals, government, and free enterprise, and to the extent Congress is required, see if we can't arbitrate this dispute in some manner that we arrive at a body of fact that is a basis of mutual agreement.

Now, what I as an individual can do is, tomorrow, I will have the Chairman of the Federal Trade Commission in my office and I will ask him the same question I pose to you right now: What is it that the Government and the industry can do to resolve the dispute of fact and publish a statement that has the consensus of both parties rather than involving the Congress?

So, my first question is: What can we do collectively to represent the innocent American?

Mr. FILER. I would be hopeful that we could arrive at some way to do that. I must confess that looking at what we have seen and looking at the motivations of the FTC staff as we tried to display them, I would not be hopeful that could be done.

It would seem to me, however, that we could come to some joint issuance of a statement that would acknowledge, for example, that the regulation of the insurance business is vested by the mandate of this Congress with the States, and not in the Federal Trade Commission. That, in fact, here are the disclosure procedures and so forth and some indication of some support of the extension of that process, which is critical in the aid of the consumer, and some understanding and recognition that we are not portraying a whole life policy as part term and part savings account.

It seems to me this does involve a change of position by the staff of the Federal Trade Commission. It would involve a recognition of

the inaccuracies of their calculations. And, I believe, it would also involve the recognition not yet asserted that this business is regulated by the States, by the mandate of this Congress, and that that should be encouraged and not discouraged.

But I would be perfectly willing to commit the American Council of Life Insurance and other associations to work toward such an accommodation if it could be done.

Senator WARNER. And work with designated persons in the Commission.

Mr. FILER. Indeed. I should hasten to add, we cooperated very extensively with the Federal Trade Commission. I, myself, came down and discussed the issues with the Chairman and some of the staff.

I know our people in our company and a number of other companies and the council have really worked extensively with the FTC staff in their inquiry over this 3-year period. It seemed not to have had an impact. But we do stand ready.

Senator WARNER. That is a subsidiary question. I think this is in the main of Congress; namely, the procedures followed here. There is an unusual element of drama.

I am informed by the staff that we didn't receive the FTC press report until after the press received it. I will check into that fact.

I am sure there are FTC people right here. Please advise your Chairman that is question No. 2.

We can come back again to the innocent person, the public, and I would hope either there is a procedure on the books to follow, FTC and yourselves resolving it, or they create a procedure, but we should move expeditiously.

The advertisements referred to by your senior agent are just appalling. I have the headlines in my local newspapers which I looked at. It is disruptive to the whole industry.

Mr. WOLFF. I do think—I want to compliment you on the methodology you are following. The urgency is critical. There are probably deeper issues that will have to be resolved over a period of time with the FTC or with this committee.

But we as agents, as Mr. Brown so eloquently stated, have a real problem today out there in the field. We really only need clarification on two points, on both of which the FTC really has already issued clarifying statements, but never efficiently in any way. They are these——

Senator WARNER. I understand one of them went before the House subcommittee and acknowledged the 4 to 5 percent rate.

Mr. WOLFF. That is correct. We would like them to correct the 1.3 forthwith.

Two, in their own report, they say whole life insurance is a valuable product. It should be purchased by people. It can be an excellent investment. They say that in their own staff report. But their press release caused all of these headlines you have seen.

We need to have them say that the press release was erroneous or caused confusion and that this should be straightened out immediately. That they never intended to say that.

Their staff people have said this off the record, but we need to have the staff report and the press release clarified on those two points.

Senator, we would welcome the opportunity to cooperate in any way to help bring this about as quickly as possible.

Senator WARNER. Does any other member of the panel wish to reply to a general question of what can be done?

Mr. Chairman, why don't I acknowledge you for a few minutes and then come back.

The CHAIRMAN. Yes. I just want to say this has been a very revealing hearing. If the analysis of the FTC report that you have presented here today is true, is correct, then the conclusion of the FTC staff report certainly can't stand.

More disturbing to me is the way in which the FTC has attempted to sell its report to the press without first giving the industry the opportunity to review and comment on the report. I am particulary disturbed by the way the FTC report has been used out of context in the ads mentioned today. If the FTC is concerned about deceptive advertising, they certainly ought to look at those ads that you have given us here.

I particularly would like to have you give us the one with reference to the Congress attributing to the Congress the actions that the Congress had no part of.

And I personally will send it to the Chairman of the FTC and tell him that he ought to take a look at it from the standpoint of deceptive advertising. That, it seems to me, is the proper role that FTC ought to be engaged in.

Now I am impressed by the fact that NAIC has taken a stand on a uniform disclosure regulation and that 28 of the States adopted it. I was very pleased to hear you gentlemen say that you support that, that you think it ought to be adopted and approved by all the States.

Of course, we all know that the McCarran-Ferguson Act—incidentally, McCarran happened to be a Senator from Nevada—restricts the jurisdiction in this area to the States, and I, for one, have no intention to change that unless some clear abuses can be shown that would justify the Federal Government stepping into this area. I don't think that that has been demonstrated at the present time.

Now, when we had the Commission before us not long ago in an oversight action, I made a statement, if I can find it here now, that I would like to quote from because I think it would be of interest to you and I think it is appropriate.

This is my statement to Mr. Pertschuk when he appeared before us.

> Let me say in closing that I happen to be one who strongly believes that the American business community is responsible in large part for the high standard of living that most Americans enjoy today. American business enterprise and technology are unsurpassed.
>
> To some degree, overregulation by the Federal Government may be a contributing factor in the current decline. While I have not backed away from the FTC mission of protecting the American public from unfair trade practices, I do want to go on the record today as advising the members of the FTC, as well as other regulatory agencies which this Commerce Committee has oversight jurisdiction on, that we will be conducting the most vigorous type of oversight activity that your agency has ever experienced.
>
> We, the Congress, have designated regulatory agencies such as the FTC to act as arms of Congress in our behalf and we expect you to act within the framework and intent articulated by us. We don't expect you in novel ways to achieve your own

special goals or any particular visions you may have as to how the American economy should operate on a day-to-day basis.

The partnership that we have with you was created by the Congress and it can be amended or terminated as the Congress sees fit. If some of you felt as though this Congress was and is a silent partner, let me put you on notice now that such will not be the case as long as I am chairman of this authorizing committee.

I am perfectly willing to believe that some people in business are capable of unfair trade practices, and I am also convinced that the FTC and its staff have the capacity to push your legal statutory authority to the brink and beyond.

Now this committee and I believe the Congress will put in place a mechanism to restore that proper balance if we have to do it.

And I just wanted to restate my believe in what I said there. The FTC performs a very useful purpose.

Mr. Pertschuk in some of our oversight hearings admitted that some of the FTC staff had overextended themselves in other areas. He stated that those staff members were no longer with the FTC.

I hope that he will take a real close look at this and see if someone has had some sort of vendetta, which he admitted had occurred in some other instances. Someone on the staff may have had a vendetta in order to try and punish this particular segment of our industry.

I certainly hope that is not so but I am going to write Chairman Pertschuk and ask him to respond to the committee after he had a chance to review your testimony here today. I think in all fairness that should be done.

I certainly applaud Senator Warner's suggestion that perhaps the industry and the FTC can get together on this issue and clear the air so to speak and lay out a position on which the American public can depend. They certainly deserve no less.

I have no further questions at this moment to any of you.

Senator Warner, do you have some further questions?

Senator WARNER. Mr. Chairman, I wish to put in a brief statement, a question submitted by my colleague, Senator Kassebaum.

She very carefully instructed me to read the preamble to the question. I quote:

This reminds me of a scene in Alice in Wonderland in which Alice wondered if the verdict was made before or after the trial. Most unfortunately that allegations are made which cast dispersion without the benefit of testimony by all parties concerned.

Then she asks the question: You expressed fear, Mr. Brown, that the FTC staff study and attendant press coverage will live on in the marketplace. Has that happened in the past?

Mr. BROWN. Because of FTC reports in the past? Things that occurred in the past?

Senator WARNER. Yes.

Mr. BROWN. We have found this to be the case of prior congressional hearings. For example, although there was no bill or no other action before the Senate Antitrust and Monopoly Subcommittee in 1973 and 1974, statements made at hearings were excerpted and reprinted and are still being used in a disparaging way in the marketplace.

Mr. WOLFF. I think this: The companies and agents who are out replacing whole life policies have so-called kits that they use. In these kits they pick up the kind of material that you were demonstrating, Mr. Brown. These kits, once put together will remain in these people's hands for years and years to come.

To answer the specific question, it would be my view that we will be living with this problem, unless it is corrected, so we can have the correction by the FTC, for a decade at a minimum.

Senator WARNER. Thank you very much. Mr. Chairman, would you comment on our conversation about the GAO?

The CHAIRMAN. Yes. Senator Warner asked whether or not this would be an appropriate area to ask the GAO to look at, as an arm of the Congress. I would simply say that GAO has already taken a look and just recently came out with a report on the issue of state regulation of insurance, and they concluded—at least they didn't recommend that the Congress should step into the area and attempt to regulate the insurance industry nationally.

Of course, as I said earlier, under the McCarran-Ferguson Act that is specifically left to the States. Absent any sort of recommendation certainly from GAO or many others, I for one would not be inclined to consider the Federal Government getting into that regulatory area at this time.

Senator WARNER. I share that. I was specifically wondering about this key point. That is, the rate of return. If they are unable to receive common consensus on it, I think we have a fiduciary responsibility to try and have some totally impartial analysis.

The CHAIRMAN. Do any of you gentlemen have anything further to offer?

[The following information was subsequently received for the record:]

QUESTIONS OF THE COMMITTEE AND THE ANSWERS OF MR. FILER

Question 1. Let me ask you a question about the NAIC cost disclosure regulation. I am told that some insurance buyers are given a computer printout with columns of figures and unexplained capital letters like "ELAD." These figures are followed by a note, that the buyer can ask his agent for a copy of the buyer's guide explaining these figures. Don't you think it would be a good idea to include a brief explanation of these terms on this same page in addition to explaining them in the buyer's guide?

Answer. I think that it would be a good idea to include explanations of many terms included in policy summaries on the sheet containing the summary information, and we would be happy to do so. However, in developing a form of presentation that will be helpful to the buyer, companies must weigh on the one hand the desirability of providing complete and accurate information and explanations and on the other hand the risk of putting so much information on a single page that no one would read it.

Filling page after page with print, including a series of footnotes, produces a negative reaction from many people, who will simply put the material aside unread, or discard it.

Both the buyer's guide and the policy summary will be delivered by the agent. The explanations offered by the competent and experienced agent will supplement the printed material; our agents are educated for this purpose. We also encourage consumers to ask questions, and the explanation given by agents are far more likely to be understood than a sheaf of printed material.

To summarize my response, I agree that including brief explanations of terms used in the policy summary on the same page that they are used (in addition to explaining them in the buyer's guide) might be helpful. However, I think that is important that the design of the policy summaries be carefully reviewed for clarity, appearance and relevance before making such a change.

Question 2. I understand that a member of the FTC staff was recently quoted as saying that both the FTC staff report and the accompanying press release were objective, but that the press created the impression that the FTC is biased in favor of term insurance. The FTC staff member was further quoted as saying the FTC apparently has no intention of correcting this misimpression, to set the record straight. Do you think this indicates the bias of the FTC in favor of term insurance?

Answer. I think that the report prepared by the staff of the Federal Trade Commission indicates a strong feeling on their part that most people would be better off buying term insurance rather than permanent insurance. It is ridiculous to say that the press created the impression that the FTC is biased in favor of term insurance. The press had only the FTC staff report and the accompanying press release to work from, and reported what was in them quite accurately. I think it is quite significant that even when apprised of the "error" the press had made, "the FTC apparently has no intention of correcting this misimpression"—reinforcing the conclusion that the FTC staff report is biased in favor of term insurance. In other words, they got what they wanted, and are not in the least inclined to change anything.

Question 3. Would you comment on the impression created by the FTC staff report that the life insurance business is geared to sell whole life insurance over term insurance.

Answer. In 1978, 52 percent of the ordinary life insurance purchase by individuals in the United States was term insurance. This is exclusive of group insurance (which is almost entirely term insurance). The life insurance business is committed to sell protection to meet the needs of its customers, most of whom need both immediate protection and long-term protection. For that reason, we sell very large amounts of both term insurance and whole life insurance. The long-run best interests of the companies and the agents lie in fitting policyholders with insurance policies that meet their needs. There is no valid reason for the business to favor one type of insurance over another. The impression given by the FTC staff report that the life insurance business favors whole life insurance over term insurance only reflects the fact that the life insurance business does not favor term insurance over whole life to the extent that the FTC staff does.

Question 4. One of the headlines that came out of the release of the staff report was, "FTC study indicated consumers losing money on life insurance." Another is "report on whole life insurance says buyers lose billions yearly." Is it true that people are losing all this money, and if so, who is getting it?

Answer. The FTC staff and accompanying press release produced the impression that people buying whole life insurance contracts were losing billions of dollars annually. No one has lost a cent. The loss cited in the press release and in the FTC staff report exists entirely in the erroneous calculation which developed a "rate of return" of 1.3 percent being credited by life insurance companies in 1977.

The "loss" calculated by the FTC staff was based on the idea that a reasonable tax-free rate of return in 1977 would have been 4 percent. The difference between 4 percent and the 1.3 percent invented by the FTC staff when applied to a base of $139.1 billion produced the imaginary loss of $3.7 billion reported in headlines.

As indicated in Mr. Taylor's testimony, a more correct calculation by the FTC staff would have resulted in a rate of return of between 5 and 6 percent. Using the test developed by the FTC staff that 4 percent would have been a reasonable tax-free rate of return, the conclusion would appear to be that the ordinary policyholders had substantial gains in 1977.

The whole discussion created by the FTC staff of "losses" (or gains) is irrelevant to disclosure or to cost comparison. This analysis of life insurance as an investment diverts people's attention from the reasons for which life insurance is bought and from the actual pricing practices of companies.

People who buy life insurance are paying for protection. Their cost will depend on the policy they choose, the company they buy it from and how long they keep the policy before dying or surrendering the contract. Any attempt to equate differences between the prices charged by different companies for various policies with investment gains or losses can only be confusing.

In short, the losses incorrectly cited by the FTC staff exist only in their analysis. No one is receiving this "lost money." The confusion of the FTC staff flows from their insistence on analyzing some life insurance policies as investment together with some incorrect assumptions made by the staff.

Question 5. Has the FTC report had any effect on the insurance-buying public? On sellers of other related products?

Answer. Because of the large number of companies and larger number of agents involved in the sale of life insurance products, it will be some time before we know how extensive the effect of the FTC report on the insurance buying public will be. We expect, however, judging from initial reports that many would-be purchasers of whole life insurance will instead purchase term insurance or pursue some other means of providing financial protection for their families. Moreover, as has already been mentioned, it is likely that a large number of policyholders will cash in their whole life policies to obtain the accrued cash values in an effort to achieve, in the

words of the FTC, "a better return on their investment." This may be disastrous for the families of those who die before obtaining term protection or who then find themselves unable to qualify for any other form of life insurance except at a very high price.

It is also clear that the FTC report, far from encouraging the purchase of term insurance alone, is being used by certain investment firms and individuals as an endorsement for the sale of a number of speculative products, many offering the possibility of high "returns" but lacking the guarantees associated with the life insurance product. The potential for abuse and irreparable financial harm is, therefore, very great. Unfortunately, the ill-effects of the FTC's misleading report will be felt long after the report itself is discredited and forgotten.

Question 6. What was your reaction to the recent GAO report on State regulation of insurance?

Answer. The GAO report was certainly not a ringing endorsement of state insurance regulation, nor was it an indictment. It goes without saying that any system of regulation can be improved, and state insurance regulation is no exception.

The overall tone of the report seemed to be that the critics of state regulation have overstated their case and that the mechanism for effective state regulation exists, although it needs work in some areas. It is also significant that the GAO did not call for federal involvement in insurance regulation.

The life insurance business favors continued state regulation of insurance, and we realize that if it is to be continued, it must be strong and effective. We are in agreement with a number of the GAO's suggestions for improving the state regulatory system, and we will do our utmost to work with the states and our member companies to achieve these improvements.

QUESTION OF THE COMMITTEE AND THE ANSWERS OF MR. TAYLOR

Question. Mr. Taylor, you stated that the overall rate of return is not a meaningful figure; that if "rate-of-return" is used you need to look at each policy not just an average rate. Could you comment on the importance of this distinction?

Answer. The phrase "rate-of-return" is used to mean different things in different parts of the FTC staff report. In one place the authors use the phrase to refer to the cost index for an individual life insurance policy produced by the Linton Yield calculations. This cost index provides an answer to the question, "How much would I have to earn on an investment over the next twenty years to do as well if, instead of buying this policy, I were to buy term insurance and invest the difference in premiums?"

The question is hypothetical in nature. The interest rate produced as an answer depends on the premium rates assumed for the imaginary term insurance considered to be purchased as an alternative. The imaginary investment will not be equal to the cash surrender values of the actual policy at any point except the ends of the period for which the index is being computed. Finally, the index is in the form of an interest rate, but it will not be the interest rate used by the company to calculate premiums nor that used in a dividend formula nor that credited by the company to its individual life insurance line of business.

The "rate-of-return" cost index developed by the Linton Yield calculation can be used to compare the prices of similar contracts for similar amounts of coverage. It will, except in the case of term insurance, produce very similar rankings of the prices of a group of policies to those produced by the interest-adjusted surrender cost index. The Linton Yield calculation is not recommended for term insurance since it produces very erratic results for policies without a cash value at the end of a period. Thus, for some policies, the "rate-of-return" that is a cost index produced by the Linton Yield calculation may be used to compare the prices of similar policies.

In contrast, the FTC staff report elsewhere used the phrase "rate-of-return" to describe an interest rate produced by the FTC staff from the annual financial reports of life insurance companies. This "rate-of-return" is produced by treating 90 percent of reserves plus 76 percent of dividends on deposit as a savings account. The increase in this "savings account" during 1977 was compared with the part of premiums collected during the year that exceeded dividends and benefits paid to policyholders during the year. From this amount, the FTC staff subtracted 150 percent of death claims, which they described as the cost of "pure insurance."

In my statement, I developed a number of reasons why their calculation produced an incorrect answer. But, whether the calculation produces a rate of 1.3 percent, 4 percent, 6 percent or more, it will not help an individual buyer select a policy or a company to buy the policy from. It does not give him any information about the

relative prices of two or more policies. It does not give a benchmark to compare the Linton Yield cost index of a particular policy with. It is not a measure of the interest rate any company used to set premiums or to determine dividends. Finally, it gives no measure of the investment returns actually credited by all companies to their individual life insurance line of business, let alone what may be credited in future years.

In summary, the only purpose we can see to the calculation that produced an "average rate-of-return" of 1.3 percent was to induce newspapers to print headlines that individual life insurance policyholders are losing billions of dollars each year. It certainly has nothing to do with disclosure or cost comparison.

The CHAIRMAN. Thank you very much. That concludes the hearings for today.

[Whereupon, at 11:50 a.m., the hearing was adjourned.]

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1979 GOV FTC STUDY OF LIFE INSURANCE COST DISCLOSURE - Cannon - 592p - bonknote

ADDITIONAL ARTICLES, LETTERS, AND STATEMENTS

THE INSURANCE FORUM,
Ellettsville, Ind., September 28, 1979.

ARTHUR A. WOOD, C.L.U.,
Rochester, N.Y.

DEAR MR. WOOD: I have read with considerable interest your letter to Senator Proxmire published in the September 1979 issue of Life Association News, and your articles in the July 19 and September 6 issues of the The Daily Record. I have a few questions.

First, have you read the FTC staff report itself? If so, did you read it before or after writing your July 19 article?

Yes—as contained in the House Commerce Committee's Report of Dec. 1978.

Second, in your July 19 article, you showed some figures comparing a $100,000 term policy with a $100,000 straight life policy. Would you please send me the full data from which your figures were developed, and also indicate the name of the "large mutual company."

See attached graph developed by Dilworth Brinton.

Third, in your July 19 article, you stated that only 1 percent of term insurance contracts result in death claims, and that less than 1 percent of all term insurance is still in force 15 years after the date of issue. Would you please indicate the source of these data.

From one of your fellow academicians—Prof. Art Williams of Penn State, writing in the "Journal of Risk and Insurance."

Fourth, in your July 19 article, you stated that permanent life insurance came into being in response to consumer demand for something better than term insurance. Would you please indicate the source of this statement.

From reading various histories of life insurance a good many years ago. I have neither the time nor the energy to track this down for you.

Fifth, in your July 19 article, you stated that full disclosure of all life insurance cost information already is mandated by the New York Insurance Department. Would you please send me a copy of the New York requirements.

You can get this as easily as I, Joe. Enclosed are a couple of "Statement of Policy Cost and Benefit Information" printouts we are required to deliver to all clients. Note the I/A Payment and I/A Surrender Cost Indices.

Sixth, in your September 6 article, you referred to a critical response by a local life underwriter defending the FTC report. Would you please send me a copy of this response, including any attachments that were included.

Enclosed.

Seventh, in your September 6 article, you referred to two comparisons made by an independent computer service—a minimum deposit comparison and a regular comparison. Would you please send me the full data from which your figures were developed, and also indicate the name of the company whose contracts were used in the comparisons.

Enclosed.

Thank you for your attention to this matter. For your general information, I am enclosing the September 1979 issue of the The Insurance Forum, which contains an article about the FTC staff report.

Sincerely yours,

JOSEPH M. BELTH, *Editor.*

ARTHUR A. WOOD AND ASSOCIATES,
TOTAL FINANCIAL PLANNING,
Rochester, N.Y., October 9, 1979.

Mr. JOSEPH M. BELTH,
Editor, The Insurance Forum, Ellettsville, Ind.

DEAR JOE: Enclosed is your letter of September 28, 1979, along with my response to each of the questions you have raised.

Turnabout being fair play, may I ask you some questions? To begin with, do you, yourself, accept the premise that there is such a thing as a "savings element" in a permanent life insurance contract? If so, would you share with us your source authority—such as a single life insurance contract which so much as alludes to a "savings element?"

In your article, "FTC Drops an Atomic Bomb," it is not clear whether you are attacking permanent life insurance per se as a savings vehicle—or attacking marketing practices within the life insurance industry which promote life insurance as a savings vehicle. You quote a work done in 1972, based on an ACLI publication dated 1962, which advocated the marketing of insurance in this manner. Question: does this establish the existence of a savings elements? Or does it simply establish a 1962 marketing strategy?

If it is your contention that marketing permanent life insurance as a savings vehicle is improper, you will get no argument, from this quarter. You may be flogging a dead horse, however, because in today's fast changing marketplace there is a clearly discernible movement away from the old "savings plan" approach, toward total needs planning and the "ultimate death claim" concept. You're really digging into the past if you have to dredge up the ghosts of S. S. Heubner and Albert Linton. In an imperfect industry, in an imperfect world, progress *is* being made.

Marketing life insurance as a savings vehicle, however, is a completely separate issue, and should be addressed separately. The fact remains that there is no savings element in a permanent contract, and life insurance is not a savings medium. This holds true in spite of what defenders and critics alike may allege. Nothing can change this unalterable fact. Calling the sky green or the grass blue doen't make it so—no matter who says it, or how often it is said. An increasing cash reserve for the purpose of maintaining a level premium does not a savings element make.

Any way you slice it, the underlying premise of the FTC Staff Report is invalid—axiomatically rendering the entire study invalid. This is why Michael Pertschuk and Albert Kramer are so richly deserving of the Golden Fleece Award.

It is disturbing, to say the least, to have anyone in a position of influence and authority (particularly those who speak in the name of the United States Government) perpetuating a fundamental misconception of what permanent life insurance is.

What about the effects of the FTC Report—the shock waves created by this "Atomic Bomb," as you characterize it? Many local underwriters report that they have had clients surrender policies as a direct result of the FTC Report. The usual accompaning explanation: "The Government says the insurance company is ripping me off." Although this hardly represents a scientific sampling, may it not be assumed that this sort of thing is going on throughout the land?

As you indicate in your article, the authors of the FTC Report were careful to point out that they "* * * are not recommending the wholesale replacement of cash-value insurance policies." Yet, how else could it be interpreted from the sensational headlines and newspaper accounts—which contained no such caveat? The unthinking consumer can glean but one thing from the media treatment: "My Government says permanent life insurance is a bad deal."

Question: why do so may people of obvious means and financial acumen (not to mention the finest counsel) buy million and multimillion dollar permanent life insurance policies, if it is such an unintelligent thing to do? Is it the purpose of the FTC to make permanent life insurance the exclusive preserve of the rich and financially sophisticated—but suppress its use by the unsophisticated masses, when their need is just as great if not greater?

All this is not to impugn the integrity of Messrs. Pertschuk and Kramer. Misguided though they may be, they are in all probability well intentioned. It is their judgment that is subject to question. Perhaps they were swayed by an overzealous staff so eager to prove a preconceived notion, that no one ever thought to first verify the existence of a "savings element" in a permanent life insurance contract. What is inexcusable, however, is that Pertschuk and Kramer failed to ask their staff the right questions—or to bring someone in who could ask the right questions. Instead, Don Quixote-like, they charged off on a Holy Quest, only to end up tilting at windmills.

There is some indication that the FTC rebuffed and/or ignored attempts at input by the "expert community" (so-called by Pertschuk)—including its own $155,000 commissioned study by Prof. Jacob Jacoby of Purdue (see "Life Association News," September 1979). Enlisting the aid of such expert counsel beforehand (and heeding it), might well have spared them the acute embarassment of being caught with a flawed premise, and, as a consequence, a completely meaningless report.

You have castigated the insurance industry for its feeble response on July 11th to the "Atomic Bomb" of July 10th. The day after Pearl Harbor, the United States did not have much of a response, either, other than to acknowledge that war had been declared on it. The industry's response since then, however, has been for the most part extremely effective—in spite of some segments which blindly swallowed the FTC bait on the "savings element" fallacy.

You're aware, of course, of Congressman James Collins vigorous dissent in the House Subcommittee Report of December 1978, which he termed, ". . . the height of arrogance." He, as so many others have been was dismayed by, ". . . the bias which runs through the whole report."

Let's see if we can't agree on something, Joe. Do you have any quarrel with the assessment that permanent life insurance is neither a good investment nor a poor investment, but rather a financial tool—a tool designed to accomplish certain financial objectives more economically than any other financial tool? And that it is nothing more, nothing less? And the same with term?

Neither term nor permanent needs its apologists. Each has its own clearly defined function. Neither is better than the other for the purpose for which each was designed. Why not, then, let them stand on their own merit—without introducing the phony "invest the difference" issue? It only serves to further confuse an already confused public.

Congressman Collins' prediction that, "The FTC meddling will not solve problems; it will only compound them," has already come to pass.

Sincerely,

ARTHUR A. WOOD.

THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS,
LAW AND GOVERNMENT AFFAIRS DEPARTMENT,
Washington, D.C., October 23, 1979.

Mr. MIKE MULLEN,
Committee on Commerce, Russell Senate Office Building, Washington, D.C.

DEAR MIKE: Enclosed are three sets of copies of the advertisements [1] and newspaper accounts illustrating the point that our witness, Rice Brown, was making before the Commerce Committee last week. The point is that the FTC staff report and press releases are unfactual and distorted and these distortions have been backed up by the press and others for the purpose of unfairly characterizing the majority of the insurance industry.

If I can be of assistance to you in the future, don't hesitate to call.

Sincerely,

MICHAEL L. KERLEY,
Counsel, Government Affairs.

Enclosures.

REPORT ON WHOLE-LIFE INSURANCE SAYS BUYERS LOSE BILLIONS YEARLY

(By A. O. Sulzberger, Jr.)

WASHINGTON, July 10—Buyers of whole-life insurance, the most popular form of insurance sold in this country, are losing "billions of dollars a year" because insurance companies are not providing the kind of information needed for consumers to make intelligent decisions, a report released today by the Federal Trade Commission concludes.

This kind of insurance, which offers holders both a death benefit and a savings element, provided an average return of just 1.3 percent in 1977, the report said. This is well below what consumers could have enjoyed had they invested their money in other areas, such as savings accounts or Government bonds.

"I think it fair to say that no other product in our economy that is purchased by so many people for so much money is bought with so little understanding of its actual or comparative value," Michael Pertschuk, chairman of the commission, told the Senate Committee on Commerce, Science and Transportation in testimony today.

The staff report, a result of a two-and-a-half year investigation, made only recommendations and is not binding on any authority. It was approved by Mr. Pertschuk. It came under immediate attack from the industry, which is in the main regulated by the states, not the Federal Government.

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[1] Only a sample was printed and the others are in the Committee files.

ANALYSIS CALLED INACCURATE

"The F.T.C. claims are based on inaccurate analysis," a spokesman for the American Council of Life Insurance said. He challenged a number of the report's findings, including the rate of return, which he said was currently from 5 to 6 percent.

Whole-life insurance policies, held by seven out of every eight United States families, provide a distinctive American form of savings. The commission estimates that at the end of 1977 consumer savings through the holding of ordinary life insurance policies totaled $140 billion, roughly equal to that held in passbook savings accounts.

In fact, the commission report said, while almost $34 billion flowed into life insurance companies last year, only $5 billion was paid out in death benefits.

Industry spokesmen said that because of the nature of their business it could not be directly compared with other measures of savings.

The staff report, which disagrees with this argument, went on to break down each premium dollar into its end uses. The report found that 15 cents of each dollar went to death benefits, 30 cents went to overhead costs such as expenses and profits, and the remaining 55 cents was used both to finance savings withdrawals and increase savings buildings.

These figures are also disputed by the industry, which says that only 21 cents, not 30 cents, is used for expenses.

Mr. Pertschuk told the Senate committee that there was no indication that the insurance companies were making excess profits from these insurance policies.

The report also made clear that the 1.3 percent figure was an average and that some insurance companies paid as high as 9 percent, depending on the type of policy and its age. Many policies sold in the 1950's and 1960's earn an "extraordinarily low rate of return," which brings down the industrywide average. The report does not make public actual company names or their rates of return.

Among the recommendations in the report are the following:

Cost information should be disclosed before purchase.

The average annual rate of return should be disclosed for such insurance.

A single index should be used to compare similar policies, rather than the six indexes now called for by the National Association of Insurance Commissioners.

Price competition in the industry was so ineffective, the report said, that companies paying 20-year rates of return of two percent or less competed successfully against companies offering 4 to 6 percent rates of return.

[From the Operating Engineer, September 1979]

BUYING LIFE INSURANCE? CHEAPER MAY BE BETTER

Over the years there have been a number of consumer guides for buying life insurance but still, today, comparatively few Americans have a clear understanding of the economics of the venture they are entering.

Recently, two reports have been issued which should be labeled "must reading" for every life insurance consumer. These reports are significant because they represent the consumer and not the industry.

One is a 185-page report by the staff of the Federal Trade Commission entitled "Life Insurance Cost Disclosure." The second is a 171-page book, "The Life Insurance Conspiracy." Its three authors are Peter Spielman, a free-lance writer, Aaron Zelman, an independent insurance agent in Milwaukee who is active in consumerism, and Dean Sharp, an attorney and economist who worked with the late Senator Philip Hart (D-Mich.) as assistant counsel of the Senate Anti-Trust and Monopoly Subcommittee.

LOSING BILLIONS OF DOLLARS

Both studies reach the same basic conclusion: Americans are losing billions of dollars each year by purchasing "whole life" or "cash-value insurance policies.

The FTC study stresses that as a result of rates of return on these policies averaging between 1 percent and 2 percent insurance buyers would do much better by purchasing far less expensive term insurance and putting the additional money into other investments.

The FTC report, which took two-and-a-half years to prepare, states that "price competition is so ineffective in the life insurance industry that companies paying 20-year rates of return of 2 percent or less compete successfully against companies that pay 4 percent or 6 percent. This disparity should be contrasted with the banking

industry, where differences of a quarter of a percent are considered to be competitively crucial."

The FTC analysis said that if the insurance industry paid a mere 4 percent interest on policyholders savings, "an additional $3.7 billion would have accrued to consumers" holding whole life policies in 1977 alone.

We are not talking about small sums of money. Life insurance firms held $140 billion in consumer savings at the end of 1977, about the same amount held in all passbook savings accounts. The report said that at the close of 1977, the industry had total assets of $350 billion.

JUST 15 PERCENT FOR BENEFITS

The FTC study said that while almost $34 billion flowed into life insurance companies last year, only $5 billion was paid out in death benefits. Out of each premium dollar, it found that 15 cents went to death benefits, 30 cents went to overhead costs such as expenses and profits and the remaining 55 cents was used to finance savings and withdrawals and increase savings buildups.

"The Life Insurance Conspiracy" is unique in that it depicits that great detective, Sherlock Holmes, and his companion Watson, uncovering the "conspiracy" in the Holmesian technique.

They offer a number of suggestions to life insurance buyers, including:

The whole point of buying life insurance is to provide financial security in case of unexpected death; yet the typical insurance agent usually persuades his client to buy a cash-value type of life policy which pay much, much smaller death benefits than term insurance costing the same amount.

The cash-value policy doesn't pay a large enough death benefit to be worthwhile. It may pay the cost of burial, but what will the family live on after that?

"Cash-surrender" life policies don't earn enough even to overcome inflation.

If you examine the fine print in your whole-life insurance policy, you may find a clause informing you that the company can make you wait up to six months before you receive your cash values.

If you die while insured by a whole-life policy, those cash values disappear. The company will pay your beneficary only the face amount of the policy; no extra cash values will be awarded.

The authors suggest that you examine your own insurance policy, if you have one, and see whether you've been sold a cash-value policy. The chances are that you have since 75 percent of life insurance written in America is cash value. The policies can be cancelled and new ones written.

There are various term policies from which you can select. The authors recommend annual renewable level term for most consumers, for many reasons, including the fact that it can keep you current with inflation.

The Spielman-Zelman-Sharp book is published by Simon & Schuster, Simon & Schuster Building, Rockeller Center, 1230 Avenue of the Americas, New York, N.Y. 10020. The FTC report will be available through the Government Printing Office, Washington, D.C., this month. The price has not yet been set.

[From the Washington Post, July 12, 1979]

INSURANCE HIT—WHOLE-LIFE POLICIES CRITICIZED FOR LOW INTEREST ON SAVINGS

(By Larry Kramer)

Consumers who purchase and hold whole-life insurance policies are losing billions of dollars each year because the average interest rate paid on savings associated with those policies is about 1.3 percent, according to a Federal Trade Commission study released yesterday.

The 185-page report criticizes the insurance industry for what the FTC says is a failure to inform customers about what they are buying when they purchase life insurance, a situation the agency claims has led to a complete lack of competition.

Whole life, also known as ordinary life or straight life, is the most commonly held policy. It remains in force as long as premiums are paid and offers full benefits upon the policyholder's death. In addition, savings accrued can be collected by the customer by surrendering the policy before death.

FTC Chairman Michael Pertschuk made the study public yesterday at a Senate Commerce Committee hearing. He testified that "it is fair to say that no other product in our economy that is purchased by so many people for so much money is bought with so little understanding of its actual or comparative value."

The FTC report, which took 2½ years to prepare, stated that "price competition is so ineffective in the life insurance industry that companies paying 20-year rates of return of 2 percent or less compete successfully against companies that pay 4 percent or 6 percent. This disparity should be contrasted with the banking industry, where differences of a quarter of a percent are considered to be competitively crucial."

Pertschuk said the amount of interest earned on consumer savings held by insurance companies is extremely important, since consumers are saving about as much through life insurance policies as through savings and loan passbook accounts. In 1977, the FTC staff found, consumer savings held by insurance companies totaled more than $140 billion.

Responding, the American Council of Life Insurance attacked the FTC study as "simplistic," and said the 1.3 percent figure "is not a measure of what is currently being credited to policy holders. Typically, companies today are basing their dividends and premium rates on interest rates of 5 to 6 percent."

The life insurance industry has long argued that it is unfair to separate the savings portion of a life insurance policy from the protection aspect, because the two are intertwined as a unitary contract, and cash benefits are only an incidental byproduct of having a policy.

Pertshuck disagreed, saying, the indisputable fact of the matter is that regardless of how the savings element is described, it is hardly incidental. The savings element accounts for three or four times as much of the premium dollar as does the insurance protection, and this has made the life insurance industry a major repository of consumer savings."

The FTC analysis says that if the insurance industry paid a mere 4 percent interest on policyholders' savings—which the staff said would be "competitive" for the tax-free income—"an additional $3.7 billion would have accrued to consumers" holding whole-life policies in 1977 alone.

In 1977 alone, the report noted, Americans paid $24.2 million in premiums on 140 million whole-life insurance policies. The outlay represented about 1.9 percent of all personal income.

In return, those policy holders received two benefits: death protection and a form of savings.

The FTC report states, for the first time, that 55 cents out of every whole-life premium dollar goes into "what are essentially savings accounts" for the policy holders, while only 15 cents goes to paying claims and 30 cents goes to industry overhead costs and profits.

But ACLI, the industry trade group, has a different breakdown. It says 79 cents of every premium dollar taken in by life insurance companies is paid out in benefits and additions to funds for policy holders and beneficiaries, while only 16 cents goes to operating expenses, 4 cents is paid in taxes and only 1 cent is left for profits.

The FTC staff said its information was based on the annual statements that more than 1,700 life insurance companies filed with various state commissions as well as on data supplied by the ACLI trade group itself.

There are also "severe but unannounced penalties for early withdrawal of the savings elements of life insurance policies," the FTC says. These penalties "do not merely reduce the return earned on the principal, but often reduce and sometimes even eliminate the principal itself," the report states.

The FTC staff expressed particular concern about policies sold in the 1960s and earlier. Return on those policies is so low, the staff said, that "a great many policy holders . . . would be well-advised to surrender their whole-life policies and purchase new ones."

The states have primary responsibility for regulating the life insurance industry. The FTC urges, among other changes:

Disclosure of cost information before a prospective purchaser signs an application for a policy, rather than with the policy delivery as proposed earlier by the National Association of Insurance Commissioners.

Disclosure of the average annual rate of return for all cash value insurance and annuity policies so that different types of policies can be compared.

WHY IS DREYFUS NOW OFFERING INSURANCE?

Inflation is forcing all of us to use every dollar wisely. It is important to buy carefully and selectively, especially financial services. That is why Dreyfus has arranged with Beneficial National Life Insurance Company to offer term life insurance to its shareholders at surprisingly low rates. With the much smaller premi-

ums, the money you save can be invested in income-producing investments, or as you see fit.

Life insurance policies have lost half their face value in purchasing power in the last 10 years, according to the Bureau of Labor Statistics. As a result, even the most coverage-conscious people are finding themselves under-insured. Term life is "pure" protection, designed to provide maximum coverage at minimal cost. It makes the most sense and costs the least. Enclosed is an article reprinted from The New York Times on July 11, 1979 indicating the importance of term life insurance. The Dreyfus Group Life Plan offers premium rates that are unusually low:

SCHEDULE OF GROUP PREMIUM RATES—CHOOSE THE PLAN THAT BEST MEETS YOUR NEEDS

[All premiums are semi-annual]

Age last birthday	Life insurance only		Life insurance with equal amounts of accidental death and dismemberment insurance	
	Plan 1 $25,000	Plan 2 $50,000	Plan 3 $25,000 Life and $25,000 AD&D $50,000 in total	Plan 4 $50,000 Life, $50,000 AD&D $100,000 in total
Under 20	$21.79	$43.58	$30.74	$61.47
20-24	24.82	49.63	33.76	67.51
25-29	26.20	52.40	35.15	70.29
30-34	28.72	57.44	37.66	75.32
35-39	36.78	73.56	45.72	91.44
40-44	54.29	108.57	63.23	126.46
45-49	84.01	168.02	92.96	185.91
50-54	130.74	261.48	139.68	279.36
55-59	203.54	407.08	212.48	424.96
60-64	306.06	612.12	315.01	630.01
65-69[1]	463.50	927.00	472.44	944.88

[1] Renewal only. Sixty-four is maximum age to begin coverage.

Note.—Rates will increase as you enter each age category. The rates are subject to adjustment, upward or downward, depending upon overall claims experience for the group.

If you would like to learn more about The Dreyfus Group Life Plan, simply return this form in the enclosed envelope. No one will call you.

COSMOPOLITAN MARKETING & CO., INC.—TAX EXEMPT INVESTMENTS AND LIFE INSURANCE

ARIZONA LIFE AGENTS

Are you fighting to make a living with a Life Company? At 55 or even 85 percent it is tough! On the average, we pay 116 percent First Year.

WANTED—LIFE INSURANCE AGENTS—REWARDS

171 percent first year graded life commission schedule; daily advances; annualized commission financing—80 percent; all commissions vested; no charge backs for lapses; cash contests; stock bonus plan; appointments set for you; all a.m. best rated companies; the most competitive life products; term or ordinary; commissionable tax exempt annuities at 9 percent interest; complete product and sales training; prestigious office space; secretarial services; one meeting weekly; complimentary lunch on meeting day; convention trips; call for confidential interview or just stop by and visit.

Ruben Villegas Loera, Vice President * * * prospective brokers also welcome.

RUBEN VILLEGAS LOERA.

Has your present life insurance company or agent, in their pretense to "Serve your interests" in such a "Benevolent and Ethical" manner ever told you in plain English—Free from Insurance Jargon—the following facts?

(1) When the insurance company pays your beneficiary the life insurance face amount, it pockets your cash value savings!

(2) That the total annual cost of your life insurance is the premiums you pay plus the interest you have lost on the cash value savings!

(3) That the actual amount of insurance is not the face amount of the policy, but the face of the policy less the cash value savings, which the company keeps at your death!

(4) That some of the more progressive companies are now offering pure protection policies—wherein the insurance and the savings are kept separate; when you die, your beneficiary will get the insurance plus the savings account with interest!

(5) That the pure protection plan would pay your agent only about one-tenth as much commission as the old plan, which your agent urges you to swallow—hook, line and sinker!

(6) Did he tell you that it was perfectly "ethical" for him to change any pure protection policy you might have to a much higher cost cash value policy, and that they would pay him full commission on the new policy!

(7) Did your agent tell you that some of the old school companies—whom the Hughes and Amrstrong investigation proved to be guilty of the rankest graft and robbery ever imposed on the public are now spending millions of the policy-holders' funds each year for every conceivable propaganda, including ex-presidents of insurance companies as radio speakers, for one purpose only—to keep a firm hold on your cash value savings, because it definitely becomes theirs at your death!

QUOTES FROM THOSE IN THE KNOW ABOUT THE PRICE OF LIFE INSURANCE

The United States Congress—"Most life insurance sold in America is deception, consumer fraud, misrepresentation, gross overcharges, planned confusion, and a national scandal."

Senator Phillip A. Hart (Democrat—Michigan)—"Policyholders are wasting millions upon millions of dollars each year."

Dr. J. E. Pawlick, Insurance Professor at Pennsylvaina State University—"97 percent of Americans are being greatly overcharged because companies and salesmen keep from the public the truth about life insurance prices."

Cosmopolitan Marketing—"Don't throw good money after bad! Regardless of how long you have your policy you are still being overcharged."

Wall Street Journal by Stanford N. Sesser—"Millions of Americans are unwittingly paying more than necessary for life insurance.

"If people knew how to compare prices, they could buy the same insurance protection they now have for less money—perhaps half.

"Insurance rates are complicated because pure life insurance is only a part of what's offered by most policies. Besides insurance protection, most policies have savings and so-called dividend provisions.

"Free" protection?

"In their sales pitches, insurance agents promote such policies as instruments for both protection and savings. They compute the cost by what's known as the 'traditional method,' they subtract the sum of the policy's 20-year cash value plus all anticipated dividends from the total 20-year premiums. Often the cash value plus dividends equal total premiums, prompting agents to claim that the insurance protection is 'free.'

"But these calculations omit a number of factors, most importantly the interest that the policyholder forgoes by giving the company the use of his money.

"Only one type of life insurance costs exactly what it appears to cost, this is term insurance, often known as 'pure protection.' The policy buyers almost never hear about term coverage from their insurance agents. Insurance men prefer to promote 'whole life' or 'straight life' coverage, which builds up an increasing cash value as premiums are paid.

"Insurance men say that policyholders like the 'forced savings' feature of whole life insurance; buyers of whole life insurance fear that if they bought low cost term insurance they would spend the difference rather than save or invest it.

"In a three-part series advising consumers on insurance, the magazine 'Consumer Reports' stunned members of the industry by flatly recommending the purchase of low cost term life insurance.

"The 'Consumer Reports' magazine charges that most families are under insured because they're persuaded by agents to buy expensive whole life insurance * * * 'The agent sells a confusing array of wares,' says Consumer Reports, 'and he seems to have a habit of keeping his pure protection (term) policies out of sight. A reason: Commissions on whole life policies average 55 percent of the first-year premium and 5 percent for the next nine years. But on term insurance, which is much less expensive to begin with, they're only 35 percent the first year and 5 percent the next four years.'

" 'The agent is likely to believe that the only form of insurance is straight life,' says the president of a large Midwest insurance company. ' That's something he's been indoctrinated with.' "

F.T.C.—"The Federal Trade Commission wants life insurance companies to tell you what you pay and what you get.

"Whole life insurance is often sold as a form of forced savings, but it shouldn't be, Federal Trade Commission official Albert H. Kramer told a House panel last month. 'Virtually all whole life policies have negative rates of return, because administrative and selling expenses are loaded into the early years.' Kramer also told the panel that the cost of essentially the same coverage can vary by more than 200 percent from company to company. The FTC wants insurance companies to supply customers with information that would allow them to compare the true costs of different policies."

Congressional Hearings—"The subject was covered in congressional hearings, held in 1973-74 by the late Senator Phillip Hart, Democrat—Michigan. Hart's hearings brought out testimony that costs for similar policies vary by up to 300 percent.

"Such disparities would mean that a bad life insurance buy will cost the purchaser hundreds or even thousands of dollars extra over the life of the policy.

"Among the remedies proposed at the hearings was one advanced by Pennsylvania's insurance commissioner Herbert S. Denenberg, who flashed a sign bearing the Latin slogan (translated as) 'The consumer has been screwed long enough'. Denenberg proposed an outright ban on the selling of cash-value whole life insurance."

Herbert S. Denenberg, Commissioner of Insurance, State of Pennsylvania—"The verdict of consumerism is likely to make cash value whole life insurance illegal." At a U.S. government hearing he urged congress to ban cash value whole life insurance.

Ralph Nader—Leading Consumer Advocate—"For almost 170 years, the life insurance industry has been a smug sacred cow feeding the public a steady line of bull."

Washington (AP)—"A yet-to-be released federal buyers' guide *warns against* signing up for the most common type of life insurance—death benefits plus a savings plan called whole life or straight life."

[From the Arizona Republic, July 11, 1979]

Insurance Plans Yield Low Return, Study Finds

Washington—The most commonly held life insurance policy is a bad buy from an investment standpoint, but most Americans don't know it, the Federal Trade Commission asserted Tuesday.

In a report culminating 2½ years of study, the commission said "whole-life" policies, the type most commonly held, yield an average return of only 1.3 percent.

That compares to bank accounts that usually pay at least 5 percent interest and bonds that often yield 9 percent.

The FTC focused on the whole-life policy which combines payments on death with savings the consumer can claim by surrendering the policy.

In revealing the findings to the Senate Commerce Committee, Michael Pertschuk, FTC chairman, said few consumers know the rate of return on their whole-life policies.

"No other product in our economy that is purchased by so many people for so much money is bought with so little understanding of its actual or comparative value," he testified.

The American Council of Life Insurance issued a statement after the hearing, saying, "We simply do not understand how the FTC arrived at an average rate of return of 1.3 percent for all whole-life policies. Their calculation is not a measure of what is currently being credited to policy holders. Typically, companies today are basing their dividends and premium rates on interest rates of 5 to 6 percent."

The industry group also disputed the government's assertion that consumers lack important information about policies. "We do not believe life insurance buyers are either as confused or as ill-informed as the FTC claims," the group said.

It said life insurance prices have been decreasing steadily, something Pertschuk attributed to higher interest rates on investments by the companies. The industry group, however, said the price reductions "prove that competition is at work."

Whole-life contrasts with term policies, which provide death benefits at far lower premium rates but generally have no savings feature.

The FTC staff said its calculation of an industry-wide average return of 1.3 percent is the first such statistic. It is likely to fuel more criticism of whole-life policies.

The report said consumers annually spend more than $30 billion on whole-life premiums, with much of that going into the savings feature.

"One would imagine that one of the first things that many consumers would want to know about their life insurance, like any other savings medium, is "what interest rate will I be getting,"" Pertschuk said.

"In fact, however, such information is simply not now available either to consumers or to life insurance agents, except perhaps for those few fortunate enough to have mastered courses in both actuarial science and computer programming," he said.

[From the Phoenix Gazette, July 10, 1979]

POOR INVESTMENT—FEDERAL SURVEY BLASTS LIFE INSURANCE RETURNS

WASHINGTON (UPI)—Americans have put $141 billion of their savings into a form of life insurance which may earn only 1 to 2 percent and cost billions of dollars in lost earnings, the Federal Trade Commission said today.

"I think it fair to say that no other product in our economy that is purchased by so many people for so much money is bought with so little understanding of its actual or comparative value," said FTC Chairman Michael Perstschuk.

FTC officials said the 1-2 percent earnings estimate for whole life or cash value policies—well below the inflation rate—is the first ever calculated for the industry.

By contrast, money put in savings and loan passbooks earns from 5 to 5.25 percent, Treasury bonds up to 7.6 percent and some corporate bonds in excess of 8 percent.

The figures are for those individually purchased policies, often touted as retirement investments, which the owner may cash in to receive the value of his savings.

They account for the vast majority of non-group policies sold. Americans paid $24.2 billion in premiums in 1977 for 140 million individual policies.

Term insurance, the type which strictly covers death benefit protection and contains no savings, accounts for only about 16 percent of all policies written and is not involved in the earnings dispute.

"The potential for consumer loss can be staggering," the report said, even taking into account that the earnings are generally tax free and there are other benefits—such as low interest loans—connected with insurance.

The report, along with Pertschuk's testimony, was prepared for a Senate Commerce Committee hearing. It called the rate of return on savings in life insurance "extraordinarily low."

The staff report recommended the states, which have the prime responsibility for policing the insurance industry, require agents to disclose cost information and the annual rate of return on the policy before the consumer signs it.

STATE FARM INSURANCE CO.,
Logan, Utah, September 25, 1979.

Mr. RICE E. BROWN,
Chairman, Federal Law and Legislation Committee, c/o NALU, Washington, D.C.

DEAR RICE: You recently asked for an example or two of how the FTC report has affected life insurance in our area. Since I am the local president it has been a real detriment to our situation since I spend probably an hour a day talking to other agents in addition to an hour or two a day trying to let people know that whole life is not a rip off as FTC had indicated. The most recent case is a person by the name of Gary Fawcett had taken a $40,000 whole life policy and added a rider on his wife and children and a week after I had written it he came in saying that he had read this report and wanted to change that to term insurance. I had him read some literature, but the information the government had given out in the FTC report so poisoned his mind that even after studying our brochures, etc., he still wanted to change to term insurance which was certainly a detriment to his future. He's only 22 years of age and could have had a very sound program for the rest of his life for $30.00 a month and instead he changed to term insurance is paying $20.00 with the idea that when he is 50 or 60 years old he'll hardly be able to afford it and certainly after age 65 will not have coverage which is a real detriment to his future and the future of his family.

This is only one example but I've had eight or ten of my policyholders who have been with the whole life program and are getting more back than they are putting in and yet wonder if they should change to term insurance five and ten years after,

so it's a very far reaching situation and I have almost a daily request of different people for changing whole life to term policies. I have fifteen to twenty million of life insurance on the books and therefore this is getting to be a real time consuming source of irritation having to resell these policies when I could be out promoting the industry and helping other people. I think that's one of the saddest parts—the extra time it taks to resell people, particularly on a whim of the Federal Trade Commission's report. Thanks for your interest. I hope you can help us on this.

Yours very truly,

WILLIAM L. RICH.

P.S.—It also occurred to me of a case on a DeVerle Hoth who, for five years, has been paying about $1,900 into a $100,000 whole life policy and this fifth year got more back by $80 than he put into it and yet people quoting the FTC report and showing the value of term insurance had nearly gotten him to give up all he had and in fact the agent of another company called our company and got a cash value return to buy term insurance and invest in another situation even as great a return as we had given. It took about three hours with that customer to make him realize that this was a serious mistake. But, all of this was triggered by the FTC report and the actual return on his money was more like 20 percent instead of a 1.3 percent as discussed in their report. So, it would have been a real injustice to have a customer like that go around thinking that term insurance was a better way to go as the FTC had indicated.

NEW ENGLAND MUTUAL LIFE INSURANCE CO.,
Cleveland, Ohio, October 2, 1979.

Mr. RICE E. BROWN,
Chairman, Federal Law and Legislation Committee, National Association of Life Underwriters, Washington, D.C.

DEAR MR. BROWN: In your letter of September 20, 1979 to Presidents of Local Associations, you asked for information relative to adverse effects that the FTC report may have had on an individual basis.

I have a client in Cleveland, a corporation to be specific, where we have $1,000,000 of insurance on two people. We also have about $780,000 of life insurance in a defined contribution pension plan. The million dollars of insurance that they have that is owned by the corporation is $500,000 on each, made up of $150,000 of OL and $350,000 of term to age 70.

Sometime early in August I received a call from one of the principals of this company asking many questions and stating at the bottom line that they were thinking about cancelling this insurance because it didn't appear to be the right thing for them to have. I asked on the basis of what information they had decided this, and the FTC report was being used by another agent from ITT Life, trying to replace the insurance that we had, not only corporately, but also with the pension plan.

Then comes along the Phil Donahue Show which one of the partners' wives happened to see, and while discussing it with him, brought up the fact that the FTC report was leaned on very heavily, on that show, and this only reinforced their position. I happened to see that show myself, and made an audio recording of it. Subsequent conversations with my client included my invitation to have the other agent, together with their attorney and accountant, meet with me, and we would have it out relative to what they should do with the pension permanent life insurance, as well as the permanent portion of the existing corporate insurance.

The other agent refused to show up, but in the conversation with my clients, the FTC report came up again, on what a rip off whole life insurance was, and that they wanted to do something about it. As a matter of fact, one of them said he had written for a transcript of the Phil Donahue Show. I said to him that I had taped the show and would come over and take as much time as necessary to go through the tape and answer whatever questions they had. I did so; took about 2½ hours with them, and answered their questions. They understand now and are back in the camp relative to keeping their existing permanent life insurance corporately, as well as the pension life insurance.

I have spent approximately 12-15 hours on this matter with them, both in research time and in front of the clients, and discussing the matter with their accountant and attorney. Had the FTC report not come out, or come out in such a

biased way, I'm sure that I would have spent very little time on the subject. I trust this information will be useful.

Sincerely yours,

DAVID W. SMITH,
General Agent.

HOUSTON, TEX., *August 29, 1979.*

LAWRENCE G. KATZ,
Houston, Tex.

DEAR LAWRENCE: Thank you so much for the insurance companies position regarding term versus ordinary insurance.

Since I have such a firm belief and confidence in the accuracy of my Federal Government's published reports, I can hardly be interested in converting any of my term to life until I absolutely have to.

However, I have read your viewpoint as well as the enclosed article with interest, but I am unimpressed.

Cordially yours,

JACK J. TURK.

STATE FARM INSURANCE CO.,
Washington, D.C., September 25, 1979.

DEAR MR. BROWN: A client of 20 years, with policies as old as 23 years, came into my office to cancel four Whole Life policies with a combined death benefit of $35,000. He also stated that he was not going to renew the $50,000 Whole Life policy that I had written for him four months previous. He wanted me to replace the policies with a $100,000 Annual Renewable Term policy because of the FTC report.

His exact words were, "I'm sure you're familiar with the FTC report." He was adamant and stated that if I didn't sell him the $100,000 Annual Renewable Term policy he would buy it elsewhere. The newer of the four policies was four years and the oldest 23 years. The net cost of protection the previous year of the $35,000 protection was $4.00. I arrived at this figure by subtracting from his annual premium the annual cash values and the current annual dividends. I did not include the interest on the accumulated dividends.

When the man realized that he would have to pay less than $4.00 annually for $35,000 term to replace the whole life policies that he wanted to cash in, in order for it to be a better buy, he changed his mind.

I emphasize that this is a client of long standing, a neighbor and an occasional golf partner. I was amazed that the FTC report had such an impact on him.

Sincerely,

FRANK B. BONNER,
Lorain County NALU President.

FRATERNALIFE INSURANCE,
AID ASSOCIATION FOR LUTHERANS,
Wausau, Wis., October 2, 1979.

Mr. JACK BOBO,
Executive Secretary, National Association of Life Underwriters, Washington, D.C.

DEAR JACK: Enclosed is an advertisement which appeared in the Wausau Daily Herald. It was my opinion, after attending the Detroit Convention, that the FTC Report does not endorse any particular kind of insurance. If I am correct, I would appreciate having you send me specific material with which we could rebut this Ad, and I also would appreciate a suggestion as to an advertisement that our local association could run.

Thanks much for your help.

Personal regards,

Sincerely yours,

ERNST A. HEINECKE,
National Committeeman WVALU.

According to a recent Federal Trade Commission report on Life Insurance, the consensus is that—Term Life Insurance Is A Good Buy!—As an Independent Insur-

ance Agency we will shop your Term Life Insurance needs with over 20 Life Insurance Companies to obtain this coverage at low, low rates.—Call One of Our Agents for a Quote * * *.

HARAWAY, HIBBARD & ASSOCIATES,
Bethesda, Md., October 11, 1979.

Mr. RICE E. BROWN,
Chairman Federal Law and Legislation Committee, National Association of Life Underwriters, Washington, D.C.

DEAR MR. BROWN: Thank you for your inquiry as to the impact of the publicity surrounding the FTC report on life insurance cost disclosure and related matters.

I can cite two examples from personal experience where the publicity contributed to significant insurance decisions. In both cases the result was disadvantageous to the client.

In the first case a policy had been proposed to accomplish two objectives, first to provide additional needed life insurance currently, and second to make unnecessary the election of a reduced pension at the mans retirement that his wife would receive a portion of his pension in the event of his death. The policy at the time of retirement would have been fully paid for and would have provided the needed additional financial security and the man would have been able to take the full pension. However, because of the adverse publicity surrounding the FTC report he decided to take no action at this time.

The second case was even more damaging. A $50,000 Whole Life policy which had been issued approximately 9 months previously was canceled because the client was shown by another insurance agent that "Whole Life is a 1.3 percent investment." This unethical and unscrupulous agent proceeded to replace the existing Whole Life policy with a new policy with term insurance. I pointed out the fact that the interest adjusted cost index of the proposed term policy was higher than the interest adjusted cost index of the replaced Whole Life policy, but it did not seem to matter. The client did not understand interest adjusted cost index and felt sure that if an agency as prestigious as the FTC thought of whole life as a poor investment it must really be so.

I hope my relaying these two cases will help you and your committee. If there is any other way I can help please contact me immediately.

Sincerely,

JOHN M. ANDREW.

Hon. HOWARD W. CANNON,
Chairman, Senate Committee on Commerce, Science and Transportation, Russell Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: In your letter of October 18, 1979, you requested a response to criticisms of the Federal Trade Commission's staff report on Life Insurance cost disclosure made by the industry representatives at a hearing before the Senate Commerce Committee on October 17, 1979. The FTC staff's responses are set forth in Attachments 1 and 2.

Also enclosed for the hearing record is a memorandum discussing the basis for the Bureau of Consumer Protection staff's belief that Section 6 of the FTC Act authorized the Commission to investigate and report on insurance issues in areas where it may not be able to regulate (Attachment 3).

In addtition, we are submitting data on the individual policy rates of return on whole life policies issued in 1977 which was requested at the July 12, 1979 hearings (Attachment 4).[1] These are representative of the rates of return which would have to be disclosed if the draft regulation recommended by the Commission to the states was adopted.

Thank you for this opportunity to provide further information to the Committee.

Sincerely,

MICHAEL PERTSCHUK, *Chairman.*

Enclosures.

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[1] This data is on file with the committee. It indicates that, with only a few exceptions, 20-year rates of return on individual policies range from 1.5 to 7 percent; a large number of policies fall in the 3.0 to 5 percent range.

[ATTACHMENT I]

RESPONSE TO INDUSTRY CRITICISMS BY STAFF OF THE BUREAUS OF ECONOMICS AND CONSUMER PROTECTION

Set forth below is each of the principal industry criticisms of the Federal Trade Commission Staff's report on Life Insurance Cost Disclosure [1] and the staff's responses.

1. *The FTC staff report "adopts the flawed theory that whole life insurance is a hybrid combination of term insurance and a savings account." Instead, "whole life is not partially insurance and partially savings. It is wholly insurance."* [2]

In Section I of the report, the staff explored why whole life insurance can appropriately be viewed as a combination of protection and savings. This in not a revolutionary concept. For decades, the insurance industry itself, and virtually all scholarly treaties have explained whole life insurance this way. On the question, Spencer Kimball, professor of law at the University of Chicago and one of the nation's foremost authorities on insurance, stated:

". . . the technically tenable actuarial point of view is, for disclosure purposes, irrelevant. The inseparable contract can be separated conceptually as easily as one can separate into two parts the purchase of a car with extra equipment for a single price. That the conceptual separation is not only possible, but an appropriate way to look at cash value life insurance, is shown not only by the fact that it is found in standard textbooks including those of the insurance saint, S. S. Huebner, but even more persuasively by the industry's own readiness to be recognized as a major savings institution when questions other than price disclosure are under discussion. Thus, the Life Insurance Association of America, in a scholarly monograph for the Commission on Money and Credit, published in 1962, had no qualms about a chapter entitled "Policyholders' Saving Through Life Insurance." The study talks of industry efforts to push whole-life and endowment as opposed to term, in the hope of "an augmented flow of savings into life insurance.". . . .

"The readiness of the industry to make the conceptual separation whenever it suits industry purposes makes it impossible for us to take the actuaries' objections to the savings notion seriously enough to argue about it further."[3]

Further, the accumulation of assets in cash value policies meets all ordinary definitions of "savings." it is considered personal savings by the Federal Reserve System's Flow of Funds Accounts,[4] the Department of Commerce's National Income Accounts,[5] and the American Council of Life Insurance's own statistical series.[6] In fact, virtually every academic reseach study [7] and textbook on insurance [8] regards cash values as savings. The insurance industry's economists and executives have repeatedly taken the same position.[9]

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[1] Appearing on behalf of the industry at the Senate Commerce Committee hearing on October 17, 1979 were Thomas Wolff, President, and Rice E. Brown, Chairman of the Federal Law Legislation Committee, of the National Association of Life Underwriters and four executives of insurance companies speaking on behalf of the American Council of Life Insurance—James R. Martin, Chairman, Massachusetts Mutual Life Insurance Company; John Filer, Chairman, Aetna Life and Casualty; Ian M. Rolland, President, Lincoln National Life Insurance Company; and John R. Taylor, Executive Vice President, Banker Life Company.

[2] Statement of John Filer at 6; *see also,* Statement of James Martin at 12.

[3] Kimball and Rapaport, "What Price Disclosure? The Trend to consumer Protection in Life Insurance," 1972 Wis. L. Rev. at 1028-1029.

[4] *See* any issue of the "Federal Reserve Bulletin," Table A-29, "Savings Institutions."

[5] *See, e.g.,* 1977 "Business Statistics," U.S. Department of Commerce, Office of Business Economics.

[6] For a description of the industry's statistical series on "saving through life insurance" see George Bishop, "Capital Formation Through Life Insurance," (Irwin, 1976). Mr. Bishop was director of economic research, American Life Insurance Association at the time the book was published.

[7] The following all refer to or analyze saving through life insurance companies: Goldsmith, Raymond, "A Study of Saving in the United States," Vols. I-III (1955-56); Goldsmith, Raymond, "Financial Intermediaries in the American Economy Since 1900" (1958); Cummins, J. David, "An Econometric Model of the Life Insurance Companies," 41-43 (1975); Jones, Lawrence, "Investment Policies of Life Insurance Companies" (1968); Neumann, Seev, "Inflation and Savings Through Life Insurance," 36 "Journal of Risk and Insurance," 567-82, (December, 1969).

[8] *E.g.,* S. S. Heubner, "Life Insurance" 26-27, 106 (4th ed. 1950); R. Mehr, "Life Insurance" 5 (1977); Vane Lucas; "Savings Through Life Insurance," in "Life and Health Insurance Handbook" 39 (3d ed.); Dan McGill, "Life Insurance" 70 (1969).

[9] "Life Insurance Companies as Financial Institutions," 16-19 Life Insurance Association of America (1962); George Bishop, (Director of Economic Research, American Life Insurance Association) "Capital Formation through Life Insurance" 18-19 (1976); Robert Rennie (Senior Vice President for Investments of Nationwide Insurance) "Investment Strategy for the Life Insurance Company" and Robert J. Ferrari (Vice President and Chief Economist of the Prudential Life

Footnotes continued on next page

The view that whole life is a combination of savings and protection is much more than just an academic point: it is the way life insurance has traditionally been sold. A recent letter to the editor of the National Underwriter from Mr. Charles Read, a Chartered Life Underwriter, illustrates this point. After explaining how he had been trained to sell life insurance as a combination of savings and protection, he commented on the industry's current posture:

"The point is that for 80+ years the life insurance industry has been drilling into everyone's heads a two-part concept. Now, when the Federal Trade Commission and certain elements of the life insurance industry press the point with reference to inflation, our industry does a turn-about. Leaders of our industry are suddenly disgusted with the very idea that life insurance is a savings plan, and that it can even be equated to such an idea." [10]

After conducting extensive hearings on this subject, the Subcommittee on Oversight and Investigations of the House Committee on Interstate and Foreign Commerce made this point emphatically: "We regard the 'inseparable whole life policy' argument as a diversionary ploy. In our view, reliance on it in the future as a defense to rate of return disclosure will cross the line into irresponsibility." "Report on Life Insurance Marketing and Cost Disclosure," 23 n. 55, 95th Cong., 2d Sess. (1978).

2. *The FTC staff's 1.3 percent average industrywide rate of return calculation is meaningless and its dissemination irresponsible.*[11]

It is important to understand exactly what this calculation represents and why it is useful. The calculation represents an estimate of the average rate of return on savings for all policyholders who owned ordinary life insurance policies in 1977; it is not a measure of what one policyholder would receive by holding a policy for any particular period of time.

The calculation was made first, to determine the life insurance industry's importance as a savings institution, and second, to compare the competitive performance of this industry with that of other savings industries on the basis of yields paid for the use of savings. This calculation provides a basis for estimating the economic loss consumers suffer from a lack of competition. The staff also performed other (though less widely reported) economic tests to measure the competitiveness and efficiency of this industry. The staff measured the price dispersion which exists among policies, and it calculated the correlation between market share and price for policies. All of the economic tests performed show a lack of price competition within the insurance industry.

The staff believes that these measures of industry performance are vitally important to insurance regulators and policymakers trying to evaluate the need for greater price disclosure. While the 1977 industrywide rate of return is not of direct help to an individual consumer wondering about the economic consequences of buying a particular policy, it demonstrates in our view the need for effective cost disclosure.

3. *The one year industrywide rate of return paid to ordinary policyholders in 1977 by the life insurance industry was 5.9 percent, not the 1 to 2 percent estimate contained in the FTC staff report.*[12]

Mr. Taylor's statement, on behalf of the American Council of Life Insurance, is the most comprehensive industry critique of the FTC estimate available, and for the first time provides an industry estimate of the disputed rate of return. For this reason, it is important to respond in detail to Mr. Taylor's statement. Because the response is long and sometimes technical, it is simply summarized here. The complete response is contained in Attachment II.

The 5.9 percent rate of return figured by Mr. Taylor and the 1.3 percent estimated by the FTC staff differ basically for one reason: Mr. Taylor allocates far more money (82 percent more) to the cost of providing pure insurance protection than did the staff. Briefly, any calculation of the rate of return must begin by allocating premium payments to the categories—to the cost of providing insurance protection and the amount credited to savings. The higher assumed cost for insurance protection means that the amount "deposited" as savings is less. Because the savings benefits (increases in cash values, dividends, etc.) remain the same, the rate of return will increase as the estimated cost of protection grows. In Attachment II, the

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Footnotes continued from last page

Insurance Company of America) "Impact of Inflation on the Life Insurance Industry and Its Investment Policies," reprinted in "Investment Activities of Life Insurance Companies" (Cummins ed.); Francis H. Schott (Vice President and Chief Economist of Equitable Life of New York), "Inflation and Life Insurance." "Vest's Review," Sept. 1979 at 2.

[10] National Underwriter, Dec. 8, 1979, at 12.

[11] Statement of John Taylor at 18-21.

[12] *Id.* at 1-21.

formula for calculating the industrywide rate of return is fully explained, but suffice it to say the estimate of the cost of pure insurance protection is the key assumption affecting the rate of return calculation.

The FTC staff estimated the cost of protection by assuming that low cost term insurance would cost about $1 for every 67 cents in benefits (a loss ratio of 67 percent). Mr. Taylor's expense allocation implies a loss ratio of 37 percent, which means that the average policyholder would have to pay $1 to get back just 37 cents in benefits. In Attachment II, we perform several tests which show why our estimate is much more plausible and reasonable than Mr. Taylor's. Significantly, our estimate is consistent with the term insurance formula used by the Society of Actuaries, the industry's association of actuarial professionals, in calculating individual policy rates of return. Mr. Taylor's method produces term rates that are much higher than the Society of Actuaries found in the marketplace. Moreover, minimum loss ratios which are mandated on some types of health coverage and credit life insurance generally are about 50 to 60 percent, while the loss ratio on group life insurance is about 80 percent. Mr. Taylor's 37 percent is far below any of these loss ratios. Thus, Mr. Taylor's calculation results in a much higher estimate of the cost of one year term insurance than appears justified.

The 5.9 percent figure is also inconsistent with the individual policy rates of return calculated by the FTC staff and earlier by the Society of Actuaries. Both showed that rates of return on policies issued in 1973 and 1977 average about 4 percent if (and only if) held for twenty years. The actual industry average must be far lower than the 20 year average rate, though, because most of the policies in force in 1977 had been held for far less than 20 years (and many of the ones that were issued more than 20 years ago have lower rates because of the more conservative interest and mortality assumptions used then). Most whole life policies have little or no cash values and small dividends for the first two or three years and hence have highly negative rates of return during these early periods. The one year rate on an individual policy, for example, is usually minus 100 percent. Even after 5 years, the average rate is less than minus 10 percent. After 10 years, policyholders do little better than break even. In 1977, 54 percent of the policies, accounting for 86 percent of the face amount of coverage, had been in force for 10 years or less. Therefore, the overall rate must be substantially below 4 percent and could not possibly be as high as 5.9 percent.[13]

On the basis of not only its own calculations and assumptions but those of industry itself, the staff stands by the original estimates of the industrywide rate of return of between 1 and 2 percent, with a best estimate of 1.3 percent.

4. *The FTC cost disclosure report was unfairly biased in favor of term insurance.*[14]

The staff report does not advocate one form of insurance over the other. As stated on pages 102–103 of the report:

"At this time there is a continuing, often emotional, debate within the life insurance industry concerning whether term or whole life is the superior product. We adopt a position of strict neutrality on this issue. Whole life insurance and term insurance plus a side fund are equally legitimate ways to protect against premature death while accumulating funds for retirement or other purposes. Either product can be a desirable purchase, depending upon an individual's circumstances."

Similarly, the FTC's draft regulation makes a concerted effort to avoid any bias in favor of term insurance. For example, the Preliminary Policy Summary explains:

"The rate of return is one factor you should consider in deciding whether to buy term or whole life insurance. There are other benefits in a whole life contract that are not generally available in term insurance contracts. Therefore a whole life policy may be a desirable purchase even if its rate of return is lower than you could receive elsewhere."

5. *Many consumers would be ill-advised to buy only term insurance because term insurance becomes prohibitively expensive at older ages.*[15]

The simple answer to this point is that all forms of insurance are expensive when a person reaches an advanced age. Although the premium for a whole life policy remains the same as long as the policy is in force, the actual amount of death protection bought by the level premium of whole life insurance declines each year as the cash value increases. For example, a 35 year old man will pay approximately $200 a year for a $10,000 whole life policy. At age 70 this policy will have a cash value of approximately $6,500. Thus, the person is actually only buying $3,500 of insurance while paying a $200 premium.

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[13] Attachment II demonstrates that the "obvious benchmarks" which Mr. Taylor cites as support for his 5.9 percent calculation are inappropriate tests to use for determining the industry-wide rate of return.

[14] Statements of Rice Brown at 2–3, and James Martin at 1.

[15] Statement of John Filer at 7–11, Ian Rolland at 13–14 and James Martin at 3.

Moreover, many elderly people may decide that they do not need to have life insurance in force. As we noted above, at advanced ages most whole life policies provide comparatively little death protection, but hold a great deal of savings. The cash value can be used to meet expenses or the policy can be kept in force to create an estate, much of which has already been saved through higher premium payments in earlier years. But an equally valid way to save for retirement or to create an estate is to buy term insurance and invest the difference in premiums. The staff analyzed 306 different $25,000 whole life policies issued in 1973 to males aged 35. These policies were compared to an alternative program of term insurance plus a side fund accumulating at 5 percent after taxes. The mean age at which the side fund would equal the whole life face amount was 67. Even these whole life purchasers who intended to keep their policies until death could have bought term insurance instead, invested the difference in premiums, and have the face amount of the whole life policy saved by age 67. Moreover, by then, the side fund would exceed the whole life surrender value (cash value) by an average of $11,088. Thus, while an older person might not have an insurance policy in force, he would have as much or more money saved (for use during retirement or to be passed on to survivors) than if he had bought a whole life policy and kept it in force.

We agree with the Report of the Subcommittee on Oversight and Investigations of the House Interstate and Foreign Commerce Committee which emphasized that both term and whole life insurance "are legitimately alternative ways of protecting against premature death." [16] The Subcommittee also points out that while term insurance premiums rise at later ages, whole life premiums are level because the insured pays more for protection in the early years on his policy.[17] As the report notes, however, the important consideration remains which form of coverage best meets the consumer's needs:

". . . if the difference between term rates and whole life premiums is large enough, and that difference can be invested at an attractive interest rate, the side fund investment may eventually accumulate to cover all of the policyholder's insurance needs. The term plus side fund alternative might then be a wiser choice than continuing to pay whole life premiums forever." [18]

6. *The FTC's cost disclosure report was unnecessary because the NAIC has issued a model cost disclosure regulation.*[19]

The FTC has recognized the efforts of the NAIC to require cost disclosure. However, the Oversight and Investigations Subcommittee of the House Interstate and Foreign Commerce Committee concluded, and as we explored at length in the staff report, the system adopted by the NAIC has serious shortcomings. For one, the system only permits consumers to compare the costs of similar life insurance plans consumers cannot compare one type of policy with another. Rate of return disclosure would permit that. Also, the NAIC system confuses the issue by including two indices—the net payment index and the equivalent level annual dividend—which its own advisory committee found objectionable. Finally, the NAIC disclosure package is generally delivered with the policy, long after the sale has taken place, thus further reducing its effectiveness.

The NAIC's Life Insurance Cost Disclosure Task Force is reviewing its cost disclosure regulation, especially in light of the FTC's findings. The NAIC Task Force requested that the FTC staff testify at their hearings on this subject in November and we did so. We hope that the NAIC's continuing evaluation of its cost disclosure regulation will result in improvements that will benefit consumers.

7. *The FTC staff disregarded or suppressed the results of consumer research which the FTC commissioned because the results of that research contradicted the staff's conclusions about the need for cost disclosure.*[20]

The FTC commissioned three studies, two by Professor Jacoby of Purdue University and one by Professor Formisano of the University of Wisconsin. The results of these studies helped improve the FTC's recommended disclosure system. They were by no means suppressed, but rather were publicly released at the earliest possible date and have been disseminated widely. All the studies are, in fact, summarized in the cost-disclosure report—the Formisano study on pages 150–163 of the text and the much more technical Jacoby studies in a 27 page appendix.

The findings of these studies support the staff's conclusions that the NAIC disclosure system is ineffective in imparting meaningful cost comparison information to

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[16] Subcommitte on Oversight and Investigations of the House Committee on Interstate and Foreign Commerce, "Report on Life Insurance Marketing and Cost Disclosure," 95th Cong., 2d Sess., 12 (1978).

[17] *Id.*, at 9.

[18] *Id.* at 11.

[19] Statements of John Filer at 13, and James Martin at 7-27.

[20] Statements of Rice Brown at 3-4, and Ian Rolland at 8-10.

consumers and that the changes the FTC recommends in this system can significantly improve consumers' motivation and ability to comparison shop for the lowest cost insurance.

For example, the second jacoby study showed that the persons tested who received the experimental FTC disclosure packages outperformed other groups—particularly the NAIC group—in selecting the most economical insurance policy. In fact, as our report indicates in Appendix IX, page 19, 26 percent of the subjects using the NAIC model failed to choose the lowest cost policy, while only 5 percent of the subjects using the FTC models failed to choose the lowest cost policy.

The Formisano study, which was conducted with the cooperation of the New Jersey Department of Insurance, consisted of personal interviews with 194 persons who had recently purchased insurance in New Jersey, a state which has adopted the NAIC model cost disclosure regulation. As a part of this study, the subjects were asked a series of 15 questions relating to basic knowledge about life insurance and how to use the index numbers provided on the policy summary The Formisano study showed that the test subjects who received the NAIC disclosure materials did not have the information essential for rational decision-making. For example, many subjects who received the NAIC materials did not understand a basic distinction between a whole life and a renewable term policy. Even more significantly, the overwhelming majority of these subjects had fundamental misconceptions about the meaning of the cost indices that are the heart of the NAIC cost disclosure system. The results of the Formisano study are consistent with earlier studies by Prudential Insurance Co. and research the NAIC has conducted concerning the comprehensibility of the NAIC buyer's guide.

In sum, the tests conducted by the FTC support the conclusion that the cost disclosure system recommended to the states by the Commission is a more effective method for permitting consumers to comparison shop for the most economical insurance policy that the NAIC model.

8. *The Federal Trade Commission should not be involved in the life insurance area because it has not received a sufficient number of consumer complaints.*[21]

Since the primary responsibility for regulating the business of insurance belongs to the states, consumer complaints about life insurance are generally addressed to them. Therefore, the volume of consumer complaints the FTC receives about life insurance may not accurately reflect consumer dissatisfaction. In any event, consumer complaints do not always provide an accurate gauge of consumer problems. The failure to disclose product information normally generates very few consumer complaints because the lack of consumer information is the essence of the problem. Because of the unavailability of meaningful comparative cost information, many consumers never know that they may pay far more than they need to for the life insurance coverage they buy.

It is important to remember that the FTC's work in this area was not undertaken in a vacuum. Public scrutiny of the cost of life insurance has been increasing throughout this decade. The hearings in 1973 and 1974 before Senator Hart's Subcommittee on Antitrust and Monopoly of the Senate Judiciary Committee indicated that the life insurance industry simply did not compete on the basis of price. Our study was undertaken largely in response to the Hart Subcommittee's pathbreaking work.

Recently, the FTC's interest in life insurance was found "wholly lawful, proper, and appropriate" by the Oversight and Investigations Subcommittee of the House Interstate and Foreign Commerce Committee. The Subcommittee went on to observe,

". . . the infusion of fresh views by an agency experienced in consumer protection is highly desirable . . . [t]he size of the life insurance industry, its importance to consumers, and its methods of doing business clearly justify the expenditure of some FTC resources to maintain at least an advisory federal presence." [22]

Review of Press Reports and Advertising Materials

In addition to responding to criticism of the staff report, the Chairman of the Commerce Committee requested that we review the press reports, advertising materials, and statements from agents which were forwarded to us concerning the Life Insurance Cost Disclosure Staff Report. Chairman Pertschuk recently met with representatives of the National Association of Life Underwriters to discuss their concerns about how the report has been presented to the public. As a result, we are preparing a proposed public statement to clear up some of the misconceptions about the report which have surfaced.

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[21] Statement of Ian Rolland at 6-7.

[22] "Report on Life Insurance Marketing and Cost Disclosure, supra," at 62.

We found that many newspaper stories were often too short to present a complete view of the FTC staff's findings. For example, in some a reader could easily reach the mistaken conclusion that the FTC staff affirmatively asserted that all whole life policies are bad guys. The FTC press release makes clear that that is not the case, and that some policies have 20 year yields of 4-6 percent. As has been previously explained in this letter, the staff report explicitly states that the staff adopts a position of strict neutrality concerning whether term or whole life insurance is the most desirable purchase. Moreover, in Chairman Pertschuk's testimony before your Committee on July 10, 1979, he emphasized that "some available whole life policies offer return rates which are competitive with other savings media.

Another area where some of the newsstories fell short was in discussing the 1.3 percent average industrywide rate of return. As explained earlier, this figure represents an estimate of the average rate of return the industry paid on all ordinary cash value policies for 1977. As such, it presents a useful measure of the industry's overall performance; it does not reflect the particular rates of return on individual policies, which vary greatly.[23] Many news stories did not explain the meaning of the industrywide rate of return calculation although it was adequately explained in the FTC press release and fully explored in the Chairman's testimony.

Some of the advertisements and sales materials forwarded to the Commission attempted to use the FTC report to promote the sale of term insurance, often to replace existing whole life policies. As we explained earlier, however, the FTC staff has not condemned whole life insurance nor advocated purchase of term insurance.

The FTC does not condone the use of its reports as a sales tool, especially when conclusions are taken out of context. In fact, the Commission once accepted a consent order prohibiting an insurance comppany subject to the Commission's jurisdiction from representing that its policies are endorsed or recommended by the Air Force or any other government agency. *In re United National Life Insurance Co.*, 75 CFT 200 (1969).

The staff was also asked to review statements from agents submitted to the Committee by the National Association of Life Underwriters on the reaction to the report in the marketplace. Many prospects and existing policyholders have undoubtedly become more questioning about life insurance as a result of the FTC staff report. We are concerned, though, that agents have not been given adequate tools to inform consumers accurately about the costs of new and existing policies.[24] A uniform system of disclosing the rate of return would enable consumers and agents to compare the true costs of different policies and would go far toward eliminating the confusion which now exists.

[ATTACHMENT II]

FTC STAFF RESPONSE TO THE STATEMENT OF JOHN TAYLOR, BANKER'S LIFE OF IOWA BEFORE THE SENATE COMMERCE COMMITTEE, OCTOBER 17, 1979

I. INTRODUCTION

Mr. Taylor's statement focuses on the FTC staff's estimate of the one year industrywide rate of return paid to ordinary policyholders in 1977 by the life insurance industry. The FTC staff report gives three different estimates of this rate of return, all between 1 and 2 percent with a best estimate of 1.3 percent. Mr. Taylor argues that our 1.3 percent estimate is "clearly wrong" and that "a far more reasonable" estimate is 5.9 percent. This statement, made on behalf of the ACLI, is the most comprehensive industry critique of the FTC estimate available and for the first time provides an alternative industry estimate of the disputed rate of return.

The FTC estimate is wrong, according to Mr. Taylor, because:

(1) 1.3 percent is much lower than several "obvious benchmarks."

(2) The FTC staff used "arbitrary" assumptions, which were "completely different from but should have been identical to" those used elsewhere in the report in calculating rates of return on individual policies. The use of these arbitrary assump-

[23] As Chairman Pertschuk testified before the Senate Commerce Committee, rates of return on individual policies vary greatly because the average consumer cannot now distinguish between competing products on the basis of their true cost. As he noted, the 20-year rate of return in 1977 for $25,000 dividend-paying whole life policies issued to males age 35, ranged from a high of 7.6 percent to a low of 1.5 percent and for similar nondividend-paying policies the scale went from 3.9 percent to 0.66 percent, indicating that the present time competition is not working in the insurance industry.

[24] Indeed, the anecdotes show that at least some agents do quote rates of return on the policies which they sell and do try to use the NAIC indices to compare the costs for whole life and term policies. As explained above, though, the NAIC system cannot be used in this way and attempts to impart such information lead to confusion.

tions resulted in far too little money being allocated to the expense of the insurance protection, producing an artificially low rate of return.

Mr. Taylor then performs his own calculation and arrives at a figure of 5.9 percent. This attachment examines Mr. Taylor's calculation to see where his assumptions differed from the FTC staff's and assesses the reasonableness of both his and the FTC staff's assumptions. It also tests the relevance of the "obvious benchmarks" proposed by Mr. Taylor and considers some alternative benchmarks.

II. WHY THE FTC STAFF'S METHOD AND MR. TAYLOR'S DIFFER IN RESULT

A question which naturally arises is how can the FTC staff and Mr. Taylor reach such contradictory conclusions given essentially the same data to work with.

A. How the industrywide rate of return was calculated by the FTC staff

In order to estimate the average rate of return on the savings element of cash value insurance policies held in 1977, the FTC used the following methodology.[1] First, the total premiums for ordinary life policies in 1977 was determined. The value of the insurance protection component was then calculated as the premium dollars all ordinary life insurance policyholders would have had to pay in 1977 for that year's coverage alone if they had purchased relatively low cost term insurance policies. That figure was subtracted from total premiums and the remainder was treated as the savings "deposit." Cash withdrawals (cash surrender values, dividends, etc.) were then subtracted to arrive at a net deposit. The rate of return for 1977 was calculated on the basis of the ratio of total savings at the end of the year to the beginning year account plus the net deposits.

B. An analogy

The key to understanding why Mr. Taylor and the FTC staff reach such different conclusions lies in the way each separates the two components of the life insurance policy—i.e., the savings and insurance elements. An analogy may be helpful. Compare the prices of the cars of two auto manufacturers. Manufacturer A's cars all come with air conditioners (not optional), whereas Manufacturer B does not provide air conditioners with its cars, even as an option. A natural way to compare the average prices charged by these two manufacturers for the basic car (without air conditioning) would be to subtract an estimated cost of an installed car air conditioner from A's prices to make them more comparable to B's. There are two ways to estimate the cost of the air conditioners. One way, similar to the FTC staff approach in computing the industrywide rate of return, is to price out on the market how much an installed air conditioner would cost. Another way, which is basically Mr. Taylor's approach, would be to do an accounting of A's expenses in manufacturing air conditioners, including the air conditioning division's "fair" contribution to company overhead and profit. These different philosophies of estimation will, of course, give differing estimates of the net price of A's cars.[2]

By allocating more expense to the air conditioner division, A can make the net price of the basic car look more attractive, but only at the expense of making its air conditioner division look less efficient. Similarly, allocating more expense to the cost of the insurance protection element of a whole life policy will make cash value life insurance appear more attractive as a savings medium, but only at the expense of being a less efficient supplier of insurance protection.

C. Mr. Taylor's method

The analogy in the previous section illustrates the two ways which separate prices for goods sold in combination can be determined. Mr. Taylor has used the second approach described in the analogy—that of allocating expenses—as compared to the market price approach used the FTC. Because both methods use the same amounts for benefits to policyholders (dividends, cash surrender, increases in cash values, etc.), and the same amounts for premiums from policyholders, the higher rate of return can be achieved only through a lower savings deposit. The lower deposit can be arrived at only by assuming a higher cost for insurance protection than the FTC staff estimated.

Mr. Taylor nowhere explicitly states his estimate of the cost of death protection. This cost can, however, be derived from the calculation which Mr. Taylor did make.

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[1] The full details of this calculation are set forth on pp. 15-20 and in Appendix II of the staff report of Life Insurance Cost Disclosure.

[2] Continuing the analogy, Mr. Taylor's "obvious benchmarks," which look at only part of the life insurance contract, seem to be similar to arguing that the net prices of A's and B's cars must be the same because the prices they charge for replacement of fenders and headlights are the same. However, just because A and B charge about the same price for fenders and headlights in no way implies that they charge the same prices for their cars.

His calculation was as follows. He started from the premise that policyholders' return on savings was some proportion of the $12.4 billion of investment income for ordinary insurance in 1977. The return to policyholders would be less than the $12.4 billion because some expenses, taxes and profits have to be attributed to investment earnings. The fraction of the 12.4 billion credited to policyholders was assumed to be the proportion that benefits (including dividends) bore to all the end uses of policyholders' funds (i.e., benefits plus expenses (including taxes) and profits). This meant that $8.2 billion was "credited" to policyholders according to Mr. Taylor's estimate. [3] Working backwards, using the formula for calculating the industrywide rate of return in the staff report, this gives a term insurance cost of $13.38 billion, more than $6 billion higher than the FTC staff estimated. [4]

No explanation was given as to why this "proportional allocation" represented a realistic basis on which to allocate expenses, taxes and profits, nor why such a method of determining the cost of insurance protection should be preferred over relying on the marketplace cost of term insurance. This section (when read together with the succeeding section) shows that it is Mr. Taylor who is making the arbitrary assumption about the cost of term insurance (the key estimate in the formula), not the FTC staff.

D. The cost of term insurance

The FTC staff estimated the cost of the protection element of ordinary life insurance on the basis of the cost of term insurance available in the market. The staff found that to purchase low cost term insurance the average policyholder would have to pay about $1 to get back 67 cents in benefits, a loss ratio of 67 percent. Although not mentioned explicitly in Mr. Taylor's testimony, Mr. Taylor's "proportional allocation" produces a loss ratio of 37 percent, which means the average policyholder would have to pay $1 to get back 37 cents in benefits. This section explores why the FTC's staff estimated loss ratio of 67 percent (and alternatives of 60 and 79 percent) are far more plausible than Mr. Taylor's 37 percent.

First, and most important, the FTC estimate (but not Mr. Taylor's) is consistent with the formula which the Society of Actuaries used to calculate term insurance premiums on individual policy rates of return. Indeed, the Society's formula produces a total term insurance cost that is somewhat lower than the amount used in the Report. This is illustrated below.

The Society's formula for computing low cost term insurance premiums for individual policies can be used to estimate what the total term insurance premiums would have been in 1977 if all ordinary policyholders had bought term insurance. This is accomplished by multiplying the Society's formula by the face amount of each policy and then summing across all issue ages and face amounts, this denivation produces the following equation: [5]

$$\text{Total term insurance premiums} = .95 \times (\text{total death claims}) + .90 \times (\text{total face amount in thousands}) + \$25 \times (\text{total number of policies})$$

By applying this formula, the total term insurance premiums can be determined. In 1977, the total death claims were $4.908 billion and the total face amount of coverage in thousands was $1.2893 billion. The only estimate needed to complete the formula is to calculate the total number of policies that would have been purchased if all ordinary policyholders in 1977 had bought term insurance.

The total number of policies can be estimated by dividing the average policy size into the total amount of coverage. The average policy size is a very important determinant of the cost per thousand of insurance protection because many expenses are independent of the size of the policy. The importance is reflected in the $25 policy fee contained in the Society's formula. While the average policy size in 1977 was a little over $9,000, the average term insurance policy in force was over $26,000, compared to less than $7,000 for the average cash value policy. More important, many, if not most, insureds own several policies purchased at different times in their lives. The FTC staff report analysis indicates that about 46 million households owned $1.289 trillion in ordinary coverage, an average of over $28,000

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[3]Statement of John Taylor, at 18.

[4]Using the equation from the FTC Staff Report, page 17, and letting "k" stand for the term multiplier,

$$1.059 = 140.910 \text{ divided by } 146.422 - k(4.908)$$

Thus, k equals 2.726 and 1/k (the loss ratio) is about .37. Because death benefits equalled $4.9 billion, total term insurance premiums would be $13.38 billion.

[5]See Exhibit I for the full equation.

per household distributed over about 3 policies. If all ordinary policyholders were to buy term insurance coverage (which is what the industrywide rate of return calculation is predicated upon), it is reasonable to assume that the average policyholder would buy only one policy, not the three the average policyholder now holds, because volume discounts are highly significant. Thus, the total number of policies for the purposes of the calculation equals 46 million. Inserting these values into the equation:

$$\text{Total term insurance costs} = (.95)\ (\$4.908 \text{ billion}) + (.90)\ (\$1.2893 \text{ billion}) + (\$25)\ (46 \text{ million}) = \$6.97 \text{ billion}$$

This figure is actually less than the $7.362 billion cost of protection used in calculating the 1.3 percent rate of return. If term premiums (the cost of protection) were $6.97 billion, the loss ratio would be 70.4 percent and the industrywide rate of return would be 1.1 percent rather than the 67 percent and the 1.3 percent in the staff report.[6]

On the other hand, Mr. Taylor's expense figure is consistent with the Society's formula only if it is assumed that ordinary policyholders would choose to buy over 300 million policies averaging $4,200 each. One can hardly imagine a less rational act than to buy 6 or 7 policies of $4,000 each, rather than one for $28,000 when there are large volume discounts. Mr. Taylor's figure not only does not permit policy consolidation, but actually requires that policyholders further fragment their coverage into smaller policies.

One phenomenon might make a 37 percent loss ratio appear reasonable: the fact that term insurance policies have very low loss ratios in the early years after purchase. The low initial loss ratio is reflected, however, in the term rates proposed by the Society of Actuaries and used in the FTC staff report to calculate individual policy rates of return. For example, the first year loss ratio in a $25,000 policy issued to a man 35 years old is about 27 percent. A heavy predominance of new policies would then produce an aggregate loss ratio that appeared to be very low. But, as shown above, applying the Society's term formula to all of the ordinary policyholders in 1977 indicates that this is not the case. Indeed, the distribution of policyholders and claims in 1977 was such that the Society's formula produces a total term insurance cost that is somewhat lower than the one used in the staff report.

Other evidence demonstrates that the loss ratios estimated by the FTC staff (60 to 79 percent) are reasonable while Mr. Taylor's is not. Minimum loss ratios that are mandated by state law on some types of health coverage and credit life insurance are generally about 50 to 60 percent. The loss ratio on group life insurance is about 80 percent. In addition, the ACLI claims that the industry—on average—returns 79 percent in benefits for every dollar paid in premiums and investment income.[7] Thus, Mr. Taylor's 37 percent loss ratio assumption is extraordinarily low, resulting in an extraordinarily high estimate of the one year cost of term insurance coverage in 1977, and a correspondingly high rate of return.

E. Why the "benchmarks" cited by Mr. Taylor to justify a 5.9 percent rate of return are not persuasive

Mr. Taylor writes that "the extent of the [FTC staff] error can be easily seen by comparing the 1.3 percent rate of return with several obvious benchmarks." The benchmarks explicitly mentioned are,

(1) Interest rates of 5 or 6 percent are currently used by life insurance companies in determining premiums or dividends.

(2) The interest rates life insurance companies assume in making their reserve calculations average about 3 percent.

(3) Companies are currently paying 5 percent or more on dividends left with the company to accumulate at interest. Mr. Taylor presumes that the average one year rate of return should be about the same as these various benchmark rates. For the following reasons there is no basis for making such a presumption:

(1) The interest rates insurance companies use to determine premiums tells nothing about the actual rate of return a policyholder can expect to receive. An assumed interest rate (or rates) is only one of many elements that go into a gross premium

[6] The term cost of $7.362 billion as used in the Report implies an average policy size of about $21,000 and 62 million policies in force. Even if one assumes that policyholders will pay more by buying multiple new policies in exactly the same amount as they are currently owned, the 139 million policies would imply a loss ratio of about 50 percent and an industrywide rate of return of 3.1 percent.

[7] Statement of the American Council of Life Insurance in Response to the FTC Staff Report on Life Insurance Cost Disclosure (July 11, 1979).

calculation. An attractive interest rate assumption can be fully offset, for example, by assuming very high acquisition, agent compensation, maintenance and termination expenses. Because the interest rate is not net of expenses, it alone tells little or nothing about the actual rate of return the policyholder can expect to receive.[8] In addition, the assumed rate in calculating premiums does not take dividends into account and these are often very important determinants of the actual rate of return to the policyholder.

Similarly, although dividends can be very important, the interest rate assumed in the dividend formula is only one of three to eight or nine different factors which determine dividend size. At a minimum, the formula will depend on an expense factor and a mortality factor, in addition to an interest factor. Hence, by itself, the rate assumed in the dividend formula tells little or nothing about the returns being credited to policyholders on policy reserves in the form of dividends.

(2) Mr. Taylor's second "benchmark" is the rates used in making reserve calculations. The interest rate used in calculating reserve requirements is again only one of the many elements that go into determining the actual rate of return on a particular policy. For a variety of reasons, this rate is not equal to the overall rates. First, reserves and cash values are not identical and are in fact very different in the early policy years. This is an important point when looking at one year rates. Second, reserves are almost always calculated on a net level premium basis which excludes all non-claim expenses, thereby greatly underestimating each "deposit" made by the policyholder. Third, the rate used in calculating reserves contains no allowance for dividends.

(3) Mr. Taylor's third "benchmark" is the actual rate paid on dividends left on deposit with the company. The interest paid on dividends left with the company is a part of the total return paid to policyholders and was included in the staff's calculation. Since they represent a relatively small part of the total savings balance, it is not surprising that the overall rate of return is not dominated by the rate paid on dividends left with the company. It is worth noting, however, that on the one portion of the return that is clearly visible to policyholders the companies are paying rates comparable to what savings and loan associations pay.

In summary, the different "benchmarks" for interest rates cited by Mr. Taylor are all at best partial measures of the actual rate of return on life insurance savings. None of them, or even all of them together, are sufficient to derive the overall rate.

Because of the deficiencies noted above, it it the FTC staff's opinion that citing these particular interest rates without disclosing the true rate of return on policies will likely mislead consumers. Yet, in responding to the FTC report, insurance industry representatives have used this "apple and oranges" comparison, For example, the American Council of Life Insurance in a press release issued on July 11, 1979 stated:

"We simply do not understand how the FTC arrived at an average rate of return of 1.3 percent for all whole life policies. Their calculation is not a measure of what is currently being credited to policyholders. Typically companies today are basing their *dividends* and *premium* rates on interest rates of 5 to 6 percent." (emphasis added)

A similar statement was made by Mr. Robert Beck, Chairman of Prudential Insurance Co., appearing on the Phil Donahue show in September 1979:

"Mr. BECK. Well, Phil, the point we're trying to make as strongly as we possibly can, and I'd love to take more questions on this point with the audience, but the fact is, we don't claim that we're an investment. We claim we're dominantly selling insurance protection, that this cash value builds up in order to keep the premium level, but as a side benefit, the fact of the matter is the rate of return is a good rate of return. The rate of return that was publicized in the press at that one point——

"Mr. DONAHUE [continuing]. By the FTC——

"Mr. BECK [continuing]. Is absolutely false. We credit, right now, and we're not alone. I'm saying most of the people in the insurance industry credit to policyholders today, 5½ to 6 percent on their funds each year. And you're not going to do better than that with some other investment."

F. An alternative benchmark

The reasonableness of the industrywide average can be roughly tested by comparing it to individual policy rates. It is impossible to make a precise calculation on this basis because available information is not sufficient to estimate exactly the key factors of how long the policy has been held, policy size, age at issue, sex of the

[8] Moreover, while it may be true that rates of 5 or 6 percent are being used on new policies, the rates were far lower on the many policies issued 10 or 20 years ago that were still in force in 1977.

insured, and type of policy. The policy rates, though, can be used to set the upper limit on the industry rate of return. The 20 year rates of return on whole life policies issued in 1977 averaged about 4.5 percent for dividend paying policies and about 2.5 percent for nondividend paying. Rates at shorter durations, policies issued in earlier years, and other types of cash value policies were lower, while rates at longer durations were only slightly higher. Therefore, the 20 year whole life rates appear to set a reasonable upper limit to the industrywide rate. Assuming that dividend-paying policies account for two-thirds of the total, this gives an upper limit of about 3.8 percent. This alone is enough to establish that a 5.9 percent industrywide average is too high and is not consistent with the individual policy rates.

The actual industry average, though, must be lower than the 20 year average policy rate because most of the policies in force in 1977 had been held far less than 20 years. Most whole life policies have little or no cash values and small dividends for the first two or three years and hence have highly negative rates of return. The one year rate on an individual policy, for example, is usually minus 100 percent. Even after 5 years, the average rate is less than minus 10 percent. After 10 years, policyholders do little better than break even, with average rates of less than 1 percent. While there are no exact figures on the distribution of policies by duration, a great many of the policies in force in 1977 must have been in force for less than 10 years. Between 1968 and 1977, more than 119 million policies were sold, but 86 million were lapsed and another 10 million were terminated through death. Using standard industry lapse and mortality tables, about 54 percent of the policies, accounting for 86 percent of the face amount, had been in force for 10 years or less. Other things being equal, however, newer policies will have smaller accumulated savings balances than older policies and so their effect on the overall average rate will be less than proportional to their number. On the other hand, new policies are, on the average, twice as large in face amount as the older ones and for this reason will have greater weight than their numbers alone suggest.

While it is not possible to calculate precisely the impact of the negative rates on policies less than 10 years old, we agree with Mr. Taylor that they will significantly reduce the industrywide rate. To get a rough answer to this question we performed a "model" calculation based on one of the best selling policies sold by the Prudential Life Insurance Company. (See Table I for the calculation and Table II for the policy's chief characteristics). The model calculation measured the industrywide return in 1977 assuming that all ordinary life insurance purchasers bought only this one average cost policy from 1958 to 1977.

This Prudential policy has a 20 year rate of return of 3.88 percent which is close to the industry average. As is typical, however, the early rates of return are strongly negative (see column 7, Table I). If it were known what was the amont of coverage held in 1977 of the policies purchased in each year from 1958 to 1977 and the amount of the premiums paid in 1977 on policies issued in each year, then it would be possible to compute deposits, withdrawals and cash value accumulations for each issue year group and thereby isolate the effect of the early negative rates of return on the industrywide one year rate of return. This has been done in Table I by assuming (1) all policies were purchased by men, aged 35 at time of purchase, (2) the face amount of each policy is $25,000, (3) policies were lapsed or terminated through death at exactly the rates given in the standard industry lapse and mortality tables and (4) the total amount purchased in each year is equal to the actual amount of ordinary insurance purchased in each year from 1958 through 1978. Using these assumptions, the deposits, withdrawals and cash value accumulations for each issue year group can be calculated separately. As shown in the table, although the people who purchased their policies in 1958 have realized a 3.88 percent average rate of return (and a rate of 5.89 percent from the 19th to the 20th year), the overall one year rate of return is only .19 percent. Thus, the early negative rates of return have virtually wiped out the later positive rates of return. Note that in estimating the industrywide rate of return this way deposits have been calculated by using the term insurance rates used in the draft regulation for calculating individual policy rates of return. This calculation provides further evidence that our estimate of 1.3 percent is broadly consistent with the policy rates of return derived by the FTC and others, while Mr. Taylor's 5.9 percent is not.

III. THE FTC STAFF CALCULATED THE INDUSTRYWIDE RATE OF RETURN AND THE INDIVIDUAL POLICY RATES IN A CONSISTENT WAY

Mr. Taylor also criticizes the FTC staff for using different methods to calculate the one year industrywide rate of return and the individual policy rates of return at various durations. The industrywide and individual policy calculations are, in fact, consistent in principle, although there are necessarily differences in intent and

method between the two calculations because of the nature of what is being measured. In each, though, the package of insurance protection and savings was unbundled and a cost assigned to the protection element with the remainder of the premiums treated as a deposit to savings. Moreover, the cost of insurance protection for both calculations was derived consistently based on an estimate of what consumers have to pay for low cost term insurance in the marketplace. The tests performed in this attachment using the Society of Actuaries' formula and other benchmarks confirm that the industrywide and individual policy methods are consistent and that the results can be easily reconciled. Thus, Mr. Taylor's criticism is without foundation.

Exhibit I

The formula was derived as follows:

$$_iYRT_x = .95(1000q_x) + \$0.90 + \$25/S_i$$

$$(S_i)\ (_iYRT_x) = .95(1000q_x)\ (S_i) + \$.90(S_i) + \$25$$

$$\sum_{i=1}^{N} \sum_{x=0}^{100} ((S_i)\ (_iYRT_x)) =$$

$$.95\sum_{i=1}^{N} \sum_{x=0}^{100} (1000q_x)\ (S_i)) + \$.90 \sum_{i=1}^{N} (S_i) + \$25(N)$$

where

x = issue age

N = Number of Policyholders

S = Policy size in thousands

i = Individual policyholder

q_x = mortality rate

TABLE I.—ALTERNATIVE CALCULATION OF THE INDUSTRY-WIDE RATE OF RETURN IN 1977, USING A POLICY WITH A 20 YEAR RATE OF RETURN OF 3.88 PERCENT AS A "MODEL"

[Dollars in billions]

Year policies issued	Face amount remaining end of year	Cash value beginning of year	Deposit	Withdrawals	Cash value end of year	One year rate of return	Average rate of return
1977	$203.04	.....	$4.15	.....	.....	−100.00	−100.00
1976	162.53	.....	3.00	$0.01	$0.01	−98.00	−98.54
1975	134.97	$0.05	2.40	0.55	2.28	+20.00	−42.20
1974	123.85	2.08	2.52	0.67	4.28	+8.91	−22.00
1973	104.58	3.78	2.10	0.69	5.57	+7.32	−12.44
1972	89.68	4.99	1.77	0.66	6.52	+6.89	−7.17
1971	78.25	5.92	1.51	0.65	7.24	+6.78	−3.96
1970	70.09	6.73	1.33	0.64	7.91	+6.60	−1.51
1969	62.56	7.31	1.18	0.61	8.35	+5.96	+0.09
1968	55.44	7.65	1.01	0.61	8.58	+6.58	+1.21
1967	48.97	7.82	0.87	0.59	8.47	+4.57	+1.74
1966	44.45	7.92	0.77	0.58	8.50	+4.81	+2.17
1965	4.058	8.00	0.68	0.58	8.52	+5.19	+2.54
1964	34.92	7.55	0.56	0.53	8.00	+5.54	+2.80
1963	29.46	6.94	0.46	0.47	7.31	+5.48	+3.07
1962	25.43	6.49	0.38	0.42	6.81	+5.58	+3.29
1961	23.89	6.57	0.34	0.42	6.87	+5.86	+3.47
1960	22.35	6.60	0.31	0.41	6.87	+5.69	+3.62
1959	21.27	6.72	0.28	0.41	6.97	+5.77	+3.76
1958	19.10	6.43	0.23	0.38	6.65	+5.89	+3.88
Total	1,395.40	109.55	25.85	9.88	125.76	+0.19	.....

Sources: Col. (1) the initial face amounts purchased were taken from appropriate issues of the Life Insurance Fact Book, 1958–78. These were reduced using the lapse figures for the first 15 years from Brzeninski, "Transactions of the Society of Actuaries," Vol. XXVII, 1975, p. 307 and the Moorhead table S rates for the last five years, FTC Report, p. VI–15. The mortality rates used are based on the 1957–60 ultimate Basic Table with selection factors. See FTC Report, p. VI–14.

Col. (2) Total cash values at the beginning of the year are calculated by multiplying the total face amount at the beginning of the year (in thousands of dollars) by the cash value per thousand on the model policy.

Col. (3) Deposits are calculated by multiplying the difference between the model policy premium and the term insurance premium by the total face amount remaining at the beginning of the year. Term rates use the Society's formula and mortality with selection. See FTC Report, p. VI–5 and references therein.

Col. (4) Withdrawals are defined to be the sum of cash surrender values (including terminal dividend) and dividends. Lapse is assumed to occur at the end of the year and the normal dividend is assumed paid even on policies that lapse at the end of the year.

Col. (5) Total cash values at the end of the year are calculated as in Col. 2, except that the total face amount at the end, rather than the beginning, of the year is used.

Col. (6) The one year rate of return, for each issue year and overall, is simply the end year cash value dividend by the beginning year cash value plus deposits minus withdrawals, all minus one. See FTC Report, pp. 15–17, for a detailed explanation.

Col. (7) The average rate of return on the model policy, for holding periods of 1 year, 2 years etc. computed by FTC staff using the same term rates as referenced in col. 3.

TABLE-II "MODEL" POLICY

COMPANY: THE PRUDENTIAL INSURANCE CO. OF AMERICA MALE AGE 35 LAST
POLICY : *OC3 PARTICIPATING BIRTHDAY
TYPE : MODIFIED PREMIUM LIFE
SMALLEST FACE AMOUNT ISSUED 2000. POLICY LOAN INTEREST RATE: 6%

POLICY YEAR	GUARANTEED CASH VALUE	ILLUSTRATED ANNUAL DIVIDEND	ILLUSTRATED TERMINAL DIVIDEND	ANNUAL PREMIUM $ 2M	$ 5M	$ 10M	$ 25M	$100M	DEATH BENEFIT
1	0.00	0.00	0.00	0.00	0.00	0.00	19.66	19.30	1000
2	0.35	0.00	0.00	0.00	0.00	0.00	19.66	19.30	1000
3	15.85	2.02	0.00	0.00	0.00	0.00	19.66	19.30	1000
4	34.34	3.19	0.00	0.00	0.00	0.00	22.38	22.02	1000
5	53.27	3.63	0.00	0.00	0.00	0.00	22.38	22.02	1000
6	72.66	4.10	0.00	0.00	0.00	0.00	22.38	22.02	1000
7	92.49	4.53	0.00	0.00	0.00	0.00	22.38	22.02	1000
8	112.79	4.95	0.00	0.00	0.00	0.00	22.38	22.02	1000
9	133.55	5.33	0.00	0.00	0.00	0.00	22.38	22.02	1000
10	154.78	5.86	0.00	0.00	0.00	0.00	22.38	22.02	1000
11	172.87	6.61	0.00	0.00	0.00	0.00	22.38	22.02	1000
12	191.27	7.37	10.00	0.00	0.00	0.00	22.38	22.02	1000
13	209.98	8.09	12.00	0.00	0.00	0.00	22.38	22.02	1000
14	228.97	8.87	13.00	0.00	0.00	0.00	22.38	22.02	1000
15	248.24	9.63	15.00	0.00	0.00	0.00	22.38	22.02	1000
16	267.76	10.35	17.00	0.00	0.00	0.00	22.38	22.02	1000
17	287.63	11.02	19.00	0.00	0.00	0.00	22.38	22.02	1000
18	307.55	11.68	21.00	0.00	0.00	0.00	22.38	22.02	1000
19	327.80	12.45	23.00	0.00	0.00	0.00	22.38	22.02	1000
20	348.28	13.19	25.00	0.00	0.00	0.00	22.38	22.02	1000
21	367.20	14.33	26.00	0.00	0.00	0.00	22.38	22.02	1000
22	386.14	15.27	26.00	0.00	0.00	0.00	22.38	22.02	1000
23	405.06	16.23	26.00	0.00	0.00	0.00	22.38	22.02	1000
24	423.95	17.14	26.00	0.00	0.00	0.00	22.38	22.02	1000
25	442.76	18.11	27.00	0.00	0.00	0.00	22.38	22.02	1000
26	461.98	19.17	27.00	0.00	0.00	0.00	22.38	22.02	1000
27	480.08	20.29	27.00	0.00	0.00	0.00	22.38	22.02	1000
28	498.54	21.45	27.00	0.00	0.00	0.00	22.38	22.02	1000
29	516.81	21.45	28.00	0.00	0.00	0.00	22.38	22.02	1000
30	534.87	21.45	28.00	0.00	0.00	0.00	22.38	22.02	1000
31	552.67	21.45	28.00	0.00	0.00	0.00	21.93	21.57	1000
32	570.16	21.45	29.00	0.00	0.00	0.00	21.93	21.57	1000
33	587.29	21.45	29.00	0.00	0.00	0.00	21.93	21.57	1000
34	604.02	21.45	29.00	0.00	0.00	0.00	21.93	21.57	1000
35	620.32	21.45	29.00	0.00	0.00	0.00	21.93	21.57	1000
36	636.22	21.45	30.00	0.00	0.00	0.00	21.93	21.57	1000
37	651.76	21.45	30.00	0.00	0.00	0.00	21.93	21.57	1000
38	667.00	21.45	30.00	0.00	0.00	0.00	21.93	21.57	1000
39	682.00	21.45	30.00	0.00	0.00	0.00	21.93	21.57	1000
40	696.77	21.45	30.00	0.00	0.00	0.00	21.93	21.57	1000

[Attachment III]

ANALYSIS OF THE FTC'S AUTHORITY UNDER SECTION SIX OF THE FTC ACT TO COLLECT AND REPORT INFORMATION ON THE "BUSINESS OF INSURANCE"

Since 1976, the Federal Trade Commission ("FTC" or "Commission") has had an active program [1] to provide state insurance commissions and the Congress with information they can use to increase price competition among industry members or otherwise benefit consumers by improving the quality of insurance regulation. The goals of this program do not go beyond providing information. More specifically, in full recognition of the McCarran-Ferguson Act, it is not intended that the Commission will exert any regulatory authority over the business of insurance to the extent that it is regulated by State law.

In a memorandum submitted for the October 17, 1979 hearings before the Senate Committee on Commerce, Science and Transportation, Aetna Life and Casualty Company ("Aetna") argues that the McCarran-Ferguson Act denies the Commission authority to investigate and report on the "business of insurance" in situations where the states are regulating. Aetna argues that the Commission's insurance investigations violate this principle, and that Congress should "clarify" the FTC's authority by amending Section 6 of the Federal Trade Commission Act (FTCA) to explicitly prohibit the Commission from investigating and reporting on the "business of insurance." [2] If this recommendation is adopted, the Commission's insurance program will be terminated.

The first section of this memorandum demonstrates that Aetna's legal analysis is incorrect. In adopting the McCarran Act, Congress limited goal was to recognize and preserve the authority of the states to tax and regulate insurance. The statute was narrowly crafted to do nothing more than to make inapplicable to the business of insurance, federal legislation [3] that would, or could be used to, preempt under the Supremacy Clause of the Constitution inconsistent state insurance regulation. The McCarran Act was never intended to, and does not, withdraw federal authority to engage in activity, such as providing information, that does not conflict with the states' right to regulate and tax. In stating the opposite conclusion, Aetna's analysis contradicts the legislative history of the McCarran Act, the language of the statute and the findings of a subcommittee of the House of Representatives.

It must be recognized, however, that the issue at this point goes beyond the Commission's legal authority under existing statutes. The larger question raised by Aetna is whether the Commission should continue to study and report on important issues facing insurance regulators. The second section of this memorandum sets forth the important public policy considerations indicating the value of continuing the FTC's insurance program.

I. THE FTC HAS LEGAL AUTHORITY TO INVESTIGATE THE "BUSINESS OF INSURANCE."

A. Investigating and reporting authority under section 6, FTCA

Before addressing the merits of Aetna's argument, it may be helpful to review the Commission's authority under Section 6 of the FTCA. Under that section the FTC possesses authority, quite apart from its regulating functions, to gather and report information of value to Congress, the states and the public. Indeed, the legislative history of the FTCA indicates that Congress intended the FTC to be, in the words of the Senate Report, "an indispensible instrument of information and publicity." [4] Section 6(a) authorizes the Commission". . . to gather and compile information concerning the organization, business, conduct, practices, and management of unex-

[1] The insurance program is made up of five investigations, each of which is designed to collect and report information about insurance problems. The specific investigations within this program deal with:

(1) sales abuses and other problems in the sale of "medi-gap" insurance to the elderly.

(2) sales abuses and other problems in the sale of extremely expensive "debit" insurance principally to low income, inner city and rural consumer.

(3) the lack of adequate price competition among sellers of whole life insurance (this project is in its final stage) answering requests for information and assistance following release this past summer of the Life Insurance Cost Disclosure Report).

(4) the availability of adequate cost information to small businessmen who purchase insurance to fund pension plans for their businesses, and

(5) the fairness of high auto insurance rates paid by some consumers solely because of their age, sex, marital status or geographical location.

[2] Aetna Life and Casualty Company, "removal of FTC's Fact-Finding and Reporting Powers by the McCarran-Ferguson Act," at 10 [hereinafter cited as the Aetna memo].

[3] This refers, of course, to federal statutes of general applicability.

[4] S. Rept. No. 597, 63d Cong. 2d Sess. pp. 6-7 (1914).

cepted corporations engaged in commerce. . . ." Section 6(f) authorizes the Commission "[t]o make public. . . information obtained by it. . . and [report] to the Congress and to submit. . . recommendations for additional legislation; and to provide for the publication of its reports for public information or use." The Commission's investigatory powers under Section 6 have been consistently construed to be a broader and entirely different from its regulatory power under Section 5 of the FTCA. [5]

B. McCarran's legislative history

The legislative history of the McCarran Act indicates that Congress never considered the Act's potential impact on the Commission's information reporting responsibility under Section 6 of the FTCA. It also established that the McCarran Act was adopted for a limited purpose—to preserve the states' authority (1) to tax and (2) regulate in ways that would violate the federal antitrust laws if they applied. A statute intended only to preserve the states' legal authority to tax and regulate should not be construed to preclude the FTC from providing advice to the states on how they might regulate more effectively (action which recognizes the primacy of state authority). Moreover, the framers of the McCarran Act repeatly assured other members of Congress that they recognized Congress' responsibility to ensure that state regulation served the public interest and to step in if it did not. It would be inconsistent with those assurances to construe the McCarran Act as denying to Congress and its various committees the benefit of information on the effectiveness of state regulation.

The McCarran Act was a direct response to the Supreme Court's decision in *United States* v. *South-Eastern Underwriters Association,* 322 U.S. 533 (1944) (hereinafter cited as *South-Eastern*).[6] The Court held that the business of insurance conducted across state lines was interstate commerce and therefore subject to the prohibitions of the Sherman Act. [7] For more than 75 years prior to the decision the Supreme Court had maintained that the business of insurance was not commerce, either intrastate or interstate.[8] It therefore followed that the business of insurance was not subject to the federal antitrust laws, since these laws are founded on the federal commerce power.

South-Eastern raised two fundamental questions about state authority. The first concerned the States' taxing power's. During the year prior to the decisions the states had raised $126 million [9] in revenues by taxing insurance. Once the Supreme Court decided that insurance was interstate commerce, some argued that taxes levied on companies which wrote policies in more than one state might be regarded as unlawful burdens on interstate commerce.[10] Within one year of the decision, court actions were filed challenging tax laws in eleven states and taxes were paid under protest in thirty-one states.[11]

The second question raised by *South-Eastern* went to the very legality of the state regulatory systems that had evolved over the seventy-five years prior to 1922.[12] Many states permitted (indeed encouraged) industry members to use rating bureaus to set insurance rates collectively (in order words, to fix prices). The legality of this form of price fixing, given the applicability of the Sherman Act, was problematical after the *South-Eastern* decision. Moreover, the seriousness and urgency of these questions was underscored by the fact that *South-Eastern* was a criminal matter, initiated by an indictment against South-Eastern Underwriters Association, twenty-seven of its officers and its 198 members.[13]

The Congressional debate over insurance regulation began in earnest after the Supreme Court's decision in *South-Eastern* was handed down. Initially, the two Houses of Congress were unable to agree on the appropriate interplay between state regulation and the antitrust laws. The Senate wanted the states to adopt regulatory systems that conformed to the Sherman Act. In the words of Senator Taft, "[w]e wish [the states] to put their houses in order by adopting laws which do not conflict

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[N5] Appeal of FTC Line of Business Report Litigation, 595 F.2d 685, 702 (D.C. Cir. 1978) *cert. denied,* 99 S. Ct. 362 (1978); *Ash Grove Cement Co.* v. *FTC,* 577 F. 2d 1368, 1875 (9th Cir. 1976).

[6] *FTC* v. *Travelers Health Ass'n.,* 362 U.S. 293, 299 (1960).

[7] 322 U.S. 533, 539, 560 (1944).

[8] *Paul* v. *Virginia,* 75 U.S. (8 Wall.) 168, 183 (1868).

[9] W. Freedman, Richards on the Law of Insurance 178 n.9 (5th ed. 1952).

[10] In his dissenting opinion, Justice Jackson stated:

"The Court's decision at very least will require an extensive overhauling of state legislation relating to taxation and supervision. The whole legal basis will have to be reconsidered. What will be irretrievably lost and what may be salvaged no one can say, and it will take a generation of litigation to determine. Certainly the states lose very important controls and very considerable revenues." 322 U.S. 590 (Jackson, J. dissenting in part).

[11] Insurance Field (Life ed.), May 25, 1944, at 17-20. See also the editions for March 16, 1945, at 3 and March 23, 1945, at 3.

[12] Dissent by J. Jackson, supra note 10.

[13] 322 U.S. at 534.

with the Sherman Act." [14] The House, on the other hand, believed that state insurance regulation should not be controlled by the federal antitrust laws.[15] Another difference concerned the FTCA. Both the House and Senate had passed bills which provided that "nothing" in the FTCA "shall apply to the business of insurance, although both bills also provided that the Sherman Act and the Clayton Act would become applicable to insurance after a moratorium period.[16] But during the House debate, several members objected to the provision exempting insurance from FTCA coverage.[17] To overcome these objections, Representative Sumners, Chairman of the House Judiciary Committee, assured his colleagues that in Conference he would make the FTCA applicable to the business of insurance following the moratorium period.[18]

The McCarran Act represents the compromise worked out on these issues in the Conference Committee. It passed the House without debate.[19] The Conference Report contains little more than the draft bill.[20] Therefore, the only legislative history directly pertaining to the bill that was finally adopted is the floor debate which took place when the Senate took up the Conference report.

The Senate debate centered on the principal issue which had earlier separated the House and Senate—when state insurance regulation authorized activity proscribed by the antitrust acts, which regulatory system would prevail? The debate makes clear that the purpose of the compromise bill was to preserve the states' authority to tax and, with certain exceptions, to regulate in ways that would violate the antitrust laws if they applied. The debate also makes clear how the statute was intended to accomplish that goal: where state law and the antitrust laws conflicted, the statute was to resolve that conflict [21] in favor of state regulation, with certain prescribed exceptions; and where there was no conflict because the states were not regulating and thus state authority was not threatened, the antitrust laws were to apply with their full force and effect.

During an exchange with Senator Pepper, Senator Ferguson, one of the conferees, summarized the bill's conflict-resolving purpose as follows:

"Mr. FERGUSON. Under the language which is now in the bill as it appears in the conference report, *if a state passes an act regulating insurance or taxing insurance, and that regulation is contrary to the Sherman Act or the Clayton Act,* with three exceptions, *then the State law would be the law.* Here are the exceptions:

"Nothing contained in this act shall render the said Sherman Act inapplicable to any agreement to boycott, coerce or intimate, or act of boycott, coercion, or intimidation.

* * * * * * *

"But with respect to anything else, if the States were specifically to legislate upon a particular point, and that legislation were *contrary* to the Sherman Act, the Clayton Act, or the Federal Trade Commission Act, *then the State law would be binding. That is exactly what we attempted to do in this bill. It is clear what we attempted to do."* [22]

Soon after this comment, the following colloquy appears.

"Mr. FERGUSON. This bill would permit—and I think it is fair to say that it is intended to permit—rating bureaus . . . [W]e believe that State rights should permit a State to say that it believes in a rating bureau.

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"Mr. PEPPER. In other words, the Senator believes in a form of rate fixing?

"Mr. FERGUSON. Yes. There is no doubt the bill allows it; but we believe that all the wisdon is not here in Congress. We believe that there is some wisdom left in the legislatures that they should exercise their judgment and regulate insurance, except in the respects which we have enumerated." [23]

Senator O'Mahoney, another of the conferees, summarized the purpose of the bill as follows:

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[14] 91 Cong. Rec. 484 (1945).
[15] Id. at 1084–85, 1208.
[16] Id. at 1005, 1027.
[17] Id. at 1027–28, 1086, 1089–94.
[18] Id. at 1093.
[19] Id. at 1396.
[20] H.R. Rep. No. 213, 79th Cong. 1st Sess. (1945).
[21] This is not intended to suggest that our position is that the federal government may regulate concurrently with the states. If the states are regulating, those regulations occupy the regulatory field, and the federal government is without authority to regulate, either consistently with or inconsistently with the state regulation. But in occupying the field for purposes of regulation, the states do not preempt federal authority to engage in nonregulatory activities.
[22] 91 *Cong. Rec.* 1481 (1945) (emphasis added).
[23] Id. (emphasis added).

"So now we endeavor to convey that *power of regulation* to the States—to recognize it, I should say, rather than convey it—to recognize as desirable [state] regulation." [24]

Senator Murdock repeated the thought:

"As the Senator from Wyoming has said, we convey no authority, we simply recognize [the State's] *right to regulate.*[25]

That the compromise bill, and especially the "proviso" to Section 2(b),[26] was simply intended to apply the full force of the antitrust laws to insurance where the states were not regulating (in other words, to preserve the residual federal authority to regulate) can be seen from the following:

"Mr. PEPPER. Will the Senator read the proviso?

"Mr. O'MAHONEY. It provides that after January 1, 1948, these several acts. . .

"Mr. PEPPER. That is, the Sherman Act and the Clayton Act. . .

"Mr. O'MAHONEY. Yes; they "shall be applicable"—there is a positive declaration—"to the business of insurance to the extent that such business is no regulated by State law," . . . . *I interpreted that to be a clear statement that if the States do not regulate, the power of Congress to regulate is clearly enunciated."* [27]

Later in the debate, Senator O'Mahoney reinforced the point.

". . . one of the House conferees, in the course of the conference, used this sentence, which I thought was extremely apt: 'This is a bill to authorize the States to regulate the insurance business; and if the States do not regulate it, the Federal Government can.'" [28]

While the legislative history is filled with indications that the purpose of the bill was to preserve states' authority to tax and to regulate in ways that would otherwise be proscribed by the antitrust laws, there is no evidence indicating that Congress intended for the bill to go beyond that purpose. Indeed, nowhere in McCarran's legislative history is there any mention of the FTC's authority under Section 6, or its investigating and reporting functions, or that in providing for these, the FTCA was different from the Sherman and Clayton Acts. Thus, there is no evidence in the legislative history that Congress intended that the McCarran Act go beyond preserving states' legal authority, to withdrawing from the FTC authoriy to collect and report to the states and Congress information on how that authority might be used more effectively.

After acknowledging the absence of such evidence,[29] Aetna proceeds to argue that Congress could not have overlooked the Commission's important information gathering and reporting function and, therefore, that it must have intended to preclude the Commission's Section 6 authority as well.[30] However, if Congress had considered this issue, it is very unlikely that some indication of that consideration would not appear somewhere in the legislative history. At a minimum, the absence of any direct Congressional expressions on this issue leaves the issue an open one—and in no event is it dispositive of the question as Aetna would suggest.

The conclusion that McCarran was enacted to achieve a limited goal is by no means novel. Since 1945, the courts have on several occasions examined McCarran's legislative history and commented on its limited purposes. In *Maryland Cas. Co.* v. *Cushing,*[31] Mr. Justice Frankfurter observed:

"Suffice it to say that even the most cursory reading of the legislative history of this enactment makes it clear that *its exclusive purpose* was to counteract any adverse effect that this Court's decision in *United States* v. *South-Eastern Underwriters Association* . . . might be found to have on state regulation of insurance."[32]

Similar language appears in *Wilburn Boat Co.* v. *Fireman's Fund Insurance Co.*[33]

"The measure Congress passed shortly thereafter, known as the McCarran Act, was designed to assure that existing state power to *regulate* insurance would continue."[34]

Finally, Aetna argues that Congress intended to protect the states from FTC reports which might point out inadequacies in state regulation.[35] Nothing in the legislative history even suggests that Congress intended to shield the states from

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[24] Id. at 1444 (emphasis added).
[25] *Id.* (emphasis added).
[26] *See* text accompanying notes 39-43 *infra.*
[27] 91 *Cong. Rec.* 1444 (1945) (emphasis added).
[28] *Id.* at 1486-87.
[29] Aetna memo, *supra* note 2, at 5.
[30] *Id.*
[31] 347 U.S. 409 (1954).
[32] *Id.* at 413 (emphasis added) (citation omitted).
[33] 348 U.S. 310 (1955).
[32] *Id.* at 319 (emphasis added) (citation omitted).
[35] Aetna memo, *supra* note 2, at 5-6.

such information. Indeed, the opposite is true. During the debates which immediately preceded passage of the Act, several senators inquired as to what steps would be taken to assure that state regulation served the "'public interest" and what would be done if it did not.[36] Assurances were given by the framers of the Act that Congress reserved the right to overturn the regulatory system permitted by the McCarran-Ferguson Act if states did not act in the best interests of their citizens.[37] It is inconsistent with the spirit of those assurances to interpret McCarran as denying the Commission's authority to report information that would permit the Congress to judge the adequacy of state regulation.

Congress' limited purpose in adopting the McCarran Act is clear from the above.[38] That purpose now defines the scope of this statute.

C. The language of the statute

The limited scope of the McCarran Act—preserving the states' authority to regulate and tax—is not only demonstrated by the legislative history; it is made clear by the language of the statute itself.

The Act states that its purpose is to "express the intent of the Congress with reference to the *regulation* of . . . insurance."[39] The first section of the Act provides:

"Be it enacted . . ., that the Congress hereby declares that the *continued regulation and taxation* by the several States of . . . insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any *barrier* to the *regulation or taxation* of such business by the several States."[40]

Section 2(a) states that "the business of insurance . . . shall be subject to the laws of the several States which relate to the *regulation* or *taxation* of such business."[41]

Aetna relies heavily for its argument on Section 2(b), which provides as follows:

"(b) No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance: *Provided,* That after June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended, shall be applicable to the business of insurance to the extent that such business is not regulated by state law."[42]

Aetna argues that the proviso, which states that the FTCA "shall be *applicable* to the business of insurance to the extent that . . . [it] . . . is not regulated by state law,"[43] (and which thus preserves residual regulatory authority in the federal government), forces the conclusion that where the states are regulating, the FTC lacks both regulatory and non-regulatory authority.[44]

The principal and *controlling* clause of Section 2(b) is narrowly focused on the possibility of federal law "invalidat[ing], impair[ing], or supersed[ing]" (in other words, preempting in whole or part) state insurance laws. By addressing itself to laws which might threaten states' authority to regulate, this clause brings Section 2(b), including the proviso, into conformity with the rest of the statute.

In concluding that the proviso has sweeping effect, Aetna apparently reads the proviso without reference to the principal clause of Section 2(b).[45] The restrictive

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[36] 91 *Cong. Rec.* 1447, 1481–84, 1487–88 (1945).

[37] *Id.*

[38] For a more complete review of the legislative history, see Weller, *The McCarran-Ferguson Act's Antitrust Exemption For Insurance, History and Policy,* 1978 Duke L.J. 587 (1978).

[39] Preamble to McCarran-Ferguson Act, c. 20, 59 Stat. 33 (emphasis added).

[40] *Id.* § 1 (emphasis added).

[41] *Id.* § 2(a) (emphasis added).

[42] *Id.* § 2(b).

[43] *Id.* (emphasis added).

[44] Aetna memo, *supra* note 2, at 1–2.

[45] It is possible that Aetna believes that the second clause is, in reality, an "exceptions clause," or, in other words, that it exempts the three antitrust statutes from the principal clause, (and its restrictive standard) and subjects those Acts only to the standards of the proviso. (For an explanation of "exceptions" clauses, see 1A. C. Sands, Statutes and Statutory Constructions § 21.11 (4th ed. 1972)). But such a reading would also be incorrect.

The legislative history indicates that both clauses were intended to refer to the antitrust statutes and thus, by implication, that the proviso should not be read as an exceptions clause but in a customary way.

First, Senator O'Mahoney, one of the Senate conferees, stated during the Senate debate immediately preceding Senate adoption of McCarran that both clauses of section 2(b) would apply to the antitrust acts. 91 Cong. Rec. 1444. Second, Congress had abandoned the Ferguson amendment which, as adopted by the Senate, provided "no act of Congress, except . . . the Sherman Act, and/or . . . the Clayton Act, shall be construed to invalidate, impair or supersede any law enacted by any State for the purpose of regulating the business of insurance. . . . " *Id.*

Footnotes continued on next page

"invalidate, impair, or supersede" standard set forth in the principal clause establishes the context for the proviso and limits its meaning.[46] Aetna's construction is therefore at odds with the well-established principle of statutory construction that the main or dominant body of an enactment is assumed to express the legislative purpose and to be controlling.[47] Moreover, when there is doubt as to their scope, provisos are strictly construed.[48]

In summary, the statute as a whole, and even the very section which Aetna relies on, demonstrates McCarran's limited purpose and scope: to perserve the states' regulatory and taxing authority. These may not be expanded, through an inappropriate reading of a proviso clause, into a broad prohibition against the FTC providing information and analysis that does not threaten the states' legal authority, and in fact should help the states exercise it more effectively.

D. Findings of a House subcommittee

During 1978, the Subcommittee on Oversight and Investigations of the Committee on Interstate and Foreign Commerce held hearings on life insurance marketing and cost disclosure. As part of those hearings, the Oversight Subcommittee considered specifically the Commission's legal authority to investigate and report on the business of insurance. The Subcommittee concluded that

". . . besides its direct regulatory authority under the FTC Act, the Commission is empowered to investigate the conduct of any corporation excepting banks and common carriers," 15 U.S.C. § 46(a), and to make reports to Congress recommending legislation, 15 U.S.C. § 46(f). We do not think that such non-regulatory activities are affected by the McCarran Act. Cf. H. App. 30B." [49]

E. A lack of case law

While the FTC's authority to investigate the business of insurance has been upheld on several occasions,[50] there are no cases which specifically address the interplay between Section 6 of the FTCA and the McCarran Act.[51]

F. Conclusions

The McCarran Act on its face, its legislative history, and findings by the Houuse Oversight Subcommittee all support the view that the Commission has authority under Section 6 of the FTCA to investigate and report on the business of insurance whether or not states are regulating in the specific area of Commission inquiry.

II. PUBLIC POLICY REASONS WHY AETNA'S PROPOSED AMENDMENT SHOULD BE REJECTED

The first section of this memorandum explains why Aetna's legal analysis of the Commission's Section 6 authority to investigate the "business of insurance" is incorrect. But whether or not Section 6 should be amended is not as much a question of law as it is one of public policy: what should be the Commission's *future* authority to investigate and report on the "business of insurance?" This section sets forth the strong public policy reasons why Congress should allow the Commission to retain such authority.

Footnotes continued from last page

at 487. If Congress had intended to exclude the three antitrust acts from the first clause, it could have simply retained the Ferguson amendment and added the FTC Act.

Moreover, as one commentator argues persuasively:

"Even if the proviso were treated as an exception clause, the "invalidate, impair, or supersede" standard of the first clause should still be applied as a minimum test for federal antitrust immunity. Since the House had adopted that standard and the Senate demanded a stricter standard, the proviso compromise could not have been anything less than that to which the House had already agreed." Weller, *supra* note 38 at 605 n. 91.

[46] *Id;* but for an *important* qualification, see *supra* note 21.

[47] *Id;* 2A C. Sands, Statutes and Statutory Construction §§ 47.08, 47.09 (4th ed. 1972).

[48] *Id.*

[49] House Subcommittee on Oversight and Investigations of the Comm. on Interstate and Foreign Commerce, 95th Cong., 2d Sess., Report on Life Insurance Marketing and Cost Disclosure 63 n.275 (Comm. Print 1978) [hereinafter cited as Moss Comm. Rep.].

[50] *See, e.g., FTC.* v. *Crafts,* 355 U.S. 9 (1957).

[51] One commentator, after analyzing the Supreme Court's decisions concerning the McCarran Act, reached the following conclusion:

"It may be argued that the McCarran Act was designed only to restrict the FTC's power to regulate, not to investigate. This interpretation is easily justified since it would leave the FTC free to gather facts for later presentation to Congress should it appear that the public interest no longer is compatible with giving the states primary authority to regulate the insurance business." Comment, *Per Curiam Decisions of the Supreme Court: 1957 Term,* 26 U. Chi. L. Rev. 297, 305 (1959).

State officials attempting to regulate in the "public interest" need information about industry performance. So does the Congress if it is to know whether the continued delegation of its reponsibilities to regulate interstate commerce in the area of insurance is in the public interest.[52] To meet their respective responsibilities each must know, for example, if the industry is competing on the basis of price; if it is operating efficiently from the consumer's perspective (if it pays out in benefits a high percentage of what it collects in premiums); if consumers have the information they need to distinguish low-cost sellers from high-cost sellers (for comparable products); if attempted regulatory solutions to known problems are effective; and so on. Without information of this type, insurance regulation is a guessing game played with trillions of dollars in consumer resources. Moreover, it is appropriate for the public to have information that will alert it to, and help it avoid, existing consumer problems. It is also appropriate that the public be advised of the effectiveness of regulatory systems adopted in its name.

The FTC is in a unique position to provide some of this information. As indicated by the National Commission for the Review of the Antitrust Laws and Procedures,[53] and demonstrated empirically in the FTC's staff report on Life Insurance Cost Disclosure,[54] certain major sections of the insurance industry do not adequately compete on the basis of price. It appears that the most effective remedy to address these problems may be to provide consumers with information that will increase their ability to price shop and thereby induce sellers to compete on the basis of price. The Commission has been working with competition problems and informational remedies for over 50 years. As a result, it has developed a great deal of experience and expertise on these issues, as well as the technical skills (in economics, data processing, statistics, and others) their analysis requires. The Commission's role in the insurance area is to make its experience, expertise, and technical capabilities available to insurance policymakers to use or disregard as they see fit.

Perhaps the value of FTC analyses on insurance issues is best indicated by the demand for it. During the last two years, FTC representatives have been invited to testify before Congress on insurance issues on ten different occasions. These invitations came from committees and subcommittees of both Houses.[55] In addition, over the last two years Commission representatives have been asked to testify before five states on insurance issues.[56] Moreover, during the same period of time, representatives from more than twenty state insurance commissions have, at their initiation,

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[52] *U.S. Const.* art. 1 § 8.

[53] In its recommendations to the President and the Attorney General, the National Commission for the Review of Antitrust Laws and Procedures concludes:

"Although there is general consensus that most segments of the industry are competitively structured, and that enhanced competition is an appropriate goal of state regulatory policy, many states adhere to regulatory scheme requiring prior approval of insurance rates, thereby discouraging independent pricing behavior. The costs of continuing the present system are not insignificant: where members of a competitively structured industry are allowed collectively published industrywide rates—often without effective state supervision—in a regulatory environment that encourages uniform pricing, insurance premiums are likely to be higher than under a system that relies more heavily on independent pricing decisions. In some prior approval states, regulation may in fact keep rates below levels that would be produced by competition. Unduly low rates, however, may exacerbate availability problems." National Commission for the Review of Antitrust Laws and Procedures, Report to the President and the Attorney General 226-27 (1979).

[54] Federal Trade Commission, Staff Report on Life Insurance Cost Disclosure 50-62 (1979).

[55] During the years 1978 and 1979, Commission representatives testified before the following Congressional Committees and Subcommittees:

96th Congress

October 11, 1979—House Committee on Small Business; Subcommittee on General Oversight and Minority Enterprise.

October 16, 1979—House Committee on Interstate and Foreign Commerce: Subcommittee on Health and the Environment.

July 10, 1979—Senate Committee on Commerce, Science and Transportation.

March 12, 1979—Senate Committee on the Judiciary.

June 14, 1979—Senate Committee on Banking, Housing and Urban Affairs.

95th Congress

February 24, 1978—House Committee on Ways and Means: Oversight Subcommittee.

April 10, 1978—House Committee on Government Operations: Subcommittee on Commerce, Consumer, and Monetary Affairs.

June 29, 1978—Senate Special Committee on Aging.

August 7, 1978—House Committee on Interstate and Foreign Commerce: Subcommittee on Oversight and Investigations.

November 28, 1978—House Select Committee on Aging

[56] Maine, North Carolina, Texas, Washington and Wisconsin.

informally discussed insurance issues with the Commission staff.[57] After the release of the staff's recent economic analysis documenting the lack of price competition among sellers of whole life insurance, the National Association of Insurance Commissioners (N.A.I.C.) invited FTC representatives to appear and testify before its task force to evaluate the N.A.I.C.'s model cost disclosure regulation. In addition, because of her extensive analysis of medicare supplement insurance problems, an FTC staff member was asked to serve on an advisory committee to the NAIC Task Force on Medicare Supplement Insurance.

The evidence of the value of Commission analysis on insurance issues is not all circumstantial. Before the life insurance cost disclosure investigation was completed, but after staff had released preliminary findings, the Commission received a letter from the State Insurance Commissioners of Massachusetts, Minnesota, New Jersey, North Carolina, North Dakota and Wisconsin advising that:

"We have followed with interest the work of the Federal Trade Commission on life insurance cost disclosure. . . . We find the FTC staff comments constructive and worthy of consideration. . . . The FTC would be doing us a service by continuing with its study and by providing assistance in this field to those states which would benefit from it." [58]

Members of Congress have encouraged and supported the Commission in its insurance investigations. For example, after learning of certain budgetary problems the Commission was facing in funding its study of medicare supplement insurance, Senators Lawton Chiles, Frank Church and Pete V. Domenici of the Senate Special Committee on Aging wrote to the Commission and advised:

"[W]e hope, however that this . . . will not preclude your intiatives in this area and that you will be able to go ahead at the earliest date possible.

"We would appreciate being kept informed of Commission decisions and actions and once again offer our assistance and support." [59]

Of course, every year since 1977, Congress has been informed of the Commission's involvement in the insurance area through the budget process. [60] Moreover, in response to FTC budget submissions on insurance, both Houses explicitly approved of the Commission working with the states in this area.[61]

In addition, the President recently wrote to the State Governors advising them of his view that:

"The model regulation [developed as part of the life insurance cost disclosure project] is designed to provide meaningful disclosure of life insurance costs. Under the law, only the states can act to require this kind of disclosure. This is an important initiative the states can take to promote price competition and to ensure that the life insurance market is responsive to the needs of consumers. I hope that the resources invested in this study by the Federal government will yield a dividend of increased Federal-State cooperation. I urge you and your insurance officials to give the model regulation the most careful consideration." [62]

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[57] These include representatives from Alaska, Arkansas, California, District of Columbia, Florida, Illinois, Indiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Nevada, New Jersey, New York, North Carolina, Pennsylvania, Virginia, Washington, and Wisconsin.

[58] Letter from the Insurance Commissioners to Michael Pertschuk, Chairman of the Federal Trade Commission (Sept. 22, 1979), Moss Comm. Rep., *supra* note 49 at 815.

[59] Letter from Senators Lawton Chiles, Frank Church and Pete Domenici (present Chairman, former Chairman and ranking minority member) of the Senate Special Committee on Aging, to Michael Pertschuk, Chairman of the Federal Trade Commission (Oct. 6, 1978).

[60] *See,* [1977], *Fed. Trade Comm. Prog. Budget Justification to Cong.* 142; [1978], *Fed. Trade Comm. Prog. Budget Justification to Cong.* 143; [1979], *Fed. Trade Comm. Prog. Budget Justification to Cong.* B-9.

[61] In a report to Congress the Senate Committee on Appropriations stated:

"The Chairman of the FTC advised the Chairman of this Committee that . . . theFTC . . . on the subject of life insurance cost disclosure . . . would seek to encourage meaningful regulation of this area at the State level. The Committee does not disagree with the efforts of the Commission to work with the states. . . ." S. Rept. No. 1043, 95th Cong., 2d Sess. 74 (1978);

The House Committee on Appropriations in referring to the FTC's investigation of the life insurance industry stated:

"[T]he Committee strongly recommends that the Commission not take any final action during fiscal year 1979 which might be inconsistent with the model regulation of the National Association of Insurance Commissioners. Such a course will provide time for appropriate committees of Congress to consider the matter." H.R. Rep. No. 1243, 95th Cong., 2d Sess. 46-47 (1978).

Later that year the House Subcommittee on Oversight and Investigations of the Committee on Interstate and Foreign Commerce held hearings on life insurance marketing and cost disclosure. The subcommittee concluded that the FTC had the authority to investigate the industry and that the FTC's role was "wholly lawful, proper, and appropriate." Moss Comm. Rep., *supra* note 49 at 63.

[62] Letter from President Jimmy Carter to the Governors of the 50 states (Jan. 8, 1980) (copy attached).

The compelling public policy reasons why the Commission should continue to collect and report on insurance issues were, perhaps, best stated by the House Oversight Subcommittee after it held extensive hearings on the subject:

". . . the infusion of fresh views by an agency experienced in consumer protection activities is *highly desirable*. . . . [t]he size of the insurance industry, its importance to consumers, and its methods of doing business clearly justify the expenditure of some FTC resources to maintain at least an advisory federal presence." [63]

THE WHITE HOUSE,
Washington.

To Governor ———:

Americans spend over $30 billion a year on life insurance premium payments. Yet too often, consumers lack the basic cost information they need to find the best policy at the lowest price. The Federal Trade Commission has recently recommended a model state regulation on life insurance cost disclosure to help achieve this purpose.

On the basis of economic study and consumer research, the Commission concluded that whole life value insurance policies not held to maturity pay a relatively low rate of return on their cash values, and that consumers are not getting the information they need to understand the true costs of their policies. The result is billions of dollars a year in unnecessary costs to consumers.

I am enclosing a copy of the model state regulation and other material which summarizes the key findings and recommendations. The model regulation is designed to provide meaningful disclosure of life insurance costs. Under the law, only the states can act to require this kind of disclosure. This is an important initiative the states can take to promote price competition and to ensure that the life insurance market is responsive to the needs of consumers. I hope that the resources invested in this study by the Federal government will yield a dividend of increased Federal-State cooperation. I urge you and your insurance officials to give the model regulation the most careful consideration.

Sincerely,

JIMMY CARTER.

AMERICAN COUNCIL OF LIFE INSURANCE,
Washington, D.C., January 30, 1980.

Hon. HOWARD W. CANNON,
Chairman, Committee on Commerce, Science, and Transportation, U.S. Senate, Russell Senate Office Building, Washington, D.C.

DEAR SENATOR CANNON: Enclosed is a copy of the response of the American Council of Life Insurance to the comments by the Federal Trade Commission on the Council's testimony on the Commission's life insurance cost disclosure report which was issued on July 10, 1979.

Sincerely,

ROBERT BLAND SMITH, Jr.

Enclosure.

COMMENTS BY THE AMERICAN COUNCIL OF LIFE INSURANCE ON THE FTC STAFF'S RESPONSES TO CRITICISMS OF THE REPORT ON LIFE INSURANCE COST DISCLOSURE

The staff of the Federal Trade Commission has chosen to respond to eight of the criticisms of the staff report made by representatives of the life insurance business at the October 17, 1979 hearing of the Senate Committee on Commerce, Science and Transportation. These responses merely repeat the erroneous ideas and conclusions that were set out at length in the FTC staff report.

We should like to offer a few comments pointing out what we see as flaws in the responses of the FTC staff in order to clarify some of the matters under dispute. Our comments will follow the same sequence used by the FTC staff.

1. *The FTC staff report "adopts the flawed theory that whole life insurance is a hybrid combination of term insurance and a savings account." Instead, "whole life is not partially insurance and partially savings. It is wholly insurance."*

In the FTC staff's response to this criticism, it studiously continues to miss the point as to what the life insurance business is and persists in the view that our industry is selling savings accounts. The primary purpose of the life insurance

[63] Moss Comm. Rep., *supra* note 49 at 62-63.

business is to provide life insurance and annuity benefits through contracts that guarantee dollars for future delivery. Appropriate disclosure should tell the purchaser what benefits are payable, the conditions under which they will be payable and the price that must be paid to purchase a contract that makes such guarantees. The National Association of Insurance Commissioner's Model Life Insurance Solicitation Regulation which has been adopted in thirty states requires insurers to give purchasers this kind of information. (In addition, many insurers provide this information voluntarily so that about 80 percent of all purchasers receive it.)

Although the life insurance business accumulates capital as a result of insurance operations and does in a macroeconomic sense contribute to the nation's supply of savings, this does not transform life insurance companies into savings banks nor life insurance policies into savings accounts. Many other institutions, both private and public, contribute to the nation's supply of savings even though they do not offer savings accounts.

The fact that life insurance policies are assets of their owners leads to "savings" in the macroeceonomic sense. It does not result in these policies being equal or equivalent to term insurance plus a savings account. The use of the term "savings through life insurance" in the economic literature relating to the life insurance business is analyzed in Appendix A to this statement.

In summary, the response of the FTC staff to this criticism has been to repeat several quotations from the text of their report and to cite several authorities from the life insurance business to prove that life insurance companies are financial institutions that accumulate savings. The latter point is clearly correct and has not, to our knowledge, ever been questioned. It is, of course, irrelevant to the disagreement between the FTC staff and the life insurance business.

We do not object to anyone claiming that a whole life insurance policy may, for some purposes, be thought of as being analogous to a combination of term insurance plus a savings account. What we do object to is the FTC staff claiming that such an analogy is a fact and that policyholders must be told the "rate of return" earned on that savings account.

For cost comparison purposes, the natural unit price for insurance is dollars of premium per thousand dollars of death benefit per year—adjusted as appropriate for dividends and cash surrender values. The recommendation of the FTC staff that a cost index stated in terms of a rate of return on a hypothetical savings account can be justified neither by the utility of such an index nor by an argument that treats analogy as fact.

2. *The FTC staff's 1.3 percent average industrywide rate of return calculation is meaningless and its dissemination irresponsible.*

The FTC staff, in defending their meaningless average industrywide "rate of return," continues to ignore the fact that the life insurance business provides guaranteed benefits which involve a definite cost as contrasted to banks or savings and loan associations that offer savings accounts and that credit interest to these accounts periodically. The 1.3 percent figure is a fiction based upon FTC staff hypotheses and does not reflect the actual operation of the life insurance business. Life insurers currently use interest rates of from 5 to 6 percent in determining the price of the guaranteed benefits that they provide.

In commenting on the FTC staff's renewed argument that industrywide "rate of return" has some significance, we wish to note again that there is no reason to attempt to develop a "rate of return" for the industry from composite financial statements since this has nothing to do with disclosing the price of life insurance to individual buyers. The FTC staff's response appears to indicate that the industrywide "rate of return" was developed primarily in order to provide a basis for sensational claims about lack of competition in the life insurance business and resulting losses to policyowners of billions of dollars.

3. *The one year industrywide rate of return paid to ordinary policyholders in 1977 by the life insurance industry was 5.9 percent, not the 1 to 2 percent estimate contained in the FTC staff report.*

As we noted in our testimony on October 17, the calculation of an industrywide "rate of return" according to the FTC staff's method could produce a result ranging anywhere from −0.1 percent to 9 percent depending upon the assumptions chosen. The result would depend on how low a set of premium rates were used to calculate the "term insurance costs." The lower the premium rates, the lower the "term insurance cost," the larger the "deposit to savings" from the balance of premiums and the lower the rate of return produced by the calculation. The term insurance premium rates chosen by the FTC staff for the calculation of the "industrywide rate of return" were, in fact, very much lower than those used elsewhere in the FTC

staff report or those actually charged by life insurance companies. They resulted in very low "rates of return."

This calculation ignores the interest actually credited by companies to their individual life insurance line of business and, thus, to the benefit of their policyowners collectively. In contrast, the calculation in Mr. Taylor's statement begins with the $12.4 billion actually credited by companies to the individual life insurance line. This amount is reduced by a portion that may be allocated to cover a share of expenses, taxes and profits. Since a life insurance company operates as a single unit, all income received by a company from both premiums and investment income is available to pay all benefits and expenses. If an industrywide "rate of return" representing investment income used for policyholder benefits is to be computed, it cannot be unreasonable to assume that premiums and investment income are allocated proportionately to provide for benefits and expenses.

The FTC staff shrugs off this allocation as "arbitrary" but does not suggest that it is unreasonable. In contrast, the alternative allocation implicit in their calculation—namely, that 80 percent of expenses, taxes and profits comes from the $12.4 billion of investment income credited by companies to their individual policyholders in 1977 and that the remaining 20 percent comes from the $24.2 billion of premium income received by companies that year is both arbitrary and unreasonable.

The FTC staff comments emphasize the importance of their estimate of the cost of "providing pure insurance protection" to the results of their calculation. To correct their calculations, the most important adjustment is to replace their estimate by premium rates that are representative of low cost term insurance rates actually charged by life insurance companies. A discussion of this point and of other corrections that should be made to the calculations of the FTC staff is contained in Appendix B.

4. *The FTC cost disclosure report was unfairly biased in favor of term insurance.*

The FTC staff was able to find two quotations from their report which they could cite to argue that their report was neutral. A careful reading of the entire report leads to quite a different conclusion. In fact, those biases continue to show in their letter of January 15. They still take the position that term insurance plus a savings fund is the same as permanent insurance which guarantees dollars for future delivery whenever an insured may die. Guarantees of insurance benefits cost money. For the insured who lives, the purchase of an insurance contract, whether term or permanent, may or may not prove to be as financially rewarding as substituting an investment for the insurance protection. But, this is not the point. The question is whether an individual needs guaranteed dollars to be delivered when specified events occur. If this is what is needed, a comparison of a hypothetical "rate of return" on an insurance contract with rates of return on investments is irrelevant. What is needed is a means of comparing the costs of insurance contracts that guarantee the particular pattern of future dollars to meet insurance needs.

5. *Many consumers would be ill-advised to buy only term insurance because term insurance becomes prohibitively expensive at older ages.*

The FTC staff response ignores the experience of insurance companies, regulators and the Veteran's Administration with policyholders who were forced to drop term insurance policies when premium rates became prohibitive even though they still needed life insurance. The blindness of the FTC staff to this problem is symptomatic of their view of term insurance and an unspecified investment as an acceptable substitute for whole life insurance.

6. *The FTC's cost disclosure report was unnecessary because the NAIC has issued a model cost disclosure regulation.*

The FTC staff claims the use of a cost index showing a "rate of return" is a needed change to the NAIC model regulation that justifies their activities in this field.

The FTC staff's claim that rate of return disclosure offers a better way to compare dissimiliar policies is totally false. The FTC staff's so-called rate of return for a particular policy is not a true interest earnings rate at all but merely another cost index which reflects the same premiums, dividends and cash values as are reflected in the NAIC Surrender Cost Index. In the case of the former, a cost of insurance is assumed and the index is expressed in terms of an interest rate; in the case of the latter, an interest rate is assumed and the index is expressed in terms of a cost of insurance. Comparative rankings of policy costs according to the two indexes show a high statistical correlation which means that the NAIC Net Surrender Cost Index is at least as ueful a cost comparison index as the FTC staff's rate of return. In fact, it is more useful since it can be used to show the relative costs of term policies as well as permanent policies which is not possible with the rate of return index. The NAIC disclosure package provides sufficient disclosure information to illustrate the pat-

tern of guaranteed insurance benefits and their costs and cost indexes to summarize what are generally the most important of these costs, together with balanced and unbiased information to aid in shopping for life insurance. In contrast, the FTC staff report contains a proposed disclosure regulation which encourages buyers to provide for their insurance needs by shifting from whole life insurance to term insurance plus an investment. Advocacy of such an incomplete insurance program may do a great disservice to insurance buyers, particularly as they find they have insurance needs which do not diminish with advancing age.

7. *The FTC staff disregarded or suppressed the results of consumer research which the FTC commissioned because the results of that research contradicted the staff's conclusions about the need for cost disclosure.*

The FTC staff misconstrues the results of the studies referred to in their response. This question is discussed at more length in Appendix C.

8. *The Federal Trade Commission should not be involved in the life insurance area because it has not received a sufficient number of consumer complaints.*

Predictably, the FTC staff responds that "consumer complaints do not always provide an accurate gauge of consumer problems."

The FTC staff's assertion that the life insurance business is not price competitive simply does not reflect trends over the last generation which are continuing up to today. The price of both permanent and term plans has been steadily decreasing reflecting improvements in investment earnings and mortality. New types of products have been introduced to meet changing insurance needs and conditions.

The FTC staff tends to focus on the extremes in insurance pricing to assert their claim that there is a lack of competition within the insurance business. Even if they could find some few life insurers that are not keeping up with changing trends in pricing, most life insurance is sold by companies that actively and aggressively compete for new business. A review of recent announcements of rate changes would indicate that there is real competition in the life insurance marketplace.

REVIEW OF PRESS REPORTS AND ADVERTISING MATERIALS

The FTC staff blames the press for failing to present a complete view of their findings. Yet the FTC press release gave greatest prominence to their false assertion that the life insurance business allocates a 1.3 percent "rate of return" to policyholders and that consumers are "losing billions yearly." These reckless and unsubstantiated assertions which were so much at variance with the facts were bound to produce sensational news stories. Now that these assertions bear the imprimatur of a federal agency, they will be used for years in the future by those who seek to persuade unwary policyholders to exchange good insurance protection for inferior alternatives. Unfortunately, the damage has been done. We are disappointed that the FTC staff continued to defend such a flagrant falsehood.

APPENDIX A

THE USE OF THE TERM "SAVING THROUGH LIFE INSURANCE"

The FTC memorandum correctly points out the common use of the term "saving through life insurance" in the economic literature relating to the life insurance business. Thus, for over 25 years, the ACLI and its prececessor organizations have provided a statistical series showing saving through life insurance compared with saving through other financial institutions.

The economic use of the term "saving through life insurance" relates to the overall picture of the economy provided by the national income accounts and the flow-of-funds accounts. It has little to do with the nature of the whole life contract and exactly what the policyholder gets in exchange for his premiums. In the national income and product accounts, there is by definition a total of saving equal to the volume of capital investment that takes place each year. This total of saving is made up of saving by individuals or households, business firms, and governments. It includes saving through life insurance companies and other financial institutions.

In the national income accounts, considerable emphasis is placed on the "personal" component of national saving. However, the distinction between "personal" and other saving is not an easy one to make. "Personal saving," as currently defined by the U.S. Department of Commerce, includes saving by proprietors, nonprofit institutions, and saving done through various financial institutions including life insurers. When governments (federal, state or local) run a surplus, they are "saving" according to the concepts in the national income accounts, although individuals' taxes contributed to this saving. When business firms have undistributed corporate profits, they are "saving" even though individuals have a claim on these profits.

In the case of life insurance companies, the ACLI has defined "saving through life insurance" as the increase in total assets of life insurers less valuation changes and the increase in policy loans. It represents a total of business and "personal saving" and undistributed profits reflected in the operations of life companies. This concept follows the definition developed by Dr. Raymond Goldsmith in his monumental work, "A Study of Saving in the United States." We have used corresponding definitions for saving through other financial institutions. In the ACLI statistical series, no attempt is made to break down the increase in assets attributable to different kinds of business or policyholders or to estimate shares contributed by business and individual customers.

The flow-of-funds accounts show how total saving derives from changes in tangible and financial assets less changes in liabilities. Saving by individuals is shown as a subsector of these accounts with breakdowns by major type of asset including those held indirectly through life insurance and pension plans. The individual saving series in these accounts is reconciled to "personal saving" as shown in the national income accounts primarily by the deduction of increases in consumer durables and in government insurance and pension reserves (which are not counted as part of personal saving in the national income accounts).

The flow-of-funds accounts use the increase in life insurance reserves as a measure of household or individual saving. The ACLI has avoided use of this series because total reserves represent a somewhat arbitrary measure of liabilities calculated on the basis of selected interest rate and other assumptions. The total of these reserves is not the sum of specific amounts owed to individual policyholders but an amount calculated by the life insurer to estimate aggregate liabilities to groups of policyholders.

The amounts that policyholders expect to receive are the various benefits enumerated in the contract subject to the contigencies also stated there. Some of these benefits may be regarded as akin to savings by the policyholder, but they are not the reserves set up by life insurers to cover all types of benefit payments expected to be made.

The distinction between policyholders' benefits and reserves, assets, and savings is perhaps clearer in the case of property-casualty insurance. The policyholder buys protection against fire, theft, etc., and the insurer accumulates reserves and assets to meet expected claims. The accumulation of assets by the insurers is a part of national saving but it is not an accumulation on which the policyholder expects to earn a return similar to interest on a savings account.

The controversy over the concept of a divided whole life contract, with a savings and a protection element, has gone on for years.[1] It has been exacerbated by the attempt to estimate a rate of return on the "savings element." To come closer to the realities involved means examining in detail what the policyholder pays in premiums and what he or she may legally and in fact expect in terms of benefits. It also means recognizing that the accumulated assets held by life companies ("savings" in an economic sense) earn the market rates of return typical of these assets no matter who holds them or how insurers make use of those returns.

Appendix B

Corrections to the Calculations of the FTC Staff of an Industrywide Rate of Return

The FTC staff characterizes the cost of insurance protection used in their calculation of an industrywide "rate of return" as being "consistent in principle" with the term premium rates used in their text and with the low cost term life insurance premium rates developed by a committee of the Society of Actuaries and used by the FTC staff in their suggested changes to the NAIC model regulation. The three sets of rates may be characterized by the FTC staff as "consistent," but the rates are, in fact, quite different. For example, the first year term premium for a $25,000 policy issued to a male, aged 35, is $80.75 according to the formula of the Society of Actuaries committee. The first year term premium for the same policy used by the FTC staff in the text of its report was $64.25—a reduction of 20 percent. Term rates equal to 150 percent of actual claims in 1977—the rates used by the FTC staff to calculate the industrywide rate of return—would be $22.50 for the same policy—a reduction of 72 percent from the low cost term rates developed by the Society of Actuaries committee.

The first year premium rates actually charged for such policies in 1979 was shown in the February 1980 issue of Consumer Reports. The ten yearly renewable term

[1] For example, see Robert I. Mehr, "The Concept of the Level-Premium Whole Life Insurance Policy—Reexamined," The Journal of Risk and Insurance, September 1975.

insurance policies with the lowest premiums shown in the tables published in that issue ranged from $82 to $95, with an average premium of $88.

Varying differences occur at other issue ages and durations. After making the appropriate adjustments to the data reported in the 1977 annual financial statements of life insurance companies, we estimate that the "low cost" term insurance rates according to the formula developed by the Society of Actuaries committee would have produced term premiums in excess of $11 billion for the individual life insurance in force in 1977. This is in contrast to the $7.4 billion produced by the FTC formula of 150 percent of actual claims.

The FTC staff had noted several criticisms pointing out that applying the loading from the premium formula of the Society of Actuaries committee ($.90 per thousand dollars of in force and $25 per policy) to the individual life insurance in force in 1977 would make provision for expenses and profits of $4.9 billion in contrast to the $2.4 billion produced by their formula. Their response reflects the extent to which they are committed to their thesis. They demonstrate that if you reduce the number of policies in force by two-thirds, you can produce a loading that is similar to that produced by multiplying death claims by 150 percent. Their arithmetic is correct but their logic is warped.

There are two further corrections that should be made in the FTC staff's calculations. First, the $24.2 billion of premiums should be reduced by $.9 billion of premiums for incidental benefits such as waiver of premiums, accidental death benefits, etc. since these benefits do not involve any so-called "savings accounts." Second, premiums should be reduced to reflect the fact that term insurance premiums actually charged by life insurers exceed those produced by the FTC staff's formula by $.9 billion. This would leave premiums of $24.4 billion for those policies that involve a "savings" element.

The net result of these three corrections is to reduce that part of the increase in savings in the FTC staff calculations that comes from premium "deposits" by about $6 billion and to increase that part that comes from interest credited by the companies by a corresponding amount. The net result is to increase the resulting "industrywide rate of return" from 1.3 percent to between 5.5 and 6 percent.

The FTC staff claims that the benchmarks used do not justify a 5.9 percent "rate of return." These benchmarks were cited because they are facts which would indicate how widely the FTC staff's "rate of return" missed the mark in describing the portion of investment income that is used for the benefit of policyholders. It is a fact that interest rates of 5 or 6 percent or higher are currently used by life insurers in determining premiums policyholders pay and dividends they receive. If statements are to be made about the average performance of the industry as a whole in allocating investment income for the benefit of policyholders, this must be taken into account. It is a fact that the average interest rate required to maintain policyholder reserves for their future insurance benefits is about 3 percent. Life insurers were required by law to allocate $4.2 billion of investment income to policyholders reserves in 1977 which is two-third times the $1.8 billion the FTC staff claims was allocated for policyholder benefits. It is a fact that 5 percent interest or higher is paid on dividends left on deposit. The fact that this portion of investment income used for the benefit of policyholders is clearly visible does not mean that lesser amounts are credited to policyholders elsewhere. Equity and competitive pressures require that investment income be allocated consistently in determining premiums, dividends and interest credited on dividends left on deposit.

The FTC staff notes in several places that citing overall industrywide interest rate benchmarks tells little or nothing to the individual policyholder. We are heartened that the staff recognizes this fact and note that it applies with equal force to their 1.3 percent industrywide rate of return. The benchmarks were not intended to measure "rate-of-return" but are facts presented to show how absurd it is to claim that life insurers allocate only 1.3 percent interest for the benefit of policyholders.

An even more bizarre approach to calculating an industrywide rate of return is presented by the FTC staff in their letter as an alternative benchmark. It is based on the assumption that the entire industry has for the past twenty years issued a single policy selected by the FTC staff. Assumption is piled upon assumption and hypothesis is built upon hypothesis. It is little wonder that the rate of return for this model of an imaginary industry is consistent with FTC staff's policy rates of return. Both are derived from the same fiction. If the FTC staff wants to attempt to separate the various factors that affect the price of life insurance, it should abandon its fantasies and arbitrary assumptions and look at how the life insurance business, in fact, really works.

Appendix C

Consumer Research Sponsored by the FTC

The FTC makes a series of assertions about the results of the consumer research they sponsored. A careful reading of the actual research reports indicates, however, that the FTC assertions are contradicted by the real results of their research.

For example, the FTC states (page 9) that the findings of Professor Jacoby's research "support the staff's conclusion that the NAIC disclosure system is ineffective in imparting meaningful cost comparison information to consumers." But Professor Jacoby himself concluded, in the summary of his second study, that consumers exposed to the NAIC materials (and others) were "able to make good purchase decisions" and "did very well in the quizzes which tested for basic life insurance knowledge." Indeed, on a quiz designed by the FTC, research subjects exposed to the NAIC materials got, on average, 18.3 of 21 questions correct. This was achieved despite the fact that the questions poised to the NAIC subjects were, overall, more difficult than those posed to subjects exposed to the FTC material.

It also should be noted that 61 percent of the NAIC subjects had a positive impression of the NAIC materials, compared to 51 percent of the respondents given the FTC materials.

The FTC asserts that Professor Jacoby's research shows that the FTC materials can significantly improve consumer's motivation and ability to comparison shop for the lowest cost insurance. But Jacoby's first FTC sponsored study states (page 29) that, "The NAIC Buyer's Guide seems to have had a direct and clear-cut effect on the two cost indices emphasized there (i.e. Surrender Cost and Net Payment). Regardless of whether a trigger was present or not, the NAIC Buyer's Guide alone was sufficient to generate a substantial increase in the attention paid to these cost indices, as compared to the accessing rates for subjects in the Control condition and the three other experimental conditions." Of course, one of the experimental groups referred to was the FTC group.

The FTC asserts that the second Jacoby study showed that people who received the FTC materials "outperformed" other groups, particularly the NAIC group. However, Professor Jacoby on pages 54 and 55 of this record report clearly indicates that the FTC designed the research in such a way to make that comparison questionable at best. Professor Jacoby states that the "policies" devised and supplied by the FTC gave "considerable assistance" to FTC subjects in choosing low cost policies. By contrast, the FTC *devised* the materials given to the NAIC groups to be much more difficult to understand. For example, as Jacoby states (pages 55)," the cost indices on both the NAIC and Belth "policies" are not prominently displayed, as in the FTC format, but are buried in the tables of the other cost information that are given." Therefore, comparisons between the groups, considering the differences in the assistance given should be made with extreme caution, if at all. The study clearly shows, however, that the NAIC materials lead to good consumer decisions, good knowledge of life insurance and that the materials are considered helpful by those who read them.

The FTC asserts that the research conducted on their behalf by Professor Roger Formisano shows that test subjects who received the NAIC disclosure materials did not have the information essential for rational decision making. Since subjects were interviewed up to six months after the purchase, their memory of what occurred during their purchase decision was understandably hazy. The Jacoby research indicated that the NAIC materials are informative and helpful. Thus, the performance of the Formisano respondents on their life insurance quiz must be attributed to knowledge diminished with the passage of time. Anyone who has studied for a test in school knows that if tested six months later, their performance would be much diminished despite their knowledge at the time of the test.

Although memory of specific events is hazy, impressions about life insurance and the performance of life insurance agents are longer lasting. Therefore, we should trust the statements of the Formisano subjects that they were very satisfied by their purchases and the agents they bought from.

To summarize, the message of the consumer research sponsored by the FTC is quite clear. The NAIC materials are helpful and do lead to good decisions. Buyers in a state that adopted the NAIC Model Regulation are well satisfied with their purchases. A careful reading of the research results would lead to an encouragment of the NAIC Model Regulation now in effect in 30 states.

STATEMENT OF SANDRA L. WILLETT, EXECUTIVE VICE PRESIDENT, NATIONAL CONSUMERS LEAGUE

Good morning, Mr. Chairman and distinguished Senators of this Committee. My name is Sandra L. Willett and I am Executive Vice President of the National Consumers League. The National Consumers League, the country's oldest consumer organization, welcomes this opportunity to report on basic problems consumers have with life insurance and to call for federal action to assure effective cost disclosure as a "first step" to life insurance reform. Founded in 1899, NCL for the past eight decades has fought for the rights, the health, and the safety of American workers and consumers. We are a national organization comprised of individual members and local affiliates. We have consistently promoted economic justice in the marketplace for the individual by supporting various legislative measures and operating research and educational programs.

The National Consumers League became interested several years ago in whether life insurance products, prices and marketing practices were meeting consumer needs. In 1978 we co-sponsored, with the U.S. Office of Consumer Affairs, a national seminar on life insurance in which leaders in the industry and government officials also participated. Our concerns about certain aspects of the industry were crystallized by the seminar debate and by the research we conducted prior to the seminar on what a consumer might experience when trying to buy adequate life coverage at reasonable rates. The research, entitled "Buying Life Insurance: One Consumer's Experience," was published as the lead article in the industry journal, Best's Review, October 1978. Since then, NCL has met with the chief executive officers and top management of several leading insurance companies, agents, trade associations, federal and state regulators, and other consumer groups in an effort to promote meaningful cost disclosure and more efficient and equitable ways to sell consumers the coverage they need at reasonable prices.

We make no claim about being technical life insurance experts; we are not. Our business is consumer protection. NCL is a national consumer organization with its ear to the ground and 80 years of experience representing consumers, yet our research confirms the 1978 Yankelovich corporate priorities study which identified the insurance industry as one of the three industries most vulnerable to public criticism in the near future. In fact, our work goes futher. We find that the 2.5 trillion dollar life insurance industry has not taken adequate steps to disclose costs and other vital information, that an impossible burden now rests squarely on the inadequately prepared consumer, and that therefore federal action is needed.

Mr. Chairman, the National Consumer League is very pleased to appear before you and this committee, and to see if, by contributing a consumer perspective, we can help build the case for reform that will encourage the life insurance industry to stand the test of the open marketplace and facilitate proper consumer purchases.

MAJOR CONSUMER PROBLEMS WITH LIFE INSURANCE

Life insurance can be complex. People don't like to think about death. A lot of money must be set aside now to alleviate possible financial hardships in the future. Each consumer, having different income and health characteristics, requires coverage tailored to those differences. Therefore, selecting the right policy can be difficult and involves risk.

However, current life insurance practices too often prevent consumers from understanding what they need and from choosing the best products to meet those needs. Vital information on costs for example, is obscured or unavailable—often a case of too little, too late. Marketing practices tend to push consumers toward whole life policies and other products made excessively expensive by high premiums and increasing inflation rates. Regulation at the state level has stopped, rather than encouraged, useful experimentation and reform.

Mr. Chairman, I understand your interest is in studying the problems of cost disclosure, so I will speak to those problems. But I would urge this Committee also to look at the industry's marketing practices and the inadequacies of certain state regulations, agent training and licensing, privacy protections, and other serious issues which cause consumers other serious problems. My written statement cites some consumer experience in these areas and I respectfully request that the statement be submitted for the record. I appreciate that this Committee cannot act on all problems at once, and I agree that the cost disclosure is the most pressing. Perhaps answers to the cost disclosure issue will provide solutions to other problems.

A. Lack of meaningful cost disclosure

Price is foremost in most consumers' minds when buying goods and services. Regarding life insurance, consumers want to know: "How much do I pay out?" "What am I getting in return—how much death protection, savings and dividends?" and "What do I get back if I cash in my policy; what does my family receive if I die?" Many consumers are now beginning to ask two additional, related questions: "How much, if any, savings do I need along with the death protection?" and "What are my options for saving at different rates of return?"

In general, consumers cannot get straight answers to these fundamental questions. Further, the vast majority of consumers does not know enough about the risk factors of death protection, about the time value of money, or about comparing different products to raise these key questions. Finally, faced with a sensitive subject, seemingly complex choices and an aggressive sales force, consumers lack the self confidence to challenge what they are told and being sold.

Our case study underscores these points. The research was conducted between January and April 1978 by a 35-year-old, well-educated woman who knew nothing about life insurance, but who thought she should have $25,000 worth of coverage to pay for college for two daughters if she happened to die within 25 years. The researcher used her real name, Ms. Chris Dodge, and certain personal statistics (although no information on income which several agents neglected to ask her).

Our research methodology was simple and straightforward. Ms. Dodge selected ten widely-know companies, large and small, which sell insurance in Washington, D.C., and asked them the same basic questions about cost and coverage.

The experience caused frustration, even outrage, for Ms. Dodge who found herself overwhelmed, pressured, or thoroughly confused by irrelevant statements, conflicting figures, and incomplete tables. She received little price information she could use to compare dissimilar policies. She felt overburdened and underserved by the companies' sales pitch, instead of aided by meaningful information relevant to her needs.

A copy of NCL's study is attached for the record. I would like to summarize the principal findings related to cost disclosure:

1. A comparison of term insurance premiums, without riders, dividends or options, is fairly straightforward. The difference between the highest and lowest premiums for basic term policies offered by the ten different companies we contacted was over 33 percent.

Cost comparisons therefore are essential, but our consumer was not encouraged to compare different term policies from different companies.

Straightforward cost information for renewable term, compared to other types of term policies, was frequently not provided. Term was not discussed in the context of buying death protection. Rather, if was painted as a waste of money if the holder does not die.

No options were discussed for starting a savings account or buying high interest certificates to accompany basic death protection.

2. Ms. Dodge's discussions on whole life insurance were infinitely more difficult and unsatisfying. Where she could compare costs of similar policies, the differences were over 100 percent. Her feelings of frustration mirror those of an increasing number of consumers who are demanding straightforward, comprehensive information to facilitate cost comparisons and better purchases.

Whole life insurance is frequently sold on the basis that it "forces" the consumer to save conveniently. However, the rate of return on the savings portion of a policy is not given. How can consumers compare the real return between different cash value policies, or with that of a savings account? They can's right now. How can consumers get answers to the fundamental questions—"How much do I pay? for what? with what return?" without a simple, common sensebased yardstick? We can't.

The National Association of Insurance Commissioners' proposed cost disclosure rule will not help the consumer answer these questions. It does not give a rate of return on whole life policies. It does not require disclosure on a timely and regular basis. It does not discuss options. It complicates comparisons by giving six indexes. Indexes are poor measures because people do not know whether higher or lower is better, do not understand how they are developed, and cannot use them to make cross-product comparisons. The NAIC model has other serious drawbacks. Those merit discussion in a moment. The point is that consumers must have a simple, consistent way of seeing and comparing what their savings are earning. We cannot do this now.

Washington, D.C. has not enacted the NAIC model law. This city's Insurance Department said earlier this week that they opposed the NAIC model law

because the cost disclosure provisions are too complicated and too late to help consumers. Wisconsin and North Carolina have seen their attempts at meaningful disclosure halted by industry opposition.

Agents Ms. Dodge talked to failed to mention several other aspects of whole life insurance costs that are essential to consumers.

Dividends are not always guaranteed. Consumers cannot count on a certain rate year after year. However, experience shows that consumer can almost always be guaranteed that the dividends will be lower than many interest rates paid on alternative savings plans.

Ms. Dodge reported that, in fact, alternative savings vehicles were not discussed. What about investing the difference between premiums for an annual renewable term policy and those for a whole life or endowment policy? These "opportunity" costs may have great significance for life insurance consumers. Further, if consumers withdraw savings from a high yield account to pay for a low yield policy, they stand to lose twice. These losses are against the consumer interest.

If whole life policies are not held for a minimum of seven to ten years, consumers will not get back in cash value what they pay out in premiums. Approximately 50 percent of consumers allow their policies to lapse in the first year. This costs dearly. However, this cost was also not spelled out to Ms. Dodge.

With double digit inflation and no sign of relief, consumers pay "extra" for whole life policies.

The face value of such policies, held over a long period of time, is seriously eroded.

The savings portion of policies held for several years yields comperatively lower and lower rates.

3. Agent pressure was heavy, at one time so intense that Ms. Dodge threatened to call for help. Agents called Ms. Dodge's home although she expressly asked them not to. One agent claimed he "spent eight hours at night preparing hand-written material just" for Ms. Dodge. Only one agent seemed to consider the consumer's needs to be of primary importance. This agent advised Ms. Dodge against whole life insurance if she wanted only death protection. This and two other agents advised her not to buy their own companies' term policies because she could buy the same coverage for less money elsewhere. This may have been the most useful information any of the agents provided.

There is no doubt that people need advice on buying the right life insurance policy or policies for their particular needs. However, we have to wonder if a commissioned salesman, whose incentives differ from those of the consumer in part because he gets a bigger commission with a more expensive policy, can be the most objective counselor.

4. The consumer cannot calculate costs accurately within different, rather than traditional, time periods. When Ms. Dodge asked for cost data on a 30-year period, two agents responded with data on 18 and 20-year periods, but nothing on 30 years. The NAIC model law does not call for information beyond the 20-year period—another one of its serious weaknesses.

Although extremely frustrating, Ms. Dodge's experience was probably more pleasant and productive than the experience most consumers face. The agents knew of her NCL association and easily understood her intelligence. However, by any way you measure it, her discussions and research exemplify the severity of the problem of currently inadequate, incomplete and inconsistent disclosure.

The consumer is asked to commit savings or scarce earnings to pay for protection against loss of income, but the consumer cannot get the necessary information to make proper choices, does not know enough to ask the right questions, lacks self-confidence and is asked to trust the sellers of insurance with his money and hopes when these very sellers have many different incentives. The current system denies the consumer basic rights to information and places on him an unfair, unrealistic burden. Such a system, which discourages inquiry and full discussion of the options, is a prime target for national reform.

B. Difficulties buying the "right" coverage

Insurance companies and agents say that consumers must be "sold" life insurance. Since people do not like to think about death, they must be "led" toward purchasing coverage. The industry also maintains that life insurance is complicated, that many different combinations of riders and options to basic coverage necessitate tailoring each policy to each individual.

These assertions, even if accurate for most consumers, invite a dynamic which can be very detrimental. This marketing dynamic asks the consumer to trust the seller of insurance, to provide detailed confidential information about income and health,

and to accept that the industry has the consumer's "best interests at heart." Lacking comprehensive and comparable cost information, and encouraged to abdicate their critical decision making powers, consumers are often sold policies which fail to meet their needs—policies which may be wrong for them, offering inadequate coverage and charging excessive premiums.

For example, if individuals require only death protection, they must question whether or not they need the lower yield savings portion of the more expensive whole life policies. I chair a consumer insurance policy committee comprised of grassroots consumers, insurance regulators and industry representatives. At our February 1979 meeting, not a single person on that committee voted to support whole life insurance as the most efficient way to buy death protection, particularly in periods of high inflation.

Women, especially single career women, have been targeted by some companies as the "rich new market." The promotions appeal to women to buy life insurance, almost as a status symbol, suggesting that if you are a smart sophisticated professional in the "fast track" business world you should have life insurance. What if these individuals have no dependents? What if they can protect their mortgages with high interest savings accounts? Should they be sold insurance?

The poor and less well educated consumers have been the principal targets for debit insurance. The 1976 Insurance Fact Book states that $30 billion of this type is held. The latest FTC figure estimated $40 billion. Debit insurance is, therefore, not an historical curiosity. It is a devastating current problem, devastating because of the excessive administrative and distribution costs, the system of selling many small policies to the same individual, and the lack of adequate information available to the most vulnerable consumers.

Life insurance marketing practices, to the extent they push inappropriate and excessively expensive coverage to unprepared consumers, are worthy candidates for public scrutiny and reform.

C. Lack of protection and redress

What assurances do consumers have that the industry works well in their behalf, that their basic rights to information, straightforward marketing practices and competitively priced choices are protected? Where can consumers turn for effective assistance and redress if they have questions about the adequacy of this protection?

The National Consumers League believes that regulation should not be necessary where the market through its own means can produce competitively priced, safe goods and services. However, we do not see the current system of state regulation for life insurance as being effective or sufficiently forceful to safeguard the consumer interest.

The NAIC model cost disclosure rule, for example is an "arithmetical monstrosity," as the noted actuary E. J. Morehead testified in 1976. NCL will not, as I mentioned earlier, support the NAIC model because it complicates rather than clarifies, and because it does not disclose the relevant costs when they are most needed by consumers. The NAIC model is a detour, if not a significant barrier, to adequate, comparable cost disclosure. In fact, it camouflages exactly what the consumer needs to know because it:

gives no rate of return,
cannot be used to compare dissimilar policies,
does not require information disclosure at the point of purchase,
does not require periodic information disclosure while the policy is in effect,
offers no guidance in distinguishing between whole life and term insurance,
does not provide cost beyond the traditional 20-year period, and
does not separate death protection from the savings portion.

The NAIC cost disclosure model with industry backing has prevailed even in those states where a more useful yardstick was available. In North Carolina, I understand, the superior regulations proposed by Insurance Commissioner Ingram were undercut by quick passage in the statehouse of an NAIC model. In Wisconsin, the industry has taken the insurance department to court to prevent adoption of a simple, direct buyers guide and policy summary which would provide consumers with much of the information on cost and coverage they need.

State regulation is weak. Even those states, where fair-minded insurance commissioners have stood up for the consumer's need, have not been able to provide reform. The industry on the one hand says "leave it to the states," and on the other hand actively opposes progressive state experiments.

The net result is—the consumer gets hurt. The current system is not working. After decades of state regulation, we have very few progressive protections and no simple common sense cost disclosure. The consumer is being taken advantage of

time and time again. We have come to the point where federal intervention is needed.

Recommendations

The National Consumers League urges this Committee to develop federal standards for a national cost disclosure system. The system, we believe, should be mandatory. It should require that companies and agents disclose meaningful information at or before the point of purchase, and periodically while the policy is in force.

Rate of Return.—The rate of return provision is the key factor. Such a yardstick can enable consumers to compare dissimilar policies and to compare policies with non-insurance savings plans. The rate of return would provide a simple, direct, accurate measure that most people can understand.

Comprehensive Buyer's Guide.—The mandatory disclosure system should outline the basic choices consumers have between different types of policies, offer guidelines for estimating coverage needs, warn consumers against misleading marketing practices, list questions to the agent, and indentify options to whole life policies for higher yeild savings plans.

Time of Disclosure.—The Buyers' Guide should be given to the consumer when the consumer is first contacted.

The rate of return should be presented to the consumer at, or prior to, the point of sale. Since the rate of return on policies tailored for individuals will have to be calculated separately from the cost of premiums, companies and agents may not be able to provide correct calculations the first time they talk with a potential customer. However, if a consumer requests the rate of return information, it should be provided as soon as as possible and no later than at the point of sale.

Cooling-off Period.—The mandatory cost disclosure system should allow consumers a cooling-off (or "free look") period of at least 20 days during which time the consumer can cancel the policy at no charge.

Periodic Information Disclosure.—It is not enough to disclose the rate on polices at the point of sale. A consumer's needs for coverage will change with changing income and family situations. Therefore, the rate of return and other relevent information should be disclosed on a regular basis, preferably annually. Such disclosure should be mandatory and clearly presented so the consumer is told its significance.

Disclosure of other Relevant Information.—Although not all potential customers or policyholders will note it, other information should be made public. We would be very interested in knowing, for example, what percentages of the premiums covers death protection and what covers savings, operating expenses and commissions.

Establishing a toll-free telephone number to an insurance information center, to the companies or to state departments of insurance would permit consumers to ask questions and register complaints.

Other Considerations.—Agent training and licensing must be upgraded. Independent agents have told me that the training they received from companies resembles more of a pep-talk than a serious review of the technical aspects of life insurance. They have also said they often feel pressured by companies to sell, especially to sell whole life, even if the consumer's needs are not met by this particular product. Agents need at least as much information as consumers do.

Savings accounts, certificates of deposits, treasury bonds and other vehicles are rarely discussed by companies and agents except in their context of "how difficult it is to save, and therefore how valuable a force savings plan is." Alternatives should be raised with the consumer. A real counselor whose purpose is to provide service, as opposed to stimulate sales, could be expected to discuss options.

The language of policies continually needs to be clarified. Simple, direct policy language is important to encourage consumers to read and evaluate their coverage.

Different ways of selling insurance should also be explored, such as through banks, in group plans, and through independent financial counselors who do not sell insurance.

The development of new products to meet changing consumer needs should be encouraged.

Conclusions

In his 1908 annual report, the Wisconsin Insurance Commissioner described a policyholder's right to disclosure, and the industry's opposition to this right.

"POLICYHOLDERS ENTITLED TO KNOW

"There is a point where the benefits of insurance are outweighed by the expense. Either the policyholder should be enablee intelligently to determine for himself

what that point is or the state should at least prescribe a maximum limit. The recent investigation committee recommended that every policy issued should state in dollars and cents for each year during the possible history of the policy, the amount provided for expenses, and amount provided for death claims, and the amount held to the credit of the policyholder as a reserve. With these facts before him, the proposed policyholder would have something on which to determine whether or not the contract was one he wanted. He would also have something definite by which he could judge how the management afterward administered its trust as to his money.

"KNOWLEDGE WOULD INJURE BUSINESS

"When the recommendation was suggested in the hearings of the committee, it met with the answer that the prospective policyholder would not take the insurance if he knew what he was paying for expense. Company managements admitted that they were writing forms of policies which men ought not to take because the expense provisions far outweighed the benefits and which they would not take if they knew what the expense provisions really were. *It would seem as if there could be no question that the present and prospective policyholder is entitled to have all the facts with regard to his policy in such form that he can understand them and be able to compare the expense and the insurance benefit. Yet so novel was the proposition to give the policyholder a chance to protect himself and so strenuous were the objections to the plan on the part of the companies, even during the hearings by the investigation committee, that the committee felt that it would be difficult to secure its immediate adoption.* (Italic added) The opposition of the companies was continued in the hearings before the committees of the legislature at the session of 1907 and the recommendation was defeated."

NCL's research, seminar and discussions with consumers and the industy lead us to conclude that times are not much different now. Asking for federal intervention in 1979 is not a popular move. We sincerely wish it were not necessary.

However, consumers continued to make improper life insurance purchases because the meaningful, straightforward information at the point of sale and while the policy is in force simply is not available. What the NAIC proposes may be worse than no change at all because it appears to provide relevent information, but does not. What the industry has complained about as being the inefficiences of 50 different sets of state regulations may in fact be what the industry prefers as a way of keeping regulations weak.

Therefore, federal standards are needed. The consumer should no longer bear the burden of inadequate disclosure, misdirected marketing practices, inefficent and ineffective state regulations, poorly trained agents, and loose privacy protections.

It is certainly time for rigorous, relevent cost disclosure. It is time to let the life insurance industry stand the test of the open marketplace. It is time to lift the burden from the consumer.

LIFE INSURANCE COST DISCLOSURE

A STAFF REPORT TO THE FEDERAL TRADE COMMISSION

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INTRODUCTION

Recently much attention has been focused on the plight of people with relatively small amounts of savings.[1] Because of Federal regulations on the maximum interest rates that banks and savings and loan associations may pay, savers who have less than $10,000 to invest have often had to settle for rates of 5 to 5-1/4 percent on their money, while open market rates are in the 9-1/2 to 10 percent range. Even the latter rates are barely sufficient to cover the current rate of inflation. Through a variety of exemptions and financial innovations, large savers have been able to obtain access to the open market rates from which small savers have been excluded by deposit rate ceilings. One economist has put the loss in interest earnings at over $8 billion on passbook savings accounts at commercial banks, savings banks and S&L's in 1978 alone.[2] Based on similar findings, Mr. Robert Gnaizda, a public interest lawyer, petitioned Congress to require a "fair warning on every passbook, in every advertisement, and on the doors of every bank..." that "Savings may be hazardous to your wealth," if the government does not end the system of deposit rate ceilings.[3]

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1 See Hearings on "Regulation Q" Before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations, 96th Cong., 1st Sess. (1979) [hereinafter cited as 1979 Hearings.]

2 See the testimony of Professor Edward Kane, id.

3 1979 Hearings, supra n. 1. Mr. Gnaizda puts the loss at over $17 billion.

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Virtually no attention has been paid, however, to how small savers have fared during the current inflation in the one major consumer savings medium that is not subject to deposit rate ceilings. At the end of 1977, consumer savings held by the ordinary life insurance industry amounted to approximately $140 billion.[4] This amount is roughly equal to the total of all passbook savings accounts held by the savings and loan industry.[5] A major portion of this report will be devoted to an examination of consumer savings through life insurance. The life insurance industry publishes no figures on the total consumer savings which it holds. Nor does the industry publish figures on the rate of return it pays on savings, either for the industry as a whole or on individual policies. This report will examine the rates of return being paid by the life insurance industry to the 45 to 50 million households that save through life insurance. Among the important findings of this report are:

1. The average rate of return paid by the industry to all ordinary life insurance policyholders in 1977 was between one and two percent;[6]

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4 See pages 11-12, infra.

5 Passbook accounts amounted to almost $144 billion in December, 1977. 1979 Hearings, supra n. 1, at 7, Table 3 (statement by Kenneth Thygerson, Chief Economist of U.S. League of Savings Associations).

6 This is the average rate paid all ordinary life policy holders. Many policies currently on the market, if held for 20 years, will yield between 4 and 5 percent. See Tables II-7, II-8, infra.

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2. The rate of return on new policies is, in many instances, substantially below alternatives readily available in the market place;
3. A significant number of holders of old policies are locked into a low-yield, fixed-dollar investment unsuited to cope with current inflation;
4. There are severe, but unannounced, penalties for early withdrawal of savings through life insurance policies. Unlike the withdrawal penalties mandated by Federal deposit regulations, the penalties imposed by life insurance companies do not merely reduce the return earned on the principal: they often reduce and sometimes even eliminate the principal itself. The consumer loss resulting from first-year lapse alone exceeds 200 million dollars a year. Just to break even, many policies bought in 1977 will have to be held until 1987.
5. Price competition is so ineffective in the life insurance industry that companies paying 20-year rates of return of 2 percent or less compete successfully against companies that pay 4 to 6 percent. This disparity should be contrasted with the banking industry, where differences of a quarter of a percent are considered to be competitively crucial.

There are important differences between saving through life insurance and saving through the banking industry. In particular, the income generated through a life insurance policy

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is essentially tax free; therefore, all the rates of return mentioned above should be compared to the after-tax return from other forms of savings or investments. Nevertheless the average rate of return on savings through life insurance is extraordinarily low even compared to current passbook rates offered by banks and S&L's, which are themselves kept artificially low by the deposit rate ceilings. We estimate that consumers would have had an additional $3.7 billion in 1977 alone if the life insurance industry had paid only 4 percent on savings.[7] Thus while deposit rate ceilings may have imposed great costs on small savers, those consumers who save through life insurance are in many instances far worse off. Indeed, life insurance savers would gain substantially if they were at least put on an equal footing with the current low deposit rate ceilings of banks and S&L's.

These problems led to this investigation of the life insurance industry. The investigation examined the magnitude of consumer injury and the extent to which life insurance cost disclosure can remedy these problems. This report is the end product of that investigation. It is divided into four parts: (1) An overview of the industry and an analysis of its role as a savings medium; (2) An analysis of consumer problems in the life insurance industry; (3) A description of some of the reasons for these problems; (4) A recommended system of life insurance cost disclosure which we believe is a prerequisite to any meaningful

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7 See pages 18-19, infra.

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price competition in the life insurance industry.

I. THE LIFE INSURANCE INDUSTRY AND ITS SERVICES

A. Description of the Industry

The life insurance industry is a large and important part of our economy. The total income of domestic life insurance companies in 1977 was $98 billion.[8] While it is difficult to comprehend a figure this large, some comparisons may help. The $98 billion received by life insurance companies in 1977 is approximately the same as the federal government spent for national defense in that year and more than twice as large as the total income of the entire farm population of the United States.[9]

The life insurance industry directly affects most families in this country. Seventy-two percent of the adult population of the United States and over 90 percent of all husband and wife families own some form of life insurance.[10] In 1977, Americans purchased $367 billion of additional life insurance coverage bringing the total of life insurance coverage to almost $2.6 trillion.[11] Insured families paid an average of over $500 a year in premiums and had approximately $37,000 insurance in force.[12]

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8 American Council of Life Insurance, Life Insurance Fact Book, at 56 (1978) [hereinafter cited as Fact Book].

9 Economic Report of the President, 339, 362 (1978).

10 Fact Book, supra n. 8, at 35. These figures are for 1976.

11 Id. at 7.

12 Id. at 7 and 56. This figure includes employer contributions
(Footnote Continued)

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The primary focus of this report is ordinary life insurance. Ordinary life insurance policies are usually sold to individuals (as opposed to groups), and are usually sold by agents. Most ordinary life premiums are paid by mail rather than collected by an agent.[13] In 1977 Americans paid $24.2 billion in premiums for 140 million ordinary life insurance policies. This expenditure represented 1.9 percent of all personal income.[14] In return for premiums paid, the life insurance industry performs two important services: it provides death protection and serves as a savings medium. The dual nature of the life insurance industry is reflected in the differences between the industry's two basic policies: "term" policies (which provide only insurance protection) and "cash value" policies (which provide both insurance protection and a form of savings). The following section describes these two basic types of policies.[15]

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12 (Footnote Continued)

and is computed by dividing premium income by the number of insured families (88 percent of about 70 million families).

13 Besides ordinary life insurance, the other major products of life insurance companies are health insurance, annuities, group life, credit life and industrial life insurance. An economic profile of the whole industry is set forth in Appendix I.

14 Fact Book, supra n. 8, at 20, 58, 59.

15 All life insurance policies are either participating or non-participating. Non-participating policies do not pay dividends and are sold by stockholder owned insurance companies. Participating policies pay dividends and are primarily issued by mutual insurance companies but are also issued by stock companies. In dividend-paying policies, the premium is set at a level greater than the anticipated future cost
(Footnote Continued)

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B. Basic Types of Life Insurance Policies

1. Term Insurance

Simply stated, term insurance provides solely death protection for a fixed period of time such as 1, 5, or 10 years or until the insured reaches a specific age such as 65. The face amount of the policy will be paid only if the insured dies within the time (or term) stated in the policy. Thus, a one year $25,000 term policy, for example, obligates the insurance company to pay the beneficiary that amount should the insured die within the year. Term insurance policies are often renewable for additional terms without the insured's being required to take a medical examination. Each time the policy is renewed for another term, the premiums increase to reflect the greater likelihood of death as a person grows older.[16] When the insured is young, term insurance is relatively inexpensive and provides the largest immediate death protection for the premium dollar. However, the premiums

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15 (Footnote Continued)

of the policy. Dividends paid reflect the company's actual costs. See generally J. Belth, "Distribution of Surplus to Individual Life Insurance Policyholders," 45 Journal of Risk and Insurance 7 (1978).

16 Certain types of term policies provide for level premium payments. For example, "term to 65" has only one "term" and thus the premium remains at a constant level until the policy expires at the stated age. The early year premiums for this form of term insurance are significantly higher than traditional renewable term. Another level premium variant is "decreasing term", in which the face amount of the insurance decreases over time while the premiums stay the same. This type of policy is often marketed as protection for long-term decreasing debts such as mortgages.

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steadily increase as the insured ages and become very high after age 65.

2. Cash Value Insurance

There are several types of cash value insurance. The most important type is "whole life" or "permanent life" insurance. Whole life insurance policies remain in force as long as the premiums are paid. They differ from term policies in three important ways. First, the premiums for a whole life policy are initially much higher than for term insurance for the same amount of insurance protection. Second, unlike the premiums for term insurance, whole life premiums do not go up with age but remain the same throughout the payment period. Third, whole life insurance policies develop cash values which increase each year.[17]

A whole life policy can have a premium that does not increase because during the early years of the policy the premiums are much higher than the amount needed to buy only death protection.[18]

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17 In addition to whole life insurance, many other policies on the market combine savings and protection in various degrees. Examples include "life paid up at 65," "20-pay life," and "endowment policies." "Life paid up at 65" and "20-pay life" are policies in which the premiums are paid over a limited period instead of over the entire life of the policy. Endowments are policies in which the cash value equals the policy's face amount at the end of a limited period, usually 20 or 30 years.

18 A 35-year old man will typically pay an annual premium of $15-20 per $1,000 of coverage for a whole life policy, while a comparable size one-year renewable term policy would cost $2.00 to $6.00 per $1,000. When the insured reaches ages 55-60, term premiums become greater than the $15-20 level premiums of the whole life policy.

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Part of these "overpayments" made in the early years of a whole life policy are invested by the company and set aside as a reserve to be used to pay part of the death benefit should the policyholder die. This reserve serves as the basis for a policy's cash values. The cash value of a whole life policy increases each year at a rate specified in the contract.[19] While alive, the policyholder can either borrow against the cash value or receive it by surrendering the policy. If the insured dies, however, the insurance company pays only the face amount of the policy, not the face amount plus the cash value.

A whole life policy can be viewed as a combination of an increasing savings element (cash value) and a decreasing amount of pure life insurance protection. This is because as the cash value of the policy increases the actual amount of death protection being purchased decreases correspondingly -- the sum of the cash value and the death protection always equals the face amount of the policy. The increasing cash value also explains why whole life insurance premiums stay the same throughout a person's life. Even though the chances of dying and thus the cost of pure death protection increases each year, the cash value reduces the amount of death protection that must, in effect, be purchased.

Although the description of whole life insurance as a

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19 The increase in cash value in any given year is due to two factors--the excess premium payments for that year and the interest credited to the cash value that has been previously accumulated. The impact of compound interest is substantial. For example, $1.00 invested at 7.2 percent will double in ten years.

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combination of death protection and savings is commonly found in insurance texts,[20] many people in the insurance industry assert that the separation of whole life insurance into savings and protection components is improper and that the life insurance contract must be viewed as an undifferentiated whole. They argue that the purchase of a whole life policy should be viewed as simply buying insurance protection on the level-premium "installment" plan. According to this view, under the level premium method, people "prepay" while they are young for insurance protection they will receive only many years later, while the savings element (cash value) is described as an "incidental" by-product of the level premium method of paying for insurance.[21]

It is true that the policy's savings element is a by-product of the level premium method of paying for insurance However, it can hardly be said to be "incidental". During the initial years of a typical whole life policy the portion of the premium that goes to build up the savings element of the policy will often be 70 percent of the total premium. Over the first twenty years of a typical whole life policy issued to a male aged 25, about 40-50 percent of the premium goes into the policy's savings element.[22] The fact that a major portion of the premiums for

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20 See, e.g., S S. Huebner & K. Black, Life Insurance 7 (1976).

21 This argument is discussed in detail at pages 113-120, infra.

22 See J. Belth Life Insurance - A Consumer's Hand Book, 49-50, (1973).

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whole life policies goes toward building up cash values makes the life insurance industry a major savings institution.

C. Life Insurance As A Savings Medium

Sales of cash value insurance policies, in conjunction with sales of annuities, make the insurance industry one of the country's major savings institutions.[23] Assets of domestic life insurance companies totaled more than $350 billion at the end of 1977.[24] In recent years, life insurance companies have accounted for about 20 percent of the growth in all personal savings.[25] As a repository of personal savings, the life insurance industry has ranked second only to savings and loan associations among private savings institutions.[26]

Individual savings through ordinary cash value insurance represent a significant part of the total consumer savings deposited with the life insurance industry.[27] Although the life insurance

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23 Although term insurance sales have been growing more rapidly in recent years than cash value sales, the latter type is still the most common form of ordinary insurance purchased and owned. Cash value policies (on adult lives and sold by ordinary agents only) accounted for about 58 percent of premiums and about 39 percent of the amount of new ordinary insurance purchased in 1975. Life Insurance Marketing And Research Association (LIMRA), 1975 Buyers Study at 19.

24 Fact Book, supra n. 8, at 69.

25 G. Bishop, Capital Formation Through Life Insurance, 91 (1976).

26 Id. at 87.

27 The remainder consists primarily of annuities and amounts held under pension plans, Fact Book, supra n. 8, at 36-38, 49-54.

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industry does not publish statistics on the total consumer savings through ordinary life insurance, this number can be estimated. In 1977, it totaled approximately $141 billion or over $1,000 for each of the 139 million ordinary life insurance policies in force.[28]

An indication of the relative importance of savings versus protection in ordinary life insurance can be seen by comparing it to group term insurance. In 1977, the two lines provided roughly equal amounts of death protection.[29] Death claims paid on ordinary life policies amounted to $4.9 billion versus $4.8 billion on group contracts.[30] Yet the public paid over $24 billion in premiums for its ordinary life insurance coverage compared to less than $7 billion for its group coverage.[31] There are two major reasons for this immense difference. First, the ordinary line is dominated by cash value policies, where the savings benefits are far larger than the death protection benefits. Second, selling costs are much higher for ordinary than for group policies.[32]

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28 Consumer savings consist of ordinary life cash values and accumulated dividends left with the companies at interest. For details of this calculation see Appendix II.

29 Ordinary life insurance in force amounted to $1,289 billion, compared to $1,115 billion for group. Fact Book, supra n. 8, at 18.

30 Id at 41.

31 Id. at 57.

32 For example in 1975, commission costs were about $1.97 per thousand of coverage on ordinary policies versus 12 cents (Footnote Continued)

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The following tables show the relative importance of ordinary life insurance as a savings institution and as a provider of death protection. Table I-1A is a summary of the total cash flows and the increase in consumer savings in the ordinary life insurance line in 1977. Table I-1B contains the same information broken down by insured household.[33]

These tables show how much money flowed from policyholders (directly and indirectly) into the industry. The money flowing into the industry consists of premiums and the investment earnings from consumer savings through ordinary cash value insurance.[34] The tables also show how much money flowed back from the companies to policyholders in the form of benefits. Finally, the tables show a breakdown of the money remaining with the companies broken out by the amount used to increase policyholders' savings and the amount retained for expenses and profits.

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32 (Footnote Continued)

for group. Home office expenses averaged $3.02 per thousand on ordinary versus 30 cents for group. These figures were derived from Table 2 in Appendix II.

33 The numbers in Table I-1B are based on the assumption that there are 46 million households with ordinary life insurance. The derivation of the number of insured households is set forth in Appendix II.

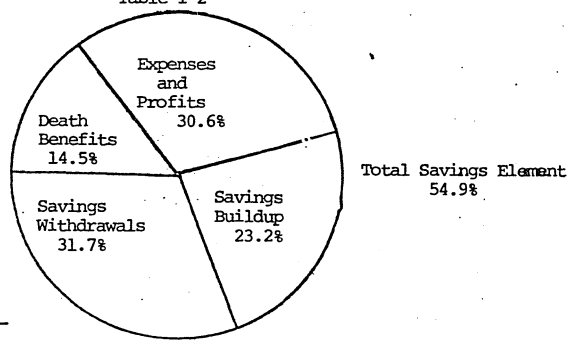
34 These reserves are technically not owned by the policyholders. However, policyholders can surrender their policies at any time and receive their accumulated cash values and dividends. Thus, we think it is appropriate to view investment income on these reserves as funds indirectly contributed by policyholders.

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The overwhelming importance of the saving element of ordinary cash value insurance is shown by the fact that, although approximately $34 billion was contributed by policyholders to the industry, only about $5 billion was returned in the form of death benefits. The death benefits paid are only slightly larger than the dividends paid and are much smaller than either the withdrawals from savings or the buildup of savings. From the perspective of the individual household, an average of $525 was paid in premiums and only $107 was received back in death benefits. This comparison excludes an additional indirect contribution of $212 per household derived from investment income.

Table I-2 is a breakdown showing approximately how policyholder-provided income (premiums plus investment income) is used in ordinary insurance. Table I-2 shows that death benefits paid in 1977 represented only 14.5 percent of the cash flow of the industry, whereas the savings element was more than 3-1/2 times as large at 54.9 percent.

Table I-2[35]



35 Table I-2 is based upon the data contained in Table I-1A.

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TABLE I - 1A

(Amounts in billions of dollars) */

Amounts Contributed by Policyholder			Amount Retained by Companies			Amount of Benefits Paid	
Premiums	$24.161		Increase in policyholder savings	$ 7.878		Death Benefits	$4.908
Investment Income	9.755	$33.916 Cash flow from policyholders to companies	Expenses and Profits	10.379	$15.659 Cash flow from companies to policyholders	Savings Withdrawals	
TOTAL	$33.916		TOTAL	$18.257		Dividends	4.671
						Surrender Values	3.964
						Supplemental Contracts	1.059
						Matured Endowments	.894
						Other	.163
						Total Withdrawals	$10.751
						TOTAL BENEFITS PAID	$15.659

*/ The source of the information in Table I - 1A is set forth in Appendix II.

TABLE I - 1B

(Amounts in dollars)*/

Amounts Contributed by Policyholder			Amount Retained by Companies			Amount of Benefits Paid	
Premiums	$525		Increase in policyholder savings	$+171		Death Benefits	$107
Investment Income	212	$737 Cash flow from policyholders to companies	Expenses and Profits	226	$340 Cash flow from companies to policyholders	Savings Withdrawals	
TOTAL	$737		TOTAL	$ 397		Dividends	102
						Surrender Values	84
						Supplemental Contracts	23
						Matured Endowments	19
						Other	4
						Total Withdrawals	$233
						TOTAL BENEFITS PAID	$340

*/ The source of the information in Table I - 1B is set forth in Appendix II.

These tables demonstrate that the life insurance industry is a major savings medium. We now turn to an examination of the average rate of return the life insurance industry pays ordinary policyholders. The life insurance industry, in return for the premiums it receives, both provides insurance protection and serves as a savings medium. By subtracting the portion of the total premium that goes to provide insurance protection it is possible to compute the average rate of return the insurance industry is paying on policyholders' savings. This rate is calculated in much the same way as the rate of return from any other savings medium such as a bank. The general formula for calculating rate of return is set forth below:

$$r = \frac{\text{savings at the end of the year}}{\text{savings at beginning of the year + deposits - withdrawals}} - 1$$

Using this formula, the average industrywide rate of return paid ordinary policyholders in 1977 can be calculated. Total consumer savings in ordinary life insurance were $137.032 billion at the beginning of 1977 and $140.910 billion at the end.[36] The withdrawals from savings were paid as dividends, surrender values, supplemental contracts, matured endowments and other miscellaneous benefits and totaled $10.7 billion.[37] In 1977, $24.161 billion was paid in premiums. Part of the total premiums can be allocated to the industry's cost of providing death protection and the remainder is the deposit added to existing savings.

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36 See Appendix II.

37 See Table I-1A.

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To determine the size of the deposit it is necessary to estimate the portion of the premiums needed to provide death protection. This can be done simply by taking the cost of providing death protection (term insurance) to be some multiple of death benefits actually paid. For purposes of this calculation we used a multiplier of 1.5. That is, people pay $1.50 in premiums to get back $1.00 in death benefits.[38] Applying this 1.5 multiplier to all death benefits paid in 1977, the amount of premium dollars needed to provide death protection is $7.364 billion:

Death benefits paid in 1977	$4.909 billion
	X 1.5
Premiums needed to provide death protection	$7.364 billion

The deposit to savings is the total premiums minus the cost of providing death protection or $16.8 billion.

Total Premiums	$24.161 billion
Cost of Pure Insurance	7.364 billion
Deposit to Savings	$16.797 billion

Table I-3 illustrates the rate of return calculation for 1977 using the 1.5 ratio to estimate cost of providing death protection.

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38 A 1.5 multiplier is the same as a 66.6 percent loss ratio. This means that for each $1.00 in premiums paid the company returns 66.6 cents in benefits. The industrywide ratio of benefits to premiums for all business in 1977 was 79 percent. Fact Book, supra, n. 8, at 62. The higher the loss ratio assumed, the lower the rate of return. The rate of return assuming different loss ratios is set forth in Table I-4, infra.

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Table I-3

Rate of Return Paid by Life Insurance Companies to Ordinary Policyholders in 1977[39]

Savings at end of 1977		$140.910 billion
Savings at end of 1976		$133.032 billion
Deposit: Premiums		$ 24.161 billion
less (1.5) X Death Benefits (4.908)		7.364 billion
		$ 16.797 billion
Withdrawals: Dividends		$ 4.671 billion
Surrender Values		3.964
Supplemental Contracts		1.059
Matured Endowments		.894
Other		.163
		$ 10.751 billion
Deposit less withdrawals		$ 6.046 billion

$$r = \frac{\text{Savings end of 1977}}{\text{Savings end of 1976 plus Deposit less Withdrawals}} - 1$$

$$= \frac{140.910}{133.032 + 6.046} - 1 = \frac{140.910}{139.078} - 1 = 1.013 - 1 \text{ or } r = 1.3 \text{ percent}$$

The industrywide rate of return depends upon the amount of the total premium dollars that are allocated to providing death protection. The dollars allocated to insurance depend upon the loss ratio assumed. Table I-4 shows the rate of return using both a 66.6 percent and other loss ratios for the years 1970, 1975 and 1977.

39. For the sources of these figures see Table I-1A, supra and Appendix II. The rates of return in Tables I-3 and I-4 do not take into account one of the important special features of cash value contracts, namely, the right to borrow against the cash value at a rate of interest specified in the policy. The calculations in the text are concerned with what the industry pays and treat policy loans as a separate transaction for reasons that are discussed in Appendix III. Nevertheless, the policy loan provision is of considerable value to those policyholders who can borrow funds at 5 or 6 percent, when their alternative would be at 10 or 12 percent. It is difficult to quantify this benefit since we have no information on the alternative rates of interest that the borrowers would have had to pay and because we would also have to reflect the value of the loss in insurance protection that occurs when a policy loan is made.

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Table I-4

Rates of Return to Ordinary Policyholders in 1970, 1975 and 1977 Using Alternative Loss Ratios

Year	Loss Ratios		
	79% (1.2658)	66-2/3% (1.5)	60% (1.66)
1970	-1%	-0.15%	0.46%
1975	0.03%	0.86%	1.45%
1977	1.2%	1.3%	1.85%

Table I-4 shows that, depending upon the loss ratio assumed, the average rate of return paid to ordinary policyholders in 1977 ranged from 1.2 to 1.85 percent. No matter which loss ratio is assumed the rate of return is extraordinarily low, even considering that it is essentially tax-free. The extremely low industrywide rate of return reflects the consumer problems discussed in the next part of this report: low average rates of return paid on individual policies, great variability in the rates of return paid on policies, negative rates of return when early lapsation occurs, and extremely low rates of return paid to policyholders who purchased their policies many years ago when inflation and interest rates were much lower.

The industrywide rate of return can be used to estimate the total loss to consumers in 1977 from all of these problems. This is done by comparing the amount of savings that would have been available if the industry had paid a competitive tax-free rate of return on policyholder's savings rather than the approxmately 1.3 percent it actually paid. A reasonable

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tax-free rate of return in 1977 would have been at least 4 percent (see page 31, infra). If the life insurance industry had paid ordinary policyholders 4 percent interest, total savings would have amounted to (139.081 x 1.04) or $144.644 billion instead of $140.910, a difference of over $3.7 billion in 1977 alone.[40]

It is important to note that the available evidence does not indicate that life insurance companies are earning massive profits on the difference between their return on investments and what they pay policyholders. In 1977, life insurance companies earned an average of 6.9 percent on their investments before Federal taxes,[41] while they paid approximately 1.3 percent to policyholders on funds invested with them. The large differential, however, does not necessarily result in excessive profits for the companies. The available evidence suggests that most of the differential is absorbed by high home office expenses, sales commissions to agents, and Federal and state taxes.[42]

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40 The difference in 1977 would be substantially greater if the industry had been paying 4 percent in earlier years as well, since the total savings at the beginning of the year would have been larger and the policyholder would have earned interest on the earlier paid interest.

41 Fact Book, supra, n. 8, at 61.

42 A recent study of the profitability of capital stock life insurance companies found that their rates of return on net worth were higher than that of other service industries, such as banking and real estate, but lower than for manufacturing and wholesale and retail trade. Since life insurance company profits are much more stable than profits in other businesses, the authors of the study also estimated rates of return adjusted for risk. Their tentative conclusion
(Footnote Continued)

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It does not really matter to consumers who purchase cash value insurance whether the low average rate of return paid ordinary policyholders is due to excess profit of companies, high expenses, or the cost of supporting an extensive agency system. What is important is that in far too many instances consumers who use cash value insurance as a way to save receive a rate of return which is substantially below what is readily available in the marketplace. The next part of this report analyzes the consumer problems in life insurance from the perspective of the individual policyholder.

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42 (Footnote Continued)

was that the risk adjusted rates of return for life insurance companies are high relative to other industries but not excessively so. See S. T. Pritchett and R. Wilder, "A Comparative Study of Stock Life Insurer Profitability: Implications for Workable Competition" (Preliminary Draft), prepared for the Huebner Foundation, Wharton School, University of Pennsylvania. A further discussion of the profitability of life insurance companies is contained in Appendix I.

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II CONSUMER PROBLEMS IN LIFE INSURANCE

Our study of this industry discloses that American consumers are losing billions of dollars yearly as a result of ill-informed and inappropriate life insurance purchase decisions. The basic problem is that the life insurance market does not provide adequate and meaningful information for purchasers to make intelligent, reasoned decisions. In the last few years, significant developments--such as the NAIC model cost disclosure regulation proposal--have resulted from increased recognition of this problem. However despite these initial efforts, the lack of meaningful cost disclosure remains an acute problem.[1] As one commentator recently observed:

> Inadequate financial disclosure is indeed a consumer problem. Americans carry more than $2 trillion worth of life insurance. However, their ability to act responsibly and make informed decisions as purchasers is seriously impeded by sales pressure, confusing terminology, numerous rows of seemingly meaningless figures, and most of all, by the lack of solid, comprehensible

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1 See Subcommittee on Oversight and Investigations of the House Comm. on Interstate and Foreign Commerce, Report on Life Insurance Marketing and Cost Disclosure 95th Cong., 2d Sess. 3 (1978) [hereinafter cited as Moss Subcommittee Report]. As part of its findings and conclusions, the subcommittee stated:

> [t]he solution proposed by the NAIC, while a step in the right direction, is not satisfactory. It contains a number of provisions that unnecessarily blunt its effect and omits altogether certain essential remedies. Id.

In subsequent sections of this report, we will present our analysis of the NAIC model regulation and suggest certain modifications to increase its effectiveness.

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> and comparable information. Often consumers do not even know which question to ask the agent to obtain the correct cost information; thus they become doubly frustrated. Simple requests for information are often met by condescending attitudes or misleading data.[2]

To indicate the magnitude of the problem created by the failure of the market to generate meaningful cost information, we reiterate that consumers paid $24.2 billion in premiums for ordinary life insurance in 1977. A large percentage of these premium dollars were spent on whole life or cash value insurance. This type of insurance is often sold as a convenient way to combine insurance with a plan to save for retirement or other purposes. This dual function of the cash value contract is often stressed during the sales presentation and in industry advertisements.[3] Indeed,

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2 Hearings on Life Insurance Marketing and Cost Disclosure Before the Subcomm. on Oversight and Investigations of the House Comm. on Interstate and Foreign Commerce, 95th Cong., 2d Sess. 542 (1978) (Statement of National Consumers League) [hereinafter cited as Moss Subcommittee Hearings].

3 A typical example is contained in a brochure prepared by Government Employees Life Insurance Company (GEICO), which states:

> A whole life or endowment policy will guarantee to pay your family a regular monthly income or a cash sum, or both, if you die. And if you live, the cash values provide a nice "nest egg" you can use as a family emergency fund for your children's college tuition costs or for additional retirement income.

A similar theme is sounded in a recent brochure put out by the National Association of Life Underwriters (NALU):

> Permanent forms of life insurance provide guaranteed protection you can't outlive. So your policy benefits are there if you die or, far more often, are there to supplement
>
> (Footnote Continued)

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it is the savings element of the cash value policy which is often extolled as the best way to provide funds for retirement. This position is stated with appropriate eloquence in one company's agent training manual:

> [L]ife insurance guarantees safe and successful investment. The dollars men are saving to provide a future income for their families and themselves probably will have to go through three or four complete swings of the business cycle. What type of institution can best be trusted to handle those dollars? A study of the various fiduciary institutions leads to the conclusion that the best of all trustees to guard the sacred dollars set aside to provide future family and personal income is the institution of life insurance.[4]

While cash value insurance is often sold and purchased on the basis of its investment utility, the consumer is given virtually no meaningful information to compare the true costs of similar policies or compare the benefits of the cash value purchase with alternative forms of savings or investment. Due to this alarming dearth of information, the life insurance purchaser buys a protection and retirement savings plan on the faith that an agent will select an appropriate policy for his or her needs. As we demonstrate below this faith is often misplaced. Moreover,

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3 (Footnote Continued)

> other income and resources for your retirement years.

Moss Subcommittee Hearings, supra n. 2, at 766,759.

4 Occidental Life Insurance Company of California, An Introduction to Life Insurance (agents' training manual) 3-3 (1970).

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the consumer is confronted by a market that has an industrywide rate of return of between 1 and 2 percent and is subject to extreme variations in costs that could result in the individual losing thousands of dollars in lost savings and unnecessary premium payments. The life insurance industry in its role as "the best of all trustees" pays in many instances an individual rate of return that is 4 to 5 percent below alternatives readily available in the marketplace. Millions of consumers who have entrusted their retirement savings to this industry will find that the 2 to 4 percent 20-year return on their cash value insurance policies will have been almost completely eroded by inflation

As we noted at the outset, we believe that the central problem is a lack of adequate and meaningful information. In our view, this problem manifests itself in four significant ways:

A. The rate of return consumers receive on the savings component of cash value insurance is often very low.

B. Consumers lose substantial amounts of money through termination of cash value policies within the first few years of purchase.

C The costs of similar life insurance policies vary widely.

D Consumers receive a small amount of protection against premature death relative to the premiums they pay for private life insurance protection.

In this section we will discuss in detail each of these areas and the manner in which they impact on the individual consumer.

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A. The Rate of Return Consumers Receive on the Savings Component of Cash Value Insurance Policies is Often Very Low

Consumers do not know the rate of return they will earn on the savings element of their whole life policies. This prevents comparison shopping with other types of savings or investments; the potential for consumer loss can be staggering. For example a person who invests $1,000 each year at 3 percent, will have, at the end of 30 years, approximately $46,000. One who invests the same amount at 6 percent will have $80,000 at the end of 30 years. In many instances this is precisely the choice unknowingly faced by consumers.

The individual rate of return concept, used in this section, is similar to the holding period yield of a bond and provides a uniform means to compare alternative forms of savings and investments.[5] In essence, it is the average annual rate of return on a particular policy if it is held for a given number of years.[6] This calculation is based on the assumption that a cash value insurance product can be viewed as a combination of death protection and savings. To compute the average annual

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5 For a discussion of bond yields, see S. Homer and M. Leibowitz Inside the Yield Book (1972). A more detailed, but more technical discussion can be found in Malkiel, The Term Structure of Interest Rates 40-49 (1966).

6 The rate of return on individual policies is conceptually distinct from the industrywide rate of return discussed in Part I. As noted there, the industrywide rates show the average rate of return in a particular year for all savings consumers have in ordinary life insurance, assuming a cost for the pure insurance coverage.

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rate of return for an individual policy, it is necessary to determine the portion of the yearly premium that constitutes the "deposit" to the savings fund. This is done by subtracting the cost of insurance protection for that year from the premium (less any dividend); the remainder is the savings fund deposit.[7] The rate of return, then, is the interest rate required to make these deposits, accumulated at interest, equal the cash value of the policy at the end of the period of years chosen for the computation.[8]

1. Many New Cash Value Policies Earn Relatively Low Rates of Return

Our analysis of individual policy rates of return is divided into two parts. The first part discusses the rates of return being offered to new policyholders in 1973 and 1977. The second part presents some evidence that the rates being offered to exist-

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7 The amount of term insurance purchased each year for purposes of the rate of return calculation is determined in such a way that the sum of the term policy's death benefit and the amount accumulated in the savings fund equals the face amount of the policy. For example, if the savings fund amounted to $10,000 after 10 years, and the face amount of the cash value policy was $25,000, the amount of coverage which must be purchased is $15,000. The cost of the term coverage in any year is the product of the term insurance premium rate for that year and the amount of protection needed.

8 This rate of return calculation is known as the "Linton Yield." It was developed by Mr. Albert Linton, a life insurance actuary, from 1927 to 1963. Mr. Linton was President of the American Academy of Actuaries as well as President of Provident Mutual Life of Philadelphia. For a more technical description of the Linton Yield and the yearly renewable term rates used to calculate the Linton Yield in this report see Appendix VI.

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ing policyholders are substantially lower than those being offered to new policy holders.

This section examines the rates of return on new policies issued in 1973 and 1977.[9] It then compares these rates of return with the higher rates available in alternative savings media and shows the significance of the difference to the individual policyholder.

Table II-1 shows the average rate of return on various new policies issued in 1973 and 1977.[10] It shows that the 5-year

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9 In 1977, new policies accounted for $4.8 billion of the $24.2 billion paid in premiums. American Council of Life Insurance, Life Insurance Fact Book 59 (1978) [hereinafter cited as Fact Book].

10 Data for 1973 comes from information furnished by 197 life insurance companies to the Hart Antitrust and Monopoly Subcommittee. Each company submitted data on its three best selling policies. 349 of these policies were whole life and are represented in Tables II-1, II-7, and II-8. Sample sizes for various ages and sizes are as follows:

	Participating		
	$10,000	$25,000	$100,000
25	116	141	138
35	120	145	142
45	120	145	142
55	118	143	140
	Non-Participating		
25	138	162	166
35	136	162	166
45	135	161	165
55	135	161	165

Data for 1977 comes from information furnished by 71 large life insurance companies to the Federal Trade Commission. Each company was asked to submit, among other things, data for its three best selling whole life policies. Sample sizes for various ages and sizes are as follows:

(Footnote Continued)

rates of return range from minus 9 to minus 19 percent, the 10-year rates are around 1 percent, and the 20-year rates range from 2 to 4.5 percent. The effects of negative rates in early policy years is discussed in Section II(B).[11] No matter what duration is looked at, the average rates of return appear low relative to market alternatives.

To place these 20-year rate of return figures in perspective, it is useful to compare these rates to alternative forms of savings

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10 (Footnote Continued)

	$10,000	$25,000	$100,000
	Participating		
25	77	88	95
35	104	119	128
45	74	85	92
55	74	85	91
	Non-Participating		
25	39	50	51
35	39	51	52
45	39	50	50
55	39	50	49

Some companies issued the same policy with two different policy loan interest rates, and dividends adjusted accordingly. These companies were asked to submit data for the rate under which the policy was most recently issued. In addition, they were asked to submit data for the other interest rate for issue age 35 only.

This explains the large sample size for participating policies, age 35. The 1977 data is in the process of being verified by the individual companies.

11 There is a negative rate of return whenever the principal at the end of the period is less than the sum of the deposits.

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and investments. Because the return on cash value insurance policies is generally tax free, a distinction is drawn between alternatives which are and are not subject to taxes.[12] Table II-2 shows the rate of return from both alternatives in 1973 and 1977. Alternative tax exempt investments range from 1 to 3 percent higher than the average 20-year rates for dividend and non-dividend-paying cash value policies. For returns that are taxable, the difference is between 4 and 6 percent.[13]

Table II-1

Average Rates of Return (Tax Free) on Whole Life Insurance Policies 1973 and 1977

			1973		1977	
Age at Issue	Face Amt of Policy	If Policy is Held For	Dividend Paying	Nondividend Paying	Dividend Paying	Nondividend Paying
25	$ 10,000	5 years	-12.04	-17.97	-12.28	-19.78
		10 years	0.51	-0.99	1.93	-1.25
		20 years	3.71	2.40	4.61	2.34

12 The interest buildup in the savings element of cash value insurance is not subject to tax as it accrues. If a policy is cancelled and the cash value withdrawn, only the amount in excess of the total premiums paid is subject to federal income tax.

13 The tax advantages of savings through life insurance must be considered in comparing saving through insurance with other forms of savings. For most people, the after-tax return from the alternatives in Table II-2 are substantially greater than the yield from insurance policies. This is because very few consumers pay taxes at anything near the maximum rate. In 1975, the latest year for which data is available, only approximately 1 percent of federal tax returns were in a 50 percent or greater marginal tax bracket. In contrast, approximately 47 percent of all returns were in a marginal bracket of 19 percent or less and 83 percent were in a marginal rate of 25 percent or less. Internal Revenue Service, Statistics of Income, Individual Income Tax Returns 105 (1975).

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	25,000	5 years	-11.73	-18.29	-11.99	-17.51
		10 years	-0.16	-1.54	1.25	-0.61
		20 years	3.28	2.14	4.21	2.71
	100,000	5 years	-12.59	-18.42	-12.25	-16.81
		10 years	-0.67	-1.78	0.96	-0.38
		20 years	3.04	2.03	4.09	2.83
35	10,000	5 years	-9.73	-13 35	-8.43	-14.31
		10 years	0.33	-1.03	1.74	-1.25
		20 years	3.33	1.98	4.32	1.91
	25,000	5 years	-9.39	-13.22	-8.36	-11.96
		10 years	-0.04	-1.20	1.43	-0.26
		20 years	3.09	1.91	4.12	2.47
	100,000	5 years	-9.99	-13.24	-8.53	-11.28
		10 years	-0.38	-1.30	1.28	-0.05
		20 years	2.93	1.87	4.06	2.64
45	10,000	5 years	-10.04	-13.28	-9.84	-14.11
		10 years	-0.66	-2.24	0.63	-2.48
		20 years	2.58	1.06	3.56	0.94
	25,000	5 years	-9.48	-12.84	-9.13	-11.65
		10 years	-0.77	-2.16	0.68	-1.34
		20 years	2.49	1.12	3.57	1.60
	100,000	5 years	-9.90	-12.75	-9.08	-10.88
		10 years	-1.00	-2.17	0.62	-0.96
		20 years	2.40	1.14	3.57	1.82

Table II-2

Rates Payable on Time and Savings Deposits and Bond Yields
1973 and 1977

Tax Exempt	Subject to Tax

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	1973	1977
High Grade Municipals	5.18%	5.56%
(Standard and Poors) State and Local Govt. Bonds (Aaa)	4.99	5.20
State and Local Govt. Bonds (Baa)	5.47	6.12

Savings and Loan Associations[14] (1973 and 1977)

Savings deposit	5.25%
Time deposits	
1 to 2 years	6.50%
2-1/2 to 4 years	6.75%
4 to 6 years	7.50%
6 to 8 years	7.75%

U. S. Treasury Bonds

	1973	1977
5 year	6.87%	6.99%
10 year	6.84	7.42
20 year	7.12	7.67

Corporate Bonds

Aaa	7.44%	8.02%
Baa	8.24	8.97

By Years to Maturity

5 year	6.88%	7.25%
10 year	7.05	7.60
20 year	7.20	7.75

Consumers who purchase a low-yield cash value policy stand to lose a considerable amount of money over the life of the policy. A difference in a rate of return of even 1 percent when compounded over a long period of time is extremely significant. Table II-3 shows the before-tax value at the end of 30 years (which can be the duration of a whole life policy) of $1,000 deposited each year in a bank account at various interest rates.

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14 These are technically the maximum interest rates payable, but almost all S&L's were paying the maximum rates in both 1973 and 1977. These rates went into effect in July 1973, so they only applied to a portion of that year.

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Table II-3

Rate of Interest	Value After 30 Years
2%	41,379
3%	49,003
4%	58,328
5%	69,761
6%	83,802
7%	101,073

This table demonstrates that the rate of return is critical whenever a person is contemplating saving over a long period of time such as for retirement.

The importance of rate of return for a person buying a $25,000 whole life policy can be illustrated by comparing the purchase of a whole life policy with a 20-year yield of 2 percent to buying term insurance and investing the difference between the term and whole life premium at 5 percent. The amount expended for each plan is the annual premium for the whole life policy ($545) less the illustrated dividends for that year. Both plans require the same expenditure each year and will provide the insured's beneficiaries $25,000 if death occurs before the 20th policy year.[15] The difference between the two plans is between the amount in the side or savings fund and the cash value of

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15 Under the term and invest the difference plan, the amount that is deposited in the side fund each year is the net premium payment less the amount of money needed to purchase term insurance. The amount of money needed to buy term insurance (term expenditure) is determined by multiplying the cost of term insurance per $1,000 for the given year by the number of thousands needed.

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the whole life policy.

Table II-4 compares these two plans. After 5 years the difference between the savings fund and the cash value is more than $1,350. The difference increases every year and at the end of 20 years is more than $4,000.

Table II-4

"Buying Term and Investing the Difference" at 5 Percent, Compared With a $25,000 Whole Life Policy--1973

Policy Size (face amount): $25,000

Premium Rate Per $1,000 of Face Amount: - $21.82
Total Premium: $545.50
Annual Rates of Return: 5 Years - 17.9 Percent
10 Years - 3.4 Percent
20 Years + 2.16 Percent

Issue Age 35

Interest Rate on Savings: 5.00 Percent

Year	Net Premium Payment	Term Insurance Protection	Term Rate Per $1,000	Term Expenditure	Savings Deposit	Side Savings Fund	Whole Life Cash Value
1	545.50	24,517.62	2.57	63.12	482.38	506.50	0.0
2	545.50	24,013.93	2.75	65.93	479.57	1,035.37	35.25
3	510.25	23,525.00	3.00	70.62	439.63	1,548.75	440.50
4	505.00	23,018.85	3.15	72.60	432.40	2,080.21	845.75
5	499.75	22,494.41	3.31	74.37	425.38	2,630.87	1,276.00
6	494.50	21,951.79	3.51	77.16	417.34	3,200.62	1,706.25
7	489.25	21,391.22	3.79	81.08	408.17	3,789.22	2,136.50
8	484.00	20,811.00	4.05	84.22	399.78	4,398.45	2,566.75
9	478.75	20,210.93	4.35	88.13	390.62	5,028.53	3,024.25
10	471.25	19,592.92	4.73	92.69	378.56	5,677.44	3,481.75
11	463.75	18,955.52	5.10	96.70	367.05	6,346.71	4,001.25
12	444.25	18,311.85	5.61	102.81	341.44	7,022.55	4,520.75
13	424.75	17,661.25	6.15	108.55	316.20	7,705.69	5,040.25
14	405.25	17,002.78	6.69	113.71	291.54	8,397.08	5,559.75
15	385.75	16,336.83	7.32	119.66	226.09	9,096.33	6,104.25
16	366.25	15,660.15	7.84	122.74	243.51	9,806.84	6,637.25
17	358.25	14,959.98	8.36	125.07	233.18	10,542.02	7,171.00
18	349.50	14,236.83	9.02	128.35	221.15	11,301.33	7,729.75
19	340.75	13,489.66	9.77	131.74	209.01	12,085.86	8,263.50
20	332.00	12,715.99	10.53	133.85	198.15	12,898.21	8,822.25

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This example is not intended to show that term insurance plus a side fund is a better buy than whole life insurance. The comparison is between a 2 percent and a 5 percent rate of return. Similar results could be obtained by comparing a whole life policy that has a 20-year return of 5 percent to one that has a return of 2 percent. See Table II-9, infra.

We want to emphasize that we are not opposed to saving through life insurance. There are some policies available offering 20-year rates of return that are competitive with other savings media (see Tables II-7, II-8, infra). Moreover, there are reasons for saving through insurance: it is convenient, many people like the forced saving aspect, and there are definite tax advantages. There are also certain attractive features of a whole life policy which cannot be duplicated in term insurance plus a side investment.[16] These reasons could well support a decision to purchase a whole life policy whose rate of return is lower than that which is available elsewhere. However, these advantages must be weighed against the extremely low rates of return that are paid on many whole life policies. Only if consumers are told

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16 In addition to tax advantages, these include the ability to use the cash value of the whole life policy to purchase paid-up insurance benefits, guarantees with respect to annuity purchase rights, and the ability to use the cash value as collateral for a relatively low-cost loan. Further, a bank or S&L cannot provide the long term investment guarantees of whole life policies, and there is no counterpart in alternative investments to the waiver of premium in the event of disability. See discussion, pages 118-119, infra.

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what rate of return they will earn on savings deposited with insurance companies will they be able to make an informed judgment whether to save through cash value insurance or through some other savings medium.

2. Substantially Lower Rates of Return Are Being Paid on Older Whole Life Policies, Especially Non-Participating Policies

The previous section showed that the rate of return on cash value insurance policies is often extremely low compared to alternatives in the marketplace. This section documents the problem that existing whole life policyholders often earn significantly lower rates of return than the rates paid on new policies. It explains the special plight of holders of old non-dividend-paying policies, and considers the potential dollar loss they suffer and possible solutions to the problem.

The magnitude of the problem facing existing policyholders can be demonstrated by comparing the 1977 industrywide rate of return to the 20-year rate of return on new policies. As seen in the previous section, the average 20-year rate of return on new policies ranged from about 2 to 4 percent in 1973 and from about 2 to 5 percent in 1977.[17] In comparison, the industrywide average rate of return for 1977 was approximately 1.3 percent.[18] The extraordinarily low rate of return earned by many policies sold in the 1950's and early 1960's is one reason for the disparity

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17 See pages 29-30, supra.

18 See pages 17-18, supra.

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between the industrywide average rate of return and the new policy rate of return. In effect, old low-yielding policies bring down the industrywide average.[19]

The low rates of return on existing policies issued in the 1950's and early 1960's reflect the low interest and inflation rates existing at the time the policies were sold. For example, in 1960 the average corporate bond (Aaa) yield was 4.41 percent, saving deposits in banks paid 3.52 percent, and the rate of inflation was approximately 1.6 percent.[20] Over the past few years there have been dramatic changes in both the rate of inflation and the rate of return available from investments. These changes have had profound consequences on persons who purchased whole life insurance in the late 1950's and early 1960's. The problems facing whole life policyholders, especially those with old low-yield non-dividend-paying policies, in this age of inflation have not gone unnoticed. For example,

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19 The other main reason for the disparity is the effect of early lapse of cash value policies. See pages 47-50, infra.

The impact of the low rates of return earned on many existing policies can also be seen by comparing the 1970 industrywide rate of return (-.15%) with the 1977 figure (1.3%). The 1970 average reflects the very low rate of return paid on many older policies. In part, the 1.5 percent rise in the industrywide rate of return over this period is due to the somewhat higher rate of return being paid on policies issued since 1970.

20 1971 Business Statistics, Dept. of Commerce, Office of Business Economics at 105 (bond yield); National Association of Mutual Savings Banks, Annual Fact Book, 23 F at Table 35 (1961) (Savings bank rate); Economic Report of the President 220 (1976) (inflation rate).

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Mr. James Anderson, a consulting actuary, recently stated:

> Consider the case of a 25-year-old buyer with a young family and a current annual income of $10,000. With an annual productivity gain of 2% and no inflation, he might expect an equivalent income at age 55 of $18,000. If however, inflation is assumed to continue throughout the 30-year period at a rate of only 5 percent, his nominal annual income at age 55 would be $78,000. If this buyer purchased a $10,000 policy at age 25, its value in constant dollars would be only $2,300 30 years later. I do not believe that fixed premium, fixed benefit, permanent, cash value life insurance has any relevance to this potential buyer's financial requirements over 30 years, considering only the consequences of inflation. I believe that most actuaries would agree that the assumptions underlying the illustration are quite modest and that even more radical changes in the financial circumstances of such an individual are more likely to occur than not.[21]

Hardest hit by inflation are consumers who purchased non-participating whole life policies during the 1950's and early 1960's. Non-participating cash value insurance policies are a low-yield, fixed-dollar saving medium, uniquely unsuited to cope with accelerating inflation.[22]

The problem of the old non-participating policyholder is

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21 Anderson, "Is the Life Insurance Business in its Terminal Stages?" Best's Review 10, 12 (July, 1977).

22 Participating policyholders have had some measure of relief. Over the past twenty years, the dividends actually paid on most participating policies have been higher than those illustrated when the policies were sold. See, e.g., "20-Year Dividend Comparisons," Best's Review 36-41 (December 1977). Thus, some of the increased earnings of the companies resulting from higher interest rates have been passed on to policyholders and the impact of inflation has been somewhat diminished.

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vividly illustrated by the actual case of a man who purchased a typical $50,000 non-participating policy in 1960 when he was 20 years old.[23] The rates of return on this policy are shown below:

Years Held	Rate of Return
5	- 17.0%
10	-1.1%
15	1.23%
20	1.96%
30	2.11%

In 1975, when he was 35 years old, his policy had a cash value of $8,450, reflecting a 1.23 percent rate of return. Even at the 1960 inflation rate (1.6 percent), his policy would not have kept pace with inflation. The heightened inflation during the policy's first 15 years has severely eroded its real value. The cash value of $8,450 in 1975 dollars is equivalent to only $4,650 in 1960 dollars. Thus, unanticipated inflation has wiped out almost $4,000 of the savings accumulation. If he had earned 5 percent from 1960 to 1975, his savings fund would have surpassed $11,000 and the ravages of inflation would have been at least partially mitigated.

If the policyholder continues to hold this policy, he continues

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23 This case of an actual policyholder was discussed by Professor Joseph Belth in the Insurance Forum, February 1976. Professor Belth supplied the FTC staff with sufficient data to perform the calculations shown in Table II-5, infra. The policy in question was purchased from the Traveler's Insurance Co., the third largest stock company in the United States. Stock companies sell virtually all of the non-dividend-paying policies being offered on the market. Traveler's is the eighth largest life insurance company in the United States ranked by assets. Fortune Double 500 Directory 60 (1978).

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to lose. The extent of his loss can be seen by comparing what would happen over 30 years if he surrendered his policy in 1975 when he was 35 years old and bought term insurance and invested the difference at 5 percent (after taxes).[24] For purposes of this comparison it is assumed that he deposits the $8,450 surrender value in a savings account and continues to spend $627.50 annually. The difference between the whole life premium he had been paying and the term premiums now used to buy an equivalent amount of death protection is deposited in the savings account. He will continue to guarantee his beneficiary $50,000 if he should die by buying an amount of term insurance which together with the balance in savings equals $50,000.

Table II-5 shows his relative position at 5-year intervals under both approaches for 30 years. Three points about Table II-5 bear emphasis. First, the policyholder can stop buying any term insurance at age 59, since at that age the savings fund alone is greater than $50,000. Second, while his existing policy accumulates a cash value of $36,300 at age 65, the alternative plan builds a saving fund of $75,813, a difference of almost $40,000. Lastly, the policyholder could do equally well by surrendering his existing policy and buying a cash value insurance policy with a 5 percent rate of return.

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24 This example assumes the policyholder is in good health and could qualify as a standard risk to buy the needed term insurance.

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Table II-5[25]

A Comparison Between Retaining a Non-dividend-paying Policy Purchased in 1960 at Age 20, and Surrendering the Policy in 1975 and Buying Term and Investing the Difference at 5 Percent (after taxes)

Age	Cash Outlay	Amt of Term Insurance Purchased	Term Rate Per $1,000	Savings Fund	Cash Value If Existing Policy Is Maintained
35	$627.50	$41,028	$ 2.57	$ 9,410	$ 9,250
40	627.50	35,737	3.51	14,976	13,350
45	627.50	29,098	5.10	21,947	17,400
50	627.50	20,744	7.84	30,719	21,750
55	627.50	9,967	11.30	42,035	26,450
58	627.50	1,871	14.38	50,535	29,400
60	627.50	0	--	57,066	31,450
65	627.50	0	--	75,813	36,300

The relative attractiveness of non-participating and participating insurance has been fundamentally changed by inflation. When rates of interest and inflation were lower, the difference in value between these two types of insurance was not great. The premiums for participating policies were generally higher, but a portion of the higher premium was returned to the policyholder in the form of dividends. If the company's actual dividends (which are determined to an extent by the company's mortality experience and investment income) exceeded the conservative estimates used in calculating illustrated dividends, then the policyholder would often be better off in the long run buying participating insurance. On the other hand, non-participating policies offered rela-

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25 The existing policy is a life paid up at 65 (no premiums after age 65), purchased at age 20.

Face Amount - $50,000
Premium - $627.50 per year
Dividends - none

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tively more security because all of the values in the contract were guaranteed no matter what happened to economic conditions. When banks were paying 3-4 percent on deposits and the rate of inflation was 1-2 percent, a guarantee of 2-2.5 percent may have been important. In that situation one gave up relatively little in return for certainty. A fundamentally different situation is presented, however, when tax-free returns of 5-6 percent are readily available in the marketplace and the rate of inflation is between 7-10 percent. In this case the non-par policyholder gives up a great deal for a guaranteed 2 percent rate of return. Table II-6 demonstrates why. It shows the value of $1,000 a year invested each year for 20 years at different interest rates.

Table II-6

Rate of Interest	Amount Accumulated
1%	$22,239
2%	24,783
3%	27,676
4%	30,969
5%	34,719
6%	38,993

Consider the person who deposits an average of $1,000 a year in the savings element of a non-participating contract that has a 20-year rate of return of 2 percent. If for some reason interest rates plummet to 1 percent over the next 20 years, then the 2 percent guarantee will have been worth approximately $1,500 -- the difference between the return at 1 percent ($22,239) and 2 percent ($24,783). If, on the other hand, current conditions continue and a person is able to earn an average of 5 percent after taxes, he would have $34,719 at the end of 20 years--a difference of

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almost $10,000 over the 2 percent return. It is difficult for a non-par company to offer a competitive rate of return because of the need to guarantee this rate for 30 to 40 years. The rate offered must of necessity be very conservative which in part accounts for the fact that the 20-year rate of return on non-participating policies issued in 1977 averages between 2 and 2.5 percent.[26]

Very serious problems currently exist in the non-participating segment of the life insurance industry. The example of the holder of the 1960 non-par policy, discussed above, indicates that a great

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26 Mr. E. J. Moorhead, writing in Best's Review, points out the problem facing the actuary in attempting to develop a competitive non-par product:

> [A]ctuaries attempting to calculate nonpar premiums that will be competitive with illustrated prices of participating policies are faced with a problem that has no satisfactory solution. The actuary, concerned as he must be with company solvency and prosperity, dares not assume in his calculations that high investment yields will continue for many future years even though he usually is personally convinced that continuing inflation will produce that result. Hence, he calculates nonpar premiums by allowing for high interest rates in the early years (when it really makes little difference what interest rate he assumes); and he grades the assumed interest rate downward in later policy years (when the policy reserve will have reached a size that makes even small interest rate differences of material consequence). In the past several years during which this observer has been publicly pointing this out, no actuary experienced in nonpar premium calculation has risen to dispute its validity.

Moorhead, "Doomsday Just Ahead for Life Insurance? Not Necessarily!" Best's Review, 10, 12 (August, 1977). [hereinafter cited as Moorhead]

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many policyholders similarly situated would be well advised to surrender their old policies and purchase new participating or term policies. Further, the extraordinarily low rates of return on many non-participating policies issued in 1973 and 1977 (see pages 29-30, supra) indicates that millions of consumers may be currently locking themselves into a low-yield, fixed-dollar saving vehicle which is highly vulnerable to inflation.[27] The challenge facing the industry was succinctly stated by Mr. E. J. Moorhead:

> [I]f interest rates stay up, companies with non-par policies on the books will be in the same untenable position that many of them are today; their informed policyholders still in good health will drop their policies to replace them by new participating policies or by term policies; only their ignorant or impaired-in-health (or lazy) policyholders will keep their policies.
>
> * * *
>
> Each--the industry and government--has part of the task to do, but in neither case is it self-evident that the task will be performed with enough speed and effectiveness to maintain public confidence in cash value life insurance.
>
> The industry will have to improve its record of initiating and supporting constructive change even when the points at issue are thorny and controversial ... State insurance departments too will have to show clear success in taking care of matters that only they can cope with, i.e., failures of elements of the industry to put policyholder well-being ahead of marketing considerations

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27 In 1975, some 34 percent of the 12.5 million ordinary cash value policies that were sold were non-participating. LIMRA, 1975 Buyer Study 6, 14.

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and profit margins.[28]

In Part IV of this report we recommend a system of life insurance cost discosure as a solution to many of the consumer problems in the life insurance industry. Cost disclosure alone will not solve the problems created by the sale of non-participating insurance, especially the problems facing the holders of old policies. If non-participating cash value insurance is to warrant public confidence, two things must be done. First, action must be taken on the part of non-par companies to alleviate the problems facing older non-par policyholders. This can be accomplished by companies unilaterally either reducing the premiums on these policies or increasing cash values or death benefits. It is not a germane response to say that these policyholders are not entitled to relief because they did not anticipate rising inflation and interest rates and therefore should be stuck with their mistakes. If companies do not improve the quality of existing non-par policies, consumers do have a choice -- they can replace the policies.

We want to stress that we are not recommending the wholesale replacement of cash value insurance policies. If a person has purchased an attractively priced policy that has an adequate yield, replacement in many instances will be harmful. This is because the person will again have to pay a heavy front-end load.[29] Moreover, a person considering replacement has to be

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28 Moorhead, supra n. 26, at 12, 13.

29 The 5-year return on whole life policies is strongly negative, see pages 29-30, supra. However, in many instances
(Footnote Continued)

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very careful to insure that the policy substituted for the existing policy is competitively priced. Unfortunately, in many instances this is not the case.[30] Nevertheless, as we have shown, consumers can often save considerable amounts of money by replacing old non-participating policies. In many cases they should do so unless the industry takes some action to improve the quality of these policies.

Second, the quality of non-participating policies currently being issued must be substantially improved. In 1977, the average 20-year rate of return on $25,000 non-participating policies was approximately 2.5 percent. Well over one-half of these policies had a 20-year rate of return of less than 3 percent. (See Table II-8, infra). With current rates of interest and inflation it is difficult to see any reason for consumers to put money into a long-term, fixed-dollar contract that has a 20-year yield

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29 (Footnote Continued)

after a policy has been held for 5 years the initial loss has been taken and the policy has a good rate of return if held from years 5 through 20. This is especially likely to be the case if the policy is attractively priced. For such policies, replacement is rarely desirable. Further, there may be other disadvantages to replacement, such as being subject to a new contestability period, that should be considered before replacement.

30 For example, whole life policies are often replaced with deposit term insurance, see Skipper, "An Analysis of Deposit Term Life Insurance," Best's Review, 10 (August, 1978). There is an enormous variation in the quality of deposit term products on the market. See pages 108-109, infra. Substantial consumer injury can result if a low cost (high-yield) whole life policy is replaced with a high cost (low-yield) deposit term policy.

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of less than 3 percent.

It may well be that the problems facing the non-par actuary of guaranteeing a competitive rate of return for 30 to 40 years are insoluble. If this is true, then the challenge facing stock insurance companies is to come up with new products that are better suited to cope with inflation. One promising development is the recent introduction by some stock companies of what are known as "combination policies." These are policies that combine term insurance with a flexible premium deferred annuity. These policies are very similar to participating cash value insurance.[31] Death protection is provided through term insurance. The savings build-up takes place in the annuity which often offers a competitive rate of return.[32] We are confident that the industry can develop other alternatives to the traditional non-par whole life

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31 Deferred annuities do not share all of the tax advantages of participating insurance. In deferred annuitites, like whole life insurance, the interest buildup is not taxed as it accrues. Unlike whole life insurance, however, if the person dies, income tax on the accrued interest must be paid. Compare IRC § 101(a)(1) [life insurance] with IRC § 72(a)(b) [annuities]. One effect of the different tax treatment between life insurance and annuities is to restrict the development of alternatives to the traditional whole life contract. Serious consideration must be given to whether this different treatment is warranted.

32 There is very little difference in the rate of return on annuities sold by stock and mutual companies. See Greene, Neter, and Tenney, "Annuity Rents and Rates--Guaranteed vs. Current." 44 J. Risk & Insurance 383 (1977). Most annuities have a guaranteed rate of interest of between 3 and 4 percent and a current rate of interest which is substantially higher. Although the current rate of interest is not guaranteed, it is related to what the company is earning and thus will reflect to a considerable degree the rate of return available from alternative investments in the marketplace.

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policy that are relevant to the needs of consumers in today's economy.

B. Consumers Lose Substantial Amounts of Money Through Termination of Whole Life Policies Within the First Few Years of Coverage

Purchasers of whole life insurance frequently do not realize the severe economic consequences that result from allowing a cash value policy to lapse within the first ten years. For example, a 35-year old person who spends $20 per $1000 of the face value amount for a whole life policy (when he could have purchased term insurance for less than $5 per $1000) has used 75 percent of the premium to make a "savings deposit" with the life insurance company. If the policy is canceled or lapsed during the first year, it will, in most cases, result in loss of this entire "savings deposit." Thus, the customer has, as the Moss Subcommittee observed, ". . . in essence, purchased one year of extremely expensive term insurance."[33] This is precisely what occurs in approximately 20 percent of all new ordinary life policy purchases within the first two years.[34] The aggregate

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33 Moss Subcommittee Report, supra n. 1, at 17-18.

34 In 1977, the average lapse rate for policies in force less than 2 years was 19.5 percent. Fact Book, supra n. 9, at 55. The lapse rates for many individual companies are much higher. The Hart Subcommittee on Antitrust and Monopoly, in its investigation of the life insurance industry, collected extensive data on lapses by company. A review of this data led Senator Hart to conclude, ". . . average industry figures for all policies do not sufficiently indicate just how high early lapse rates are. A better indicator is the 13-month lapse rate of the biggest selling cash value policy of each company. For instance, of 148 companies surveyed by the subcommittee, one out of four policyholders

(Footnote Continued)

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consumer losses due to first year lapsation alone exceeded $200 million in 1977.[35]

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34 (Footnote Continued)

of 64 companies dropped the best selling policy within 13 months after buying it in 1971. Fifteen of these companies had unbelievable high early lapse rates ranging from 40 to 50 percent." 121 Cong. Rec. 21476 (1975), S 11976 remarks by Senator Hart on the occasion of his introduction of the Consumer Information and Fairness Act.

35 The details of this calculation are set forth in Appendix V. We note that the draconian consequences flowing from early lapse of whole life insurance have been recognized as a serious problem in this industry for over 100 years. In 1872, the Massachusetts Insurance Commissioner in speaking to the National Insurance Convention noted the growing difficulties created by lapsation and recommended that "some measures should be adopted to prevent this wholesale slaughter of policies of life insurance." Official Report of the Proceedings of the National Insurance Convention, (New York, 1872) at 161 (Reprinted in Moss Subcommittee Hearings, supra n. 2, at 706,709). A similar call for action was issued in 1915 by the West Virginia insurance commissioner in an address to the National Convention of Insurance Commissioners:

> Instead of agency service they [policyholders] too often receive high pressure methods, in which the needs of the insurer and his ability to continue are given slight consideration. This is evidenced by the amount of business lapsing in the first and second years.
>
> * * *
>
> Are the companies in the mad rush for new business giving too little attention to that already on their books? There is an enormous wastage here, and it can be materially reduced. I submit that this problem is worthy of the best thought of those responsible for conditions in the field of life insurance. There is no more important question before them today.

Reprinted in Moss Subcommittee Hearings, id. at 704-705.

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The reason for the severe economic consequences of early lapse is the manner in which cash values accumulate. As noted previously, cash values build up very slowly during the early years of the policy. To a significant extent, this is due to heavy sales and administrative expenses levied against the first year premium which is commonly referred to as the "front-end load." This initial premium payment is normally used to pay the agent's first year commission (which is usually at least half of the first year's premium) and other administrative costs.[36] Consequently, most whole life policies do not have any cash value in the first year and have a fairly low accumulation during the remaining early years of the policy. Indeed, as Table II-1 demonstrates, the annual rate of return on whole life policies averages approximately minus 10 percent if the policy is surrendered after 5 years and between minus and plus 1 percent after 10 years. A negative rate of return means that the amount of money at the end of the period is less than the sum of the deposits.[37]

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36 Moss Subcommittee Report, supra n. 1, at 17.

37 While other types of savings such as savings and loan certificates of deposit and U.S. Government Series E bonds have penalties for early withdrawals, they are not nearly as severe as the life insurance penalties. For example, the penalty on an 8-year certificate of deposit is forfeiture of 3 months' interest and credit for the remaining months at the passbook rate of 5 1/4 percent. Thus, if an 8-year certificate of deposit with a 7 3/4 percent interest rate is surrendered after 5 years, it would yield about 4 1/2 percent instead of the full 7 3/4 percent. In no case except life insurance is the penalty severe enough to result in a negative rate of return. Moreover, in all advertise-
(Footnote Continued)

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In view of these facts, whole life insurance is rarely a desirable purchase unless held for substantially more than 10 years. Yet for every 1000 whole life policies that are sold, approximately 450 lapse by the end of the 10th year resulting in economic loss for the policyholder.[38]

C. The Cost of Similar Life Insurance Policies Varies Widely

Section IIA, supra, demonstrates that the average rates of return on cash value policies are often low compared to those available in alternative savings media. This fact indicates that there is little price competition between the life insurance industry and alternative savings media. This section considers additional evidence of weak competition and attendant consumer injury within the life insurance market--the extreme cost variation among similar policies around those low average rates of return. Undue cost dispersion also means that the

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37 (Footnote Continued)

ments and promotional material, savings and loans must disclose to the consumer the nature and amount of these penalties for early withdrawal. 12 C.F.R. 526.6(e) (1978).

38 See Moss Subcommittee Hearings, supra n. 2, at 775. In the previous section, it was shown that the industrywide rate of return for 1977 was substantially lower than the 20-year rate of return on new policies issued in that year. One of the important factors that explains this difference in rates of return is the effect on the overall industry rate of lapse. Besides those who keep their policies for 20 years, the average industrywide rate of return reflects the 20 percent of all policyholders who lapse in the first year and generally earn a minus 100-percent return, and the approximately one half of all policyholders who lapse within the first ten years of the policy and usually earn a negative rate of return.

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injury caused by low rate of return falls unequally on life insurance purchasers. In many cases, those consumers who least understand and are least able to judge the costs of whole life policies are most likely to buy the most expensive policies. (Part III discusses the relationship between the lack of meaningful cost information and increased dispersion and low average rates of return).

The existence of extreme cost variation among similar policies is strong evidence of the lack of effective price competition. In an efficiently functioning competitive market the prices of very similar products will tend toward uniformity.[39] This section shows that life insurance costs are much more widely dispersed than the costs of a variety of other products. It also shows that there is little relationship between the cost of a life insurance policy and its market share. If there is effective price competition, to the extent prices do vary, the lower cost products should win larger shares of total sales.

1. Evidence of Cost Dispersion Among Similar Policies

Various studies conducted over the past ten years have documented the extreme variation in the costs of similar life insurance policies. Professor Joseph Belth, the Society of Actuaries, and others have "shown conclusively . . . that costs vary over a wide range."[40] As a result of this wide variation

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39 See Mansfield, Microeconomics 222-226 (1970).

40 See Moss Subcommittee Report, supra n. 1, at 34 and studies cited therein. The term "costs" does not simply mean premiums, (Footnote Continued)

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for similar policies, consumers often spend more than they need to for the insurance they buy. For example, consumers can save as much as $4,700 over a 20 year period by buying a low rather than a high cost $25,000 whole life policy. (See pages 55-56, infra.)

An American Council of Life Insurance (ACLI) study attests to this cost variation and what it can mean to unfortunate consumers who buy the most expensive policies. Although the ACLI, in testimony before the Moss Subcommittee, contended that the cost variations for similar policies were insubstantial,[41] the data submitted in support of this conclusion ironically demonstrate the impact of the problem for the average consumer.[42] The ACLI stated that

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40 (Footnote Continued)

but rather an index measure which takes into account cash values and dividends, as well as premiums and the value of money over time. See page 128, infra.

41 In its statement, ACLI observed, "[t]he dispersion . . . [of rates in its sample] . . . is small enough to suggest that it is difficult to sell life insurance where the premiums or interest adjusted cost indexes for similar competing products differ drastically from the average." Statement of Julius Vogel, Senior Vice President and Chief Actuary, Prudential Life Insurance Co. of America on behalf of the American Council of Life Insurance, Moss Subcommittee Hearings, supra n. 2, at 337.

42 The ACLI analyzed 116 different participating and non-participating whole life policies, issued by companies licensed in New York State, with face amounts of $25,000 sold to males aged 35 and tabulated 20-year interest adjusted cost indices for these policies. As described in its prepared statement, the ACLI study showed (Id. at 336):

> One: For non-participating policies, the average premium per $1,000 was $16.70. Of the 53 policies shown, 44 had premiums ranging from $1.50 less to $1.50 more
>
> (Footnote Continued)

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the cost differences in a $25,000 whole life policy (marketed to men 35 years of age) generally ranged between $1.50 per thousand below the mean and $1.50 per thousand above the mean. This $3.00 spread between the indices for the lower cost and higher cost policies translates into a consumer savings of $75.00 per year. If these savings were deposited in an account earning 5 percent a year, the individual buying the lower cost policy would have $2,604 at the end of the twentieth year. In our view, this is not an insubstantial amount of savings.[43]

The large variation in the cost of similar policies can be

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42 (Footnote Continued)

than this average. The average interest-adjusted cost index was $7.55 per $1,000 of insurance. Of the 53 policies shown, 46 had indexes ranging from $1.50 below the average to $1.50 above the average.

Two: For participating policies, the average premium per $1,000 was $21.50. Of the 63 participating contracts shown, 39 had premiums within $1.50 of the average. The average interest-adjusted cost index was $6 per $1,000 of insurance. Of the 63 policies shown, 54 had indexes ranging from $1.50 below the average to $1.50 above the average.

43 The potential savings to a consumer in buying a low rather than high cost $25,000 whole life policy is greater than $2,600. The ACLI study was based on information contained in a shoppers guide put out by the New York Department of Insurance in 1977. Many higher cost companies do not do business in New York. Cf. First Report of the Industry Advisory Committee to the Agent's Compensation Systems Task Force of the NAIC C-3 Life Insurance Subcommittee at 47 (1976). Moreover, the ACLI study had separate categories for participating and non-participating insurance. It is our position that these policies can be compared, see Part III.B., infra. If this is done, the spread in the surrender indices between high and low cost policies becomes 4.50. This disparity translates into a 20-year difference of savings of approximately $3,800.

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Variation in Rates of Return on $25,000 Whole Life Insurance Policies Issued in 1973 and 1977

Dividend Paying Policies

Age at Issue	Year of Issue	Duration of Holding Period	Average Rate	Lowest Rate	Highest Rate	Standard Deviation	Coefficient of Variation
25	1973 N= (141)	5 years	-11.73	-28.84	0.67	7.48	64
		10 years	- 0.16	- 6.62	3.68	2.10	--
		20 years	+ 3.28	- 0.22	4.78	0.75	23
		30 years	+ 3.71	+ 0.84	4.84	0.58	16
	1977 N= (92)	5 years	-11.99	-48.04	0.54	8.70	73
		10 years	+ 1.25	- 3.47	5.99	1.89	151
		20 years	+ 4.21	+ 1.88	7.33	0.84	20
		30 years	+ 4.58	+ 2.22	7.63	0.72	16
35	1973 N= (145)	5 years	- 9.39	-22.59	+0.47	5.57	59
		10 years	- 0.04	- 6.53	+3.14	1.83	--
		20 years	+ 3.09	- 0.57	+4.41	0.73	24
		30 years	+ 3.49	+ 0.45	+4.55	0.59	17
	1977 N= (123)	5 years	- 8.36	-30.07	0.58	4.64	56
		10 years	+ 1.43	3.35	5.55	1.56	109
		20 years	+ 4.12	+ 1.52	7.61	0.78	19
		30 years	+ 4.45	+ 1.79	7.75	0.69	16
45	1973 N= (145)	5 years	- 9.48	-21.66	-0.66	4.81	51
		10 years	- 0.77	- 7.76	+2.02	1.77	--
		20 years	+ 2.49	- 1.55	+3.89	0.79	32
		30 years	+ 2.94	- 0.48	+4.25	0.64	22
	1977 N= (89)	5 years	- 9.13	-72.03	1.92	8.12	89
		10 years	- 0.68	- 4.63	5.58	1.69	--
		20 years	+ 3.57	- 0.15	7.44	0.94	26
		30 years	+ 3.91	+ 0.20	7.59	0.93	24

Note: In these instances when the average rate of return was close to zero, a coefficient of variation was not computed.

Table II-7

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Variation in Rates of Return on $25,000 Whole Life Insurance Policies Issued in 1973 and 1977

Non-Dividend Paying Policies

Age at Issue	Year of Issue	Duration of Holding Period	Average Rate	Lowest Rate	Highest Rate	Standard Deviation	Coefficient of Variation
25	1973	5 years	-18.29	-56.64	1.60	8.72	48
	N=	10 years	- 1.55	-21.27	5.20	2.77	181
	(163)	20 years	+ 2.14	- 3.08	4.29	0.97	45
		30 years	+ 2.44	- 0.50	6.12	0.66	27
	1977	5 years	-17.51	-38.96	3.25	10.00	57
	N=	10 years	- 0.61	- 9.54	3.83	2.71	--
	(50)	20 years	+ 2.71	- 1.10	4.67	1.14	42
		30 years	+ 2.83	+ 0.84	4.30	0.75	27
35	1973	5 years	-13.22	-45.05	+0.18	5.78	44
	N=	10 years	- 1.20	-20.02	+4.98	2.25	188
	(162)	20 years	+ 1.91	- 3.77	+4.23	0.85	45
		30 years	+ 2.17	- 1.22	+3.88	0.55	25
	1977	5 years	-11.96	-26.86	1.88	6.09	51
	N=	10 years	- 0.26	- 7.14	2.90	2.02	--
	(51)	20 years	+ 2.47	- 0.66	3.93	1.03	42
		30 years	+ 2.56	+ 0.17	3.86	0.79	31
45	1973	5 years	-12.84	-43.11	-1.80	4.74	37
	N=	10 years	- 2.16	-22.37	+2.94	2.30	106
	(161)	20 years	+ 1.12	- 5.63	+3.14	0.99	88
		30 years	+ 1.48	- 3.98	+3.07	0.72	50
	1977	5 years	-11.65	-22.06	-1.24	4.82	41
	N=	10 years	- 1.34	- 6.36	+1.80	1.84	137
	(50)	20 years	+ 1.60	- 1.99	+2.86	1.09	68
		30 years	+ 1.80	- 1.41	+3.08	0.94	52

Note: In these instances when the averate rate of return was close to zero, a coefficient of variation was not computed

Table II-8

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demonstrated by an analysis of the variation in average annual rates of return for various policies issued in 1973 and 1977. Tables II-7 and II-8 show the variation in rates of return for participating and non-participating policies by issue age, issue year, and duration of holding period. Using the standard $25,000 whole life policy issued to males aged 35, the twenty-year rates of return in 1973 varied from minus .57 to plus 4.41 percent for participating policies and from minus 3.77 to plus 4.23 percent for non-participating policies. In 1977, the twenty-year rates of return for the same whole life policy varied from 1.52 to 7.61 percent for participating policies and from minus .66 percent to plus 3.93 percent for non-participating policies. The range in cost is even more extreme for shorter holding periods of 5 and 10 years.

In addition to the range in rates of return, Tables II-7 and II-8 contain more meaningful statistical measures of variation: the standard deviation and the coefficient of variation. Because the range depends only on the highest and lowest observation, it is sensitive to a single extreme rate of return. The standard deviation, on the other hand, reflects the variation in all the rates of return for all policies. (The coefficient of variation is simply the standard deviation divided by the average.)

The standard deviation is especially helpful because it can be used to estimate how close a certain percent of the policies

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are to the average.[44] For example, the average 20-year rate of return on dividend-paying whole life policies issued to men age 35 in 1973 was 3.09 percent with a standard deviation of .73. This means that about 32 percent of all the policies had rates of return below 2.36 percent or above 3.82 percent. Likewise, the average 20-year rate of return on dividend-paying policies sold in 1977 was 4.12 percent with a standard deviation of .78. This means that about 32 percent of all policies had rates of return below 3.34 percent or above 4.90 percent. For non-dividend-paying policies issued in 1977, 32 percent fell below 1.44 percent or above 3.50 percent. The variation in cost is even more extreme when dividend and non-dividend-paying policies are compared. In this situation differences in rates of return of three to four percent are common.

A difference in rate of return of 3 percent between two whole life policies translates into a considerable amount of money. Table II-9 sets forth a comparision between buying two $25,000 whole life policies where one has a 20-year yield of 2 percent and the other has a 20-year yield of 5 percent. It demonstrates that a consumer can save over $4700 by buying a

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44 For normal or bell-shaped distributions, 68 percent of the population will fall within one standard deviation of the average and 95 percent will fall within two standard deviations of the average. The figures in the text assume that the rates of return are normally distributed. In fact, they are skewed downward. Therefore, slightly more policies are below the average.

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low rather than high cost $25,000 policy.[45]

2. Cost Dispersion Among Similar Policies Exceeds That Found for Other Products

This part compares how cost variation for similar insurance policies compares with the price variation in other products. The prices of most goods and services show some price dispersion. Table II-10 contains a summary of a limited number of studies of price variation among various products.[46] It shows that the

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45 There also exist substantial variations in the cost for similar term insurance policies. The state of Wisconsin in the fall of 1978 conducted a survey of the cost of insurance policies sold in that state. They found that the interest-adjusted surrender index for $50,000 term policies ranged from 2.31 to 15.00. Twenty-five percent of the policies had indices equal to or below 4.68 and 75 percent of the policies had indices equal to or below 5.82. Partial results of the Wisconsin survey were set forth in the Life Insurance Buyer's Guide which is contained in Appendix X. For an explanation of the interest-adjusted index, see pages 130-132, infra.

46 The systematic study of price dispersion by economists is of relatively recent origin. A good survey of the theoretical literature can be found in Rothschild, "Models of Market Organization with Imperfect Information: A Survey," 81 Journal of Political Economy 1283-1308 (1973). Empirical studies are listed in Table II-10.

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coefficients of variation of the cost of insurance policies are extraordinarily high compared to the variation in prices for other products. For example, the coefficients of variation of rates of return for $25,000 participating policies is 24 percent, and 45 percent for non-participating policies. This compares with a coefficient of variation of approximately 6 percent for automobiles, appliances and gasoline.[47]

Table II-10[48]

Product	Average Price	Coefficient of Variation

47 The nationwide variation in Heinz catsup prices was more than double the variation of the other products. However, given the small unit price this degree of variation is expected. The 1962 auto insurance premium rates appear to be comparable to other products at about 9 percent. The 1976 survey showed much greater dispersion (23 percent). The difference may be due to the fact that in 1962 the State of Illinois had a system of prior approval of automobile insurance rates while in 1976 they did not regulate automobile insurance rates.

48 Jung, "Price Variations Among Automobile Dealers in Metropolitan Chicago," 33 Journal of Business 31-42 (1960). Jung, "Major Appliance Prices in the Chicago Area," 50 Journal of Business 231 (1977). Maurizi and Kelly, "Prices and Consumer Information," American Enterprise Institute (1978). R. Steiner, "Brand Advertising in the Consumer Goods Economy," American Enterprise Institute (forthcoming). Jung, "Automobile Insurance Rates in Chicago, Illinois," 45 Journal of Risk and Insurance 507 (1978). Greene, Neter, and Tenney, "Annuity Rents and Rates--Guaranteed vs. Current," 44 Journal of Risk and Insurance 383 (September 1977).

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			(%)
Automobile Price Chevrolets, Chicago (1959)		$2,436.00	1.7
Prices of Washing Machines and Refrigerators, Chicago	(1955)	$ 230.00	5.89
	(1975)	$ 420.00	4.68
Retail Price of Gasoline in 17 Areas (Nov. 1970)			
Leaded Regular		$ .36	5.8
Leaded Premium		$ .40	4.9
Heinz Catsup Prices (August, 1975)		$ .71	12.77
Automobile Insurance Rates, Chicago	(1962)	$ 175.00	8.7
	(1976)	$ 578.00	22.9
Interest Rates Paid on Annuity Accumulations 42 Life Insurers (1975)		6.9%	16.5
Life Insurance 20 Year Rates of Return on $25,000 Whole Life Policies Male, Age 35			
(1973) (Participating)		3.09%	24
(Non-Participating)		1.91%	45
(1977) (Participating)		4.14%	19
(Non-Participating)		2.47%	42

If meaningful cost disclosure can increase the amount of price competition within the life insurance industry and thus reduce the amount of cost variation for similar policies, the savings to consumers would be large. It is impossible to precisely measure these potential savings, since it is not known exactly how individual companies would change their policies in order to make them more competitive. One can get a crude measure of the potential impact by assuming that the highest cost (lowest yielding) 20 percent of the policies are eliminated

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and that the remaining policies have lower dispersion (a coefficient of variation of about 10 percent) around the new average rate of return. The average 20-year rate of return on dividend-paying policies in 1977 would rise from 4.14 percent to 4.40 percent and from 2.47 percent to 2.88 percent on non-dividend-paying policies. Some 68 percent of the dividend-paying rates of return would be between 3.96 percent and 4.84 percent and between 2.59 percent and 3.17 percent for the non-dividend-paying policies.

However, even if disclosure resulted in increased price competition among whole life policies, substantial consumer problems would remain.[49] Even if the highest cost 20 percent of policies were eliminated, and if the coefficient of variation in the rates of return on whole life policies issued in 1977 were reduced to 10 percent, the average 20-year rate of return on participating policies would still only be 4.4 percent. Average non-participating rates of return would be even lower at 2.88 percent. The 5- and 10-year rates would be substantially lower. As shown in Part IIA, these rates of return are lower than those readily available elsewhere in the marketplace. Thus, to have effective competition in the life insurance market, there must be both price competition among similar policies and competition between life insurance and alternative savings media.

3. There is Little Relation Between the Cost of Policies and Their Market Shares

[49] Most cost disclosure proposals, including that adopted by the NAIC, only address the problem of similar policy comparisons. See discussion, Part IV.A.2, p. 102, infra.

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As shown above, cost dispersion among similar life insurance policies exceeds that found in other products. This wide cost variation is evidence of a lack of effective price competition among similar policies. High and low cost policies are not punished and rewarded as would be expected in a price competitive system. Some high cost policies have large market shares. Some low cost policies have small market shares. As Mr. E. J. Moorhead has observed:

> Individual life insurance marketing seems to be demonstrating that it is an exception to the pronouncement made two centuries ago by Adam Smith--his contention being that the choices made by buyers in a free market have the effect of rewarding the efficient seller whose prices are low, and correspondingly penalizing the inefficient or greedy seller whose prices are high.[50]

This section demonstrates that policy cost does not correlate with market share in a fashion consistent with effective price competition.

To determine the correlation between cost and sales, data supplied to Senator Hart's subcommittee during its investigation of the life insurance industry for best selling whole life policies issued in 1973 was examined.[51] The policies were ranked by cost and grouped in deciles.[52] The lowest cost poli-

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50 Moss Subcommittee Hearings, supra n. 2, at 509.

51 The sample was subdivided by type (participating or non-participating) and size (face value at which the policy was most frequently issued). For details of this categorization see Appendix IV.

52 The results for other policy sizes and the Pearson (Footnote Continued)

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cies are in decile 1 and the highest cost policies are in decile 10. Table II-11 shows the total sales by face amount for the policies in each decile for $25,000 whole life policies issued to males aged thirty five.

Table II-11 - Sales by Cost Decile[53]

Non-Participating

Decile	Face Value of Sales (000)	Number of Policies in Decile	Median Cost
1	656,469	5	39.08
2	99,870	5	40.93
3	100,763	5	41.62
4	334,112	5	43.32
5	71,686	5	45.18
6	84,353	5	47.88
7	97,344	5	48.17
8	408,042	6	50.46
9	104,365	6	54.20
10	117,308	6	60.54
Total	2,071,312	53	

Participating

1	886,782	5	29.72
2	393,263	5	34.27
3	1,115,373	5	36.37
4	770,059	5	38.21
5	1,213,673	5	39.70
6	1,314,155	5	40.41
7	626,327	5	42.89
8	2,709,282	5	46.07
9	424,271	6	50.61

52 (Footnote Continued)

correlations between cost and market share are contained in Appendix IV.

53 The measure of cost used in Table II-11 is the Company Retention Index computed using a 5 percent rate of interest and Moorhead's lapse table "S". For an explanation of the Company Retention Index see pages 146-147, infra.

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10	65,713	6	57.84
Total	9,518,898	52	

Table II-11 shows that there is little relationship between policy cost and market shares. For participating policies, for example, the five policies in the eighth decile ranked 40th to 45th in cost out of the 52 policies examined. Yet the face amount of sales for these policies exceeded $2.7 billion in 1973, or approximately 29 percent of the total sales for all 52 policies studied.

The life insurance industry competes for agents and in designing unique policies that are often merely sales tools. But as shown in this section, it does not compete vigorously on the basis of price. Without meaningful cost disclosure, effective price competition is impossible.[54]

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54 See pages 81-83, infra.

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D. Consumers Often Receive a Small Amount of Protection Against Premature Death Relative to the Premiums Paid for Ordinary Insurance.

The amount of protection against premature death that Americans buy with their ordinary life premiums is small relative to the amount that same expediture would purchase through low cost term insurance (either individual or group). This relatively small amount of insurance protection (per dollar of premium) appears to result from a lack of consumer knowledge concerning alternatives and from certain features of the agency system which favor the sale of cash value insurance, rather than from an informed consumer preference for savings intensive types of insurance policies. This section examines the dimensions of this problem and the extent to which the Social Security system compensates for the small amount of protection against premature death provided by ordinary insurance.

Ralph Nader, in testimony before Senator Hart's Subcommittee in 1973, stated that the life insurance industry's principal shortcoming was its failure to sufficiently protect its ultimate consumers -- the widows and children -- from the financial risks of the premature death of the breadwinner.[55] Mr. Nader then observed:

> The Institute of Life Insurance--the public relations arm of almost the entire industry--maintains that "the main reason why a man buys life insurance is to protect his family

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55 The Life Insurance Industry: Hearings Before the Subcomm. on Antitrust & Monopoly of the Sen. Comm. on the Judiciary, 93rd Cong., 2nd Sess. 8 (1974) [hereinafter cited as Hart Subcommittee Hearings].

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> from financial hardship when he dies." Whether or not companies sell life insurance for other purposes such as to provide a savings or investment medium or to make a profit, the primary measure of their performance is the extent to which the financial needs of widows and children are being met. The real consumers of life insurance are those who survive after the premature death of the breadwinner. The industry's own analysis of the benefits received by survivors demonstrates that it has failed miserably.
>
> "The Widows Study" conducted by the Life Underwriter Training Council and the Life Insurance Agency Management Association and published in 1970--but never widely circulated within the industry--provides shocking and tragic evidence of this failure. Fifty-two percent of a representative sample of all widows received less than $5,000 in benefits even though 92 percent were covered by some form of life insurance.[56]

As Mr. Nader noted, slightly more than one-half of the widows studied received less than $5,000 in insurance benefits.[57] This "less than $5,000" figure included proceeds from all forms of life insurance held, including group, veterans and credit life insurance. The study concluded that "[j]udged by any standard,

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56 "The Widows Study" referred to in Mr. Nader's testimony was sponsored by the industry to evaluate its success in accomplishing the goal of alleviating the hardships caused by the premature death of the family head. The information was gathered in a series of personal interviews conducted in 1968 and 1969 from among a sample of women whose husbands had died prematurely (under the age of 65) in 1965. Life Insurance Underwriter Training Council and Life Insurance Agency Management Association, The Widows Study (1970), Vol. 1 at 2. Reprinted in Hart Subcommittee Hearings, id., Vol. 1 at 313.

57 In the lowest income range, 93% of the widows received less than $5,000 in proceeds, while even at the highest income level displayed, 1 in 5 had life insurance benefit payments of less than $5,000. Id. at 363.

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the amounts of life insurance received by the widows were low."[58]

Furthermore, the situation does not appear to have improved since 1966. In the intervening years, the average amount of life insurance per family has risen from $15,800 to $32,400. However, the average disposible personal income has also doubled, from $8,200 in 1966 to $16,400 in 1977.[59] Yet, the average death claim per policy was only $4,465, an increase of only $1,100 since 1966. Thus, if decedents in 1977 were insured under three policies, the average death benefit from ordinary insurance would have amounted to ten months of the average personal disposable income per family.[60]

This report considers two phenomena--agent bias for whole life insurance and the lack of consumer understanding about term insurance--which partially explain why many consumers receive less death protection than they need from ordinary insurance. Part III D, infra, discusses how agent training and compensation creates a system that often promotes whole life insurance regardless of a person's needs.

Another reason many consumers purchase inadequate amounts of insurance protection with the dollars they spend for ordinary insurance is because they are either uninformed or misinformed

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58 See Hart Subcommittee Hearings, supra n. 55, at 322.

59 Fact Book, supra n. 9, at 24.

60 Id. at 41. As the Moss Subcommittee Report notes, the death benefits of the average life insurance policy (per family) would only be sufficient to cover the average family's needs for two years or so. Moss Subcommittee Report, supra n. 1, at 19.

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as to the best type of insurance for their particular needs.[61] Purchasers often do not realize when they are young and their needs for protection are generally the greatest that they can obtain three to five times as much initial death protection by buying renewable individual or group term insurance as they can for the same amount spent on ordinary whole life insurance. For example, in 1977, the public owned about the same amount of group insurance as ordinary life insurance.[62] Although group insurance paid somewhat higher amounts in average death benefits,[63] the public paid over 3.5 times more for its ordinary coverage than for its group coverage.[64]

Since the "right amount of life insurance"is something that individuals must decide for themselves, taking cost as well as their special circumstances into account, it is difficult to make a blanket determination that people are generally under or overinsured. Accordingly, we make no general recommendation that people buy more life insurance, nor do we recommend that consumers only buy term insurance. However, for certain groups -- households with young children and low incomes -- term insurance is the only way they can afford adequate death

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61 For a detailed discussion of consumer knowledge in the field of life insurance see Part III C, p.74, infra.

62 Fact Book, supra n. 9, at 18.

63 Id. at 41. The average death benefit paid on ordinary insurance was $4,466, while the average death benefit paid on group insurance was $5,597.

64 Id. at 57.

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protection.[65] To the extent these people are unaware of the low cost death protection available in term insurance, they are likely buying less death protection than they want. The Moss Subcommittee Report acknowledged this potential for inappropriate purchase:

> Thus, for persons who do not have enough premium dollars to purchase adequate whole life coverage, term insurance is likely to be the best choice. Allocating all premium dollars to purchase whole life will, in such a situation, lead to underinsurance.[66]

Although many consumers are receiving less death protection than they need from the dollars they spend for ordinary insurance, the impact on society of the problem of underinsurance has been reduced by the expansion of suvivor benefits under Social Security. The U.S. public now has far more total life insurance protection, relative to income than ever before. This is primarily due to the dramatic increase in life insurance protection provided to survivors under the OASDI program of Social Security. As shown in Table II-12, the total amount of equivalent life insurance in force was almost four times disposable income in 1977, up from less than twice disposable income 20 and 30 years ago.

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65 As Ralph Nader noted in the 1974 Hart Hearings:

> Husbands do buy life insurance, but they buy too much of the wrong kind. With limited funds available, they are too often misled into putting them all into low benefit cash value policies at inflated prices.

Hart Subcommittee Hearings, supra n. 55, at 8.

66 Moss Subcommittee Report, supra n. 1, at 18.

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The amount of private life insurance has risen roughly in proportion to disposable personal income in the past 25 years, but the amount of equivalent life insurance through Social Security has risen more rapidly. Since 1973, the equivalent life insurance inherent in the OASDI program has exceeded the total for all private life insurance. This massive increase in governmentally provided life insurance protection appears to have had little effect on the private sales, with the result that the total amount of life insurance coverage has doubled.

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III. SOME REASONS FOR THE PROBLEMS

A. Introduction

The problems discussed in the preceding section are very serious ones: average rates of return that are 3 to 6 percentage points below alternative rates, extreme variation in rates of return, large but undisclosed penalties for early lapse, low rates of return earned on old policies, and relatively small per capita amounts of private insurance protection. The first four problems imposed on consumers unnecessary costs of billions of dollars in 1977 alone, while the underinsurance problem defies any simple dollar measure of loss. This section offers some explanations why these problems have arisen and persist in an industry which in terms of the number of companies and agents vying for sales ought to be competitive.

The single most important cause of these problems is the lack of meaningful information by which the quality and cost of one life insurance policy can be compared to another and to alternative forms of saving. Currently, the marketplace is not providing this information. Two factors explain this lack of information: the inherent complexity of life insurance, and the confusing variety of products companies offer, which complicates cost comparison. This section examines the complexities of the life insurance market and considers evidence documenting consumer inability to evaluate life insurance costs. It explains how this inability to judge cost in turn is a primary cause of the lack of price competition which in large part explains the problems discussed in Part II. Finally

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this section considers various incentives in the agency system favoring whole life insurance which in conjunction with the absence of price information contribute to the lack of meaningful price competition in the life insurance market.

B. The Cost of Insurance Is Difficult to Evaluate

The current complexity of the life insurance market makes it difficult for consumers to evaluate the cost of a life insurance policy. Part of this difficulty arises out of the fact that premiums are not an accurate measure of cost. Part is attributable to the wide variety of policy types offered in the market. We consider each of these causes in turn.

Comparing whole life insurance costs is difficult because the amount paid for the policy (the premium) does not accurately measure the actual cost. This is because policies accumulate cash values and often pay dividends. Moreover, it is not enough simply to subtract illustrated dividends and cash values from total premiums. Because of the time value of money, real cost depends heavily on how quickly cash values and dividends accrue as well as their eventual size.

The following analysis of the correlation between premiums and real cost demonstrates the dubious reliability of premiums as a predictor of real cost. Table III-1 is an array of 306 best selling whole life policies issued by almost 200 life insurance companies in 1973. Using "deciles," Table III-1 ranks policies by premium and by the 20-year rate of return. If a policy ranks in the first premium decile, it has a lower premium than at least 90 percent of all of the policies. Similarly, if a policy

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Table III - 1

Decile Comparisons Between Premium Size and 20-Year Average Annual Rates of Return - $25,000 Whole Life Policies Issued to Men Aged 35 in 1973

Premium Decile	Average Annual Rate of Return Decile											
	1	2	3	4	5	6	7	8	9	10		
1	1	2	5	3	8	6	5	0	0	0	30	
2	0	0	2	5	5	7	8	2	2	0	31	124
3	0	2	0	3	2	4	7	8	5	1	32	
4	2	1	0	0	2	4	1	5	10	6	31	
5	2	0	0	0	0	3	1	3	10	11	30	
6	7	2	2	1	2	1	1	3	3	9	31	
7	11	5	3	4	0	2	2	2	0	2	31	
8	3	8	7	3	6	0	2	0	0	0	29	121
9	3	10	7	5	2	0	1	2	0	1	31	
10	1	0	5	7	4	4	3	4	1	1	30	
	30	30	31	31	31	31	31	29	31	31	306	

Note: The first decile corresponds to the lowest premiums and the highest average rates of return. The number of policies in each decile differs because of ties in the rankings.

Source: FTC staff computations, using the data collected by the Senate Anti-Trust and Monopoly Subcommittee. The sample of 306 whole life policies includes both dividend-paying and non-dividend paying policies.

ranks in the first rate of return decile, it has a higher rate of return than at least 90 percent of all of the policies.

Table III-1 demonstrates the weak correlation between premium and actual cost in two ways. First, the upper left hand entry of Table III-1 indicates that only one of the 30 policies with the lowest premiums also has a rate of return sufficiently high to place it in the first rate of return decile. To put it another way, only one policy is common to both the 30 policies with the lowest premiums and the 30 policies with the best rates of return. Second, Table III-1 shows that 124 policies are in the first four premium deciles; that is, they have lower premiums than at least 60 percent of all of the policies. Only 26 of these 124 policies, however, have better than average rates of return (i.e., rank in the first four rate of return deciles). In contrast, more than twice as many (60) have worse than average rates of return (i.e., at least 60 percent of the policies offer higher rates of return). Conversely, a high premium policy can be mistaken for a high cost policy. Of the 121 policies whose premiums are higher than at least 60 percent of all the policies (premium deciles 7-10), two out of three (82) have higher than average rates of return (rate of return deciles 1-4). Furthermore, only one out of five have below average rates of return. Therefore, Table III-1 supports the rather suprising conclusion that consumers have a better chance of buying a low cost policy if they restrict their choice to the higher than average premium policies rather than the lower

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than average premium policies.[1]

Since premium size is an unreliable measure of cost, and the simultaneous analysis of premiums cash values, and dividends is so difficult, the vast majority of consumers are unable to calculate the actual cost of a particular policy or compare different policies. Further, this difficulty of evaluating cost applies after as well as before purchase. Few people who bought a non-competitively priced policy 10 years ago could determine now that they made a bad buy when they purchased. Friends are not likely to compare their policies' dividends or cash values. Nor do most consumers buy insurance frequently enough to learn through experience.[2] Consequently, even consumers who have bought life insurance in the past are not likely to be able to evaluate its real cost.[3]

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1 This arises because many of the dividend-paying policies are low in cost, but have higher than average premiums. Looking at non-dividend-paying policies alone, premiums are a fairly good guide to cost. Premiums are not a good guide to costs for dividend-paying policies. Given the public's low level of knowledge regarding participating versus non-participating policies, many people will not distinguish between the two (in fact, persons should often compare the two, see n.71 at page 141, infra). Thus, direct premium comparisons are often likely to be unproductive, or even counter-productive.

2 About the only way a consumer could learn that a prior life insurance purchase was bad would be if another agent tried to replace that policy.

3 Economists refer to products whose performance cannot be evaluated through normal use as "credence goods." One of the main reasons for poor market performance in life insurance is that the policies are very good examples of "credence goods." See Darby and Karni, "Free Competition and the Optimal Amounts of Frauds," 16 Journal of Law and
(Footnote Continued)

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Besides the difficulty of evaluating the cost of an insurance policy, the life insurance market is made even more confusing for consumers by the near endless variety of policies offering slightly different benefit features. As stated by Professor Joseph Belth:

> [T]he proliferation in life insurance has reached large proportions. There are many so-called specialty policies. These usually are designed to fit an elaborate sales presentation, rather than to perform real services for the buyer. There are also many different policies of the so-called conventional type -- so many, indeed, that is difficult to distinguish between conventional policies and specialty policies.[4]

Similarly, Spencer L. Kimball, professor of law at the University of Chicago, stated at the Hart Hearings on the life insurance industry: "Product differentiation, partly produced by advertising and sales efforts and partly by the wide range of variations in the content of the life insurance contract fragment the

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3 (Footnote Continued)

Economics 67-88 (April 1973). Professor Neil Borden many years earlier made a somewhat similar distinction between goods with "external" characteristics that could be used to judge quality before purchase such as green vegetables, clothing, etc. and those with "hidden" characteristics where quality cannot be judged before purchase such as watches, refrigerators and drugs. In discussing drugs and cosmetics, Borden noted that for some goods the "hidden" characteristics might stay hidden even after purchase. See N. Borden, The Economic Effects of Advertising, 425-426 (1942).

4 The Life Insurance Industry, Hearings Before the Subcomm. on Antitrust and Monopoly of the Senate Judiciary Comm., 93d Cong., 2d Sess. 568 (1974) [hereinafter cited as Hart Subcommittee Hearings].

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market."[5]

In short, the inherent complexity of the product and the confusing array of policies make informed shopping for life insurance difficult. At the same time, these factors contribute to a widespread lack of knowledge among consumers about life insurance.

C. Consumer Inability to Determine the Real Cost of Insurance

The previous section considered aspects of the life insurance market which makes comparison shopping by consumers difficult. This section examines evidence tending to show that consumers are not well informed about insurance in general or about how to evaluate its real cost in particular. Specifically, this lack of knowledge appears to show up in consumer behavior in four important ways. First, many consumers are not well informed about the general aspects of life insurance. Second, most people are uncertain about how to define the "cost" of a life insurance policy, yet lean heavily on the premium as the measure of cost. Third, in part because of uncertainty as to cost, most people do not attempt to compare costs of different policies. Fourth, many people do not understand the

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5 Id. at 1087. Whatever the reason for its existence, many commentators have remarked on the extent of product differentiation in life insurance. Mark S. Dorfman, professor of finance at Miami University of Ohio, and Albert L. Auxier, professor of finance at the University of Tennessee, have testified on separate occasions that there is undue product differentiation in the life insurance market. Statement of Mark S. Dorfman, id. at 1237; testimony of Albert L. Auxier, presented at Wisconsin Insurance Department Hearings on proposed regulation 2.14, July 19, 1977.

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major differences between term and whole life insurance.

1. Consumers Are Uninformed About Life Insurance

Many observers of the life insurance industry have commented on the public's relatively low level of knowledge about life insurance. For example, the Daniel Yankelovich organization, on the basis of an extensive survey carried out in 1967 and 1968, reported to the major company trade association (which had sponsored these studies) that:

> Due in part to the inherent characteristics of the product, the average person feels far less self-confident as a buyer of life insurance than of any other major purchase. Indeed, the entire act of purchasing life insurance is fraught with anxiety; people are not confident about their ability to comprehend the pros and cons of alternative plans; they are unsure of how much influence the agent's commission has on his recommendations (they suspect that it is substantial); they are unsure about what amount of coverage is adequate or desirable; they feel locked into their policy choice once it is made; they have a suspicion of the "fine print" in the life insurance contract; and their most basic anxieties are aroused by the subject of death and the need to provide for others in the event of death.[6]

In seven out of the eight surveys conducted since 1968, more than half of the respondents have described themselves as either "not too well informed" or "not at all informed" about life insurance. In a survey conducted in 1976, only one in four said that he or she did not feel uneasy about selecting a life

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6 Institute of Life Insurance, Monitoring Attitudes of the Public (MAP) 23 (1969).

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insurance policy.[7]

2. Consumers Are Unable to Evaluate Cost

In a 1975 Life Insurance Marketing and Research Association (LIMRA) study, a large number of people were asked what they meant by the "cost" of a life insurance policy. More than half responded that cost meant the premium or the premium per $1,000 of coverage. Only about one in five stressed the value they would get for their money.[8] Over 6 in 10 of these same people said that they "have a lot" or "some" difficulty in determining whether they're getting their money's worth.[9] Thus, although some people were aware that aspects of the contract (e.g., cash values and dividends) could differ even though two policies had the same premiums, most of them were vague about how they would compare two policies that differed in benefits, saying that they would try to get the "best value" or "return" for their money.

The finding that purchasers often equate premium with cost is confirmed by evidence of actual behavior. In Part II.C. (Tables II-7 and II-8), supra, it was seen that similar policies

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7 American Council of Life Insurance, Monitoring Attitudes of the Public (MAP) 50-51 (1976.

8 Institute of Life Insurance and Life Insurance Marketing and Research Assn., Life Insurance Consumers: A National Survey of Cost Comparison Attitudes and Experience 11 (August 1975).

9 Id. at 12.

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varied widely in terms of actual cost. Premium dispersion, however, is much lower than cost dispersion. This evidence is consistent with survey results that consumers are unable to gauge the true cost of a policy without cost disclosure. Indeed, it indicates that they rely on very inexact substitutes for cost, such as premiums.

Table III-2 (below) shows the coefficient of variation for premiums of selected policies issued in 1973. The coefficients of variation in life premium rates are between 6 and 8 percent, which is midway between the 1 to 13 percent range for other products shown in Table II-10, supra. The rates of return (which are an accurate measure of cost) show an immense variability (24 percent and 45 percent for par and non-par policies respectively). This difference in dispersion rates indicates that policyholders often (mistakenly) view the premium as the "cost" of the policy and that price comparisons are often limited to premium comparisons.

Table III-2

Variance in Premimum Rates, 1973[10]

Type Policy	Mean	Standard Deviation	Coefficient of Variation
Non-par, 10,000	$18.72	1.06	6%
Non-par, 25,000	17.16	1.11	6%
Par, 10,000	23.12	1.56	7%
Par, 25,000	21.99	1.75	8%

An experimental study found that even people with training in finance and insurance did only slightly better than chance in

10 See Appendix IV.

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distinguishing between high and low cost policies. Professor Albert Auxier asked the 32 members of his life insurance class to rank whole life policies on the basis of what they judged was the average rate of return for the policy. These students averaged almost 4 college level courses in insurance and finance. Given the raw information on premiums, dividends and cash values, the students did only slightly better than chance at choosing those policies that actually ranked in the best third.[11] They averaged 2.75 right as compared to an expected value of 2 right if they had chosen randomly. Professor Auxier also notes that the students "exhibited a disturbing tendency to select poor value policies (those ranked in the lower one-third) despite a wide range of policies from which to select." The students did worse than chance in mistaking high cost policies for low cost policies. He concluded that "the participants demonstrated little ability to discriminate correctly among policies on a cost basis without the aid of a summary cost measure."[12] In view of the ideal test conditions and the sophistication of the subjects, the general life insurance buying public is likely to discriminate even more poorly than this group of students.[13]

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11 The students had become familiar with the method of computing the rate of return. See "A Test of the Usefulness of Policy Information in Ranking Life Insurance Alternatives," 43 Journal of Risk and Insurance 87-98 (1976).

12 Id at 98.

13 The Commission conducted experimental studies concerning
(Footnote Continued)

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Thus, most people have a natural tendency to equate premium with cost, but, as we have seen, the premium is a poor guide to cost. And although many people recognize that comparing premiums alone is insufficient, they are unsure of how to make a more meaningful comparison.

3. Most Consumers Do Not Compare Policies For Cost

Perhaps because of these difficulties in evaluating costs, few people try to compare cost even when they think that policies differ substantially. For example, in the 1975 study previously discussed (page 76, supra), 65 percent of the participants thought that there were differences in policy costs, yet only 42 percent of those people said that they had ever compared company costs.[14] A subsequent question suggests that the difficulty of comparing costs may explain why many participants did not try to comparison shop.[15] Asked what they would do when an agent presented a policy

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13 (Footnote Continued)

the ability of consumers to evaluate insurance policies. Appendix IX summarizes the results of these studies.

14 Institute of Life Insurance, Monitoring Attitudes of the Public (MAP) 54-55 (1975).

15 An additional reason that people do not shop for insurance is that substantial numbers of people still believe that policies cost about the same. In the 1975 LIMRA survey, 35 percent of the respondents said that all insurance policies cost about the same or that they didn't know. As previously discussed, 65 percent equated premium with cost. Other surveys have indicated that substantial numbers of people mistakenly believe that all insurance costs about the same. Subcommittee on Oversight and Investigations of the House Comm. on Interstate Commerce, Report on Life Insurance Marketing and Cost Disclosure, 95th Cong., 2d Sess., 37 (1978) [hereinafter cited as Moss Subcommittee Report].

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if a standard way to compare costs existed, 85 percent said that either they would do nothing until they had a chance to compare the costs of policies offered by the particular agent with those of other companies or they would ask the agent how his company compared to others.[16] Only 13 percent said they would buy the policy without comparing costs if the policy seemed right for their needs. Therefore, while it appears that most people currently do not try to compare costs because they don't know how, they would compare costs if a standard way existed.[17]

Finally, survey evidence indicates that many people do not fully understand the differences between term and whole life insurance. In one study, for example, participants were asked to describe the differences between term and whole life insurance: 33 percent could give no answer, 10 percent gave incorrect answers, only 3 percent mentioned that term insurance is "cheaper (more coverage for lower premiums than whole life)," only 4 percent mentioned that term policies generally do not have cash values, while only 13 percent mentioned cash values or living benefits of whole life policies.[18] About 50 percent of the people correctly indicated that coverage under term insurance

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16 Institute of Life Insurance, Monitoring Attitudes of the Public (MAP) 55 (1975).

17 The 85 percent who answered that they would use additional information in deciding what to buy may overstate the percentage who would use the newly disclosed information in an actual purchase situation. See Appendix IX.

18 Institute of Life Insurance, Monitoring Attitudes of the Public (MAP) 40-41 (1972).

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is for a prescribed period of time, whereas whole life coverage remains available for life. As the researchers point out, however,

> The frequent mention of limited duration of "term" insurance, and the permanence of "whole life" suggest that these are educated guesses based upon the names of these policy types.[19]

In sum, the available evidence indicates that most consumers have great difficulty understanding how to compare the cost of one life insurance policy to another. Premium tends to be equated with cost, a mistake which can prove to be very expensive. Most consumers appear unsure of how to compare cost and relatively few do. In general, they know little about the different types of life insurance policies available and, in particular, they know little about the important differences between term and cash value insurance.

D. The Relationship Between the Lack of Price Information and Reduced Price Competition

Thus far, Part III has examined why and to what extent consumers do not know how to determine the real cost of life insurance. We now consider how such lack of knowledge relates to the problems discussed in Part II. The short answer is that the absence of cost information reduces the price competition which cash value policies face from alternative savings media and from each other.

How consumer inability to compare prices can reduce price

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19 Id. at 30.

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competition is best illustrated by its effect on price dispersion among similar policies. Many economists argue that those markets in which consumers have a difficult time evaluating and comparing prices will be characterized by more price dispersion.[20] Moreover, this increased price dispersion, according to the theory, will be skewed upwards and therefore raise the average price. Simply put, the idea is that when price shopping is more difficult the individual seller will lose fewer sales if he increases his price above the competitive price. Although he will lose the business of comparison shoppers, he will get a higher than competitive price from all those customers who continue to buy from him. In other words, where comparison shopping is difficult at least some sellers will have an incentive to charge higher than competitive prices. As George J. Stigler put it: "price dispersion is a manifestation -- and, indeed, it is the measure -- of ignorance in the market."[21]

The absence of cost information also reduces the price competition which cash value insurance policies face from alternative savings media. Because consumers do not fully understand the savings aspect of cash value insurance and are unable to determine its actual rate of return, it follows that competition from alternative savings media is muted. To that extent, insurance

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20 See, e.g., Rothschild, "Models of Market Organization with Imperfect Information: A Survey," 81 Journal of Political Economy 1283 (1973).

21 Stigler "The Theory of Information," 69 Journal of Political Economy 171, 172 (1961).

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companies can offer lower rates of return than are available from bonds or savings and loans, for example, and still successfully sell cash value insurance.

Finally, many observers believe that the lack of cost information might channel competition away from prices towards non-price competition. In a statement submitted to the Hart Subcommittee, Spencer Kimball stated:

> In the present market, there is no real price competition. There is competition among insurance companies for agents who can effectively sell, and then among agents for applicants. Price competition is greatly muted; it can hardly be said to exist at all.[22]

There can be no effective competition in the life insurance industry without meaningful cost information. As long as buyers are unable to compare the cost of similar policies, companies that charge high prices can sell as successfully as companies that charge low prices.[23] Further, until consumers are aware of the rates of return they receive on their savings through ordinary life policies, insurance companies will be able to compete effectively for savings dollars even though they often pay a rate of return that is several percentage points below alternatives available in the marketplace.

E. The Agency System Exacerbates the Competitive Problems

The agency system is another reason for the problems

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22 Hart Subcommittee Hearings, supra n. 4, at 1088.

23 See pages 59-62, supra.

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discussed in Part II. In view of the complexity of the life insurance market it is not surprising that many consumers consult an "agent". Besides being well informed, an agent's financial incentives should ideally foster choices in the client's best interests. Indeed, the "golden rule of agency" provides that the agent should recommend the choice the client would make himself if he had expert knowledge. The reality of the life insurance agency system is far from this ideal. This section examines how certain aspects of the agency system contribute to the consumer and competitive problems discussed in this report.

1. Many Agents Do Not Believe There Are Substantial Differences in Policy Costs

Many agents and their supervisors appear to be misinformed on whether costs for similar policies differ significantly. As stated in the Moss Subcommittee Report:

> ... the stunning fact, revealed in a 1976 survey, [is] that 37 percent of full time life insurance agents, and 45 percent of their supervisors, believe that 'there is little difference in net cost for similar policies.' A further 11 per-cent of both agents and supervisors had no opinion on the question. This presumably means that nearly half of all agents in the field would not think it important to advise their clients about the savings possible from purchasing low cost insurance.[24]

Two principal factors explain agents' lack of awareness of cost differences. First, because of extremely high turnover, a great many agents are inexperienced. For example, in 1975,

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24 Moss Subcommittee Report, supra n. 15, at 37. The data cited came from a joint study conducted by the National Association of Life Underwriters and LIMRA, Survey of Agency Opinion 33 (1976) (Question 6).

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59 percent of all ordinary life agents had less than four years experience. (see pages 89-90, infra). Second, many companies' agent training programs place little emphasis on cost comparison methods.[25] Agents' lack of awareness of cost differences contribute to the lack of price competition in the industry. As stated by Mr. E.J. Moorhead:

> Life insurance is a competitive business, but in the individual insurance market the direct competition is heavily in the finding and keeping of productive agents. Price competition is indirect in nature, being dependent upon insistence by those agents that they be given attractively priced products to sell. A weakness of this indirect pressure is found in the widespread lack of agent recognition...that large price

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25 See Life Insurance Marketing and Cost Disclosure: Hearings Before the Subcomm. on Oversight and Investigations of the House Comm. on Interstate Commerce, 95th Cong., 2d Sess. 511 (1978) (statement of Mr. E. J. Moorhead) [hereinafter cited as Moss Subcommittee Hearings]. Professor Joseph Belth has observed,

> Many if not most life insurance agents are ill-equipped to provide reliable financial advice to their customers. State licensing examinations require a minimum of knowledge about life insurance. Company training programs and most industrywide training programs place the emphasis on sales skill rather than technical knowledge....[T]hose responsible for sales development generally have come up through the sales ranks. Many of these sales executives were successful in the field, but sales success is not synonymous with technical knowledge. Indeed, it is often argued that technical knowledge tends to hamper sales efforts.

Statement of Joseph Belth, Hart Subcommittee Hearings, supra n. 4, at 567.

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differences are prevalent.[26]

The second aspect of the agency system that contributes to the lack of price competition and the consumer problems discussed in Part II is the preference many agents have for cash value insurance. The next section examines the reasons for this preference and its impact on consumers.

2. The Commission Structure Provides Financial Incentives Favoring Whole Life Insurance

The agent commission structure in most cases strongly favors the sale of cash value policies. For most companies, the first-year commission rate on a typical whole life policy is substantially larger (per premium dollar) than that on a typical term policy. Table III-3 sets out the differences in rates which the Hart Subcommittee found between whole life and five-year renewable term policies issued to a male age 35.[27] As that table shows, first-year commissions on whole life policies average 55 to 60 percent, compared to 35 to 40 percent for term policies.[28] Renewal commissions are similar for both types of policies.

Table III-3

Commission Rates on Whole Life and Term Policies By Company Asset Size, 1973[29]

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26 Moss Subcommittee Hearings, supra, n. 25, at 510 (statement of E. J. Moorhead).

27 Hart Subcommittee Hearings, supra n. 4, at 2858.

28 For a detailed discussion of these rates see Appendix VII.

29 See Hart Subcommittee Hearings, supra n. 4, at 2858-2859. Figures are given for only those companies not licensed
(Footnote Continued)

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First-Year Commission Rates

Asset Size	Whole Life[30]	Term Insurance[31]
Top 20 Companies	59%	36%
21st-50th	57	36
Not in top 50	64	41
2nd to 10th Year Renewal Commissions		
Top 20 Companies	5%	5%
21-50	5	5
Not in top 50	5	5
11th and 12th Year Commissions[32]		
Top 20 Companies	1%	
21-50	2	
Not in top 50	2	

An agent's commission income depends not only on the commission rate, but also on the amount of premium. The amount of premium, in turn, is a product of the premium rate and the face value of the policy. The premium rate at any given age is likely to be several times higher for whole life than for term. These factors combine to give agents a strong financial incentive to sell whole life insurance. Table III-4 shows that ordinary agents in 1974 averaged 176 percent more in first-

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29 (Footnote Continued)

in New York. With minor differences, the figures for New York licensed companies show the same marked difference in first year commission rates for whole life and term.

30 Whole life policies issued to males age 35.

31 5-year renewal term policies issued to males age 35.

32 No summary data was given for years 11 through 20 for term policies.

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year commissions on whole life sales than on level term sales. They also averaged 370 percent more on whole life than on decreasing term sales. Since the established agents (five years or more as an agent) average less than one sale a week and since renewal commission income is likely to be 25 percent or less of total commission income,[33] the commission rate structure provides the agent with a strong financial incentive to sell cash value contracts regardless of the needs of the client. Assuming the average agent depicted in Table III-4 received a weekly renewal commission income of $90, his total commission income per week would be $363 if he sold the average size whole life policy, $188 if he sold the average size level term policy, and $148 if he sold the average size decreasing term policy.

Table III-4[34]

Commission Income to Ordinary Agents from Different Types of Policies, 1974

Type of policy	Avg. Size Policy	Prem. Per $1000	Prem. Per Policy	1st-Yr. Comm. Rate	Amt. of 1st-Yr. Comm.
Whole Life	$19,560	$25	$497	55%	$273
Level Term	46,430	6	280	35	98
Decreasing Term	30,610	5	167	35	58

During the Hart Hearings, the president of one large insurance

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33 See Rappaport, "Consumerism and the Compensation of the Life Insurance Agent," 26 Transactions of the Society of Actuaries 529 (1974) [hereinafter cited as Rappaport].

34 The 1974 Buyers Study, at 17. Note: Sales on adult male lives only.

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company candidly stated: "No agent, manager, general agent, or agency system can live very well on the commissions from only term insurance."[35]

The job and financial pressures which agents face are reflected in the high turnover rate among agents. A large number of newly-recruited agents quit in their first years. According to a LIMRA study of several companies, only an average of 15 percent of recruits remain agents with a company four or more years.[36] Also, LIMRA surveys consistently show that more than one-third of the inexperienced ordinary recruits leave their companies before the end of the year in which they are hired.[37] Moreover, this group of new agents (characterized by high turnover rates) constitutes a significant portion of all life insurance agents. For example, in 1975, agents with four or less years experience comprised 59 percent of all agents working for ordinary life

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35 Hart Subcommittee Hearings, supra n. 4, at 1922.

36 Dorfman, "Reformation in Life Insurance Agents' Compensation," 43 Journal of Risk and Insurance 447 (1976) [hereinafter cited as Dorfman].

37 LIMRA, Insurance Report 1972-11 -- Factors Related to Salesman Turnover 1. There are a variety of reasons for high turnover rates among agents. According to a 1970 study, 43 percent of those agents who left did so for financial reasons. Another 32 percent left because they were dissatisfied with aspects of the job. Some of the job features singled out were "hours," "prospecting," and "dislike of selling." Besides not making enough money, the financial reasons for leaving included "security," "fringe benefits," and "stability." LIAMA, Research Report 1970-7 -- Where Do They Go?, A Statistical Study 11.

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companies and generated 38 percent of the total volume of sales.[38] Thus, a substantial amount of insurance is sold by agents who have not been working long and are likely to be less informed about insurance. For many struggling agents, the two-tier commission structure is likely to present an extremely strong incentive to sell cash value insurance.

3. Agent Training Often Emphasizes Selling Cash Value Policies

The training received by agents may also explain why many agents favor cash value policies. The NAIC Advisory Committee hypothesized that "the compensation bias may not be as important as those [biases] that the agent is taught."[39] An agent of 19 years gave three reasons why many agents seldom sell term:

> First, when they were trained, it is possible that term life insurance was ignored. Second another possibility is that they were told the premium is lower and so is the commission, therefore agents shied away from term. Third, it could be that they have never been taught what term insurance really is and its various uses.[40]

Aside from the reference to the lower commission rate paid on the sale of term insurance, this agent's reasoning boils down to a lack of agent training on term insurance.

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38 LIMRA, The Manpower and Production Survey, Ordinary, Multiple-Line Exclusive-Agent, and Combination Companies 13 (1975).

39 NAIC, First Report of the Industry Advisory Comm. to the Agent's Compensation Systems Task Force of the NAIC C-3 Life Insurance Subcomm. 42 (June 6, 1976) [hereinafter cited as NAIC Industry Advisory Committee Report].

40 Dorfman, supra n. 36, at 455, quoting Kalmowitz, "Term Conversions are Beautiful," Life Assoc. News 83 (April 1975).

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Industry publications, produced by LIMRA and used to train and assist agents, often reflect a bias for whole life insurance. For example, a section on opening comments which an agent should give at an interview recommends emphasizing the savings aspect of insurance:

> Many agents like to put something into the prospect's hand immediately to get the heat off themselves and to capture the prospect's attention. A reprint of the company's retirement ad showing a couple basking on the Florida sands: "I came to talk to you about the Wilsons. Can you picture yourself retired some day like them?"[41]

In a LIMRA publication entitled Profitable Selling, the agent is told that whole life is almost always the best sale:

> Temporary insurance is often both necessary and desirable. But if an agent sells a high proportion of temporary insurance because of its lower first cost, not only will persistency be less favorable, but policyowners will neither be satisfied nor well served. The policyowner receives premium notices regularly, but finds that no cash value or paid-up values accumulated for emergency use -- the premiums will increase with each renewal of the term period -- and that the time almost has to come when he or she will not be insured.
>
> It is profitable to recommend that permanent life insurance is nearly always the best sale -- for the buyer and the agent.[42]

We do not question the sincerity or integrity of those companies or agents who believe in the superiority of cash value

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41 LIMRA, Getting the Interview 42 (1974).

42 LIMRA, Profitable Selling 42 (1976).

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insurance.[43] Nor do we challenge the right of companies to determine how they compensate their agents. As we show in the next section, however, the agent compensation system and the bias in favor of cash value insurance contribute to the consumer and competitive problems discussed in this report.

4. The Impact of the Agency System

The agency system has arisen in the life insurance industry, in part, because many consumers know very little about life insurance. Thus, they rely upon the advice of an agent. Ideally, an agent will recommend the plan of insurance that best fits the buyer's needs. The ideal is often not realized in practice because substantial numbers of agents have a strong philosophical or financial bias favoring one form of insurance over another. In such a situation it is unlikely that an agent will provide consumers with all the information they need to make an informed purchase decision. For example, an agent attempting to sell whole life insurance is unlikely to compare the rate of return available from the whole life policy to alternative savings plans.[44] Although the rate of return is not the only thing a person should consider in choosing between term and whole life, it is certainly an important factor (see page 103, infra).

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43 We note that many agents are equally strong in their conviction that term insurance is almost always a more desirable purchase.

44 In most cases companies do not supply rate of return information to agents. Thus, they are unable to supply this information even if they want to.

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Because many agents have little incentive to disclose the rate of return, the amount of price competition between life insurance and alternative savings media is decreased.[45]

The bias of many agents in favor of whole life insurance also contributes to the problem of underinsurance. The insurance needs of some people, especially young families with modest incomes and several small children, can be met only through the purchase of term insurance. Yet, in many cases, they may be sold insurance by an agent who has a strong philosopical and financial bias in favor of whole life insurance. As stated in the Moss Subcommittee Report:

> [W]e think it worthwhile to say that any agent who sells $10,000 of whole life rather than $40,000 of term to a young, asset-poor family head is probably doing his client a gross disservice. The NALU witness admitted that such sales do occur and agreed that they were deplorable. It is evident to us that many purchasers in such situations have acted solely on the agent's advice and without any real understanding of what they were doing.[46]

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45 Moss Subcommittee Report, supra n. 15 at 12-13, discussed this problem:

> We want to make clear that we are not ascribing any improper acts or unethical conduct to agents in promoting their views to their customers. We are simply determining that the natural operation of the ordinary life insurance marketing system is not very likely to foster the informed consumer choices necessary to produce benefits from competition and maximize consumer welfare. It is clearly undesirable for a consumer's purchase decision to be determined by the views of whichever agent gets to him first.

46 Id. at 19.

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The agent compensation system also contributes to the problem of early lapse. As shown in Part II, a serious consumer problem is the early lapsing of cash value policies. The agent compensation system does little to deter lapse. As Table III-3 shows, commissions are generally heavily "front loaded," that is, the agent gets most of the total commission in the first year. The commission structure provides only small rewards for good "persistency" (low early lapsation) and small penalties for bad persistency. Ms. Anna Maria Rappaport, an observer of the agency system, has estimated that an agent in his fifth year who has much better than average persistency will only earn about 5 percent more than an agent with average persistency.[47] Similarly, the penalty for poorer than average persistency is small. Therefore, because low persistency sales do not come at the expense of high persistency sales, many agents may regard any sale--even a sale which will lapse early--as more profitable than no sale.

The same is not true for the company. Typically the first-year expense of putting new business on the books exceeds the first year premium. If the policy lapses in the first year both the consumer and the company lose money (although the former loses much more than the latter.)[48] Only the agent gains.

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47 Rappaport, supra n. 33, at 544.

48 See Richardson, "Expense Formulas for Minimum Non-forfeiture Values," 29 Transactions of the Society of Actuaries 44 (1977) for estimates of the excess of first year costs over renewal cost for various types of policies.

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Rappaport estimates that the company is hurt four times as much as the agent by low persistency.[49] In view of this fact, it is rather surprising that the companies have only recently been trying to improve the quality of their business by giving persistency bonuses to their ordinary agents. The commission structure contains little in the way of penalties for agents who consistently produce low persistency business.

In recognition of this problem, an advisory committee to the National Association of Insurance Commissioners (NAIC) has recommended that companies begin giving agents smaller first year commissions and larger renewal commissions.[50] This recommendation and various adaptations of it have been implemented by some companies.[51] The NAIC advisory committee also concluded that there is a trend among companies toward installing some sort of persistency bonus system.[52] Notwithstanding some adjustments in company commission structures, however, the evidence is that first year commissions remain large.[53] Consequently, while

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49 Rappaport, supra n. 33, at 545. Brzezinski criticizes this estimate, but he agrees that the company is hurt more than the agent by bad persistency. Id. at 576.

50 NAIC Industry Advisory Committee Report, supra n. 39, at 8.

51 Id. at 9.

52 Id. at 13.

53 Id. at 9. Rappaport states that Metropolitan has begun using quality payments to spur persistency. Rappaport supra n. 33, at 568. Similarly, Equitable is said to be shifting away from a front load commission to a servicing fee that follows the account to provide continuing service.
(Footnote Continued)

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the various bonus plans may ameliorate the lapse problem, the agent commission structure continues to contribute to lapsation.

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53 (Footnote Continued)

LIAMA, Proceedings of 1973 Annual Meeting 81 (November 14, 1973).

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IV. RECOMMENDATION: A COST DISCLOSURE SYSTEM FOR LIFE INSURANCE

The recommendations in this report focus on the lack of adequate information available to consumers and agents on the types and relative costs of life insurance policies. While these recommendations deal with only one of the causes of the problems discussed in this report,[1] this one cause is basic. No reform of the industry will be completely effective unless consumers and agents are provided with sufficient, clear information to compare the benefits and costs of different life insurance policies and to compare saving through life insurance with other savings media. Therefore, while perhaps not the total solution, cost disclosure is a necessary first step to any effective reform in the life insurance industry.

In May 1976, the National Association of Insurance Commissioners (NAIC) adopted a "model" cost disclosure regulation. The NAIC regulation requires that insurance companies give purchasers two documents at the time their new policies are delivered: (1) a "buyer's guide," which contains general information about life insurance, and (2) a "policy summary," which sets forth the basic financial information about the policy and cost indices

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1 A complete discussion of possible remedies for the problems analyzed in this report would require that some consideration be given to changing the manner in which agents are compensated, possible changes in the solvency regulations, and the anti-rebate and replacement laws. These subjects are important, but they are beyond the scope of this report. (See Appendix VIII).

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used to compare the costs of similar policies.[2] This regulation addresses some of the problems discussed in this report, and we commend the NAIC's sensitivity to the need for disclosure. Our analysis of the problems begins from the NAIC's recognition of the fundamental need for information disclosure. Our review of the NAIC model is designed to bring about essential improvements in the information presented to consumers.

The merits of any proposed disclosure system must be measured by its effectiveness in redressing the problems that have been detailed in Parts I and II. To summarize they are: (1) low average rates of return on life insurance savings; (2) severe but undisclosed penalties for early lapse of cash value policies; (3) widely varying costs for similar policies; (4) low rates of return received by existing policyholders, compared to the rates offered to new policyholders; and (5) the small average amount of individual ordinary life insurance protection against premature death relative to the premiums paid.

The following sections describe our recommendations on how to modify the NAIC model regulation to address these problems more effectively. Appendix X contains a draft regulation, buyer's guide and disclosure statements which incorporate these recommendations. The documents in Appendix X are not meant as the definitive solution to the cost disclosure problem. Rather they are provided to illustrate how the necessary elements of

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[2] A copy of the NAIC model regulation is contained in Appendix X.

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a cost disclosure system can be incorporated into an effective cost disclosure regulation. We recognize that there are no easy answers when it comes to the question of life insurance cost disclosure; there is room for discussion and disagreement. Undoubtedly, state regulators and others interested in cost disclosure will be able to suggest improvements on these materials.[3]

Our discussion of recommended modifications of the NAIC model regulation is divided into three sections:

1. The need to disclose the average annual rate of return for all cash value insurance and annuity products.
2. The choice of an index number for comparing similar policies.
3. Recommendations concerning other apects of the NAIC model regulation.

A. The Need to Disclose the Average Annual Rate of Return on All Cash Value Insurance and Annuity Products

Parts I and II demonstrate that many consumer problems in the life insurance industry stem directly from the extremely low rates of return offered on far too many cash value insurance products. The current lack of rate of return information is a major reason for the existence of these problems. The most important improvement that can be made in the NAIC model regula-

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[3] In this connection we note that the insurance departments of Wisconsin, North Carolina and Massachusetts proposed cost disclosure regulations which represent significant improvements over the NAIC model. Many of the recommendations in this report reflect the pioneering work done by these three departments. Unfortunately, none of the proposed regulations are currently in effect. The North Carolina regulation was overturned by the state legislature, the Wisconsin regulation is being challenged in court, and the Massachusetts proposal has not been finally adopted.

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tion is to require disclosure of the average annual rate of return on cash value insurance and annuity products. Specifically, the NAIC model regulation does not provide consumers with the information necessary: (1) to evaluate cash value insurance as a savings vehicle, and (2) to compare dissimilar types of insurance policies. This section shows how rate of return is essential to consumers in making these decisions. It also discusses various industry objections to rate of return disclosure. Further, it sets out the appropriate method for computing rate of return, and the durations at which rates of return should be displayed.

1. Rate of Return Disclosure is Necessary to Evaluate Cash Value Insurance As A Savings Vehicle

Life insurance is often sold as a convenient way to save for retirement or other purposes. As shown in Part I, the life insurance industry is second only to savings and loan associations as a depository for personal savings. Yet it is the only savings medium that does not disclose the rate of return paid on consumer savings. Basic fairness dictates that consumers be given the rate of return they will receive on their savings though cash value insurance or annuities. The only information consumers currently receive concerning cash values, and all they would receive under the NAIC model regulation, is a ledger statement showing the cash value at selected years. Table IV-1 illustrates the type of information disclosed under the NAIC model regulation for a non-participating policy issued to a male at age 35.

Table IV-1

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Policy Year	Premiums	Guaranteed Cash Value	Death Benefit
1	446.50	0.0	25,000
2	446.50	66.0	25,000
3	446.50	458.50	25,000
4	446.50	860.75	25,000
5	446.50	1,272.75	25,000
10	446.50	3,472.00	25,000
20	446.50	8,533.00	25,000
Age 60	446.50	10,807.75	25,000
Age 65	446.50	13,034.00	25,000

Although useful, the information contained in Table IV-1 does not tell the consumer much about the relative value of the policy as a savings vehicle. At the end of twenty years the policy will have a cash value of $8,533. To many purchasers this sum might appear substantial for an annual expenditure of $446.50 since they have also received $25,000 worth of insurance. Because a portion of the premium provides death protection, the average consumer is unable to tell whether a whole life policy's cash value represents an adequate return on premiums paid. In fact, the policy in Table IV-1 has a 20-year rate of return of 2.09 percent. If the consumer had bought term insurance and invested the difference at 5 percent (after taxes), the side savings fund at the end of 20 years would be $12,216, a difference of over 40 percent.[4]

This example demonstrates that the NAIC model does not provide sufficient information to enable the consumer to judge

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[4] For a description of this calculation see pages 55-56, supra. The actual calculation for the first twenty policy years is contained in the Hearings on Life Insurance Marketing and Cost Disclosure Before the Subcomm. on Oversight and Investigations of the House Comm. on Interstate and Foreign Commerce, 95th Cong., 2d Sess. 808 (1978) [hereinafter cited as Moss Subcommitte Hearings.]

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the relative attractiveness of savings through cash value insurance compared with alternatives in the marketplace. It also shows the importance of making this comparison. Part II revealed that many policies in the marketplace have a 20-year rate of return of 3 percent of less. (See Tables II-7, II-8, supra). A person who saves $1,000 each year at 3 percent will have, at the end of 30 years, approximately $49,000. One who saves the same amount over the same period at 6 percent will have $84,000.

2. Rate of Return Disclosure is Necessary to Compare Dissimilar Types of Insurance and Annuity Products

Rate of return disclosure on cash value products can also greatly assist consumers in making a choice between dissimilar policies. The NAIC model regulation does not attempt to deal with this problem.[5] Yet this choice may be the most important decision a consumer has to make. The choice between dissimilar policies is often characterized as the choice between buying whole life insurance or buying term insurance and investing the difference. At this time there is a continuing, often emotional, debate within the life insurance industry concerning whether term or whole life is the superior product.[6] We adopt

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5 The indices provided in the NAIC model can only be used to compare the relative costs of similar policies.

6 See, e.g., Subcommittee on Oversight and Investigations of the House Comm. on Interstate and Foreign Commerce, Report on Life Insurance Marketing and Cost Disclosure, 95th Cong., 2d Sess. 9 (1978) [hereinafter cited as Moss Subcommittee Report].

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a position of strict neutrality on this issue. Whole life insurance and term insurance plus a side fund are equally legitimate ways to protect against premature death while accumulating funds for retirement or other purposes.[7] Either product can be a desirable purchase, depending upon an individual's circumstances. In deciding between an insurance program based primarily on term or whole life insurance, many factors should be considered including the individual's need for death protection, his tax bracket, and the rates of return available on other investments. But one of the most important factors that should be considered in choosing between term and whole life is the rate of return on the savings element of a cash value insurance policy.

The choice between dissimilar policies is much broader than deciding between term and whole life. The marketplace offers a multitude of policy types that combine insurance protection with savings in varying degrees--whole life, limited-pay life, deposit term, term plus annuity, economatic, modified whole life--to name just a few. Currently, consumers lack meaningful information to assist them in choosing among these dissimilar types of cash value policies. The information disclosed under the NAIC model regulation offers very little help in this regard. The following discussion illustrates the usefulness of rate of

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7 Mathematically, term and whole life are very similar. Appendix III shows that a whole life policy can be viewed as a level premium term insurance policy that is renewable through age 100.

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return in evaluating dissimilar cash value insurance policies, deposit term insurance and annuities.

a. Comparing Dissimilar Cash Value Policies

The difficulties facing the consumer in comparing dissimilar cash value policies, and the failure of the NAIC model to address this problem, are illustrated by looking at two $50,000 policies issued to a 35-year old male--a whole life and a 30-year endowment.[8] Table IV-2 shows the information concerning each of these policies that would be disclosed under the NAIC model regulation.[9]

Table IV-2

Endowment

Policy Year	Premiums	Cash Value	Death Benefit
1	1,349.50	0.0	50,000
2	1,349.50	678.00	50,000
3	1,349.50	1,877.00	50,000
4	1,349.50	3,114.50	50,000
5	1,349.50	4,386.50	50,000
10	1,349.50	11,313.50	50,000
20	1,349.50	28,628.00	50,000
Age 60	1,349.50	38,210.50	50,000
Age 65	1,349.50	50,000.00	50,000

Whole Life

Policy Year	Premiums	Illustrated Dividend	Cash Value	Death Benefit
1	1,117.50		70.50	50,000
2	1,117.50	102.50	872.50	50,000
3	1,117.50	136.50	1,693.00	50,000

8 In an endowment policy the cash value equals the policy's face amount at the end of a selected period, in this case 30 years.

9 Cost index numbers would also displayed. However, these can only be used to compare similar policies. See page 128, infra.

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4	1,117.50	171.50	2,530.50	50,000
5	1,117.50	208.00	3,384.50	50,000
10	1,117.50	405.50	8,595.50	50,000
20	1,117.50	819.00	18,591.50	50,000
Age 60	1,117.50	1,108.00	23,101.00	50,000
Age 65	1,117.50	1,268.00	27,521.50	50,000

Both of these policies will pay $50,000 if the insured dies within the first 30 years of the policy and both provide savings accumulation in the event the insured lives. They differ in the size of the premium, how long the premiums must be paid, and the proportion of the premium dollar that goes to provide protection and savings. Looking at the information in Table IV-2, most consumers would be unable to determine which of the policies represents the better buy. The rate of return provides a simple answer to this question. The policies have the following rates of return:

	Endowment	Whole Life
5 years	-10.53%	-5.13%
10 years	- 1.04	3.38
20 years	1.86	5.01
30 years	1.99	5.32

Table IV-3 indicates what would happen over the first thirty policy years if the difference between the amount paid for the endowment policy and the whole life policy were invested in a savings fund at 5 percent (after taxes). At the end of thirty years, the endowment policy has a cash value of $50,000. Under the "buy whole life and save the difference plan," the total savings are $78,774 which is the sum of savings fund and the whole life policy's cash value. Thus, the difference in savings between the two plans is $28,774. This example demonstrates

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both the usefulness of rate of return in comparing dissimilar cash value policies and the importance to the consumer of being able to make this comparison.

b. Comparing Traditional Cash Value Insurance to Additional First-Year Premium Policies

The rate of return is also extremely useful in comparing traditional types of cash value insurance to "additional first year premium" policies. These policies require the payment of an additional premium in their first year or years, and provide for the return of the additional payment with interest at the end of a specified period. The most common of these policies is known as "deposit term." The recent introduction of deposit term has provoked spirited comments within the industry, ranging from highly exaggerated claims of its value to attempts by some industry members to get state regulators to ban its sale.[10] Like most insurance products, however, it is neither inherently good nor bad. Whether it represents a desirable purchase depends upon the consumer's needs and the relative value of the benefit structure of the policy. It is, nonethe-

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10 See, e.g., Sylvia Porter, "Is 'Deposit Term' For You?" New York Post (August 1, 1977); "Agents' Opposition to New Deposit Term Life Plans Topic of Hearing in Texas," The National Underwriter, (Life/Health Ed.) at 1 (October 15, 1977); "Deposit Term-A Proponent Speaks," The National Underwriter, (Life/Health Ed.) at 13 (February 4, 1978); "Deposit Term Vs. Whole Life," The National Underwriter (Life/Health Ed.) at 8 (February 25, 1978); "Agent Exec. Join Deposit Term Debate," The National Underwriter (Life/Health Ed.) at 11 (March 18, 1978); and "Should 'Deposit' Policies Be Banned," The National Underwriter (Life/Health Ed.) at 11 (April 1, 1978).

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Table IV-3

Year	(1) Endowment Premium	(2) Net Whole Life Premium	(3) Whole Life Cash Value	(4) Endowment Cash Value	(5) [1-2] Savings Deposit	(6) [5 + Interest] Side Acc. Fund 5%	(7) [3 + 6] Total Savings Component Whole Life Cash Value + Side Fund	(8) [(3-2) + 5] Savings Depo Difference
1	1,349.50	1,117.50	70.50	0	232.00	243.50	314.00	314.00
2	1,349.50	1,015.00	872.50	678.00	334.50	607.00	1,479.50	801.00
3	1,349.50	981.00	1,693.00	1,879.00	368.50	1,024.50	2,717.50	838.50
4	1,349.50	946.00	2,530.50	3,114.50	403.50	1,499.50	4,030.00	915.50
5	1,349.50	909.50	3,384.50	4,386.50	440.00	2,036.50	5,421.00	1,034.50
6	1,349.50	872.00	4,396.00	5,694.50	477.50	2,639.50	7,035.50	1,341.00
7	1,349.50	833.50	5,423.00	7,040.00	576.00	3,313.50	8,736.50	1,696.50
8	1,349.50	793.00	6,465.50	8,424.00	556.50	4,063.50	10,529.00	2,105.00
9	1,349.50	752.50	7,523.00	9,848.00	597.00	4,893.50	12,416.50	2,568.50
10	1,349.50	712.00	8,595.50	11,313.50	637.50	5,807.50	14,403.00	3,089.50
11	1,349.50	671.00	9,540.00	12,821.50	678.50	6,810.50	16,350.50	3,528.50
12	1,349.50	628.50	10,498.50	14,374.00	721.00	7,908.00	18,406.50	4,032.50
13	1,349.50	586.50	11,470.50	15,971.50	763.00	9,104.50	20,575.00	4,603.50
14	1,349.50	544.40	12,454.50	17,616.50	805.00	10,405.00	22,859.50	5,243.00
15	1,349.50	501.50	13,451.00	19,311.00	848.00	11,815.50	25,266.50	5,955.50
16	1,349.50	460.00	14,458.50	21,057.00	889.50	13,340.50	27,799.00	6,742.00
17	1,349.50	417.00	15,476.50	22,858.00	932.50	14,986.50	30,463.00	7,605.00
18	1,349.50	372.00	16,505.00	24,717.50	977.50	16,762.00	33,267.00	8,549.50
19	1,349.50	335.00	17,543.00	26,189.00	1,014.50	18,665.50	36,208.50	10,019.50
20	1,349.50	298.50	18,591.00	28,628.00	1,051.00	20,702.50	39,293.50	10,665.50
21	1,349.50	260.50	19,492.50	30,420.50	1,089.00	22,881.00	42,373.50	11,953.00
22	1,349.50	109.00	20,395.50	32,269.50	1,240.50	25,327.50	45,723.00	13,454.00
23	1,349.50	75.50	21,299.00	34,179.00	1,274.00	27,931.50	49,230.50	15,051.50
24	1,349.50	42.00	22,201.00	36,157.00	1,307.50	30,701.00	52,902.00	16,745.00
25	1,349.50	9.50	23,101.00	38,210.50	1,340.00	33,643.00	56,744.00	18,533.50
26	1,349.50	- 23.00	23,997.50	40,348.50	1,372.50	36,766.50	60,764.00	20,415.50
27	1,349.50	- 55.00	24,889.00	42,582.00	1,404.50	40,079.50	64,968.50	22,386.50
28	1,349.50	- 86.50	25,774.50	44,924.00	1,436.00	43,591.50	69,366.00	24,442.00
29	1,349.50	- 118.00	26,652.50	47,390.50	1,467.50	47,312.00	73,964.50	26,576.00
30	1,349.50	- 150.50	27,521.50	50,000.00	1,500.00	51,252.50	78,774.00	28,774.00

less, a product for which meaningful rate of return disclosure is critical.[11]

In deposit term, the consumer pays a first year premium that is substantially higher than subsequent premiums. This additional premium or "deposit" will be returned at the end of a specified period (usually 10 years) in an amount that is generally double the initial deposit. The representation is made that the "deposit" will thus earn interest at the rate of 7 to 10 percent. In most cases, this representation is misleading. A rate of return of 10 percent on the "deposit" means little if the consumer is paying an exorbitant rate for the term insurance component of the policy.[12] What is important is not the rate of return that is imputed on the "deposit" but the average annual rate of return on the gross premiums paid for the total package of insurance and savings.

In an article in the August 1978 Best's Review, Professor Harold Skipper of Georgia State University calculated the 10-year average annual rate of return of 21 deposit term policies

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11 Our discussion of deposit term is applicable to the other additional first-year premium policies.

12 Deposit term can be viewed as a special type of endowment insurance. It differs from the traditional endowment in that the premiums are not level and the deposit term product does not mature for the full policy face amount. The traditional mathematical view of endowment insurance is that it is a combination of level term insurance and a pure endowment--each in the same amount. Similarly, deposit term is a combination of (usually) ten-year level term insurance and a pure endowment but in unequal amounts. See Skipper, "An Analysis of 'Deposit Term' Life Insurance," Best's Review, at 10 (August, 1978).

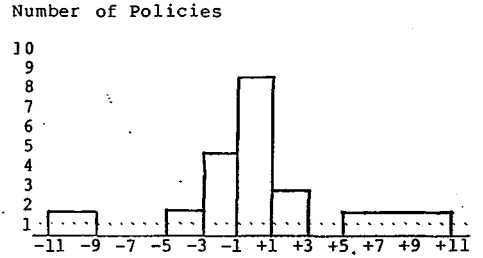
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using the same low annual renewable term rates to calculate the return for each policy.[13] He found that, while all the companies claimed an implicit rate of return of 7-10 percent on the deposit, the actual rate of return on the policy as a whole at issue age 25 varied from a high of plus 9.34 percent to a low of minus 9 percent. Table IV-4 shows the average rates of return for policies issued at ages 25 and 45 and the distribution of rates of return at age 25:

Table IV-4

Claimed Implicit Rate of Return	No. of Policies	Average Rates of Return Age 25	Age 45
7-8%	13	-0.23%	-5.33%
9-10%	8	1.30%	-3.23%
Averages for all policies		0.32%	-4.65%

Distribution of Rates of Return - Age 25



The Skipper study demonstrates two points: (1) there is an enormous variation in the quality of deposit term products on the market and (2) the only way consumers can evaluate whether this type of policy is a desirable purchase is if they are pro-

13 Id. at 12.

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vided with the rate of return on gross premiums paid.

The preceding analysis of deposit term insurance illustrates a further need for mandatory, standardized rate of return disclosure. In some cases what purports to be rate of return information is given, but it is calculated and used in a misleading manner. An example of this is the representation that the "deposit" in deposit terms earns 7 to 10 percent annual interest.[14] The most important area where this problem arises is in the sale of annuities which is discussed in the next section.

c. Using Rate of Return Disclosure to Evaluate Annuity Products

Annuities are contracts used to provide a policyholder with retirement income.[15] Prior to retirement the contract is much like a savings account. The amount contributed minus sales and administrative charges earns interest. If a policyholder dies before retirement, he or she receives either the cash value of the contract or premiums paid, whichever is greater. Upon retiring, the policyholder usually can turn in the contract for its cash value or choose from annuity payment options which are set forth in the contract. These payment options guarantee to pay the annuitant a stipulated

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14 In some whole life sales presentations an example is given comparing a whole life policy with buying term and investing the difference. The whole life policy is made to appear to be a better buy by using expensive term insurance rates in the comparison.

15 The number of annuities in force with domestic life insurance companies under individual and supplemental contracts totaled 4.3 million in 1977. Individual annuities accounted for nearly 3.7 million of the total. The amount paid into individual annuities in 1977 was $4.4 billion. American Council of Life Insurance, Fact Book 36, (1978) [hereinafter cited as Fact Book].

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income for a specified period--usually life.[16]

Two types of information are generally disclosed for annuities: (1) the annuity rate which is the number of dollars per $1,000 accumulated that will be paid the annuitant monthly starting at retirement, and (2) the interest rate paid on the sums deposited into the annuity. The rate of interest will determine the amount of investment accumulation or cash value of the annuity.[17] The actual amount of monthly income the annuitant will receive is called the annuity rent. The annuity rent is a function of both the annuity rate and the investment accumulation (or cash value) by which this rate is multiplied. As with life insurance, the cost of comparable annuities varies widely.[18] This cost dispersion results, in part, from the current lack of meaningful standardized cost disclosure.

The NAIC has proposed a separate model cost disclosure regulation for annuities which requires disclosure of the guaranteed and current annuity payments at the scheduled commencement of the annuity. This information is important and should be disclosed. The NAIC model regulation, however, does not require disclosure of the interest rate (rate of return) that the annuity pays on the savings deposited in it. For reasons stated below, the staff recommendation would go

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16 In addition to providing income for life, most annuities guarantee the payment for a fixed number of years, such as ten.

17 Both the annuity rate and interest rate are usually displayed on a guaranteed and current basis. The current rate is the rate that is being paid at the time the annuity is sold.

18 A study of annuity rents, annuity rates, and investment performance of 42 life insurers in the United States in 1975 found significant variability in all three areas. Greene, Neter, and Tenney, "Annuity Rents and Rates--Guaranteed vs. Current", 44 J. Risk & Insurance 383 (1977) [hereinafter cited as Greene, Neter, and Tenney.]

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further than the NAIC regulation and require rate of return disclosure on annuity products.[19]

Two common types of advertisements used to promote the sale of annuities illustrate the possible deception when non-standardized rates of return are used. First, some advertisements guarantee a high rate of return, for example, 8 percent. They fail to explain that this figure does not represent the return on the gross premium paid. Rather it gives the return on the gross premium only after substantial administrative charges and sales commissions are deducted.[20] If the rate of return is expressed as a percentage of premiums paid, the return in some cases plummets to as low as 4 percent. For a description of the advertising of annuity interest rates see the Federal Trade Commission's Staff Report on Individual Retirement Accounts/Annuities (1978). That Report gives the following examples:

> [O]ne flexible premium annuity advertised by Pacific Mutual at 8 1/4% has an actual rate of return of -.49% after 5 years, 2.82% after 10 years and 4.52% after thirty years. Thirty percent of the first year's payments to this flexible premium annuity will go for company costs. Valley Forge Life Insurance projects investment growth at 5% yet after 5 years its average annual rate of return was -10.36%, after 10, -1.11%, and after 30 years, 4.48%.[21]

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19 The staff recommendation with regard to annuities is incorporated into the draft regulation, see Appendix X.

20 Sometimes the advertisements do qualify the interest rate quoted by adding the words "with deduction of fees" after the quote. But usually neither the amount of these fees nor the effect they will have on the advertised rate of return is disclosed.

21 See Federal Trade Commission, Bureau of Consumer Protection Staff Report on Individual Retirement Accounts/Annuities (IRAs) submitted to the Subcommittee on Oversight, House Ways and Means Committee, at 64-67 (March 1978). In particular see page 4 of Appendix E of the IRA Report.

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Second, some advertisements guarantee in large print a high rate of return. In minute print at the bottom of the ad, however, they limit the high rate guarantee to the policy's first three years and guarantee a much lower rate for succeeding years. In both cases, the method by which the rate of return for annuities is calculated should be standardized.

As previously mentioned, the monthly income an annuity will ultimately pay (the rent) is a function of both the annuity rate and the amount of cash accumulation to which the rate is applied. The cash accumulation is, in turn, determined by the rate of interest the annuity pays. One study of annuities found substantially less variation in annuity rates than in cash accumulations. It concluded that the investment accumulation is a more important factor than annuity rates in determining the amount the annuitant will ultimately receive (the rent).[22] It is important to disclose the amount of the annuity payment that a consumer will receive. This information, however, will not allow consumers to compare savings through annuities with alternative savings media. To make this comparison, the annuity's rate of return (or interest rate) must also be disclosed. This can be accomplished by requiring disclosure of the average annual rate of return on gross premiums paid for all annuity products.

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22 Greene, Neter, and Tenney, supra n.18, at 388-389. The coefficients of variation for annuity rates, investment accumulations and rents is set forth below:

	Guaranteed Basis	Current Basis
Rents	10.1%	13.6%
Rates	3.7%	5.7%
Investment Accumulation	7.4%	11.3%

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3. Industry Arguments Against Rate of Return Disclosure

In our discussion of rate of return we have viewed cash value insurance, in part, as a savings medium. Many industry spokesmen object to rate of return disclosure on the ground that it requires what they allege is an improper separation of whole life insurance into savings and protection. In their view, life insurance is an inseparable contract and can only be viewed as a whole.[23] An example of this argument can be found in a paper prepared for the NAIC Life Insurance Cost Comparison Task Force by the Institute of Life Insurance (now ACLI). It states:

> The whole life insurance contract is a contract of protection - an arrangement by which the insured person, upon regular payment of a level premium, is guaranteed that upon

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23 Another common way to view whole life insurance is to look at it as the purchase of insurance protection on the installment plan. Professor Robert Mehr has written, "What people want is the opportunity to buy their whole life insurance on the installment plan, just as they purchase their homes, automobiles, heavy appliances, and other large capital items. For example, instead of paying a single premium of $3,000 for a $10,000 whole life policy, the 25 year old buyer would normally prefer to pay a series of equal annual payments, either for life or for a limited number of years. . . . [T]he installment premium explanation of the level premium is the correct one because it is consistent with the method used to compute level premiums." Robert Mehr, "Development of Life Insurance in the Past Two Years in the United States," Pacific Insurance Conference, 2-4 (August 23-31, 1973).

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> his death his beneficiary will receive a stated amount.
>
> While the central purpose of the contract is insurance protection, the contract also provides auxiliary rights which are available to the policyholder during his lifetime if he does not wish to continue the original arrangement. These stem from the level premium plan, the effect of which is to collect from the policyholder more than the cost of the pure risk in the early years to permit accumulation of a reserve against the rising risk of the later years, when the level premium alone would be insufficient.
>
> A fair reading of the whole life contract, and an analysis of the history of its development, will demonstrate that the foregoing language accurately describes the true nature of the contract and points up the impropriety of definitions which would split the policy into two parts: i.e., protection and savings elements.[24]

It is a matter of semantics whether a cash value insurance contract is described as an indivisible whole, insurance purchased on the installment plan, or a combination of death protection and savings. The debate should not focus on whether a particular definition is correct, but rather on whether the definitions are useful in helping to understand different aspects of the whole life contract. Each of these definitions can be useful for different purposes. The value of looking at the whole life contract from "complementary vantage points" has been expressed by Spencer L. Kimball and Mark S. Rapaport:

> Their view [the actuaries] is not the

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24 The Nature of the Whole Life Contract 27 (NAIC 1974) [hereinafter cited as The Nature of the Whole Life Contract].

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> common sense view, but it is not nonsense. It is appropriate for an actuary to regard the savings element as an integral part of an insurance contract. The "savings element" is an indispensible feature of level premium life insurance without which the system would not work. The narrow actuarial perspective, however, does not represent ultimate truth and need not govern others who see the policy from a different and complementary vantage point. The savings element in life insurance is not exactly like a savings account. Nevertheless, the cash value is available to the policyholder. All he need do is either terminate the policy, pay interest on a policy loan, or assign the policy as collateral for a loan from a lender other than the insurer, and the cash value is available. For the planning of his personal finances it would be inane to advise a policyholder not to regard his cash value as an asset.[25]

The view of cash value insurance as a combination of death protection and savings is commonly found in life insurance textbooks because it is a very useful and understandable way to

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25 Kimball and Rapaport, "What Price Disclosure? The Trend to Consumer Protection Life Insurance", 1972 Wisc. L. Rev. 1025, 1028 [hereinafter cited as Kimball and Rapaport]. The authors give the following example of the usefulness of this approach:

> The most striking illustration of the value of looking at phenomena from "complementary" viewpoints resulted from the development of quantum theory. As a result, it became useful to consider light sometimes as discrete particles instead of, as was traditional, waves. The choice depends on the purpose for which an inquiry is made and study techniques used. This notion of complementarity from the hard sciences ought to be readily understood by mathematically trained actuaries. Holton, "The Roots of Complementarity," 99 Daedalus 1015 (1970).

Id. at 1028 n. 14.

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describe a complex financial instrument.[26] The industry admits that agents also often describe the contract in the same way for the same reason:

> [E]ven the most dedicated agent can be hard put to explain the intricacies of a product to a client who is ill-equipped by education to grasp the details of the life insurance contract, and as experience shows, is not likely to study the policy very thoroughly. By dividing the contract into protection and savings elements, the agent, like many educators, may find it easier to describe the whole life policy in terms of this and rather than in technical language.[27]

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26 ...under the level-premium plan a $1,000 policy does not provide $1,000 of pure term insurance. Rather it provides a decreasing amount of term insurance and an increasing investment element which when combined are always just equal to the face amount of the policy. This analogy of the combination of protection and investment is found in all level-premium plans....

S. Huebner & K. Black, Life Insurance 11 (1972). A similar description is contained in Linton, How Life Insurance Can Serve You 63 (1958).

27 The Nature of the Whole Life Contract, supra n. 24, at 20.

Moreover, agents are often trained to refer to the whole life contract in this way. An Occidental Life agent training manual contains the following definition,

> Permanent insurance is a combination of insurance protection and savings. .... As we said, permanent insurance has built-in savings values. A portion of each premium paid goes into a 'savings account' (represented by the policy's cash value) and these savings increase steadily, year by year.... As the cash value increases throughout the policy period, the insurance protection decreases proportionately.

Occidental Life Insurance Company of California (agent training manual) 10-11 (1970).

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Kimball and Rapaport provide a succinct answer to the industry's opposition to rate of return disclosure on the "indivisible whole life contract" theory:

> Thus the technically tenable actuarial point of view is, for disclosure purposes, irrelevant. The inseparable contract can be separated conceptually as easily as one can separate into two parts the purchase of a car with extra equipment for a single price. That the conceptual separation is not only possible, but an appropriate way to look at cash value life insurance, is shown not only by the fact that it is found in standard textbooks including those of the insurance saint, S.S. Huebner, but even more persuasively by the industry's own readiness to be recognized as a major savings institution when questions other than price disclosure are under discussion. Thus, the Life Insurance Association of America, in a scholarly monograph for the Commission on Money and Credit, published in 1962, had no qualms about a chapter entitled "Policyholders' Saving Through Life Insurance." The study talks of industry efforts to push whole-life and endowment as opposed to term, in the hope of "an augmented flow of savings into life insurance." They further expressed hope that the "declining trend in life insurance savings" would be transitory.
>
> The readiness of the industry to make the conceptual separation whenever it suits industry purposes makes it impossible for us to take the actuaries' objections to the savings notion seriously enough to argue about it further.[28]

The Moss Subcommittee reached a similar conclusion: "We regard the 'inseparable whole life policy' argument as a diversionary ploy. In our view, reliance on it in the future as a defense to rate of return disclosure will cross the line into irresponsi-

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28 Kimball and Rapaport, supra n. 25, at 1028-1029 (footnotes omitted).

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bility."[29] We agree.

The industry also objects to rate of return disclosure because some features of a whole life policy are unique and cannot be duplicated by any program based on term insurance plus savings.[30] We agree whole life policies have unique characteristics that cannot be duplicated precisely by a program based on term insurance plus savings. As we have previously stated, supra, page 34, these advantages of the whole life contract may well lead consumers to accept a lower rate of return from a whole life

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29 Moss Subcommittee Report, supra n. 6, at 23 n. 55.

30 This argument was presented in the testimony of the American Council of Life Insurance before the Moss Subcommittee:

> Unlike a bank savings account, the cash value of a whole life policy may be used in many ways such as to purchase extended or paid-up insurance benefits, or to provide a life income to the insured or beneficiary, or as collateral for a relatively low cost policy loan. Moreover, since whole life insurance policies are not, in fact, bank accounts plus term insurance, income taxes are not payable on any interest that might be imputed to the policyholder. Further, at death, life insurance proceeds can be obtained quickly without passing through the estate of the insured and without having to be probated. Savings accounts do not provide any of these features, nor can banks provide the very long term investment guarantees which are inherent in whole life policies. Also, banks cannot enhance the insured's ability to continue his program of family protection by providing such benefits as the waiver of premiums in the event of disability. These advantages of permanent life insurance are ignored in the "buy term and invest the difference" comparison.

Id. at 21.

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policy than they could receive elsewhere. The existence of these advantages is not, however, a valid argument for not disclosing the rate of return. Only if consumers know the rate of return received on a whole life policy, can they balance the unique characteristics of the whole life policy against the higher rates of return that may be available elsewhere.[31] The buyer's guide should contain an explanation of the unique features of cash value insurance that distinguishes it from other forms of savings.

A further argument against rate of return disclosure is that it may cause many purchasers to select term rather than whole life insurance. Some argue that the only way many people can save for retirement or build an estate is to buy whole life insurance. It is contended that if people buy term insurance they will not save the difference between the term and whole life premium and will thus be left without funds in their later years. We see no evidence that consumers are only able to save through cash value insurance. Moreover, if consumers buy term and spend the difference, that is their choice. It is not an

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31 A variant of this argument is that it may be difficult in practice to duplicate exactly a whole life policy by term insurance and a side fund because the marginal reductions in the amount of term insurance purchased implicit in the Linton Yield calculation may not be readily available in the marketplace. What the yield does is give a measure of the relative value of a cash value policy by comparing it to a hypothetical program of buying term insurance and investing the difference. The fact that a person may not be able to duplicate exactly the whole life policy does not detract from the usefulness of the information conveyed.

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argument against rate of return disclosure. We agree with the Moss Subcommittee's analysis of this argument:

> Even assuming that many people will "spend the difference" without remorse, it does not follow that the solution is to promote whole life sales by obscuring rate of return differentials. We simply reject the notion, implicit in this argument, that insurance companies should be allowed to fool people into saving for the future. If, from a social policy standpoint, we want people to save, and are afraid they will not do so voluntarily, the response has to be crafted on the floors of Congress, not in insurance company boardrooms.[32]

Finally, the industry argues that the rate of return will vary somewhat depending upon the yearly renewable term rates used in the calculation.[33] A report by the Society of Actuaries on life insurance cost comparison index methods recommended that a low scale of term rates be used because "it would typically be assumed that one who seriously considers the two alternative programs upon which the method is based would attempt to obtain a low priced YRT (Yearly Renewable Term) policy."[34] We agree and think it is important that the rates used accurately reflect low cost term insurance available on the market.[35] If they do,

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32 Moss Subcommittee Report, supra n. 6, at 25.

33 The rate of return can vary as much as 1 percent if high-cost rather than low-cost term rates are used in the calculation. Society of Actuaries, Analysis of Life Insurance Cost Comparison Index Methods 145 (1974) [hereinafter cited as Actuaries Report.]

34 Id. at 141.

35 It is important that all companies use the same YRT rates to calculate the Linton Yield. To insure that the rates used accurately reflect the low-cost term rates available (Footnote Continued)

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we do not think it is particularly relevant whether a different yield could be obtained by the use of high YRT rates.[36]

4. Method Used for Rate of Return Disclosure

Parts IV.A.1 and 2 demonstrate the usefulness of rate of return disclosure. This section considers the method that should be used to calculate rate of return.

In this report we recommend what is known as the "Linton Yield" as the method for rate of return disclosure. The Linton Yield is a compound annual rate of return on gross premiums paid over a selected holding period. For example, if a policy has a 10-year Linton Yield of 3.5 percent it means that, if the policy is held for ten years, it will have earned an average of 3.5 percent per year compound interest. It is calculated by deducting from the whole life premium (less any dividend) the amount it would cost to buy as much term as is represented by the policy's pure insurance portion. The difference can be considered as a savings deposit. The rate of return, then, is the interest rate required to make these deposits, accumulated

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35 (Footnote Continued)

in the market, it would be useful if an organization such as the Society of Actuaries or the NAIC survey market term rates on a yearly basis.

36 Because the rate of return is somewhat sensitive to the term rates assumed in the calculation, the Buyer's Guide should give examples of the term rates used for selected ages and face amounts. If this is done, consumers will be able to judge for themselves the appropriateness of a policy's rate of return for their particular situations. See Buyer's Guide in Appendix X.

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at interest, equal the cash value of the policy at the end of the period of years chosen for the computation.[37]

The Moss Subcommittee concluded that rate of return is an essential component of any meaningful disclosure system. While they stated that the Linton Yield was an acceptable method of disclosing rate of return, they preferred an alternative rate of return calculation known as the "cash accumulation method." The cash accumulation method compares a cash value insurance policy with a "buy term and invest the difference" alternative. It does this by comparing the funds available under an insurance policy with the fund available by allocating available premium dollars between term and a side investment fund that earns a specified interest rate.[38] The number disclosed to consumers is the dollar amount in the side fund at the end of selected years.

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37 Moss Subcommittee Report, supra n. 6, at 13-14. A description of how the Linton Yield is calculated is set forth at pages 25-26, supra.

38 In the calculation, the cash outlay for each program is kept the same. In addition, the sum of the term face amount and the side fund is equal to the whole life face amount. Therefore, the beneficiary will always receive the same dollar amount under either program should the insured die. The only difference between the two programs is between the amount of the whole life policy's cash value and the side investment fund. The cash accumulation method is very similar to the Linton Yield except the interest rate is assumed rather than solved for. See Appendix VI for further details on this method as used by the FTC staff in this report. At various points in this report we have used the "cash accumulation method" of analysis, see e.g. page 337 supra. This method of comparing term and whole life was first described in Murray, "Analyzing the Investment Value of Cash Value Insurance," 43 J. Risk & Ins. 121 (1976).

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The Subcommittee expressed its reasons for preferring the cash accumulation method over the Linton Yield as follows:

> The cash accumulation method shows when the side fund exceeds the whole life face amount. This is important for purchasers who never intend to surrender their whole life policies. They are not especially interested in how the whole life cash value increases, and do not find a Linton Yield figure very useful because it merely reveals the side fund earnings rate that would be needed to exceed the cash value. This consideration convinces us, on balance, to prefer the cash accumulation method over the Linton Yield as a comparative method. However, we do not affirmatively oppose the Linton Yield, and regard both approaches as acceptable.[39]

We recognize that the disclosure of the point when the side fund exceeds face amount of the insurance policy is an advantage of the cash accumulation method. This advantage, however, must be weighed against features of the Linton Yield which we think are clearly superior. There are two advantages of the Linton Yield. First, the Linton Yield gives a percentage figure for the rate of return. This concept is very familiar to consumers. The normal way that other forms of savings or investments are compared is through a percentage rate of return.[40] Therefore, the Linton Yield may well be more understandable than the dollar amounts of the side fund displayed under the cash

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39 Moss Subcommittee Report, supra n. 3, at 20.

40 This is not to say the higher yielding investment should always be selected. The lower yielding investment may be subject to less risk, have different tax consequences, or have a variety of other characteristics that make it a desirable purchase. Nevertheless, the rate of return is an essential fact that is considered in most saving or investment decisions.

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accumulation method. Second, the cash accumulation method is most useful in comparing term and whole life. The term/whole life choice is, however, only one aspect of the dissimilar policy comparison problem. It is also very important to be able to compare the quality of the wide range of products on the market that combine protection and savings in various degrees (see discussion, page 102 supra). The Linton Yield provides a standardized, easily understood method to do this. In contrast, the cash accumulation method is of limited use in comparing dissimilar types of cash value policies.[41] For these two reasons we prefer the Linton Yield as the method to disclose rate of return information, although an effective disclosure system could be built around either method.

We recommend the rate of return be disclosed for the 5th, 10th, 20th and 30th years of the policy. In Part II it was seen that the early lapse of cash value policies is a major consumer problem. The 5th and 10th year rate of return will

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41 The cash accumulation method shows the amount available in the side fund at age 65 for all cash value policies. The difference between a policy's cash accumulation and its cash value, can be compared to the differences for other similar policies to produce a ranking of policies consistent with a Linton Yield. The policy with the lowest difference would be the lowest cost policy. If the policies were different, like the example on page 104, supra ($50,000 endowment versus $50,000 whole life), the information generated by the cash accumulation method would be of little use in comparing costs. The method would disclose for each policy the amount in the side fund if the premium dollars were allocated between term insurance and the side fund. However, the difference between the cash accumulation and the cash value would tend to be greater for the endowment policy, even if it was a better buy. This is because endowment premiums tend to be substantially greater than whole life premiums, and their cash accumulations are thereby larger.

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disclose to consumers the severe economic consequences of the early termination of many cash value insurance products. It will reinforce the message contained in the buyer's guide that a person should not buy a whole life policy unless one plans to keep it for at least ten years.[42]

The 30-year rate of return is useful for two reasons. First, the annual rate of return on many insurance policies increases until a policy is held 15 or 20 years. At that point, it essentially levels off. (See Tables II-7, II-8, supra). The 30-year rate of return will disclose this leveling process and eliminate any inference that the early year pattern of a substantially increasing rate of return continues after the policy has been held for 20 years. Second, the 30-year rate of return will indicate to consumers

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42 To deter early lapse of whole life policies, the Moss Subcommittee recommended that any cash value table displayed for a whole life policy print in red the policy year and the corresponding cash value figure for all years that have a negative Linton Yield. The cash value table would be accompanied by the following notice: "WARNING-Termination of this policy during the years printed in red will result in a loss to you. Do not purchase this policy unless you intend to keep it at least long enough to avoid loss. Ask your agent for further details." Moss Subcommittee Report, supra n. 6, at 27. This proposal has considerable merit and we would like to see it tried. We think however, that disclosure of the five- and ten-year Linton Yields would accomplish the same goal. Moreover, the approach we recommend has two advantages. First, disclosure of the yields could be done before sale, whereas the Subcommittee proposal would be contained in the Policy Summary delivered with the policy. Second, disclosure of the yield will indicate the magnitude of the loss in the case of a five-year lapse (where minus 25 percent rates of return are common) and the often low ten-year yield even if it is positive.

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those policies whose dividends and cash value increases level off after the twentieth year. Traditionally, twenty years has been the period used for cost comparison purposes. As a result, some policies' benefits substantially decrease after the twentieth year.[43] Disclosure of the 30-year rate of return will alert consumers to the possible pitfalls in purchasing such a policy.

This section discussed the need to provide consumers with information to compare dissimilar insurance policies. It showed that the NAIC model regulation does not address this problem and demonstrated the usefulness of rate of return (Linton Yield) in comparing dissimilar policies.[44] The next section deals with the problem that the NAIC model does address--that of comparing similar policies.

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43 An example of one such policy is contained in the Moss Subcommittee Hearings, supra n. 4, at 178. This policy had the following average annual rates of return: 5-year: -2.80%; 10-year: 2.36%; 20-year: 3.78%; 40-year: 2.71%.

44 As discussed later, the Linton Yield can also be used to compare similar cash value policies, see pages 158-159, infra.

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B. Choice of an Index Number for Comparison of Similar Policies

Central to any cost disclosure system is an index number to provide a means to compare similar life insurance policies. As previously noted, a major problem facing consumers is the selection of a low-cost policy among an array of comparable policies. This problem is particularly acute in the case of cash value insurance. There, it is impossible to ascertain the true cost of a policy simply by looking at the premium, because, in addition to providing death benefits, whole life policies accumulate cash values and, in many cases, pay dividends. To compare the costs of two similar cash value policies, it is necessary to use an index that takes these factors, as well as the time value of money into account.[45] This section examines the current NAIC cost index system and recommends modifications of that proposal.

1. NAIC Cost Indices

The cost index system proposed by the NAIC stems largely from a recognition of the inherent failings of the traditional techniques used by agents to indicate life insurance costs. Traditionally, the life insurance industry employed the "net cost method" to explain life insurance costs. The agent would illustrate the cost of a particular policy by adding up the

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45 It is also necessary to use an index to compare the costs of two term policies because the first-year premium is often an unreliable guide to the policy's actual cost, since the renewal premiums for some term policies go up faster than others. In addition, many term policies pay dividends which may lower the cost of those policies.

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premiums paid over a selected period (usually 20 years) and subtract from this sum the dividends received and the cash surrender value of the policy at the end of the twentieth year.[46] This result was then divided by the face amount of the policy to obtain a "cost" per thousand dollars of coverage which could be compared to "cost" of other policies.

The 20-year net cost figure was often negative. This gave rise to the totally misleading representation by many agents that over a twenty-year period, if a person bought a whole life policy, the insurance would not cost the individual anything. This representation illustrates the fundamental flaw in the traditional net cost method: it totally ignores the time value of money.[47] In representing that purchasers would receive essentially free insurance, the traditional net cost method failed to consider the cost to consumers of foregoing the use of their money over an extended period of time.[48]

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46 See, Moss Subcommittee Report, supra n. 6, at 33.

47 The time value of money simply means that, because of interest, $100 available for use today is worth more than the same amount some time in the future.

48 As the traditional net cost method ignores the time value of money, it is also often an unreliable way to compare the relative costs of two similar cash value policies. This is because comparable insurance policies often have very different patterns of dividends. For example, two policies with the same premiums, dividends paid and cash value at the end of twenty years will have the same net cost. If one policy, however, pays very low dividends in the early years of the policy and high dividends in the policy years 15 to 20, if the time value of money is considered, it may be of substantially less value to a consumer than a policy that has a more level pattern of dividend accumulation.

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Due in large measure to increasing criticism of the traditional net cost method of cost comparison, three major life insurance company associations in 1969 formed a Joint Special Committee on Life Insurance Costs.[49] This committee was asked "to consider the method or methods that a prospective buyer of life insurance may find most suitable for use in comparing the premiums, dividends and cash values of comparable policies offered by different life insurance companies."[50] The Joint Special Committee Report recommended that the industry abandon the use of the net cost method in favor of an interest-adjusted cost index (also known as the surrender index), a method of comparison that recognizes the time value of money.[51]

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49 The committee, chaired by Mr. E.J. Moorhead, the President-elect of the Society of Actuaries, was formed by the American Life Convention, the Institute of Life Insurance and the Life Insurance Association of America. See, Report of the Joint Special Committee on Life Insurance Costs (1970) (hereinafter cited as Special Committee Report.)

50 The Life Insurance Industry, Hearings Before the Subcomm. on Antitrust and Monopoly of the Senate Judiciary Comm., 93d Cong., 2d Sess. 691 (1974). (testimony of E.J. Moorhead).

51 The interest-adjusted index differs from the traditional method in three respects:

1. Instead of merely adding the premiums for 20-years, they are accumulated with interest at a rate representative of what the purchaser could obtain in a personal investment of equivalent security and stability. The interest factor used in the 1970 Report was 4 percent. The rise of interest rates available in the market have resulted in a rise in the rate used in the calculation to 5 percent.

2. The dividends, instead of being added, are accumulated at the same interest rate as in 1;

(Footnote Continued)

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In 1971, the NAIC embarked on an effort to develop "a useful life insurance consumer price disclosure method."[52] In June, 1973, it adopted an interim model cost disclosure regulation that mirrored the cost comparison recommendations of the Joint Special Committee. This regulation (1) prohibited the use of any cost disclosure method that did not recognize the time value of money and (2) required the use of the interest-adjusted cost method (surrender index).[53] The final NAIC model regulation, adopted in May 1976, requires in addition to the surrender index, the disclosure of the payment index and the equivalent level annual dividend.[54] Furthermore, each of these indices must be displayed for the tenth and twentieth years. Thus, the NAIC recommendation would provide the consumer with two numbers for each of the following indices:

1. Surrender index - this index is a measure of the cost of an insurance policy if an individual

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51 (Footnote Continued)

3. Instead of dividing by the number of years (for example 20) the net amount of accumulated premiums less accumulated dividends less the cash value is divided by the amount to which a dollar paid at the beginning of each year will accumulate, using the same interest rate as in (1) and (2),

52 Moss Subcommittee Hearings, supra n. 4, at 248 (statement of Herbert W. Anderson).

53 Actuaries Report, supra n. 33, at 5.

54 NAIC Model Life Insurance Solicitation Regulation, May 4, 1976, reprinted in Moss Subcommittee Report, supra n. 6, at 71, Appendix A.

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surrenders it at a fixed point in time, either 10 or 20 years.[55]

2. Payment index - this index measures the relative cost of a policy if death occurs in the tenth or twentieth year. In other words, this index assumes the policyholder will make no use of his policy's cash values during these time periods.[56]

3. Equivalent level annual dividend - this number is intended to show the relative importance of illustrated dividends in calculating the surrender and payment indices. The purported purpose for this figure is to demonstrate the costs--for either the surrender or payment indices--of a participating policy if no dividends were paid.[57]

In prohibiting the use of the traditional net cost method

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55 To compute this index, the premiums are accumulated at interest for the stated period (10 or 20 years). From this total, the sum of the dividends accumulated at interest and the surrender value in the final year are subtracted.

56 The payment index is calculated by accumulating premiums at interest, subtracting this figure from the total of the dividends (also accumulated at interest). It is calculated in the same way as the surrender index except that cash values are not included in the calculation. For both the payment and surrender index, the lower the number the lower the cost on that index.

57 The equivalent annual dividend is calculated by accumulating dividends at interest and then converting the result to a present value on a level annual basis.

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and requiring an index which recognizes the time value of money, the NAIC took an extremely significant step towards providing meaningful cost information for comparison shopping among similar policies. However, we have serious reservations regarding the utility of certain of the indices provided. Moreover, we are concerned that in requiring six index numbers for similar policy comparisons the NAIC model regulation may be unnecessarily complex and confusing to consumers. In the following section we discuss the drawbacks to the present NAIC cost index proposal in the context of (1) the payment index, (2) the equivalent level annual dividend (3) the duration for which the index numbers are displayed.

2. Deficiencies in the Present NAIC Proposal

Any workable and useful disclosure system must provide consumers with manageable amounts of relevant information, presented in a manner that will facilitate informed decision-making. In our view, the cost index system proposed by NAIC model regulation fails to meet this standard in several significant respects. As we detail below, the NAIC proposal presents the prospective purchaser with a "bewildering array" of index numbers, most of which are of doubtful relevance to the average insurance consumer.[58]

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58 Hearings before the Senate Subcomm. on Housing, Insurance, and Cemeteries of the Comm. on Veteran's Affairs, 95th Cong., 1st sess. 150 (1977) Statement of Mr. E.J. Moorhead, [hereinafter cited as Veteran's Hearings]. The full text of this portion of Mr. Moorhead's statement reads:

(Footnote Continued)

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a. Payment Index

The payment index purports to provide consumers with a gauge to measure costs of similar policies should the purchaser die in the tenth or twentieth year. Our concern with the payment index is that when used to compare whole life policies it fails to take into account the worth to policyholders of the cash value component of their policies. Thus, it implicitly assumes that cash values are of no value to the purchaser.[59] This assumption is inherently invalid.[60] As previously noted, significant amounts of whole life policy premiums

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58 (Footnote Continued)

> ... the model bill of the National Association of Insurance Commissioners places before the buyer a potentially bewildering array of surrender cost indexes, net payment cost indexes, and equivalent level annual dividends. Very few life insurance buyers possess enough knowledge of life insurance intricacies to arrive at the right answer from so many indexes.

59 Mr. E.J. Moorhead stated in recent testimony before the Wisconsin Insurance Commission that it is both irrational and improbable "that [consumers] will never want to use the cash values in their policies . . ." Statement in Opposition to the Six-Index Comparison System of the NAIC Model Life Insurance Regulation, April 16, 1979 [hereinafter cited as Statement in Opposition] Apparently, the assumption that cash values are of no worth to the purchaser is based on the conclusion that a person buying a policy knows how he or she plan to use that policy. We doubt that many people who are 25-35 (who buy the bulk of life insurance) are able to state conclusively how they intend to use the policy over a twenty to thirty year period.

60 The payment index assumes, for example, that access to the cash value and the opportunity to use it as collatteral for loans has no value to policyholders who, at the time of purchase, fully intend to hold policies throughout their lifetimes.

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go toward the accumulation of cash values. Indeed, this is one of the major attractions of whole life insurance.[61] Moreover, policyholders are much more likely to make use of their policies' cash values than death benefits. Data submitted to the Moss Subcommittee indicate that for every 1000 whole life policies, 510 will have been surrendered or lapsed by the 15th policy year and only 16 will have resulted in a death claim.[62] In addition, of the 474 policies that remain in force after 15 years, many policyholders will have utilized their cash values by taking out a policy loan.[63] Thus, we question whether the payment index is relevant for most consumers.

The use of this index can also present a distorted picture to purchasers who may subsequently decide to take advantage of their policy's cash value. The payment index often makes policies that have poor cash value scales appear to be relatively low-cost. An index taking cash values into consideration would show that many of these same policies are high cost.[64]

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61 If prospective purchasers are genuinely disinterested in the cash value component of a whole life policy, there are very few situations in which they would not be better off buying pure death protection, i.e. term insurance.

62 See, Moss Subcommittee Hearings, supra n. 4, at 774-76. This information further indicates that after 33 years, 626 policies will have been surrendered or lapsed, with 92 resulting in a death claim and 282 policies still in force.

63 Life insurance company policy loans to policyholders against the cash values of their insurance policies amounted to $27.6 billion in 1977. Fact Book, supra n. 15, at 85.

64 The Actuaries Report found a high correlation in ranking (Footnote Continued)

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A comparison of two $25,000 whole life policies available to a 35 year old male illustrates this phenomenom.[65] Policy A has a payment index of 14.67 and a surrender index of 5.63. Policy B has a payment index of 15.61 and a surrender index of 2.85. Based on the payment index, Policy A appears to be a better buy. However, if a person decided to make use of his cash value and the policy were surrendered in the twentieth year, the purchaser of Policy B would have saved approximately $2,000.

Proponents of the payment index argue that it is useful for people who intend to hold their policies until they die and plan to make no use of the policies' cash values. They argue that for such people term insurance is not a viable option because term insurance premiums become very expensive after age 65.[66] This argument assumes that the only way individuals

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64 (Footnote Continued)

among cost disclosure methods that include cash values such as the surrender index, company retention and Linton Yield. There is a much lower correlation between any of these indices and the net payment index. Actuaries Report, supra n. 33, at 100.

65 The indices for these two policies were taken from Best's Review (Life/Health Ed.): Policy A (February 1977), and Policy B (December 1976).

66 It should be noted that all forms of insurance are expensive after age 65. Although the premium for a whole life policy remains the same as long as the policy is in force, the actual amount of death protection bought by the level premium declines each year as the cash value increases. For example, a 35 year old man will pay approximately $200 a year for a $10,000 whole life policy. At age 70 this policy will have a cash value of approximately $6,500. Thus, the person is actually only buying $3,500 of insurance.

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will be able to provide an estate for their survivors is through the proceeds of an in force whole life policy. What is needed, however, is a source of money for survivors if death occurs after age 65. Whole life insurance is only one of many ways to guarantee that such funds will be available. An equally valid way to build an estate is to buy term insurance and invest the difference. The staff analyzed 306 different $25,000 whole life policies issued in 1973 to males aged 35. These policies were compared to an alternative program of term insurance plus a side fund accumulating at 5 percent after taxes. The mean age at which the side fund would equal the whole life face amount was 67. This means that even whole life purchasers who intend to keep their policies until death (and who are therefore not interested in cash values) could buy term instead and have the face amount of the whole life policy saved by age 67. Moreover, at that time, the number of dollars in the side fund will exceed the whole life surrender value (cash value) by an average of $11,088.

In addition to providing information that is at best marginally relevant to most prospective purchasers, the payment index enhances the chances for consumer confusion. The industry's own Joint Special Committee on Life Insurance Costs recognized this in recommending against the use of the payment index. The Committee observed:

> A second question has been whether the use of two methods might be desirable--one for persons desiring to appraise a life insurance policy in terms of its attractiveness if kept in force until maturity by death or endowment,

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> the other designed particularly for those who attach greater importance to the cash values it provides . . . Putting forward a choice of methods is tempting but unwise. To do so would inevitably complicate a subject that greatly needs to be kept straightforward.[67]

The former chairman of this committee, Mr. E.J. Moorhead, has indicated that introduction of this confusion element was not purely accidental, noting that the committee specifically recommended against inclusion of the payment index that is required by the NAIC model regulation.[68] Mr. Moorhead further stated:

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67 Special Committee Report, supra n. 49, at 20. The possibility of consumer confusion in providing both the surrender and payment indices was also graphically demonstrated by the second Purdue Study (see page 161, infra). As part of the comprehension quiz, the subjects who were given the NAIC disclosure system were asked the following true/false question:

> The Net Payment Cost Index helps you compare the cost of similar policies if at some future point in time you were to surrender each policy and take its cash value.

Only 36.6% of the subjects answered this true/false question correctly when they first took the quiz. The lowest percentage of correct answers for any of the other 20 questions was 73.2%. Even when the subjects retook the test with the Buyer's Guide before them only 67.6% of the subjects answered the question correctly.

68 See, Statement in Opposition, supra n. 59, at 1. In a statement before the Senate Committee on Veterans Affairs, submitted in June 1977, Mr. Moorhead observed:

> A company that sells an exorbitantly priced policy can continue to do so if it can display enough indexes so that at least one of that multitude can be stated to be competitively attractive.

Veteran's Hearings, supra n. 58, at 151.

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> The six-index system of the NAIC Model was never proposed by the Commissioners; it was adopted by them to satisfy companies desiring to sell non-participating whole life insurance. The pleas of those companies were, unwisely but understandably, supported by the American Council of Life Insurance.

Regardless of the merits of that controversy, we think that the NAIC model regulation would be substantially improved by the deletion of the payment index from the insurance cost comparison system.

b. Equivalent Level Annual Dividend

As noted above, the equivalent level annual dividend is a measure designed to demonstrate the role that illustrated dividends play in the calculation of the cost index of a participating policy. It is calculated by accumulating dividends at interest and then converting the result to a present value on a level annual basis. The resulting figure can then be added to the cost index for a participating policy to show how the cost index would increase if no dividends were paid.

Using the equivalent level annual dividend in this way highlights the fact that the values in a participating policy depend to some extent on the assumption that the illustrated dividends will in fact be paid. There is nothing conceptually wrong with this type of comparison. However, the difficulty with the equivalent level annual dividend as contained in the NAIC model is with the assumption made in the calculation that no dividends will in fact be paid. This is extremely unlikely to occur. To our knowledge there has never been a case where a participating policy which illustrated dividends has totally

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failed to pay any dividends. In fact, over the last twenty years the actual dividends paid on participating policies have been consistently higher than those illustrated at the time of issue.[69] While there are several reasons why actual dividends have exceeded illustrated dividends over the past twenty years, it is predominantly due to improvements in companies' investment earnings and mortality experience. Although investment earnings and mortality experience may not continue to improve in the future as they have in the past, there is also no reason to believe that, to any significant degree, companies will be unable to at least meet their current illustrated dividend scales. Further, there is certainly no reason to believe that companies will totally fail to pay any dividends. We agree with the Moss Subcommittee that the equivalent level annual dividend is potentially deceptive. As the Subcommittee's Report noted:

> We think, however, that the "level annual dividend" is a profoundly inappropriate way of describing the risk differences between par and non-par policies. The figure is well suited only for painting a lurid picture of improbable par company catastrophe, and bears no worthwhile relevance to a reasonable analysis of actual risk. Providing this figure will put a tool highly conducive to misleading use directly into the hands of the agents who have a strong incentive to employ it deceptively.[70]

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69 See, e.g., Best's Review 30 (December 1976).

70 Moss Subcommittee Report, supra n. 6, at 45. A similar opinion was expressed by E.J. Moorhead in a statement to the Senate Committee on Veterans Affairs:

(Footnote Continued)

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In rejecting the use of the equivalent level annual dividend we do not want to imply that the problems associated with the use of illustrated dividends in computing cost indices are not important or that consumers should not be aware of the advantage of guaranteed cost in non-participating policies.[71] The uncertainty of illustrated dividends makes any cost index of a participating products only approximate. The potential for problems in the area of illustrated dividends is likely to increase.

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70 (Footnote Continued)

> I deplore the NAIC adoption (at industry request) of the equivalent level dividend. In my opinion it is sufficient if the display for a participating policy simply states, as has long been required, that dividends are not estimates or guarantees but reflect only the company's current dividend scale. The purpose of the equivalent level dividend is to help non-participating life insurance to compete successfully with participating.

Veteran's Hearings, supra n. 58, at 150.

71 The buyer's guide should contain a clear explanation that illustrated dividends are not guaranteed. See, Appendix X. If such an explanation is provided, we see no reason why consumers can't compare the cost indices of participating and non-participating policies. The Society of Actuaries found in their 1974 report that based upon the policies they analyzed, dividends actually paid would have to fall 30% below illustrations before participating policies would have generally lower 20-year comparison indices than guaranteed cost policies. Actuaries Report, supra n. 33, at 131-132. They concluded". . . it would seem inappropriate to dismiss as a useless exercise the comparison of cost indices between otherwise comparable participating and guaranteed cost polices for fear that illustrative dividends may not be fully realized. There appears to be some room for actual dividends to fall short of those illustrated and still enable participating business to compete reasonably well with guaranteed cost." Id. at 132.

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If meaningful cost disclosure becomes widespread there will be pressure on participating companies to increase their illustrated dividends to appear more favorable on a cost index.[72] We recognize that this is a potential problem. However, we believe industry restraint and regulatory oversight are a more appropriate way to handle the problem of unrealistic illustrated dividends than inclusion of the potentially deceptive equivalent level annual dividend in a cost disclosure system.[73]

c. Duration Displays for Similar Policy Comparison Index

The NAIC model regulation requires that each of the cost comparison indices be displayed for the tenth and twentieth policy years. In our view, the tenth year index figures provide little meaningful information and should be eliminated. Indeed,

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72 In a 1975 report prepared by the Special Committee of the Society of Actuaries entitled "Dividend Illustration Philosophies" for the Life Insurance Cost Comparison (C3) Task Force of the NAIC, actuaries completed questionnaries relating to various aspects of illustrated dividends. A substantial majority (80%) of the actuaries who completed the questionnaire believe there will be increased company pressure on the actuary to produce more liberal dividend illustrations for new business if the consumer is to cost-shop and compare costs on some widely accepted basis mandated by law or regulation. Society of Actuaries Committee on Cost Comparison Methods and Related Issues, "Philosophies in the Computation and Dissemination of Dividend Illustrations" 52 (September 1974).

73 We note there is currently a considerable amount of interest within the actuarial profession and the NAIC with the problem of dividend illustrations. We hope this activity will continue and that the industry and regulatory authorities will be able to develop a standardized method of calculating illustrated dividends and adequately police their use to insure against abuse. See also discussion at pages 152-154, infra.

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as the Moss Subcommittee Report stated, "We do not see much use for cost indexes [of duration less than 20 years] except to illustrate the folly of purchasing a whole life policy for a short duration."[74]

The reasons for removal of the ten year displays are clear. The necessary holding period to make whole life a viable purchase almost always exceeds ten years. As shown in Part II the average ten year rate of return for $25,000 participating policies issued in 1977 was between minus 1.30 and plus 1.25 percent, and for non-participating polcies was between minus .61 and minus 3.86 percent. Accordingly, a person considering insurance for a ten year period is almost always better off buying term insurance.[75]

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74 Moss Subcommittee Report, supra n. 6, at 46.

75 A statement submitted by the Northwestern Mutual Life Insurance Company on a proposal by the Wisconsin Department of Insurance to require five-year index figures succinctly sums up the reason for not displaying index numbers of short duration. In remarks equally appropriate to a tenth year index, Northwestern Mutual stated:

> [F]ive year figures could point a buyer in a unintended direction. One should not consider the purchase of permanent life insurance for a five year duration. Therefore, if a prospective buyer isn't considering surrender after five years, a purchase decision likewise should not be made based on five year index figures. The buyer should not be cautioned indirectly about the high cost of early surrender of cash value life insurance through cost indexes; this should be explained directly in the Buyer's Guide.

Statement Concerning Proposed Life Insurance Solicitation Regulation, The Northwestern Mutual Life Insurance Company, submitted to the Wisconsin Department of Insurance, June 27, 1978, at 2-3.

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A related question is whether cost indices should be displayed for periods longer than 20 years. In rejecting later years displays, the NAIC task force concluded:

> [T]wenty years was about as far as projections of future events could be made while retaining any validity for cost comparison purposes. The principal areas of uncertainty are the applicability of dividends according to dividend scales currently in use and the accuracy of interest rates at which future costs are discounted. Also of concern to the task force was the relatively small proportion of life insurance policies that remain in force after twenty years and the possibility of unwarranted emphasis placed on information at these later durations. An additional factor in favor of a twenty year or shorter period is uncertainty as to the course of inflation and the purchasing power of dollars projected for delivery into the future.[76]

We agree with the NAIC that there is marginal value in displaying index numbers for greater than twenty years.[77]

In sum, we believe that the goal of a cost disclosure system --to help consumers find attractively priced insurance products-- may be frustrated by the inclusion of the payment index, equivalent level annual dividend and the tenth year duration display. While these figures may be of some use to the sophisticated buyer of insurance, their potential for misuse, combined with the confusion they will inevitably cause the average consumer, leads us to conclude that the NAIC model regulation would be

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76 Moss Subcommittee Hearings, supra n. 4, at 304.

77 As previously discussed, different considerations govern the years for which the average annual rate of return should be displayed. See, pages 125-126 supra.

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substantially improved by the deletion of these index numbers. In our view, meaningful similar policy comparison can be achieved by the use of a single index number (which recognizes the time value of money) displayed for the twentieth policy year. We now turn to a discussion of what method should be employed to provide this index number.

3. Selection of an Appropriate Index Number

Over the past several years a variety of index methods have been proposed for making similar policy comparisons.[78] In this report we limit our discussion of the appropriate method to the surrender index and the company retention index because most cost disclosure proposals employ one or the other of these two indices and they are representative of the two basic approaches of presenting comparative cost information.

The surrender index is the best known of what is termed the "event specific" or "snapshot" approach to similar policy comparison. This technique looks at a particular point in time and assumes a specific event will occur. For example, the 20th year surrender index will show the relative cost of two policies based on the assumption that they are surrendered for their cash values after the policies have been held for twenty years.

The company retention index is an example of the "group average" approach. This method looks at each policy year and,

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78 A description of the more important of these indices and the mathematical formulas used in computing them is found in Actuaries Report, supra n. 33. See also Special Committee Report, supra n. 49, at 9-19.

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through the use of average probabilities of lapse and surrender, determines the likelihood that any policy payment--premiums, dividends, cash value or death benefits--will be made. These "expected values" are combined into an index which can be described as a representation of the average cost of a policy to a group of similar policyholders. The most commonly used group average approach is the "company retention index" developed by Professor Joseph Belth of Indiana University.[79] The company retention index is essentially the present expected value[80] of all premiums, less the present expected value of all death benefits, policy dividends and cash values. To determine the "expected value" of the premiums, dividends, and death benefits, the amount paid is weighted by the probability that it will have to be paid; i.e., the probability that a person will not die during the year. Similarly, the "expected value" of the cash value in a given year is determined by the probability that a person will surrender or lapse a policy in that year.[81] The index is called

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79 Professor Belth describes the "company retention" method in, "The Relationship Between Benefits and Premiums in Life Insurance," 36 Journal of Risk and Insurance 19-39 (1969).

80 Present value refers to the fact that an interest rate is used to discount every future cash flow in the calculation (premiums, dividends, death benefits, and cash value) back to the present. For example, a $1.00 dividend to be received at the end of the year has a "present" (beginning of the year) value of about 95 cents. Thus, the company retention index, like the surrender index, incorporates the time value of money into the calculation, see page 128, supra.

81 The mortality and lapse probabilities used in the calculation are industrywide averages. They are contained in Appendix VI,
(Footnote Continued)

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"company retention" because it measures how much (in present value terms) policyholders on the average can expect the company to retain out of their premium payments for expenses and profits.[82]

We wish to stress at the outset our concurrence with the NAIC task force, which concluded that the choice between the surrender index and the company retention index should not be made solely on the basis of which index is technically the most accurate.[83] As previously discussed, the relative uncertainty of illustrated dividends makes any index applied to participating policies (the predominate form of ordinary life insurance), of necessity, only approximate. Moreover, all indices depend

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81 (Footnote Continued)

together with the mathematical formula used to calculate the company retention index.

82 The retention figure does not measure the actual amount a given insurer will retain from a given policyholder over the period selected for the evaluation. This is because it is calculated using industrywide average mortality and lapse rates that may bear little relation to the insurer's actual experience. As an average measure, however, it provides a good indication of the relative attractiveness of similar insurance policies, see discussion, page 146, infra.

83 The NAIC task force concluded:

> There is marked similarity of the messages conveyed by particular average and snapshot approaches. The conclusion is that the choice between these approaches should not be made on a hypothesis that one approach is more accurate than the other.

Report of the NAIC Life Insurance Cost Comparison Task Force, NAIC Proceedings - 1975, Vol. II at 426 (June 10, 1975).

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upon assumptions made in their calculation.[84] Therefore, no cost index can be totally accurate. A cost index should reveal if a policy is generally high-cost and guide the consumer to a policy or group of policies that are attractively priced. Both the surrender index and company retention index do this rather well. It is significant that there is a high degree of correlation between the rankings of policies by cost under the two approaches.[85]

We also share the NAIC's concern that, insofar as possible, a cost index be simple and understandable to consumers. In a statement submitted to the Moss Subcommittee, the NAIC gave the following reasons for basing its diclosure system on the interest-adjusted method:

> In general, these particulars led to the selection of the interest adjusted disclosure because it is simple and relatively inexpensive to produce, provided cost rankings for policies that are consistent with more complex methods such as the company retention index, and it provides useful information regarding policy benefits assuming certain specified events which the policyholder can easily relate to.[86]

We do not, however, find the fact that calculating the company

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84 The surrender index assumes an interest rate and that the policyholder will surrender the policy in the twentieth year. The company retention calculation requires an assumed interest rate plus assumed mortality and lapse probabilities.

85 See, e.g., Moorhead, The Manipulation Issue: Research Project 2 (NAIC 1975) at 4; Actuaries Report, supra n. 33, at 74-79.

86 Moss Subcommittee Hearings, supra n. 4, at 262.

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retention index is more complex than computing the surrender index to be a fatal flaw. As a practical matter both indices would be generated by company computers and supplied to agents.[87] We also note that it is not necessary for consumers to understand how cost indices are calculated in order to use them effectively.[88] As the Society of Actuaries observed:

> Few would disagree that, as a minimum, it is important that the consumer understand the purpose of any cost comparison index method and that he accept its results, perhaps on faith, as a means whereby his purchase decision can be assisted. The question of whether a consumer need understand the mathematical basis behind the calculation of such an index is more subject to debate. Precedents do exist wherein the consumer seems to accept on faith on index whose mathematical basis is not specifically defined or generally understood. For example, the general public has an "understanding" of the meaning of such indices as the Consumer Price Index or the Dow-Jones Industrial Average, although it may lack specific knowledge of the details involved in the actual calculation of the results themselves. It is possible that similar "understanding" of a life insurance cost comparison index

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87 We also do not see much difference in the cost of producing two indices. The necessary computer programming is relatively easy and the calculations are not complicated or costly.

88 It is perhaps also not crucial that agents understand the mathematical calculation behind the cost indices. See Actuaries Report, supra n. 33, at 39. Indeed, agents often express difficulty in fully understanding cost indices. For example, Mr. Joel Shapiro, an experienced life insurance agent and the chairman of the Committee of Federal Law and Legislation for the National Association of Life Underwriters, testified at the Subcommittee hearing: "I consider myself rather intelligent. I majored in insurance in college. I was a C.L.U. and I have a difficult time really understanding the various cost indices." Moss Subcommittee Hearings, supra n. 4, at 464.

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> method is achievable and is all that is necessary.[89]

We agree with the Society of Actuaries that a general understanding of the meaning of the index and how it is used is all that is necessary. Applying this standard we see little to differentiate the surrender index from company retention in terms of understandability to the consumer.[90]

However, in one area -- manipulation -- there appear to be significant differences between the surrender index and the company retention index.[91] In the view of some experts, the surrender index is highly susceptible to manipulation.[92]

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89 Actuaries Report, supra n. 33, at 40.

90 Some have argued that company retention is actually easier to understand than the surrender index. The Canadian Institute of Actuaries recommended the use of the company retention index. Canadian Institute of Actuaries, Second Report of the Committee on Cost Comparisons of Industrial Life Insurance Policies (November, 1976). It stated at page 2, "While the mathematics of the Interest-Adjusted methods is easier to comprehend than that of the Retention method, the concept of the Retention method is actually easier to understand."

91 "Manipulation" can be defined as the structuring of a policy's benefits (cash values, dividends, etc) or its premium structure to make the policy appear more attractive on a particular cost index then it actually is. Thus a company may be able to change the cash flows in a policy in a manner that dramatically reduces its apparent cost on a particular index without offering any increased value to the policyholder.

92 For example, Professor William Scheel has written that "Perhaps the most overwhelming deficiency of the I-A index . . .[the surrender index] is that it is subject to manipulation in much the same manner as the traditional net cost index . . . The window dresser has not been put out of business--he merely changes styles." Scheel, "A Critique of the Interest-Adjusted Net Cost Index," 40 Journal of Risk & Insurance 257-58 (1973).

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This is possible because the surrender index focuses on only one year -- the twentieth.[93] Thus a company can lower a policy's apparent cost on this index by either having a large increase in the twentieth year cash value or the twentieth year "terminal surrender dividend."[94] While such changes would increase the benefits a policyholder would receive if the policy was surrendered in the twentieth year, these increased benefits could be more than fully offset by reducing cash values or terminal dividends in some or all the years for which the index is not shown.[95]

There appears to be much less potential for manipulating the company retention index by altering the patterns of cash values and terminal dividends. This is because in calculating the index all major cash flows of the policy are considered for each year over the duration of the index, and each cash item is discounted for the time it might be paid and the probabilty that it will be paid.[96] Thus the company retention

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93 This argument applies with equal force to the NAIC proposal to include the tenth year index.

94 Terminal dividends are a special dividend paid only to surrendering policyholders.

95 See id. It should also be noted that since the average rate of return and the surrender index make use of the same data, the Linton Yield is subject to the same type of manipulation.

96 The Canadian Society of Actuaries, in recommending the company retention method as the single cost comparison index, noted that:

> The Company Retention Method is less subject to manipulation than the other methods proposed. For example, a steepening of the

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index effectively discourages highly selective increases in cash values and terminal dividends in the year the index is calculated which could falsely indicate that a non-competitive policy is competitive.[97]

Neither the company retention nor the surrender index provides any protection against the manipulation of illustrated dividend scales.[98] As noted earlier, it is impossible to be totally precise in forecasting future dividends.[99] The use of illustrated dividends in cost indices would create few problems if the actual dividends paid by companies differed from illustrated dividends by the same percentage. Unfortunately, this has not been the

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96 (Footnote Continued)

> cash values scale in new issues by moving from a single to a dual interest assumption does not have the drastic effect on policy rankings that it has under the Traditional or Interest-Adjusted net cost methods.

See First Report to the Council of the Canadian Institute of Actuaries From the Committee on Cost Comparisons (Chairman: J. Bruce McDonald), page 11 (unpublished).

97 While the company retention index is significantly less vulnerable to manipulation, it is not totally immune. See Moss Subcommittee Report, supra n. 6, at 42 n. 154.

98 All cost indices include the dividends illustrated at the time of sale in their calculations.

99 The amount a company has available to pay in dividends depends on a variety of factors including its investment earnings and mortality and lapse experience. Of these, the most important factor is the income the company earns on its reserves. Over the past ten years company expenses and mortality have moved in opposite directions and have generally offset each other. See Palmer, "Illustrated and Realized Dividends: An Empirical Analysis," 43 Journal of Risk and Insurance, 673 (1976).

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case in the past and is even less likely to be true in the future.[100] The basic problem is that more and more companies are computing dividends in a fashion that is both inconsistent with traditional practice and that make dividend illustrations inherently incomparable between companies employing these different "dividend philosophies." This problem was well expressed by Mr. James Reiskytl, an actuary for Northwestern Mutual, in a letter to the Chairman of the NAIC advisory committee on manipulation:

> Now, at the very time when consumerist pressures are focusing increasing attention on comparison shopping for life insurance, the comparability of dividend illustrations issued by the several companies is (we fear) rather dramatically declining.[101]

In particular, many companies appear to be adopting dividend philosophies that have the effect of favoring newer policyholders at the expense of the old.[102] The competitive advantage conferred on those companies might turn out to be specious from the new

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100 For example, Bruce Palmer has shown that over different 20-year periods the actual dividends paid by different companies have ranged between 70 percent and 160 percent of those illustrated at the time of sale. Id. at 673, 690.

101 Letter dated March 26, 1979 addressed to Mr. Julius Vogel, Senior Vice President and Chief Actuary, Prudential Life Insurance Company of America.

102 The major changes in dividend philosophies referred to above are the trend toward the use of "investment year" year methods to allocate dividends to particular classes of policyholders (as opposed to the more traditional "portfolio method") and the increasing use of terminal dividends. For a discussion of these and other aspects of dividend philosophies see J. Belth, "Distribution of Surplus to Individual Life Insurance Policy Owners," 45 J. Risk & Insurance 7-22 (1978).

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policyholder point of view and will, in any case, come in part at the expense of the holders of old policies.

There are presently few restrictions designed to prevent manipulation.[103] Effective control of this type of conduct can occur only through active policing by state regulators willing to commit the resources necessary to review policies for manipulation and remove from the market those policies that have in fact been manipulated. Regulation of the type of manipulation that the company retention index discourages (cash value and terminal dividend) is relatively easy to detect and is correspondingly difficult for company actuaries to explain.

Despite these serious concerns, we recommend retention of the surrender index as presently contained in the NAIC model regulation.[104] The major basis for our recommendation is the fact that this index is currently in fairly widespread use. The American Council of Life Insurance estimates that companies that sell over 50 percent of the life insurance business in the United States either now deliver, or will soon deliver, policy summaries with their policies that contain the surrender index.[105] In addition, the surrender index has been used for

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103 Minimum cash values are specified in every state by the minimum non-forfeiture laws. Since many companies provide cash values in excess of the minimum, however, the scope of cash value manipulation is only reduced, not eliminated, by the non-forfeiture laws.

104 As previously discussed, we urge that the tenth year duration be deleted.

105 Statement of Julius Vogel on behalf of the American Council
(Footnote Continued)

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a number of years to rank similar policies by major industry publications such as the National Underwriter and Best's Review. There has undoubtedly developed a fair amount of agent and consumer comprehension of the interest-adjusted concept embodied in the surrender index and some acceptance of its usefulness in comparing the cost of similar policies. This growing comprehension should not be lightly disregarded. Further, there would be a certain expense involved in the widespread adoption of use of the company retention index, although, as we have earlier stated, this expense would not be prohibitively large. Cost disclosure regulations should not needlessly interrupt the progress that has been made in the past nor should they unnecessarily add to company expense. These factors militate in favor of the continued use of the twentieth year surrender index. However, we reiterate that the index's utility can only be maintained by concerted efforts on the part of state regulators to guard against manipulation.[106]

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105 (Footnote Continued)

of Life Insurance, Moss Subcommittee Hearings, supra n. 4 , at 339.

106 If a state insurance commission does not have the resources necessary to police policies for manipulation, it should seriously consider adoption of the company retention index.

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4. The Need to Supply Comparative Cost Information

As noted in the preceding section, the surrender index provides a good way to compare the costs of similar life insurance policies. However, simply providing the twentieth year surrender index does not eliminate the difficulties facing the consumer searching for a low-cost policy. This is because the twentieth year surrender index, standing alone, has little intrinsic meaning.[107] For example, consumers may know that a particular policy has a surrender index of 6.21; but they have no way of knowing whether this means a policy is high or low cost relative to other policies on the market. Therefore, if the twentieth year surrender index is to be effective in comparison shopping, some form of gauge or "yardstick" is crucial. One way to provide this information is to include a range of surrender indices for a representative sample of different types of policies (of varying issue ages and face amounts) in the buyer's guide.[108] This range table will provide the prospective purchaser with a general basis for evaluating the cost of a particular policy relative to other similar policies. Although the tables will not contain every type of policy, issue age, and face amount of the policies on the market, it will--at the minimum--demonstrate the widely

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107 The company retention index suffers from this same problem.

108 This basic approach to providing yardstick information is contained in the buyer's guide required by the State of Wisconsin, a copy of which is contained in Appendix X. The FTC draft buyer's guide in Appendix X also contains an example of this type of yardstick.

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divergent cost of similar policies and the desirability of comparison shopping for life insurance.[109] The yardstick information in the buyer's guide should be supplemented with statements in the disclosure documents which emphasize the importance of comparing life insurance costs.

Another way of providing yardstick information that offers great promise is the recently implemented "Hotline" in the State of Wisconsin. This system provides a toll-free telephone service that consumers can call to find out whether the policy they are considering is high, average, or low cost compared to other similar policies offered for sale in that state.[110]

In the absence of a surrender index-yardstick approach, an alternative is the use of the Linton Yield to compare similar as well as dissimilar cash value insurance policies.[111] The advantage of the Linton Yield to compare similar cash value policies is that the rate of return it expresses has an indepen-

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109 It is hoped that consumers who are considering policies not displayed in the range tables will be encouraged to seek comparative information from a number of companies and in essence prepare their own range table.

110 The Wisconsin Department of Insurance conducted a survey to determine the range of surrender cost indices for various policies sold in that state. This information was supplied to the Center for Public Representation, a public interest law firm connected with the University of Wisconsin, which actually runs the telephone service.

111 The rankings of policy costs as determined by the twentieth-year surrender index and the twentieth-year Linton Yield are highly correlated. This is to be expected because the same information is used in calculating both indices.

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dent meaning to consumers.[112] The Massachusetts Division of Insurance has proposed a cost disclosure system that uses the Linton Yield to compare both similar and dissimilar policies.[113] The only indices required under the Massachusetts proposal are the 5th, 10th and 20th year Linton Yields.[114] Among the reasons for the choice of the Linton Yield was the fact that it has an independent meaning to consumers. Mr. James Hunt, who is head of the Massachusetts Rating Bureau, has compared the Linton Yield to the Annual Percentage Rate required under Truth-in-Lending:

> A better example of a simple and understandable cost comparison index is the Annual Percentage Rate (APR) under the Truth-in-Lending Act. Although the calculation of an APR is often highly complex, the statement of the calculation's result is not only simple, but it has meaning in and of itself and therefore is understandable. There is no compelling need to issue the buyer a yardstick with the disclosed APR so that he or she may tell whether the rate is high or low. An APR is disclosed in an environment of considerable bank and other institutional advertising of interest rates on deposits and other investments and of loan

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112 Even if the Linton Yield were used, it would be useful to have yardstick information to point out what were the range of rates of return for that type of policy. It would not, however, be essential as is the case if the surrender index is used.

113 It should be noted that this is only a partial solution since the average annual rate of return (Linton Yield) cannot be used to compare the cost of similar term policies. Therefore, if this alternative were adopted, it would be necessary to use the surrender index to compare term policies.

114 The Massachusetts' proposal was outlined in a May 9, 1979 letter from the Department of Insurance to the principal industry trade association. A copy of this letter is included in Appendix X. The letter announced preliminary guidelines for policy form filing under Massachusetts' "Easy to Read" law that would have required rate of return disclosure. As of this time, this requirement has not been finally adopted.

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> rates, as well as prominent press attention to frequent movements of the prime rate. Disclosure of an APR, then, comes with its own yardstick, or frame of reference, for the buyer. We should prefer this type of disclosure tool to any others.[115]

As previously discussed, the surrender index is widely used and is generally accepted within the industry and by agents as a legitimate way to compare the costs of similar life insurance policies. For this reason we recommend the use of the surrender index for similar policy comparisons if meaningful yardstick data is provided. If yardstick information is not provided, however, we recommend that the Linton Yield be used to compare both similar and dissimilar policies.

C. Recommendations Concerning Other Aspects of the NAIC Model Regulation

The previous sections have discussed the index numbers that should be contained in a cost disclosure system. The index numbers provided are only one part of a cost disclosure regulation. This section contains our recommendations concerning the modifications of the other aspects of the NAIC model regulation. It is divided into six parts:

1. Consumer research concerning the understandability of the NAIC disclosure system.
2. The timing of disclosure.
3. The information that should be contained on the disclosure statements in addition to index numbers.
4. Information that should be contained in a life insurance buyer's guide.

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115 J. Hunt, unpublished memorandum on cost disclosure, at 24-25.

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5. Coverage of the regulation.

6. Enforcement provisions.

1. Consumer Research Concerning the Understandability of the NAIC Disclosure System

In 1976, New Jersey adopted the NAIC model regulation. In 1978, the Federal Trade Commission contracted with Professor Roger Formisano of the University of Wisconsin to conduct a study to attempt to assess the effectiveness of the NAIC disclosure system in New Jersey.[116] This study, which was conducted with the cooperation of the New Jersey Department of Insurance, consisted of personal interviews with 194 people who had recently purchased insurance in New Jersey.[117] The interviews took place between February

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116 The Commission also contracted with Professor Jacob Jacoby of Purdue University to conduct two experimental studies designed to determine how a cost disclosure system can be made more understandable. The first Purdue study sought to determine what information consumers use when they purchase life insurance and the features that can be incorporated in a disclosure system to increase the use of cost information. The purpose of the second Purdue study was to compare the relative effectiveness, in an experimental setting, of several life insurance cost disclosure systems in helping consumers select appropriate life insurance policies. The disclosure systems tested were the NAIC model, a system developed by Professor Joseph Belth of Indiana University and several variants of a system prepared by the FTC staff for purposes of the experiment. These research studies will hereinafter be referred to as Purdue Study I and Purdue Study II. Some of the findings of these studies will be discussed in this section. A summary of the results is found in Appendix IX.

117 All of the subjects had purchased insurance from either Metropolitan Life Insurance Company or Prudential Insurance Company, the two largest insurance companies in the state of New Jersey.

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and May 1979. The results of this study raise serious questions concerning the effectiveness of the NAIC model regulation. The New Jersey study found that the majority of people did not look at the disclosure materials that were provided. Fifty-eight percent of the subjects could not remember receiving the buyer's guide and 32 percent did not remember receiving the policy summary. Of those who did recall receiving the buyer's guide, only 15 percent said they either read the guide closely or read parts closely, while 15 percent said they skimmed the booklet and 11 percent said they didn't look at the guide. Eighty-six percent of the subjects said that the guide had no influence on their purchase decision.

As part of the study the subjects were asked a series of 15 questions relating to basic knowledge about life insurance and how to use the index numbers provided on the policy summary. The results for five of these questions are set forth below:[118]

1. True or False: The lower a policy's cost index, the better buy it is.

X	True	7.2%
	False	39.7%
	Don't Know	53.1%

2. For a 35-year-old man, which policy will have a lower premium at first?

X	$25,000 renewable term policy	39.4%
	$25,000 whole life policy	17.6%
	Don't Know	43.0%

3. True or False: The Net Payment Cost Index helps you compare

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118 The correct answer is indicated by an X. Other results of the study will be discussed in later parts of this Section.

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the cost of similar policies if at some future point in time you were to surrender each policy and take its cash value.

	True	31.1%
X	False	4.7%
	Don't Know	64.2%

4. True or False: The best way to choose between a term policy and a whole life policy is to compare each policy's Surrender Cost Index and Net Payment Cost Index.

	True	27.8%
X	False	11.3%
	Don't Know	60.8%

5. True or False: The dividends of a participating policy are usually guaranteed.

	True	46.1%
X	False	22.3%
	Don't Know	31.6%

The New Jersey study showed that the test subjects who received the NAIC disclosure materials simply did not have the information essential to rational decision-making. The above questions and answers dramatically show, for example, that the test subjects who received these materials did not understand a basic distinction between a whole life and a renewable term policy and did not know a basic fact about participating policies. Even more significantly, the overwhelming majority of these subjects had fundamental misconceptions about the meaning of the cost indices that are the heart of the NAIC cost disclosure system.

The results of the New Jersey study are consistent with earlier studies that had been conducted concerning the comprehensibility of the NAIC buyer's guide. In March 1976, a survey research firm, Actionfacts, Inc., was commissioned by the Institute of Life Insurance (the predecessor of the American Council of

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Life Insurance) to test market the NAIC buyer's guide. The Actionfacts report was presented to the NAIC in May 1978. The report was based on 320 interviews in eight metropolitan areas. Though the subjects tested gave the NAIC buyer's guide high subjective ratings for understandability, most of them did very poorly on an objective test of the guide's key cost information section. For example, after reading the NAIC buyer's guide only 31 percent of the respondents knew to check a policy's index numbers to compare the cost of life insurance policies. In addition, 61 percent admitted not knowing how to use the index numbers at all, while only 21 percent knew that the lower a policy's index number, the lower its cost.[119] The report concluded, "The principal shortcoming of the booklet is the cost section, which was more the occasion of confusion than knowledge. It is clear that the cost section of the guide requires substantial revision."[120] The cost section of the guide has not been revised.

A study conducted by Prudential Insurance Company during the summer of 1976 produced even more disturbing results. In that study, Prudential distributed copies of the NAIC buyer's guide to its new policyholders in Georgia along with delivery of their policies, just as they are required to do under the

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119 Actionfacts, A Report on a Study of Consumer Reaction to and Comprehension of a Life Insurance Buyer's Guide 6 (1976).

120 Id. at 8.

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NAIC model regulation. There were a total of 413 subjects in the study. Prudential's researchers interviewed the purchasers a short time after they had received the buyer's guide. They found that only 63 percent of the policyholders even remembered getting a copy of the buyer's guide, and of those, 60 percent could not recall any of the topics contained in it.[121] Furthermore, 40 percent of those who did remember getting the guide did not look at it, while only 23 percent read all or most of it. Most disturbing of all, though 80 percent of those who read the guide claimed it was helpful, only 33 percent could explain the difference between term and whole life insurance and only 5 percent knew how to use the surrender index.[122]

The New Jersey, Actionfacts and Prudential studies, taken together, raise fundamental questions concerning the capacity of the NAIC disclosure system to convey even the most basic information about life insurance to most life insurance purchasers. Set forth below are suggested modifications in the NAIC model which we think may increase understandability and use.

2. Timing of Disclosure

The information provided by a disclosure system should be easy for a consumer to understand and use, and should be provided at a time when a consumer is trying to decide which, if any, policy to buy--not after that decision has been made.

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121 Public Affairs Department CORP, Impact Among Policyowners of the New Business Booklet 3, 13 (Prudential, 1976).

122 Id. at 11, 15, 21, 23.

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Under the NAIC model regulation, purchasers usually receive the disclosure package when the policy is delivered. This is generally a week to 10 days after purchase. If cost disclosure is to be effective, it must take place before the purchase decision. Once that decision has been made, the buyer becomes psychologically committed to it and is, therefore, very unlikely to read and use a disclosure package provided 10 days after purchase.[123] The NAIC model regulation grants the life insurance purchasers a ten-day "cooling-off" period in which to rescind their purchase if they did not receive a disclosure package before they bought the policy. While the NAIC's "cooling-off" period is important, it is no substitute for full mandatory disclosure at the time of sale.

Existing industry data indicates that very few consumers are likely to avail themselves of the NAIC "cooling-off" period granted after policy delivery. In 1977, the American Council of Life Insurance (ACLI) surveyed 22 large life insurance companies that allow their customers a 10-day "cooling-off" period. It found that of the approximately 5,000,000 new policies sold by those companies only about 1.4 percent were returned.[124]

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123 Both the New Jersey and Prudential studies found that the majority of purchasers did not look at the disclosure materials that were provided. See pages 162, 164, 165, supra.

124 One reason more people did not use the cooling-off period is that they may not have known of its existence, see page 175, infra.

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In a slightly different context, that of policy replacement, the ACLI has recognized the inadequacy of post-sale disclosure combined with a "cooling-off" period. The NAIC model replacement regulation is designed to give the company whose policy is being replaced by another insurance policy the right to convince their policyholder not to replace the policy. The regulation requires that the insurer who is attempting to replace the existing policy either (1) delay issuance of the policy until 20 days after notice of replacement is sent to the existing insurer, or (2) issue the policy immediately, but grant the policyholder a 20-day "cooling-off" period that the company whose policy is being replaced can use to attempt to get the policyholder to retract his decision. In a June 13, 1978 letter to the NAIC, the ACLI opposed the 20-day "cooling-off" period option on the following ground:

> Once a replacement sale has been consumated and the existing policy, insurer or agent have been discredited in the eyes of the policyholder, a reversal of that action will be extremely difficult, even if replacement is shown to be disadvantageous to the policyholder.125

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125 Reprinted in Moss Subcommittee Hearings, supra n. 4, at 409.

In testimony before the Moss Subcommittee, Mr. Julius Vogel, Vice President and Chief Actuary of Prudential Insurance Company, testifying on behalf of the ACLI, readily admitted that the industry has taken inconsistent positions on the timing of disclosure in initial sales and replacements.

> Mr. SHAFFER (Subcommittee counsel): My obvious question is, isn't this inconsistent with your position on timing for the model solicitation rule?
> Mr. VOGEL (ACLI): Yes, it is.

Id. at 410.

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There are practical difficulties in disclosing all of the information required by the NAIC model prior to sale. The NAIC model regulation requires a policy summary that contains two different types of information: six indices that can be used for similar policy cost comparison and basic information about the policy such as premiums, death benefits, cash values and dividends for the first five policy years and representative years thereafter. The industry arguments against pre-sale disclosure are directly related to the amount of information disclosed. They contend that it would be impossible for agents to have with them during the sales presentation schedules of cash values and dividends for every issue age and face amount for all policies the company issues. They further argue that because the required disclosure calls for agents to fill in over 20 numbers there is a substantial likelihood that agents will make errors in filling out the disclosure statements. Currently, most companies comply with the NAIC regulation by producing the policy summary at the home office, generally by computer, and delivering it with the policy after sale.

We recognize there are legitimate practical problems connected with disclosure before sale of all of the information called for by the NAIC model regulation, problems which stem from the amount of information that must be disclosed. We therefore recommend modifying the NAIC model to require a

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two-part disclosure.[126] The buyer's guide and a preliminary policy summary would be given prior to the time prospective purchasers are provided with an application for a policy. The preliminary policy summary would contain basic information such as policy type and size, premium, cost index and the rate of return. The preliminary policy summary contains only a limited amount of information essential to an informed purchase decision. It is not unreasonable to require agents to have all the information needed to fill out the preliminary policy summary with them during the sales presentation.

The second part of the disclosure would be a policy summary delivered with the policy. That summary requires, in addition to the information on the preliminary policy summary, detailed yearly information concerning the cash flow elements of the policy (premiums, illustrated dividends, death benefits and cash values). The basic information provided is essentially what is required by the NAIC model regulation.[127] This information is important and useful to the consumer. Because it is detailed, it may not be readily available to the agent during the sales presentation. It is appropriate, therefore, that the policy summary be delivered with the policy. The two-part

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126 A similar two-part disclosure is required by the cost disclosure regulation recently proposed by the Wisconsin Insurance Department. Wisc. Ins. Code, § 2.14. A copy of the Wisconsin cost disclosure regulation is contained in Appendix X.

127 The exact information required for different types of policies is set forth in the draft regulation in Appendix X.

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disclosure we recommend strikes an equitable balance between the consumer's right to have essential cost information prior to purchase and the burden on companies and agents to supply this information.[128]

3. The Information That Should Be Contained on the Disclosure Statements In Addition to the Index Numbers

The next section describes in more detail the information that should be contained in the two disclosures statements we recommend.

a. Preliminary Policy Summary

Three features that can be incorporated into the preliminary policy summary may substantially increase consumer understanding and use of the information provided. First, the preliminary policy summary should contain information designed to make clear to the consumer the benefit of using cost information. Judging from the results of the New Jersey and Prudential studies it is evident that many people simply

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128 The Moss Subcommittee recommended that a preliminary policy summary and buyer's guide be given prior to the time a prospect is asked to sign a policy application, and that the agent be prohibited from accepting a premium deposit when the application is signed. The agent would be required to prepare a "Final Policy Summary" that would be mailed to the consumer together with a premium billing notice. The notice would provide the customer with a minimum of 20 days to remit and would advise him that he is under no obligation to purchase the policy. Moss Subcommittee Report, supra n. 6, at 51. One concern with this approach is that it might unduly disrupt the sales process with few countervailing benefits to the consumer. We think consumers will have an adequate opportunity to comparison shop if they are given a preliminary policy summary prior to the application and are, in addition, granted a 10-day "cooling off" period after the delivery of the policy.

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did not look at the information provided to them. The preliminary policy summary should tell the consumers the importance of the cost information they are being given. An example of how this can be done is contained in the Wisconsin regulation which requires each preliminary policy summary to begin with the following statement:

> IMPORTANT: Many people think all life insurance policies cost about the same. They don't. The cost of similar policies varies sharply. You can save many hundreds or even thousands of dollars by choosing a low-cost policy. To find out how this particular policy ranks, compare its Cost Index (found below) to the range of cost indexes for similar policies. For further information on cost comparison and examples of the range of cost indexes for a number of policies, see pages 4-8 in the Wisconsin Buyer's Guide to Life Insurance which you should have received with this policy summary.[129]

The second feature we recommend incorporating in the preliminary policy summary is a brief explanation of the cost information provided and how it can be used.[130] Without some explanation, the indices on the preliminary policy summary will mean little to most consumers. Putting explanatory material

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129 A similar statement is contained in our draft disclosure materials in Appendix X. Purdue Study I indicated that providing consumers with information that highlights the importance of cost information may substantially increase consumers' use of cost information. See Appendix IX

130 The explanation of the surrender index should contain the statement "To find a low-cost policy, look at the policy's 20-year surrender index, not its premium." This warning is essential. As seen in Part III, many consumers equate cost with premium, yet premiums are a totally unreliable guide to the actual cost of a policy.

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on the preliminary policy summary will not only make the summary itself more self-contained, it should also stimulate interest in reading the buyer's guide.

Third, the precise format of the preliminary policy summary should be specified in the regulation. Format is almost as important as the substantive information being conveyed. If too much information is disclosed, or if companies disclose the information in a confusing format, the whole purpose of disclosure can be defeated. Under the NAIC model regulation, companies are free to disclose the information in any way they choose subject only to the general requirement that "All information required to be disclosed must be set out in such a manner as to not minimize or render any portion thereof obscure."[131] Most companies prepare the policy summary by computer. This often results in a presentation that is confusing and difficult for the consumer to use. An example of a typical computer-generated policy summary is set forth on the following page.

The draft regulation contains a standardized preliminary policy summary that can be used for both whole life and endowment policies and one that can be used for term insurance and term riders. If a cash value policy is sold with a term rider, a separate preliminary policy summary would be provided for the basic policy and each term rider.[132] For annuities and

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131 NAIC model regulation, Section 4(G)(11). See Appendix X.

132 See draft regulation, Appendix X.

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CONNECTICUT GENERAL LIFE INSURANCE COMPANY

HARTFORD, CONNECTICUT 06152

STATEMENT OF POLICY COST AND BENEFIT INFORMATION

THIS EXHIBIT PROVIDES BASIC INFORMATION ABOUT THE COST AND COVERAGE OF THE INSURANCE SUMMARIZED BELOW.
IT IS NOT AN OFFER TO CONTRACT FOR OR ALTER OR MODIFY ANY POLICY THAT MAY BE ISSUED

PREPARED FOR: POLICY NUMBER: 0 AGE 35 SEX M

COVERAGE DESCRIPTION

BASIC POLICY: ORDINARY LIFE FACE AMOUNT 25000 NON-PARTICIPATING

SUPPLEMENTARY BENEFITS (1) (2)
(3) (4)

POLICY YEAR	ANNUAL PREMIUM (INCLUDING POLICY FEE) BASIC POLICY	SUPPLEMENTARY BENEFITS (1)	(2)	(3)	GUARANTEED DEATH BENEFIT (BEGINNING OF POLICY YEAR) BASIC POLICY	SUPPLEMENTARY BENEFITS (1)	(2)	GUARANTEED CASH VALUE (END OF POLICY YEAR) BASIC POLICY	SUPPLEMENTARY BENEFITS (1)	(2)	ILLUSTRATED DIVIDENDS* (END OF POLICY YEAR) BASIC POLICY
1	413	0	0	0	25000	0	0	0	0	0	0
2	413	0	0	0	25000	0	0	0	0	0	0
3	413	0	0	0	25000	0	0	325	0	0	0
4	413	0	0	0	25000	0	0	725	0	0	0
5	413	0	0	0	25000	0	0	1125	0	0	0
10	413	0	0	0	25000	0	0	3225	0	0	0
20	413	0	0	0	25000	0	0	8550	0	0	0
AGE 65	413	0	0	0	25000	0	0	13050	0	0	0

POLICY LOAN INTEREST RATE (APPLIED IN ARREARS): 6 %

*DIVIDENDS USED HEREIN ARE BASED ON PRESENT SCHEDULES AND ARE NOT GUARANTEES FOR THE FUTURE. THEY REPRESENT A RETURN OF PART OF THE PREMIUM PAID AND ARE DEPENDENT ON INVESTMENT EARNINGS, MORTALITY EXPERIENCE, AND EXPENSE EXPERIENCE

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PREPARED FOR: POLICY NUMBER: 0

LIFE INSURANCE COST INDEXES AND EQUIVALENT LEVEL ANNUAL DIVIDEND*

THE INDEXES SHOWN BELOW PROVIDE A MEANS OF COMPARING THE RELATIVE COSTS OF PROTECTION UNDER POLICIES WHICH ARE SIMILAR BOTH AS TO PLAN AND AMOUNT OF INSURANCE. IN SUCH COMPARISONS, IF EVERYTHING ELSE IS EQUAL, THE POLICY WITH THE LOWER INDEX USUALLY REPRESENTS A BETTER VALUE.

IT IS IMPORTANT TO NOTE THAT THESE INDEXES DO NOT TAKE INTO ACCOUNT (1) THE VALUE OF THE SERVICES OF AN AGENT OR COMPANY, (2) THE RELATIVE STRENGTH AND REPUTATION OF THE COMPANY, AND (3) DIFFERENCES IN POLICY PROVISIONS.

AN EXPLANATION OF THE PROPER USE OF THESE INDEXES AND THE EQUIVALENT LEVEL ANNUAL DIVIDEND IS INCLUDED IN THE LIFE INSURANCE BUYER'S GUIDE.

PER $1,000 OF INSURANCE

	LIFE INSURANCE COST INDEXES@ @ 5.00 %						EQUIVALENT LEVEL ANNUAL DIVIDEND* @ 5.00 %
	SURRENDER COST INDEX			NET PAYMENT COST INDEX			
	BASIC POLICY	SUPPLEMENTARY BENEFITS (1)	(2)	BASIC POLICY	SUPPLEMENTARY BENEFITS (1)	(2)	BASIC POLICY
10TH YEAR	6.75	0.	0.	16.52	0.	0.	0.
20TH YEAR	6.67	0.	0.	16.52	0.	0.	0.

@ EXCLUDING OPTIONAL RIDERS WHICH ARE LIMITED TO BENEFITS SUCH AS ACCIDENTAL DEATH, DISABILITY WAIVER OF PREMIUM, PRELIMINARY TERM LIFE INSURANCE COVERAGE OF LESS THAN 12 MONTHS, GUARANTEED INSURABILITY BENEFITS AND POLICIES AND RIDERS COVERING MORE THAN ONE LIFE.

*DIVIDENDS USED HEREIN ARE BASED ON PRESENT SCHEDULES AND ARE NOT GUARANTEES FOR THE FUTURE. THEY REPRESENT A RETURN OF PART OF THE PREMIUM PAID AND ARE DEPENDENT ON INVESTMENT EARNING, MORTALITY EXPERIENCE AND EXPENSE EXPERIENCE

NAME OF AGENT

DATE THIS STATEMENT WAS PREPARED 06/05/79

ADDRESS OF AGENT

additional first year premium policies, the draft regulation specifies the basic information that must be disclosed and provides that preliminary policy summary forms must be approved by the State Insurance Commissioner.[133] It is desirable to provide for prior approval of these products rather than providing a specified form because of the wide variation in the types of products.[134]

b. Policy Summary

In addition to cost indices, the NAIC policy summary requires that premiums, death benefits, cash values and dividends be shown for the first five policy years and representative years thereafter. We agree with the NAIC that it is useful to provide this information.[135] There are two additional items of informa-

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133 See draft regulation, Appendix X.

134 The Moss Subcommittee report notes that the problem caused by policies that combine elements of cash value and term insurance and states it would be desirable to develop a single format that will be applicable to any life insurance policy or annuity. Moss Subcommittee Report, supra n. 6, at 56. The potential problems caused by a combined policy are adequately handled by requiring a separate preliminary policy summary for the cash value and term elements of such a policy. We agree with the Moss Subcommittee that a single uniform format for all insurance related products would theoretically be desirable. However, we doubt if it is possible to have a single format because the information a consumer needs to shop for different types of products is quite different. For example, renewal rights and the amount of renewal premiums are very important for term insurance, but not for cash value insurance or annuities. Similarly, the rate of return is critical in cash value insurance and annuities but has no relevance when term insurance is being considered.

135 The 1974 Society of Actuaries report stressed that ade-
(Footnote Continued)

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tion we recommend including in the policy summary.

First, the interest rate assessed policyholders for paying premiums other than annually should be disclosed. In 1976, 81 percent of ordinary life policies purchased were paid for on other than an annual basis.[136] A survey of 15 companies prepared for the Moss Subcommittee by Professor Joseph Belth shows that the interest rates assessed for periodic payments are significant and vary widely from company to company. For example, he found that the added cost of paying premiums monthly rather than annually ranged from 4.9 to 29.3 percent on an annual percentage rate basis.[137] There are conveniences to the consumer and expenses to the company if premiums are paid more frequently than annually. If consumers want to pay premiums on other than an annual basis, they should be informed of the cost of this convenience.[138]

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135 (Footnote Continued)

quate information disclosure must consist of both a method for comparing costs of competing policies and a method for disclosing the cash flow elements and benefits of a particular life insurance contract as it relates to the individual purchaser. The cash flows of a policy are defined by the Society for this purpose as "the actual transfer of funds between the policyholder and the insurance company, in either direction, and includes premiums, dividends, cash values and death benefits." Actuaries Report, supra n. 33, at 6.

136 Moss Subcommittee, Report, supra n. 6, at 49.

137 Moss Subcommittee Hearings, supra n. 4, at 179.

138 On a $50,000 policy with a premium of $700 a year, if the company charges 15 percent for paying premiums monthly, the consumer will pay an additonal $48.80 a year. If the (Footnote Continued)

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Second, the policy summary should contain information concerning the existence of, and how to exercise, the 10-day "cooling-off" period.[139] The "cooling-off" period is an important component of the NAIC model regulation. If consumers are to make effective use of this right, they must know of its existence.[140]

4. The Buyer's Guide

The NAIC model regulation requires that a standardized buyer's guide be given purchasers along with the policy summary. The NAIC buyer's guide is a short booklet describing the types of insurance available and how to use the cost indices provided on the policy summary. This section contains our recommendation concerning how to modify the NAIC buyer's guide.[141]

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138 (Footnote Continued)

amount were invested each year at 5 percent (after taxes) it would amount to approximately $1,680 at the end of 20 years.

139 This same information should be contained in the buyer's guide. See Appendix X.

140 The New Jersey study provided graphic evidence why this provision is needed. It was found that only 10 percent of purchasers knew that the New Jersey cost disclosure regulation granted a 10-day cooling-off period. Another 10 percent thought they had a 5-day cooling-off period, while 24 percent thought they had 30 days, 3 percent thought the period was 60 days and 55 percent answered they did not know what "cooling-off" rights they were granted under New Jersey law.

141 At various points in this report we have made recommendations concerning the information that should be contained in a buyer's guide, see page 121 n. 36, supra. These recommendations will not be repeated here.

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One of the most important decisions consumers have to make is whether to base their insurance program on primarily term or whole life insurance. Other than providing a brief narrative description of the difference between term and whole life insurance, the NAIC buyer's guide contains little to help the consumer make this decision.[142] We recommend the following changes to assist consumers in making the term/whole life decision.

1. The NAIC buyer's guide does not mention group insurance.

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142 None of the NAIC index numbers are relevant to the term/whole life decision, see pages 99-106, supra. To help the consumer choose between term and whole life the NAIC system relies solely on the narrative information in the Buyer's Guide. Moss Subcommittee Report, supra n. 6, at 59. The Moss Subcommittee found this information to be inadequate:

> The 'narrative explanation' referred to is a short, general description of the differences between term and whole life. It fails altogether to explain the significance of even the most fundamental aspects of the term-whole life choice. The NAIC rule neither provides rate of return data nor even mentions the concept. Instead, the NAIC adopts the position of non-disclosure that has been advanced by insurers for years to avoid revealing the information that would enable consumers to make a meaningful decision. The NAIC thus finds itself endorsing irrelevant and unpersuasive arguments devised by insurers to protect their economic position as financial intermediaries.
>
> We would have expected to find the NAIC employing its influence to dissipate the wholly unnecssary confusion that surrounds the term-whole life controversy. Regrettably, we find the NAIC at the forefront of efforts to perpetuate it.

Id.

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Almost one-half of the insurance currently in force is group insurance.[143] For many people, group insurance can provide a relatively inexpensive way to provide for their basic insurance needs.[144] Group insurance should be discussed in the buyer's guide.

2. The NAIC buyer's guide states that, "term insurance generally provides the largest immediate death protection for your premium dollar." The guide should point out that for many families, especially those with modest incomes and small children, the only way they can meet their basic insurance needs is by buying primarily term insurance. It would also be useful to give a specific illustration of how much more term insurance per premium dollar a person can buy at younger years.

3. The industry often distinguishes between term and whole life insurance on the grounds that term insurance is designed for temporary needs while whole life insurance is for the person who wants insurance for their entire life.[145] The buyer's

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143 See page 12, n. 29 supra.

144 In addition to pointing out the potential advantages of group insurance, the buyer's guide should list the drawbacks, one of which is that the amount of coverage available under a group policy is often limited and a person may lose his group coverage if he changes employment.

145 An example of this is contained in a recent brochure put out by the National Association of Life Underwriters (NALU). With regard to term insurance, they state, "term insurance has an important purpose. But, remember, a term policy gives temporary protection only. It's like renting instead of buying." This is in contrast to the description of whole life insurance, "chances are if you bought permanent life insurance, it was in answer to permanent needs. If
(Footnote Continued)

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guide should point out that renewable term insurance can be used to meet long term insurance needs, at least through age 65. A 25-year old person who buys renewable term insurance and holds it until age 65 will have had protection for 40 years. It is hard to say this is temporary insurance coverage. The guide should also point out that term insurance premiums become very high after age 65, and if a person wants a life insurance policy in force after age 65 he should probably should buy whole life.[146]

4. The NAIC buyer's guide describes three types of insurance--term, whole life, and endowment. For many people the best insurance program is a combination of term and cash value insurance. The buyer's guide should note this and discuss the ways these basic types of insurance can be combined (for example, through the purchase of a whole life policy with a term rider attached).

5. As discussed throughout the report, the savings element is an integral part of cash value insurance. The only mention of the savings feature of whole life insurance in the NAIC

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145 (Footnote Continued)

those needs have not changed, then you still need the permanent protection. . . .Thus, if life insurance protection is required for relatively long periods, whole life insurance is the least expensive form of individual life insurance policy." This booklet is reprinted in Moss Subcommittee Hearings, supra n. 4, at 752-64.

146 We repeat the points made earlier that all insurance is expensive after age 65 and that whole life insurance and term insurance plus a side fund are equally legitimate ways to provide protection at any age. See pages 136-37, supra.

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buyer's guide is a description of cash values and the fact a person can either borrow against them or receive them by surrendering the policy. We recommend that the explanation of the savings element of cash value insurance be expanded to include a statement that whole life insurance can be viewed as a combination of death protection and savings, with the size of the protection element decreasing over time as cash values increase. Additionally, it should include a description of how to use the rate of return.[147]

5. Coverage of the Regulation

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147 This description should include i) a discussion of the unique characteristics of whole life that may make a relatively low yield acceptable (see page 120, supra), ii) the YRT rates used in the rate of return calculation (see page 121, supra), and iii) a description of the tax advantages of life insurance (see page 29, supra). The buyer's guide should also contain information on how to use the surrender index to compare similar policies. It should provide an example of how much a person can save by buying a low as opposed to a high-cost policy. It should also inform the consumer that small differences in the cost of similar policies may be offset by other policy features. See draft guide, Appendix X. The NAIC buyer's guide contains a statement that small differences in index numbers should be ignored and may be offset by other policy features. It does not, however, say what a small difference is. It would be extremely useful if the buyer's guide contained some concrete indication of what is a small difference. Mr. E. J. Moorhead has suggested that the figures be 50 cents per thousand. Statement before Senate Veterans Committee, supra n. 58, at 151. We think the use of this figure is appropriate and it is contained in the draft buyer's guide.

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The NAIC model regulations totally exclude group insurance and group annuity products.[148] The regulation we propose only excludes these products if at least a portion of the cost is borne by a person other than the person insured or his beneficiaries.[149] It can be argued that cost disclosure is not necessary where employers who are paying part of the premium can be relied upon to search for an attractively priced product. In other group sales, however, this protection is not available. Therefore, it is appropriate to require cost disclosure for group products if the insured bears the total cost.

The NAIC model regulations do not apply to "life insurance policies issued in connection with pensions and welfare plans as defined by, and which are subject to, the Federal Employees Retirement Income Security Act of 1974 (ERISA).[150] We recommend dropping this exclusion. Individual life insurance and annuity products are often sold to fund Individual Retirement Accounts (IRAs), H.R. 10 (Keogh Plans) and small pension plans established under ERISA. The need to provide meaningful cost disclosure in this area is as great as in the individual market. The need to provide rate of return information is especially strong because the insurance and annuity products sold to plans under

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148 NAIC model regulation, Section 3(b). See Appendix X.

149 This modification of the NAIC model regulation is contained in a cost disclosure regulation recently proposed by the Maryland Department of Insurance.

150 NAIC model regulation, Section 3(B)(4). See Appendix X.

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ERISA are primariliy designed to provide retirement income. Currently, neither the Department of Labor nor the Internal Revenue Service, the agencies having the responsibility to administer ERISA, require rate of return disclosure on insurance or annuity products.[151]

We also recommend that purchasers of small face amount policies, including industrial insurance, be given the same disclosure materials as purchasers of larger policies. Although the NAIC did not exempt small policies from the scope of its model,[152] several states have excluded small policies from their disclosure requirements. There is little reason for exempting such policies. They are often purchased by lower income persons who may know even less about the true costs of an insurance policy than purchasers of larger policies. We note that substantial consumer problems peculiar to the small policy market, particularly for debit insurance, have been revealed in recent years. A principal criticism which has been leveled against many of these policies is that their cost is abnormally high compared to larger ordinary policies. Purchasers of small policies should have the right

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151 ERISA preempts state insurance regulation in certain areas. The recent decision in Wadsworth v. Whaland, 562 F.2d 70 (1st Cir. 1977), indicates, however, that ERISA would not preempt a state cost disclosure regulation which applies to insurance company products sold to fund pension and welfare plans.

152 The NAIC Model Life Insurance Solicitation Regulation permits insurers to omit some information from the policy summary on polcies whose Equivalent Level Death Beneift is less than $5000. However, the cost indices must be provided. Our draft regulation contains no such exemption.

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to find out how their insurance investments compare with other policies and other savings media.[153]

6. Enforcement Provisions

The NAIC model regulation requires each company to maintain a file of one copy of each document authorized by the insurer for use pursuant to the model regulation.[154] This provision will be useful in determining whether authorized company forms comply with the regulation and is included in the draft regulation. This provision is of limited use, however, in determining whether an insurer and its agents are actually complying with the regulation. It will now show whether the forms actually used comply or whether the forms are correctly filled out.

The draft regulation contains an alternative provision that a state may wish to consider in lieu of NAIC, Section 6(A). This alternative provision requires insurers to maintain copies of the preliminary policy summary and policy summary for each policy they issue. This information will enable insurance departments to determine easily whether insurers and agents are fully complying with the regulation. This information will also enable companies to determine whether their agents are complying with the regulation. The preliminary policy summary will be filled out by the agent during the sales presentation. If the company has a copy of

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153 On the question of whether small policies should be exempt from disclosure, Spencer Kimball has concluded that the arguments favoring exemption are unpersuasive. He observed that, "...the low or moderate income consumer who purchases a small policy is the very person who most needs price disclosure information, to get the most from his limited resources." Kimball and Rapaport, supra n. 25, at 1047.

154 NAIC model regulation, Section 6(A). See Appendix X.

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the policy summary, it can easily check it against the policy summary it provides to the consumer and thus determine if the information on the preliminary policy summary is correct.

The drawback of the alternative provision is that it would, to an extent, increase company cost in complying the regulation. There would be a certain cost involved for companies to retain the required disclosure statement in the customer's file. This small additional cost should be weighed against the possibility of violations of the regulation and the saving in enforcement costs which would result from the adoption of the alternative enforcement provision.

Other enforcement mechanisms should also be considered that might make the regulation more self-enforcing. One method would be to permit the purchaser to return the policy and obtain a full refund within fourteen months after the policy is delivered if the disclosure requirements are not fully complied with. A provision of this type would give companies a substantial incentive to take all necessary steps to ensure that they fully comply with the regulation. It would substantially reduce the need for an insurance department to commit resources to enforce the regulation.

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To summarize briefly. The life insurance industry is a major repository of consumer savings, holding over $140 billion in 1977. Yet in 1977, the industry paid its policyholders less than 2% on their savings in a year when the rate of inflation was around 10% and in which all other savings institutions were paying higher rates. Life insurance companies paying 2% after 20 years compete successfully against companies paying 5%. Penalties for early withdrawals are remarkably severe but unannounced. We recommend that the life insurance industry be required to disclose the rate of return and several other items of information to their policyholders in a simple and effective manner. Price competition can only be effective when some significant fraction of the market is able to compare prices, and this is what the disclosure system is designed to do.

We note that the call for life insurance cost disclosure is not new. In 1908, the Wisconsin Commissioner of Insurance wrote:

> There is a point where the benefits of insurance are outweighed by the expense. Either the policyholder should be enabled intelligently to determine for himself what that point is or the state should at least prescribe a maximum limit. The recent investigation committee recommended that every policy issued should state in dollars and cents for each year during the possible history of the policy, the amount provided for expenses, the amount provided for death claims, and the amount held to the credit of the policyholder as a reserve. With these facts before him, the proposed policyholder would have something on which to determine whether or not the contract was one he wanted.

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> He would also have something definite by which he could judge how the management afterward administered its trust as to his money.
>
> When the recommendation was suggested in the hearings of the committee, it met with the answer that the prospective policyholder would not take the insurance if he knew what he was paying for expense. Company managements admitted that they were writing forms of policies which men ought not to take because the expense provisions far outweighed the benefits and which they would not take if they knew what the expense provisions really were. It would seem as if there could be no question that the present and prospective policyholder is entitled to have all the facts with regard to his policy in such form that he can understand them and be able to compare the expense and the insurance benefit. Yet so novel was the proposition to give the policyholder a chance to protect himself and so strenuous were the objections to the plan on the part of the companies, even during the hearings by the investigation committee, that the committee felt that it would be difficult to secure its immediate adoption. The opposition of the companies was continued in the hearings before the committees of the legislature at the session of 1907 and the recommendation was defeated." (1908 Annual Report, Wisconsin Commissioner of Insurance).

Due to inflation the need for meaningful cost disclosure has never been greater. We note with encouragement that the insurance departments of Massachusetts, North Carolina and Wisconsin have attempted to enact cost disclosure systems responsive to the problems addressed in this report and hope that other insurance commissions will follow the lead of these states. We think that the reaction of other state regulators to the problem of life insurance cost disclosure in the year ahead will be a very good measure of the adequacy of state regulation of insurance.

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APPENDIX I: BACKGROUND STATISTICS ON THE LIFE INSURANCE INDUSTRY

I. Introduction

This appendix describes the major features of the life insurance market and attempts to place ordinary insurance--the focus of the report--in context. The first part will discuss the size, concentration and profitability of the industry. The second part will compare ordinary insurance to group, industrial and credit insurance.

II The Life Insurance Market

A. Size. The life insurance market is enormous by any measure. The average amount of life insurance in force per family increased from $17,000 in 1967 to $26,500 in 1974 and to $32,400 in 1977.[1] In total, the amount of life insurance in force in 1977 exceeded $2,582 billion.[2] In that same year, Americans purchased $367 billion in new life insurance[3] and received a total of $26.5 billion in payments, including $10.2 billion in death payments as shown in Table I-1 below.

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1 American Council of Life Insurance, Life Insurance Fact Book 24 (1978) [Hereinafter cited as Fact Book].

2 Id. at 18.

3 Id. at 11.

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Table I-1[4]

Life Insurance Benefit Payments in the United States (000 Omitted)

Year	Death Payments	Matured Endowments	Disability Payments	Annuity Payments	Surrender Values	Policy Dividends	Total
1940	$ 995,000	$ 269,200	$103,500	$ 176,500	$ 652,000	$ 468,100	$ 2,664,300
1945	1,279,600	406,700	87,600	216,400	210,900	466,100	2,667,300
1950	1,589,700	495,100	99,600	319,400	592,300	634,600	3,730,700
1955	2,240,700	613,900	110,000	462,300	895,900	1,059,900	5,382,700
1960	3,346,100	673,100	123,800	722,000	1,633,400	1,620,100	8,118,500
1965	4,831,400	931,100	163,000	1,038,900	1,932,300	2,519,900	11,416,600
1966	5,218,200	981,600	169,300	1,152,600	2,120,600	2,699,900	12,342,200
1967	5,665,300	1,017,100	174,600	1,261,300	2,243,100	2,932,200	13,293,600
1968	6,209,300	967,200	195,600	1,401,000	2,456,400	3,155,500	14,385,000
1969	6,758,100	952,600	204,700	1,558,600	2,721,600	3,328,900	15,524,500
1970	7,017,300	978,300	232,900	1,757,100	2,886,400	3,577,400	16,449,400
1971	7,423,300	990,200	256,800	1,944,400	2,881,600	3,680,900	17,177,200
1972	8,007,000	1,000,400	271,200	2,213,200	3,027,400	4,054,900	18,574,100
1973	8,572,000	1,025,600	316,600	2,597,900	3,417,800	4,382,900	20,312,800
1974	8,885,100	991,400	374,500	2,904,300	3,641,700	4,655,300	21,452,300
1975	9,192,100	946,300	426,000	3,176,800	3,763,200	5,031,800	22,536,200
1976	9,593,300	976,200	458,000	3,879,900	4,147,600	5,556,200	24,611,200
1977	10,195,700	931,700	495,000	4,617,500	4,308,900	5,913,200	26,462,000

Source: American Council of Life Insurance. Figures represent benefit payments under original policy contracts, including benefits that are left with the companies for future payment under supplementary contracts, but excluding payments from existing supplementary contracts. See page 47 for supplementary contract payments and page 48 for health insurance benefits paid by life companies.

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4 Id. at 39.

The significance of the life insurance industry is also evident in the awesome size of its holdings. The assets of U.S. life insurance companies totaled $351.7 billion at the end of 1977, an increase of 9.4 percent over the previous high of $321.5 billion in 1976.[5] Those assets, consisting largely of financial instruments, have been an important source of investment capital in the American economy, totalling $29.2 billion of net investments in U.S. capital markets in 1977. In 1977, life insurance ranked 5th among the major domestic institutional sources of capital, providing 8 percent of the total monies flowing into U.S. financial markets.[6]

B. Concentration. An estimated 1,750 legal reserve life insurance companies were in business at the end of 1977.[7] With the exception of Alaska, at least two insurance companies are domiciled in every state.[8] This number has grown steadily from the early 1800's to the 1960's and since then has hovered about 1,750:

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5 Id. at 68, 69.

6 Id. at 68.

7 Id. at 89.

8 Id. at 89-90.

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Table I-2[9]

Number of U.S. Life Insurance Companies

Year	Number	Year	Number	Year	Number
1759	1	1900	84	1963	1,488
1760	1	1905	126	1964	1,547
1770	2	1910	284	1965	1,629
1780	2	1915	295	1966	1,704
1790	3	1920	335	1967	1,715
1800	4	1925	379	1968	1,763
1810	2	1930	438	1969	1,773
1820	6	1935	373	1970	1,780
1830	9	1940	444	1971	1,765
1840	15	1945	473	1972	1,753
1850	48	1950	649	1973	1,766
1860	43	1955	1,107	1974	1,757
1870	129	1960	1,441	1975	1,746
1880	59	1961	1,448	1976	1,742
1890	60	1962	1,469	1977	1,750

Note: The figure for 1976 is revised. The figure for 1977 is preliminary.
Sources: Marketing Life Insurance *(J. Owen Stalson), American Council of Life Insurance,* and Best's Review.

9 Id. at 90.

It should be noted, however, that this 1750 figure may be misleading because some of these reserve companies are wholly owned by one holding company. For example, American General of Houston, Texas wholly owns eleven insurance subsidiaries.[10]

Furthermore, although there are numerous legal reserve insurance companies, most of the assets and insurance in force are concentrated in a relatively few companies. The Hart Hearings found:

> At the end of 1968, the two largest life insurance companies (by admitted assets) accounted for about 28% of the industry's admitted assets, the four largest about 40%, the eight largest (Prudential, Metropolitan Life, Equitable of New York, New York Life, John Hancock, Aetna Life, Northwestern Mutual, and Connecticut General) about 54%, the twenty-five largest about 74%, and the fifty largest [accounted for] about 84% [of the industry's admitted assets].[11]

Likewise, a 1972 article in the Journal of Risk and Insurance stated that the top 20 life insurance companies in the United States, according to admitted assets, accounted for 70.69 percent of the total assets in the life insurance industry, while those 20 companies also held 58.05 percent of the industry's total surplus and dividends in 1969. In that group of top companies as of 1968, the top 4 companies had 34.20 percent of ordinary life insurance in force, the top 8 held 44.65 percent of ordinary

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10 Best's Insurance Reports, Life & Health 98 (1978).

11 J. Belth and W. Maxwell, "The State of Competition in the Life Insurance Industry," 15 Antitrust Bull. 213 (1970).

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life insurance in force, and the top 20 together held 60.79 percent of all the ordinary life insurance in force.[12]

Table I-3

Life-Health Insurance Concentration Ratios, 1976

Base	Concentration ratios 4-Firm	8-Firm	20-Firm
Total premiums	28.9	43.2	58.2
Assets	36.9	50.3	68.2
Life insurance issued	25.9	36.7	54.8
Life insurance in force	31.2	44.1	59.5
Health insurance premiums*	27.2	42.7	61.4
Credit life insurance issued	23.8	33.3	50.8

* Excludes health insurance premium of property-liability insurance companies.

Sources: Universe data (except for credit life insurance) from American Council of Life Insurance, Life Insurance Fact Book (1977), p.7. Company data from Best's Review, Life-Health Edition, August, 1977 (p. 35) June, 1977 (p.42), September, 1977 (p. 41) and October, 1977 (p. 39).

The concentration among the large firms may not, however, be cause for concern. First, when compared to other markets, the concentration ratio for the life and health insurance industries are low to moderate (Table I-3).

12 J. Cummins, H. Denenberg, and W. Scheel, "Concentration in the U.S. Life Insurance Industry," 34 J. of Risk and Insurance 177, 184 (June 1972).

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Second, entry restrictions are few. The only significant restrictions in the life-health insurance sector result from state regulation. New York, the state with the strictest standards, requires minimum paid-in capital of $1 million, minimum surplus of $2 million or twice the amount of paid-in capital (whichever is greater), and minimum reserves of $1 million, minimum surplus of $2 million or twice the amount of paid-in capital (whichever is greater), and minimum reserves of $1 million.[13] Similarly, recent studies of scale economies in the U.S. and Canadian life insurance industry show slight returns to scale. Firms with the lowest output levels had average costs about 25 percent above those of the largest firms. However, the small firms accounted for a small percentage of industry output and, at least in the Canadian industry, such firms are shielded by favorable tax treatments.[14] In short, there appears to be a limited capital requirement entry barrier.

The absence of significant barriers to entry is borne out by the existing evidence. Table I-4 shows the large number of legal reserve life insurance companies doing business in the United States from 1950 through 1977 and the frequency of entry and exit of such companies. The great majority of the companies added through the years were new firms (others had converted

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13 U.S. Securities and Exchange Commission, Institutional Investor Study Report 509 (1971).

14 Randall Geehan, "Returns to Scale in the Life Insurance Industry," 8 Bell Journal of Economics 497 (1977).

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from fraternal insurers or had been formed by consolidation of existing firms). Most companies that discontinued operations either merged with other insurers or had their outstanding business reinsured.[15]

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15 Fact Book, supra n. 1, at 89.

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Table I-4[16]

Change in Number of U.S. Life Insurance Companies in Business in the United States

Year	In Business Start of Year			New Operations	Discontinued	In Business Year-End			Net Changes During Year	
	Stock	Mutual	Total			Stock	Mutual	Total		
1950	478	133	611	44	6	507	142	649	+	38
1951	507	142	649	50	20	531	148	679	+	30
1952	531	148	679	62	11	567	163	730	+	51
1953	567	163	730	117	15	661	171	832	+	102
1954	661	171	832	115	30	753	164	917	+	85
1955	753	164	917	216	26	942	165	1,107	+	190
1956	942	165	1,107	133	49	1,035	156	1,191	+	84
1957	1,035	156	1,191	120	38	1,119	154	1,273	+	82
1958	1,119	154	1,273	142	50	1,212	153	1,365	+	92
1959*	1,212	153	1,365	125	65	1,273	152	1,425	+	60
1960	1,273	152	1,425	96	80	1,286	155	1,441	+	16
1961	1,286	155	1,441	87	80	1,292	156	1,448	+	7
1962	1,292	156	1,448	101	80	1,312	157	1,469	+	21
1963	1,312	157	1,469	86	67	1,332	156	1,488	+	19
1964	1,332	156	1,488	131	72	1,393	154	1,547	+	59
1965	1,393	154	1,547	149	67	1,475	154	1,629	+	82
1966	1,475	154	1,629	156	81	1,550	154	1,704	+	75
1967	1,550	154	1,704	90	79	1,561	154	1,715	+	11
1968	1,561	154	1,715	112	64	1,608	155	1,763	+	48
1969	1,608	155	1,763	74	64	1,619	154	1,773	+	10
1970	1,619	154	1,773	73	66	1,627	153	1,780	+	7
1971	1,627	153	1,780	49	64	1,612	153	1,765	—	15
1972	1,612	153	1,765	76	88	1,603	150	1,753	—	12
1973	1,603	150	1,753	75	62	1,619	147	1,766	+	13
1974	1,619	147	1,766	73	82	1,612	145	1,757	—	9
1975	1,612	145	1,757	63	74	1,603	143	1,746	—	11
1976	1,603	143	1,746	85	89	1,601	141	1,742	—	4
1977	1,601	141	1,742	N.A.	N.A.	N.A.	N.A.	1,750		N.A.

Note: Data for 1976 are revised. The figure for year-end 1977 is preliminary. A change in domicile is reflected in both new and discontinued operations.

N.A.—Not available.

*Includes seven companies domiciled in Alaska and Hawaii which were started in earlier years.

Source. American Council of Life Insurance.

16 Id. at 91.

C. Profitability. Current evidence does not permit any firm conclusions about profitability. Although there is an extensive literature on profitability in the property-liability insurance industry, little has been published on life insurance profitability. Profitability in the life insurance industry is more difficult to measure. Moreover, since its pricing is unregulated, there may have been less immediate need for profit studies. However, recent concern about the workability of competition in the life insurance industry and recent availability of financial statements for stock life insurance comparable to those of companies in other industries has prompted some research. 17/ At this point, the evidence does not indicate that life insurance companies are making massive profits. The companies did earn about 7 percent on their investments, before federal taxes, in 1977. The available facts do not support the conclusion that the differential between what the companies earn and pay out results in very high profits. Most of the differential is absorbed by high home office expenses, sales commissions to agents and federal and state taxes. Since entry into the life insurance industry appears to be easy, 18/ and there has been a

17/ See, e.g., Pritchett and Wilder, "A Comparative Study of Stock Life Insurer Profitability: Implications for Workable Competition," S.S. Huebner Foundation for Insurance Education, Wharton School, University of Pennsylvania. See Part I at n. 42.

18/ For example, the minimum capital requirement for life insurance company licensed in Arkansas was $37,500, a sum that some people in the Washington, D.C. area would consider to be more like a down payment on a house than the capital upon which to found a life insurance company.

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great deal of it, 19/ massive profits would likely be eroded.

While figures for 1977 are not available, we know that in 1975 the life insurance companies net investment income assets generated by their ordinary life business was about $9.4 billion, which represented about a 7 percent before-tax rate of return. 20/ According to our calculations, they credited about $1.1 billion in interest to policyholders, a rate of return of less than 1 percent (assuming a 66-2/3 percent loss ratio). The difference is a whopping $8.3 billion for the year 1975 alone. If all of the companies' investment income had been credited to the policyholders, then the policyholders would have earned over 7 percent rather than 1 percent. However, the same statistics show that general expenses, sales commissions and taxes amounted to $8.4 billion. With a loss ratio of 66-2/3 percent, only $2.2 billion is available for covering expenses, an amount that was insufficient to cover sales commissions alone ($2.5 billion). If all of the $8.4 billion in expenses and taxes were allocated to the cost of insurance, the loss ratio would be about 35 percent or policyholders could expect to pay about $2.89 in premiums to get back $1 in death benefits. They would then be paying an extremely high price for their pure insurance protection, but earning over 7 percent on their savings. Since one can buy term

19/ There were 1750 life insurance firms in business in mid-1977, up from 1100 in 1955. Many of the new entrants appear to be in the credit life lines or in other than ordinary life insurance and are extremely small.

20/ These figures are taken from Appendix II, Table 2.

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insurance with a 1.5 multiplier, it seems more appropriate to allocate only $2.2 billion of expense to the pure insurance portion and the remaining expense shows up as a low rate of return.

On the other hand, the evidence does not demonstrate that the life insurance industry is unprofitable. The $8.3 billion difference between what the companies earned and what they paid must be offset by the $6.2 billion in expenses and taxes that would not be recovered at competitive term rates. This leaves about $2.1 billion for profits (or contributions to surplus in the case of the nonprofit mutual companies). Without further information it is not possible to judge whether this figure is high or low. Although some companies are extremely profitable, many appear to be only of average profitability.

III. The Significance of the Different Types of Life Insurance

A. Types. Besides ordinary life insurance, there are three other types of life insurance: group, industrial and credit insurance. This section briefly explains the difference among these types of insurance.

Although not entirely exclusive, the four types of life insurance can be distinguished by differences in policy size and sales methods:

(1) Ordinary life insurance is generally sold to individuals in face amounts exceeding $1,000.[21] Most ordinary life insurance is sold through the agency system. However, mass-marketed wholesale insurance has come into wider use in recent years and, in

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21 Report of the Subcomm. on Oversight and Investigations of the House Comm. on Interstate and Foreign Commerce, 95th Cong., 2d Sess. 5 (1978) [hereinafter cited as Moss Subcommitted Report.]

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1977 new issues amounted to $2.2 billion.[22] Nonetheless, in 1967, the most recent year for which detailed data are available, of the 740,000 persons who worked in the life insurance industry, and about 220,000 persons derived from 50 percent to 100 percent of their income from the sale of life insurance.[23]

(2) Group life insurance normally involves term insurance offered by employers (86.1%), unions (4.1%), professional societies and employee associations (4.8%).[24] Many group life plans provide for coverage on the lives of dependents of group members.

(3) Industrial life insurance is issued for small amounts, usually less than $1,000 and premiums generally paid weekly

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22 Fact Book, supra n. 1, at 28.

23 Id. at 92.

24 Id. at 30. Percents are based on a survey of group life in force at year-end 1973.

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or monthly to an agent who calls at the policyholder's home.[25]

(4) Credit insurance is term coverage to insure the life of a debtor.[26] It is issued through banks, finance companies, credit unions and retailers and is designed to satisfy the debt should the debtor die.[27] Accordingly, credit life generally decreases in amount as the loan is repaid. It is commonly a part of consumer credit contracts.[28]

B. Relative Significance. Although there are signs of change, ordinary life insurance is the principal type of life insurance for most Americans. Of the total $2,582 billion of life insurance in force in 1977, about $1,289 billion was in ordinary life insurance, a 9.5 percent increase over the previous year. The remaining amounts of life insurance in force included $1,115 billion of group insurance; $139 billion of credit life insurance; and $39 billion of industrial life insurance.[29] Therefore, at the end of 1977, ordinary insurance amounted to half of all life insurance in force. However, in recent years group insurance in force has grown rapidly, and at the end of 1977 it amounted to 43 percent of all life insurance in force. It should also be noted that in 1975, although group insurance

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25 Id. at 31.

26 Id. at 33.

27 Moss Subcommittee Report, supra n. 21, at 5 n.6.

28 Fact Book, supra n. 1, at 33.

29 Id. at 7.

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constituted only 20 cents of the premium dollar, it accounted for the distribution of 42 percent of all the death benefits.[30]

Table I-6[31]

Life Insurance Purchases in the United States
(Exclusive of Revivals, Increases, Dividend Additions and Reinsurance Acquired)

	Ordinary		Group		Industrial		Total	
Year	Policies (000 Omitted)	Amount (000,000 Omitted)	Certificates (000 Omitted)	Amount (000,000 Omitted)	Policies (000 Omitted)	Amount (000,000 Omitted)	Number (000 Omitted)	Amount (000,000 Omitted)
1940	3,855	$ 6,689	285	$ 691	14,017	$3,350	18,157	$ 10,730
1945	4,343	9,859	681	1,265	11,869	3,430	16,893	14,554
1950	5,279	17,326	2,631	6,068	14,924	5,402	22,834	28,796
1955	7,572	30,827	2,217	11,258*	14,356	6,342	24,145	48,427*
1960	8,734	52,883	3,734	14,645	12,287	6,880	24,755	74,408
1961	8,735	55,016	3,971	17,019	12,327	7,000	25,033	79,035
1962	8,662	56,998	3,498	15,533	11,799	7,046	23,959	79,577
1963	9,046	64,267	3,534	18,152	11,407	7,154	23,987	89,573
1964	9,605	74,012	4,225	23,684	11,059	7,312	24,889	105,008
1965	9,937	83,485	7,007	51,385†	10,492	7,296	27,436	142,166†
1966	10,131	88,693	4,055	26,219	9,764	7,078	23,950	121,990
1967	10,192	94,694	4,353	39,118*	9,404	7,056	23,949	140,868*
1968	10,461	103,944	4,875	39,877*	8,417	6,674	23,753	150,495*
1969	10,588	113,500	5,156	39,329	7,916	6,454	23,660	159,283
1970	10,968	122,820	5,219	63,690†	7,582	6,612	23,769	193,122†
1971	11,281	132,130	5,403	49,407	8,326	7,274	25,010	188,811
1972	11,844	145,479	6,698	55,857	8,123	7,394	26,665	208,730.
1973	12,198	162,506	7,065	64,461	7,506	7,224	26,769	234,191
1974	12,763	182,755	7,994	111,622†	6,747	6,680	27,504	301,057†
1975	12,549	188,003	8,146	95,190†	6,397	6,729	27,092	289,922†
1976	13,219	213,784	9,145	104,683	5,962	6,382	28,326	324,849
1977	13,485	242,842	10,170	117,960	5,800	6,533	29,455	367,335

*Includes Federal Employees' Group Life Insurance of $1.9 billion in 1955, $8.3 billion in 1967, and $3.4 billion in 1968.

†Includes Servicemen's Group Life Insurance of $27.8 billion in 1965, $17.1 billion in 1970, $29.2 billion in 1974 and $1.7 billion in 1975.

Sources: Life Insurance Marketing and Research Association and American Council of Life Insurance. Figures from 1940-1973 exclude all credit life insurance. Beginning with 1974, data include long-term credit insurance (life insurance on loans of more than four years' duration). Data for 1977 are preliminary.

30 Based on figures in the Annual Statement for 1975 of the U.S. Legal Reserve Life Insurance Companies.

31 Fact Book, supra n. 1, at 13.

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Within the area of ordinary life insurance, whole life policies account for the highest proportion of the amount in force although the percentage of whole life has declined from about 63.0 percent in 1974 to about 60.9 percent in 1977.

For a more precise picture of the relative size of the four types of insurance we rely on the following four tables. Tables 6 and 7 portray the aggregate size by type.

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Table I-7[32].

Life Insurance In Force in the United States

(000,000 Omitted)

	Ordinary		Group		Industrial		Credit		Total	
Year	No.	Amt.	Cert.	Amt.	No.	Amt.	No.†	Amt.	No.	Amt.
1900	3	$ 6,124	—	—	11	$ 1,449	—	—	14	$ 7,573
1905	5	9,585	—	—	17	2,278	—	—	22	11,863
1910	6	11,783	—	—	23	3,125	—	—	29	14,908
1915	9	16,650	*	$ 100	32	4,279	—	—	41	21,029
1920	16	32,018	2	1,570	48	6,948	*	$ 4	66	40,540
1925	23	52,892	3	4,247	71	12,318	*	18	97	69,475
1930	32	78,576	6	9,801	86	17,963	*	73	124	106,413
1931	33	79,514	6	9,736	85	17,635	*	85	124	106,970
1932	32	75,898	5	8,923	79	16,669	*	69	116	101,559
1933	31	70,872	5	8,681	78	16,630	*	63	114	96,246
1934	32	70,094	6	9,472	79	17,036	*	75	117	96,677
1935	33	70,684	6	10,208	81	17,471	1	101	121	98,464
1936	33	72,361	7	11,291	83	18,863	1	138	124	102,653
1937	34	74,836	7	12,638	85	20,104	1	216	127	107,794
1938	35	75,772	7	12,503	85	20,396	2	256	129	108,927
1939	36	77,121	8	13,641	85	20,500	2	307	131	111,569
1940	37	79,346	9	14,938	85	20,866	3	380	134	115,530
1941	39	82,525	10	17,359	87	21,825	3	469	139	122,178
1942	41	85,139	11	19,316	90	22,911	2	355	144	127,721
1943	43	89,596	13	22,413	94	24,874	2	275	152	137,158
1944	46	95,085	13	23,922	98	26,474	2	290	159	145,771
1945	48	101,550	12	22,172	101	27,675	2	365	163	151,762
1946	53	112,818	13	27,206	104	29,313	3	729	173	170,066
1947	56	122,393	16	32,026	106	30,406	5	1,210	183	186,035
1948	58	131,158	16	37,068	106	31,253	6	1,729	186	201,208
1949	61	138,862	17	40,207	107	32,087	8	2,516	193	213,672
1950	64	149,116	19	47,793	108	33,415	11	3,844	202	234,168
1951	67	159,109	21	54,398	109	34,870	12	4,763	209	253,140
1952	70	170,875	24	62,913	111	36,448	14	6,355	219	276,591
1953	73	185,007	26	72,913	112	37,781	18	8,558	229	304,259
1954	76	198,599	29	86,410	111	38,664	21	10,046	237	333,719
1955	80	216,812	32	101,345	112	39,682	28	14,493	252	372,332
1956	83	238,348	35	117,399	110	40,109	32	16,774	260	412,630
1957	87	264,949	37	133,905	108	40,139	34	19,366	266	458,359
1958	89	288,607	39	144,772	104	39,646	35	20,536	267	493,561
1959	93	317,158	41	160,163	102	39,809	38	24,998	274	542,128
1960	95	341,881	44	175,903	100	39,563	43	29,101	282	586,448
1961	97	366,141	46	192,794	98	39,451	45	31,107	286	629,493
1962	99	391,048	49	209,950	95	39,638	47	35,341	290	675,977
1963	102	420,808	51	229,477	93	39,672	52	40,666	298	730,623
1964	104	457,868	55	253,620	92	39,833	58	46,487	309	797,808
1965	107	499,638	61	308,078	89	39,818	63	53,020	320	900,554
1966	109	541,022	65	345,945	88	39,663	69	58,059	331	984,689
1967	113	584,570	69	394,501	84	39,215	70	61,535	336	1,079,821
1968	116	633,392	73	442,778	81	38,827	75	68,357	345	1,183,354
1969	118	682,453	76	488,864	79	38,614	78	74,598	351	1,284,529
1970	120	734,730	80	551,357	77	38,644	78	77,392	355	1,402,123
1971	123	792,318	82	589,883	76	39,202	76	81,931	357	1,503,334
1972	126	853,911	85	640,689	76	39,975	78	93,410	365	1,627,985
1973	128	928,192	88	708,322	75	40,632	78	101,154	369	1,778,300
1974	131	1,009,038	94	827,018	71	39,441	84	109,623	380	1,985,120
1975	134	1,083,421	96	904,695	70	39,423	80	112,032	380	2,139,571
1976	137	1,177,672	100	1,002,647	67	39,175	78	123,569	382	2,343,063
1977	139	1,289,321	106	1,115,047	66	39,045	79	139,402	390	2,582,815

Note: "Credit" is limited to life insurance on loans of ten years' or less duration. "Ordinary" and "Group" include credit life insurance on loans of more than ten years' duration.

*Fewer than 500,000. †Includes group credit certificates.

Sources: Spectator Year Book *and American Council of Life Insurance. Totals for "In The United States" represent all life insurance (net of reinsurance) on residents of the United States, whether issued by U.S. or foreign companies. Beginning with 1959, the data include Alaska and Hawaii.*

32 Id. at 18.

The second two tables give figures for adults and households contracting agent-marketed and employee group insurance.

Table I-8

Ownership of Life Insurance by Adults 1976

Percent of Adults Insured by Type of Life Insurance

	All Types of Life Insurance		Agent-Marketed Individual Life Insurance		Employee Group Life Insurance	
Total Adult	72%		54%		31%	
Men	80		59		42	
Women	65		50		21	
Age	Male	Female	Male	Female	Male	Female
18-24	63%	57%	43%	39%	24%	21%
25-29	83	65	57	45	50	29
30-34	90	76	67	60	57	28
35-44	86	71	65	53	54	31
45-54	89	68	65	51	57	25
55-64	87	68	63	60	46	17
65 and Older	68	55	56	49	17	5
Total Life Insurance Coverage (All Adults)						
$100,000 or More	2%		1%		+	
$50,000-$99,999	5		2		2%	
$25,000-$49,999	9		4		3	
$15,000-$24,999	8		5		4	
$ 5,000-$14,999	21		16		14	
Less than $5,000	27		26		8	
	72%		54%		31%	
Average Amount of Coverage						
Total Adult	$18,720		$12,280		$16,250	
Men	28,980		19,210		20,620	
Women	7,640		5,240		8,620	
Wives	8,470		5,980		8,900	
Children	2,630		2,450		2,310	

Ownership of Life Insurance by Households 1976

Percent of Households in Which at Least One Member Owns Life Insurance

	All Types of Life Insurance	Agent-Marketed Individual Life Insurance	Employee Group Life Insurance
All Households	83%	65%	46%
Male Head	88	69	52
Female Head	67	52	24
All Families	88%	70%	51%
Husband-Wife Families	90	71	55
With Children Under 18	93	73	63
Without Children Under 18	88	70	47
Individual Heads	64%	46%	25%
Percent of Households in Which Household Head Is Insured			
All Household Heads	80%	59%	42%
Male Head	85	62	48
Female Head	64	49	21
Heads of All Husband-Wife Families	88%	65%	50%
With Children Under 18	91	67	59
Without Children Under 18	84	62	41
Heads of All Families	85%	63%	46%
Incomplete Families*	71	54	25
Individual Heads**	63	44	24

+Less than .5%.

*A family of two or more related individuals in which the family head does not have a spouse living in the household.

**Includes households of one person and households in which two or more unrelated adults live together.

Note: "All Types of Life Insurance" includes coverage with legal reserve life insurance companies, Veterans life insurance, and life insurance issued by savings banks, fraternal organizations, mutual aid and burial societies, and similar types of coverage. "Agent-Marketed Individual Life Insurance" comprises ordinary and/or industrial (but not group) life insurance individually purchased through an agent.

Source: A national consumer survey conducted in 1976 for the American Council of Life Insurance and the Life Insurance Marketing and Research Association.

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33 Id. at 35.

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In sum, this appendix illustrates the enormous size of the life insurance industry, but finds no conclusive evidence of undue concentration or profits. It explains the four different types of insurance and finds that ordinary insurance represents one half of all insurance in force.

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APPENDIX II - STATISTICAL SOURCES FOR CALCULATING INDUSTRY-WIDE RATES OF RETURN TO ORDINARY POLICYHOLDERS

The basic information from which the industry-wide rates of return (shown in table I-4 of this Report) were calculated comes from the "Gain and Loss Exhibit" of the Annual Statement filed by each life insurance company to the various State Insurance Commissions. The "Gain and Loss Exhibit" provides a wealth of detail on the sources of net gain from operations (after dividends to policyholders and federal income taxes) on some 11 "lines of business," of which one (column 3) is "ordinary life insurance." 1/ From time to time, the American Council of Life Insurance aggregates the individual company statements of virtually all the U.S. Legal Reserve Life Insurance Companies in the United States to produce tables such as 1 and 2 which are reproduced here. These tables, supplemented by the figures reported in the 1978 Fact Book formed the basis for the FTC staff's calculation of industry-wide rates of return. These tables were supplied to the FTC staff by the American Council of Life Insurance.

Since the aggregate figures were not available for the year 1977 by line of business, the FTC staff estimated them by assuming that the 1977 figures for the ordinary line bore the same relationship to the total figures reported in the Fact Book,

1/ The Annual Statement accounts are described in great detail in Joseph Noback, Life Insurance Accounting 5-6 (Irwin, 1969). See also the discussion of the "Gain and Loss Exhibit" by Robert Gaegler in chapter 4 of Life Insurance Accounting (edited by R. Strain), Merrit, 1977.

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as did the corresponding figures in 1975. For example, the Fact Book reports that policy dividends (in all lines) amounted to $5,031.8 million in 1975. 2/ Line 28 of table 2 shows that $3,954.889 million was paid in dividends to holders of ordinary life insurance policies. In other words, about 78.6 percent of the total dividends paid in 1975 went to the holders of ordinary life insurance policies. We assume that of the total dividends paid in 1977 ($5,913.2 million), 3/ 78.6 percent, or $4,648 million, went to the holders of ordinary life policies. A similar procedure was followed for the other types of benefits paid. The ratios used were:

Dividends	78.6%
Surrender Values	91.9
Supplemental Contracts	78.8
Matured Endowments	95.6
Disability Payments	33.5
Annuity Payments	0.1

The basic formula for $1 + r_t$, where r_t is the industry-wide rate of return for year t, is:

$$1 + r_t = \frac{\text{Savings Account}_t}{\text{Savings Account}_{t-1} + \text{Deposit}_t - \text{Withdrawals}_t}$$

The savings account in year t consists of the sum of policyholder cash values and dividends left to accumulate with the companies. Cash Values were estimated by taking 90 percent of the ordinary life reserves as shown on page 67 of the 1978 Fact Book. 4/ Policy dividend accumulations were estimated by

2/ American Council of Life Insurance, Life Insurance Fact Book 39 (1978) [hereinafter cited as Fact Book].

3/ Id.

4/ Hearings Before the Subcomm. on Oversight and Investigations of the House Comm. on Interstate and Foreign Commerce, 95th Cong., 2d Sess. 397 (1978).

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taking 78.6 percent of the total figure. 5/ The formulas for deposits and withdrawals are:

Deposit $_t$ = Premiums (Fact Book at 57) minus the term multiplier (alternatively, 1.2658, 1.5 and 1.6667) times Death Benefits $_t$ (Fact Book at 41).

Withdrawals $_t$ = Dividends $_t$ + Surrender Values $_t$ + Supplemental Contracts $_t$ + Matured Endowments $_t$ + Disability Payments $_t$ + Annuity Payments $_t$ + (all from Fact Book, at 39, except supplemental contracts payments from at 47).

The rates of return shown in Table I-4 for 1970 and 1975 used the numbers that appear in Tables 1 and 2 in this appendix. The location of the numbers used to calculate the deposit and withdrawals are as follows:

Deposit = Premiums: (line 1 + line 2 + line 3 + line 3A, column 3) minus term multiplier (Alternatively, 1.2658, 1.5, & 1.6667) times death benefits (line 8, column 3)

Withdrawals = (line 9 + line 10 + line 11A + line 12 + line 14 + line 16, column 3)

Notice that considerations for supplementary contracts are included in premium income and payments on these under withdrawals. The savings figures were calculated in the same manner as the 1977 figures described above.

5/ See Fact Book, supra n.2, at 67.

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Selection of the Term Multipliers or Loss Ratios

The multipliers used in the industry-wide rate of return calculations should be representative of those actually available on low cost term insurance policies in the market for that particular year. The precise figure will depend on the age composition, face amounts and issue ages of the entire group of ordinary policyholders (not just those that have purchased term insurance policies). Since such detailed information is not available on the 139 million policies in force in 1977, we are forced to use an average figure. The three multipliers used (see Table I-4 in the text) appear to cover the reasonable range available on low cost term insurance. The lowest multiplier (1.2658), or a loss ratio of 79 percent, is equal to the ratio of all benefits to premiums plus investment income for the life insurance as a whole (1978 Fact Book, p. 62). It is also about equal to the loss ratio on group life insurance (see Table 2, this appendix, column 8). The 79 percent loss ratio seems representative of the lowest cost term insurance available and it leaves a 21 percent margin for expenses and profits. The 1.5 multiplier, a loss ratio of 66 2/3 percent, is broadly consistent with the loss ratios implied by low yearly term rates contained in the proposed regulation (see Appendix X). The ratio of the present value of the premiums for a $25,000 policy running from ages 35 to 54 to the present value (at 5 percent) of the death benefits, is 1.45. The ratio is higher at younger ages and for smaller face amounts. Given the uncertainty as to the precise number, ratios of 1.5 and 1.6667 were used in an attempt to cover the middle and high range of low cost loss ratios. The 1.6667 multiplier, a loss ratio of 60 percent, is similar to the minimum

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loss ratio that have been set on certain types of life insurance policies, such as credit life. Retaining 40 percent for expenses and profits would appear ample for low cost life insurance.

Tables I-A and I-B

The total dollar figures shown in Table I-A are derived from the 1978 Fact Book. With the exception of death benefits, the benefit figures in the Fact Book include benefits paid under all types of life insurance contracts. Benefits paid to ordinary life insurance policyholders were estimated by using the ratios shown on p.II-2 in the same manner as for the rate of return calculations described there.

Table I-B was derived from I-A by dividing the totals shown there by 46 million, to get the average amount per household. The 46 million figure is a crude estimate, which was derived as follows: A 1976 survey (reported in the 1978 Fact Book, p.35) found that 70 percent of all households had "agent-marketed" life insurance coverage, that is, ordinary plus "industrial" coverage. There were about 79.6 million households in 1977, so if the survey results were extrapolated, about 55.7 million would have had either ordinary coverage, industrial coverage, or both. Since relatively few households have both kinds of coverage, we assume no overlap. There were 67 million industrial policies in force in 1977. Assuming an average of 7 industrial policies per household (see FTC Staff Report on Industrial Life Insurance), this would mean that 9.7 million households have industrial coverage. Subtracting 9.7 from 55.7 gives our ballpark figure of 46 million. Since there were 139 million ordinary life policies in force in 1977, this would mean an average of about 3 policies per insured household.

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ANNUAL STATEMENT FOR THE YEAR 1970 OF THE U.S. Legal Reserve Life Insurance Companies

ANALYSIS OF OPERATIONS BY LINES OF BUSINESS
(Gain and Loss Exhibit)

TABLE I - A

$ Thousands

	Total (1)	Industrial Life (Including Joint and Limited Dual Agency and Accidental Death Benefits) (2)	Ordinary: Life Insurance (3)	Ordinary: Total and Permanent Disability (4)	Ordinary: Accidental Death (5)	Ordinary: Individual Annuities (6)	Other Lines (including CPD & Accd.) (7)
1. Premiums and annuity considerations (Exhibit 1, Part 1)	36,766,641	1,371,377	15,889,687			959,872	522,827
2. Considerations for supplementary contracts with life contingencies	266,396	36	9,363	X X X	X X X	744	196,144
3. Considerations for supplementary contracts without life contingencies and dividend accumulations	1,513,501	3,339	974,850			4,312	410,028
4. Net investment income and capital gains and losses (Exhibit 2)	10,063,040	329,279	5,009,696			393,027	572,255
5.	(1) 104,138	1,810	55,436			10,318	7,554
6.							
7. TOTALS	48,973,316	2,105,675	23,130,911			1,367,273	1,758,758
8. Death benefits	7,102,812	422,271	3,301,309	X X X		18	137,799
9. Matured endowments	1,005,786	114,471	839,097	X X X	X X X	47	58
10. Annuity benefits	1,254,840	36	1,259	X X X	X X X	471,918	9
11. Disability benefits	251,417	2,903	3,576	X X X	X X X	129	83,177
12. Surrender benefits	3,940,551	90,172	2,508,410	X X X	X X X	1,931	4,210
12A. Group conversions	4,019	310	20,338	X X X	X X X	292	603
12B. Transfers on account of group package policies and contracts	X X X		717	X X X	X X X		488
13. Benefits under accident and health policies	8,777,551	721	361	X X X	X X X		185
14. Interest on policy or contract funds	169,352	1,054	18,558			2,686	2,329
15. Payments on supplementary contracts with life contingencies	401,730	26	15,572	X X X	X X X	9	310,147
16. Payments on supplementary contracts without life contingencies and of dividend accumulations	1,712,758	1,156	709,837			3,656	761,099
16A. Amounts transferred between accounts	326,549					4,656	35,611
16B. Payments of withdrawal funds	65,256		2,785			616	2,933
17. Increase in aggregate reserve for policies and contracts with life contingencies	8,641,528	12,705	6,827,256			582,095	167,552
18. Increase in reserves for supplementary contracts without life contingencies and for dividend accumulations	180,009	1,905	167,041			1,669	-272,609
19. Increase in reserves for accident and health policies	544,669	- 57	1,959			665	209
19A.	137,276	1,112	41,671			6,265	-3,354
20. SUBTOTALS (Items 8 to 19A)	33,801,116	1,671,224	13,088,313			1,074,689	1,212,518
21. Commissions on premiums and annuity considerations	3,319,129	311,423	1,764,135			51,954	74,522
22.							
23. General insurance expenses (Exhibit 3, Cols. 1 and 2, Line 12)	4,756,651	300,551	2,609,256			80,195	128,872
24. Insurance taxes, licenses and fees, excluding federal income taxes (Exhibit 6, Cols. 1 and 2, Line 10)	807,264	40,920	364,607			7,566	15,501
25. Increase in loading on and cost of collection in excess of loading on deferred and uncollected premiums	65,066	- 1,810	68,771			3,607	1,121
25A. Adjustments between accounts							
26.	83,983	1,582	15,319			2,906	- 736
27. TOTALS (Items 20 to 26)	42,833,151	1,683,390	17,908,600			1,222,916	1,431,898
28. Net gain from operations before dividends to policyholders and federal income taxes (Item 7 minus Item 27)	6,140,225	417,084	5,228,531			139,357	190,860
29. Dividends to life policyholders (Exhibit 7)			1,454,565				
30. Dividends on accident and health policies (Exhibit 7)		X X X	X X X	X X X	X X X	X X X	X X X
31. Increase in amounts provisionally held for deferred dividend policies							
32. TOTALS (Items 29 to 31)	3,762,668	191,741	2,776,967			91,549	62,537
32A. Net gain from operations after dividends to policyholders and before federal income taxes (Item 28 minus Item 32)	2,377,557	225,343	1,451,566			47,808	258,323
32B. Federal income taxes incurred	1,248,580	108,178	832,067			24,390	85,562
33. Net gain from operations after dividends to policyholders and federal income taxes (Item 32A minus Item 32B)	1,128,977	116,965	619,502			23,418	172,756

(1) Including in separate account capital gain and losses only.
(2) Including transfers between accounts.

ANNUAL STATEMENT FOR THE YEAR 1970 OF THE U.S. Legal Reserve Life Insurance Companies

ANALYSIS OF OPERATIONS BY LINES OF BUSINESS
(Gain and Loss Exhibit)

TABLE I - A (cont'd)

$ Thousands

	GROUP		ACCIDENT AND HEALTH	
	Life Insurance (a)	Annuities (b)	Direct (c)	Other (d)
1. Premiums and annuity considerations (Exhibit 1, Part 1)	4,665,119	2,761,137	8,240,334	1,076,338
2. Considerations for supplementary contracts with life contingencies	64,994	15,115	x x x	x x x
3. Considerations for supplementary contracts without life contingencies and dividend accumulations	117,418	1,554	922	159
4. Net investment income and capital gains and losses (Exhibit 2)	369,373	1,647,346	144,541	137,666
5.	12,261	251	1,281	6,213
6.				
7. TOTALS	5,207,167	4,777,207	8,461,478	1,220,456
8. Death benefits	3,057,608	3,655		32
9. Matured endowments	9,051			
10. Annuity benefits	1,023	1,249,750		
11. Disability benefits	136,218	11,653		
12. Surrender benefits	66,525	8,507		206
12A. Group conversions	25,562	- 985	221	-218
12B. Transfers on account of group package policies and contracts	143,935	- 98	-143,882	-345
13. Benefits under accident and health policies			7,335,246	1,521,859
14. Interest on policy or contract funds	23,165	23,139	8,017	616
15. Payments on supplementary contracts with life contingencies	36,857	49,626	-	13
16. Payments on supplementary contracts without life contingencies and of dividend accumulations	130,452	13,402	1,012	144
16A. Amounts transferred between accounts	-36,595	321,015		
16B. Payments of withdrawal funds	3,102	61,317	327	
17. Increase in aggregate reserve for policies and contracts with life contingencies	320,681	2,365,223	3,010	1,303
18. Increase in reserves for supplementary contracts without life contingencies and for dividend accumulations	1,732	58,491	1,246	-65
19. Increase in reserves for accident and health policies	113	3,778	396,961	150,300
19A.	8,778	26,557	-27,539	1,020
20. SUBTOTALS (Items 8 to 19A)	4,001,534	4,238,206	7,692,535	1,677,905
21. Commissions on premiums and annuity considerations	214,456	19,840	235,581	664,218
22.				
23. General insurance expenses (Exhibit 3, Cols. 1 and 2, Line 13)	270,496	109,850	582,736	666,510
24. Insurance taxes, licenses and fees, excluding federal income taxes (Exhibit 6, Cols. 1 and 2, Line 10)	97,836	6,481	184,692	89,511
25. Increase in loading on and cost of collection in excess of loading on deferred and uncollected premiums	-9,775	- 142	186	138
25A. Adjustments between accounts				
26.				
27. TOTALS (Items 20 to 26)	4,574,607	4,374,235	8,695,730	3,098,292
28. Net gain from operations before dividends to policyholders and federal income taxes (Item 7 minus Item 27)	632,560	402,972	-234,252	122,164
29. Dividends to life policyholders (Exhibit 7)	x x x	x x x	x x x	x x x
30. Dividends on accident and health policies (Exhibit 7)	x x x	x x x		
31. Increase in amounts provisionally held for deferred dividend policies			x x x	x x x
32. TOTALS (Items 29 to 31)	261,501	278,127	76,012	22,234
33. Net gain from operations after dividends to policyholders and before federal income taxes (Item 28 minus Item 32)	371,059	124,845	-310,264	99,930
33B. Federal income taxes incurred	187,732	38,554	135,477	36,370
34. Net gain from operations after dividends to policyholders and federal income taxes (Item 33A minus Item 33B)	183,327	86,291	-175,357	63,560

ANNUAL STATEMENT FOR THE YEAR 1975 OF THE U.S. Legal Reserve Life Insurance Companies

TABLE I - B

ANALYSIS OF OPERATIONS BY LINES OF BUSINESS

$ Thousands (Gain and Loss Exhibit) (Excluding Capital Gains and Losses)

	1 Separate Account	2 Industrial Life	Ordinary 3 Life Insurance	Ordinary 4 Individual Annuities	Ordinary 5 Supplementary Contracts
1. Premiums and annuity considerations (Exhibit 1, Part 1)	1,537,283	1,302,492	21,031,330	2,398,873	[illegible] 14
2. Considerations for supplementary contracts with life contingencies	1,322	1	XXX 10,163	XXX 745	215,222
3. Considerations for supplementary contracts without life contingencies and dividend and coupon accumulations	14	3,513	1,302,062	12,215	540,177
4. Net investment income (Exhibit 2)	483,990	853,164	9,431,550	781,136	457,490
5. Commissions and expense allowances on reinsurance ceded	97	156	100,141	- 46	106
5A. Reserve adjustments on reinsurance ceded	6	46	45,961	- 19,728	- 43
6.	837	6,573	103,142	- 37,974	1,868
7. Totals	2,023,549	2,165,945	32,024,349	3,135,219	1,214,834
8. Death benefits	57	472,634	4,455,746	[illegible] 411	-55
9. Matured endowments (excluding guaranteed annual pure endowments)		61,908	904,505	[illegible]	[illegible]
10. Annuity benefits	150,951	22	3,633	724,322	17
11. Disability benefits and benefits under accident and health policies	2,664	9,630	142,631	622	
11A. Coupons, guaranteed annual pure endowments and similar benefits (Exhibit 7)		265	71,685	249	154
12. Surrender benefits (Includes withdrawal of Benefits)	235,367	253,769	1,458,805	14,980	203
13. Group conversions		121	- 36,600	[illegible]	119
13A. Transfers on account of group package policies and contracts	[illegible]	[illegible]	XXX 2,814	XXX 2,170	[illegible] 53
14. Interest on policy or contract funds	1,419	2,309	66,778	7,630	2,603
15. Payments on supplementary contracts with life contingencies	843	6	9,865	[illegible]	339,710
16. Payments on supplementary contracts without life contingencies and of dividend and coupon accumulations	127	4,967	999,113	7,068	651,581
17. Increase in aggregate reserves for life and accident and health policies and contracts	1,035,566	132,140	7,124,535	1,608,151	5,993
18. Increase in reserve for supplementary contracts without life contingencies and for dividend and coupon accumulations	117	1,161	633,715	4,588	51,138
19.	472,423	53	51,013	61,647	- 2,782
20. Totals (Items 8 to 19)	1,902,556	939,276	17,888,238	2,431,468	1,048,844
21. Commissions on premiums and annuity considerations (direct business only)	2,676	306,220	2,537,310	183,491	405
21A. Commissions and expense allowances on reinsurance assumed			75,408	2,348	
22. General insurance expenses (Exhibit 5, Cols. 1 and 2, Line 10)	10,462	302,852	3,893,546	201,032	25,267
23. Insurance taxes, licenses and fees, excluding federal income taxes (Exhibit 6, Cols. 1 and 2, Line 7)	388	45,844	543,318	19,976	1,120
24. Increase in loading on and cost of collection on excess of loading on deferred and uncollected premiums	---	- 659	131,942	10,051	**
25.	44,804	1,039	76,833	63,031	271
26. Totals (Items 20 to 25)	1,960,886	1,594,571	25,146,595	2,921,897	1,075,904
27. Net gain from operations before dividends to policyholders and federal income taxes (Item 7 minus Item 26)	62,663	571,374	6,677,754	213,322	138,927
28. Dividends to policyholders (Exhibit 9)	45	187,300	1,954,889	124,180	53,170
29. Net gain from operations after dividends to policyholders and before federal income taxes (Item 27 minus Item 28)	62,618	383,984	2,922,865	- 40,858	85,657
30. Federal income taxes incurred (excluding tax on capital gains)	2,985	153,818	1,452,660	19,791	42,381
31. Net gain from operations after dividends to policyholders and federal income taxes (before tax on capital gains) (Item 29 minus Item 30)	59,633	230,166	1,470,205	- 60,649	43,27

[1] Business not exceeding 120 months duration

Employers may exclude amounts for [illegible] Line 1

Line 8 Line 13 Line 17 Less than $500

ANNUAL STATEMENT FOR THE YEAR 1975 OF THE U.S. Legal Reserve Life Insurance Companies

ANALYSIS OF OPERATIONS BY LINES OF BUSINESS

TABLE I - B (Cont'd)

$ Thousands (Gain and Loss Exhibit) (Excluding Capital Gains and Losses)

	6 Credit Life (Group and Individual)	Group 7 Life Insurance	Group 8 Annuities	Accident and Health 9 Group	Accident and Health 10 Credit (Group and Individual)	Accident and Health 11 Other
1. Premiums and annuity considerations (Exhibit 1, Part 1)	1,208,870	5,792,381	6,229,718	13,948,043	629,451	4,496,906
2. Considerations for supplementary contracts with life contingencies		64,397	16,613	X X X	X X X	X X
3. Considerations for supplementary contracts without life contingencies and dividend and coupon accumulations	41	147,678	26,183	1,057		459
4. Net investment income (Exhibit 2)	66,413	676,314	3,092,980	330,090	53,230	261,554
5. Commissions and expense allowances on reinsurance ceded	87,563	9,895	1,517	48,620	95,952	38,387
5A. Reserve adjustments on reinsurance ceded	2,806	- 347	4,353	1,253	7,094	6,720
6.	5,486	10,837	39,730	17,082	5,567	11,218
7. Totals	1,371,179	6,701,155	9,411,095	14,367,552	792,196	4,815,234
8. Death benefits	476,407	3,862,921	XXX 1,251	X X X	X X X	X X X
9. Matured endowments (excluding guaranteed annual pure endowments)	11	7,143	X X X	X X X	X X X	X X X
10. Annuity benefits	X X X	XXX 1,267	2,332,785	X X X	X X X	X X X
11. Disability benefits and benefits under accident and health policies	35,693	212,151	27,660	12,511,964	356,202	2,350,111
11A. Coupons, guaranteed annual pure endowments and similar benefits (Exhibit 7)						12
12. Surrender benefits (Includes withdrawal of Benefits)	- 96	- 88,381	XXX 153,008	X X X	X X X	XXX 523
13. Group conversions	5	37,643	X X X	2,322		- 2,286
13A. Transfers on account of group package policies and contracts	4,777	211,898	- 4,511	- 211,464	- 4,653	XX- 1,083
14. Interest on policy or contract funds	1,760	63,448	262,371	17,543	393	178
15. Payments on supplementary contracts with life contingencies	2	46,760	56,316	X X X	X X X	X X X
16. Payments on supplementary contracts without life contingencies and of dividend and coupon accumulations	51	150,533	21,061	1,586	3	177
17. Increase in aggregate reserves for life and accident and health policies and contracts	55,027	376,566	5,930,572	263,299	81,725	339,954
18. Increase in reserve for supplementary contracts without life contingencies and for dividend and coupon accumulations	- 5	12,367	24,373	- 363	- 3	16
19.	- 10,144	120,139	51,717	- 8,276	14,108	9,893
20. Totals (Items 8 to 19)	563,480	5,391,217	8,876,603	12,576,611	447,770	2,697,391
21. Commissions on premiums and annuity considerations (direct business only)	351,421	136,537	55,359	335,364	198,587	844,275
21A. Commissions and expense allowances on reinsurance assumed	53,025	13,415	4,158	90,862	60,596	- 60,396
22. General insurance expenses (Exhibit 5 Cols. 1 and 2, Line 10)	119,862	339,199	230,479	1,058,610	75,374	1,066,620
23. Insurance taxes, licenses and fees, excluding federal income taxes (Exhibit 6, Cols. 1 and 2, Line 7)	35,840	120,121	15,508	308,891	16,105	136,667
24. Increase or decrease in net cost of collection on excess of loading on deferred and uncollected premiums	- 832	- 18,177	889	375	38	- 372
25.	6,308	10,473	131,300	9,310	6,367	2,596
26. Totals (Items 20 to 25)	1,129,192	5,992,785	9,314,496	14,379,923	805,017	4,805,725
27. Net gain from operations before dividends to policyholders and federal income taxes (Item 7 minus Item 26)	241,987	708,370	96,599	- 12,371	- 12,821	9,514
28. Dividends to policyholders (Exhibit 7)	37,168	288,415	233,878	87,255	611	18,865
29. Net gain from operations after dividends to policyholders and before federal income taxes (Item 27 minus Item 28)	204,819	419,955	- 137,279	- 99,626	- 13,432	- 9,351
30. Federal income taxes incurred (excluding tax on capital gains)	31,193	107,043	18,255	73,486	2,552	5,500
31. Net gain from operations after dividends to policyholders and federal income taxes (excluding tax on capital gains) (Item 29 minus Item 30)	173,626	312,912	- 155,534	- 173,112	- 15,984	- 14,851

Line 23

APPENDIX III: HOW THE WHOLE LIFE POLICY MAY BE VIEWED AS A COMBINATION OF INSURANCE AND BANKING SERVICES: THE GENERAL MATHEMATICS

A whole life policy can be defined or described in many equivalent ways. One of these ways is this: a whole life policy is a yearly premium term policy, renewable until age 100, with a level premium. In this appendix, we show mathematically (1) how this definition is equivalent to the common definition of whole life policies given in textbooks and (2) how a bank could "create" a whole life policy for its customers by creating an "installment" type plan for them to purchase one year renewable term insurance from their insurance company. The insurance company sells only one year term policies and a particularly simple kind of single payment annuity. The bank provides no "insurance" services whatsoever, nor does the insurance company provide any banking service whatsoever. Together these two "pure" operations combine to form a whole life insurance company which provides banking and insurance services.

This analysis shows how one can, in principle, use the books of an insurance company, or the annual reports of the whole industry, to estimate what rate of interest the company or the industry is paying its customers on the deposits they leave with it.

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Textbooks define the whole life policy in two parts.[1] First, using a mortality table and a known rate of interest, one can derive an expression for a single premium, payable immediately, that provides coverage for the whole of life. Suppose there are l_x people alive of age x years and that we wish to provide each beneficiary with $1 upon the death of the insured. It is assumed that death occurs at the end of the year and that any leftover funds are invested at an interest rate r. If d_x number of people die at the end of the first year, then we will need to deposit $d \div 1+r$ to pay $1 to each of their beneficiaries. At the end of the second year, d_{x+1} people die and we need $\$d_{x+1}/(1+r)^2$ on deposit now to pay $\$d_{x+1}$ in two years. Proceeding in this fashion, one can show that the single premium (A_x) that l_x people must pay now to build a whole life fund is equal to,

$$l_x \cdot A_x = \frac{d_x}{(1+r)} + \frac{d_{x+1}}{(1+r)^2} + \cdots \frac{d_{T-1}}{(1+r)^{T-x}}$$

or,

$$(1) \qquad A_x = \sum_{i=0}^{T-1-X} v^{i+1} \frac{d_{x+i}}{l_x}$$

where $v = 1/(1+r)$

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[1] See, e.g., Walter Menge & Carl Fisher, The Mathematics of Life Insurance ch. 2 (2d ed, 1965). Note that, for simplicity, only the "actuarially fair" premium is discussed, that is, administrative selling costs and profits are ignored.

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The second step is to find the level annual premium (P_x) that is equivalent (worth as much as) the single premium. To do this we must first define a life annuity.[2] Suppose that each of l_x people alive at age x agree to pay \$1, starting now, at the beginning of each year, providing that they are alive to pay it. What is the "present value "(a_x) of such a promise ? I will receive $\$1_x$ right away, and these have a present value of $\$1_x$. I receive $\$1_{x+1}$ at the beginning of the second year, and these have a present value of $\$v \cdot 1_{x+1}$, since that sum now, would grow to $\$1_{x+1}$ if left on deposit for a year. Proceeding similarly one finds that,

$$l_x \cdot \ddot{a}_x = v^0 l_x + v^1 l_{x+1} + \ldots v^{T-1-x} l_{T-1}$$

or,

$$(2) \qquad \ddot{a}_x = \sum_{i=0}^{T-1-x} v^i \frac{l_{x+i}}{l_x}$$

We can now easily find the level annual premium (P_x) due at the beginning of each year, that is equivalent to the single premium, A_x. Such a level annual premium is in fact a promise to pay $\$P_x$ at the beginning of each year if you are alive.

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[2] More precisely, we derive a life annuity "due" which means that the first payment is due at the beginning of the year.

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Therefore

$$P_x \cdot \ddot{a}_x = A_x$$

and the required expression for P_x is,

$$(3) \quad P_x = \frac{A_x}{\ddot{a}_x}$$

We now show that the level annual whole life premium P_x can be written as a weighted average of annual renewable term rates (TR_x), where the weights are particular fractions of the whole life annuity a_x. First, we need to define a "pure endowment," ${}_iE_x$. A pure endowment is a promise to pay \$1 to a person who is now age x, when and if that person attains age x+i. If the person dies before age x+i, nothing is paid. If l_x people pay ${}_iE_x$ into a fund now, that fund must accumulate to l_{x+i}, i years from now. That is,

$$l_x \cdot {}_iE_x = v^i \, l_{x+i}$$

or

$$(4) \quad {}_iE_x = v^i \frac{l_{x+i}}{l_x}$$

Note that the whole life annuity (equation 3) is simply a sequence of pure endowments to the end of the mortality table, or that

$$(5) \quad a_x = \sum_{i=0}^{T-i-x} {}_iE_x$$

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The actuarially "fair" premium for a one year term policy, issued at age x+i, is,

$$l_{x+i} \cdot TR_{x+i} = v\, d_{x+i}$$

or

$$(6) \qquad TR_{x+i} = v \frac{d_{x+i}}{l_{x+i}}$$

Note that

$$({}_iE_x)\,(TR_{x+i}) = \left(v^i\, l_{x+i} \Big/ l_x\right)\left(\frac{v \cdot d_x + i}{l_x + i}\right)$$

or,

$$(7) \quad ({}_iE_x)\,(TR_{x+i}) = (v^{i+1} \cdot d_{x+i}) \Big/ l_x$$

But the right hand side is the same as the i^{th} term in equation (1) defining a single premium whole life payment. Therefore, substituting equation 7 into equation 1, we get

$$A_x = \sum_{i=0}^{T-1-x} {}_iE_x \cdot TR_{x+i}$$

The level annual premium P_x is simply A_x divided by $\ddot{a}_x$. But the latter is simply the sum of the pure endowments (see equation (5). Hence, using equations 5 and 3, we get

$$A_x = \ddot{a}_x \cdot P_x = \left(\sum_{i=o}^{T-1-x} {}_iE_x\right) \cdot P_x = \sum_{i=o}^{T-1-x} ({}_iE_x)(TR_{x+i})$$

(TR_{x+i})

or,

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$$(8) \qquad P_x = \sum_{i=0}^{T-1-x} \left(\frac{{}_iE_x}{\ddot{a}_x} \right) \cdot TR_{x+i}, \text{ where}$$

$$\sum_{i=0}^{T-1-x} \frac{{}_iE_x}{\ddot{a}_x} = 1$$

Equation 8 says that the premium for a whole life policy is weighted average of the one year renewable term rates through the end of the mortality table. The weight for the i^{th} policy year is the i^{th} year pure endowment divided by the whole life annuity. In the next section, we give an intuitive explanation for the equivalence shown in equation 8.

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The Pure Bank and The Pure Insurance Company

To get a better understanding of equation 8, consider the following story. Our world consists of a life insurance company that issues only one year renewable term insurance policies and pure endowments (as defined above), a bank that pays a fixed rate of interest of r per year on all funds left on deposit with it, and a large number of policyholders/depositors. The bank's market research department finds that many of its customers would like to "levelize" their life insurance premium payments, just as they levelize their mortgage payments on their houses, rather than pay the constantly rising annual term insurance premiums. The financial department says that the bank may easily provide such a service, without engaging in any way in the insurance business (which would be against regulations). The financial department shows how such a contract should be priced, and the legal department draws up the contract.

The gist of the contract is this: In return for a level annual premium of $\$P_x$ (at issue age x) payable on the first day of every year, if the customer is alive, the bank agrees to pay the insurance company the term insurance premium (at the rate corresponding to the customers' attained age) on the agreed amount of coverage from the customer's "insurance savings fund." If and when the customer dies, with the contract in force, then the bank's obligation ends. The insurance company pays the customer's beneficiary the face amount of the term insurance

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policy, and the bank has fully met its obligations under the contract. On the other hand, if the customer decides to cancel the contract while he or she is still living, then the bank agrees to "refund" the unspent portion of the insurance savings fund to the customer. The amount of the refund is specified in the contract for each year the contract is in force.

The chief of the financial department explains how to price the contract. For each individual customer of age x, the bank will receive $\$P_x$ right away, another $\$P_x$ one year later from each customer that survives one year, $\$P_x$ two years later from each survivor, etc. It is clear that $\$P_x$ delivered now from each customer is worth exactly $\$P_x$ to the bank, but what is the worth of $\$P_x$ delivered one year from now--if the customer survives? The answer, the chief points out, is $({}_1E_x).\$P_x$. Since ${}_1E_x$ is previously the present value of \$1 to be paid one year from now, should a person currently aged x years survive to age x+1. Similarly, the promise of $\$P_x$ two years from now contingent on survival is worth $({}_2E_x).\$P_x$. Thus the value of the contract to the bank is simply,[3]

$$\$P_x \cdot \sum_{i=0}^{T-1-x} {}_iE_x$$

[3] Note that it is assumed that all deaths occur at the end of the year, and that no one survives past age T.

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What is the cost of the contract to the bank? The bank must pay $\$TR_x$ right away for insurance coverage for each customer. One year from now it must pay the insurance company $\$TR_{x+1}$ for each customer that has survived to reach age x+1. What is the cost of this obligation? Simply $({}_1E_x).\$TR_{x+1}$. The company must deliver to the insurance company $\$TR_{x+1}$ for each customer that survives to age x+1. But the present value of such an obligation (per dollar) is exactly given by the one year pure endowment, ${}_1E_{x+1}$. Similarly, the officer computes the costs for all future years and concludes that the cost to the bank is simply,

$$\sum_{i=0}^{T-1-X} ({}_iE_x) \cdot TR_{x+i}$$

Since the bank prices at cost, it equates the present value of revenues to the present value of cost and solves for the "price," P_x. The price so determined is given by equation 8, or simply the premium for a whole life policy.

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The Bank's Income Statement

Since, elsewhere in this report, we will use insurance company income and balance sheet statements to estimate the rate of return the companies and the industry is paying savings depositors on the banking function they perform, it is worthwhile to examine in more detail the nature of such accounts.

For our simple example, let us follow the mathematics of the accounts for a single age cohort. Suppose the bank enters into whole life contracts with l_x number of people of age x. For simplicity, let the face amount of coverage under each contract be $1. On the first of each year, the surviving customers pay $\$P_x$ to the bank. The bank in turn, on the same day, purchases term coverage for these customers from the insurance company and deposits any money left over in the insurance saving fund. The "deposit" can be negative, that is, the fund can be used to supplement the customers current payments, if these are insufficient to buy the term insurance coverage.

The account is shown on the next page.

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The Bank's Income and Insurance Saving Fund Account Statement*

Year	Beginning of Year Savings Fund	Bank Income	Premium Payments to Insurance Company	Deposit to Savings Fund	End of Year Savings Fund
1	0	$l_X \cdot P_X$	$l_X \cdot TR_X$	$l_X(P_X - TR_X)$	$l_X(P_X-TR_X)(1+r)$
2	$l_X (P_X-TR_X) (1-r)$	$l_{X+1} \cdot P_X$	$l_{X+1} \cdot TR_{X+1}$	$l_{X+1}(P_X-TR_{X+1})$	$l_X(P_X-TR_X)(1+r)^2 + l_{X+1}(P_X-TR_{X+1})(1+r)$
3					
.					
.					
.					
T-X	EF_{T-X-1}	$l_{T-1} \cdot P_X$	$l_{T-1} \cdot P_X$	$L_{T-1} (P_X - TR_{T-1})$	0

*NOTE: It is assumed that no one survives past age T (i.e., $l_T = 0$) and that death claims are paid at the end of the year.

The end of year savings fund (EF_{i+1}) is defined to be,

$$EF_{i+1} = l_{x+i} \cdot (P_x - TR_{x+i})\ (1+r) + EF_{i-1}\ (1+r)$$

(NOTE: This is the fund at the end of the $(i+1)^{st}$ policy year).

Substituting for EF_{i-1}, we can solve for EF_i in terms of all of the preceding deposits.

$$EF_{i+1} = \sum_{j=o}^{i} l_{x+j} \cdot (P_x - TR_{x+j})(1+r)^{i-j+1}$$

In particular, the savings fund at the end of the final year (the $(T-x)^{st}$ or at age T-1) is,

$$EF_{T-X} = \sum_{j=o}^{T-X-1} l_{x+j} \cdot (P_x - TR_{x+j})\ (1+r)^{T-X-j}$$

We now show that the savings fund is exhausted in the $(T-X)^{st}$ year, that is, the level premium P_x paid by the survivors (l_{T-1} in number) when added to the beginning year savings account (EF_{T-X-1}) is just enough to pay that years term premiums for the survivors.

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To show this, multiply equation 9 above by $\frac{l_x \cdot (1+r)^T}{(1+r)^T}$, $\frac{(1+r)^T}{l_x}$,

$$EF_{T-X} = \sum_{j=0}^{T-x-1} \left[\frac{l_{x+j}}{l_x} (P_x - TR_{x+j}) (1+r)^{-(x+j)} \right] \cdot \left[l_x (1+r)^T \right]$$

but $\frac{l_{x+j}}{l_x} (1 + r)^{-(x+j)} = v^j \frac{l_{x+j}}{l_x} = {}_jE_x$

So,

$$EF_{T-X} = \left[\sum_{j=o}^{T-X-1} {}_jE_x (P_x - TR_{x+j}) \right] \left[l_x (1+r)^T \right]$$

Now the first bracketed term on the right hand side is simply our basic pricing equation 8, which shows that the bracketed term is equal to zero. Since the second bracketed term is positive, the whole expression is equal to zero.

Refunds, Cash Values and Policy Loans

If the customer cancels the contract, he or she is entitled to the return of the unspent portion of the contract. How much does the customer get back? Consider a customer who wants to cancel at the end of the i^{th} year. The insurance saving fund is equal to EF_i and there are now l_{x+i} of the original customers left alive. Therefore, the equitable refund is just EF_i/l_{x+i}. This refund can be shown to be exactly equal to the theoretical terminal reserve held on a whole life policy, which, in turn, would be equal to the policy's cash value if the policy were being supplied at its "actuarial cost."

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Suppose a surviving customer wants to borrow from "his" portion of the saving fund. Can he just withdraw his funds, as he would, on any normal savings account? The answer is no. The bank will point out to the customer that their contract requires the bank to purchase term insurance for the customer, using the accumulated fund. If the customer wants to borrow from his fund then, he must promise to repay the "loan" with interest, in order for the bank to meet its commitments under the contract. Policy loan provisions in cash value contracts, of course, work exactly like this. If the customer dies, before repaying the loan, the bank will, of course, recover its money from the term insurance proceeds, that is, the beneficiary will receive the face amount of the term policy minus any indebtedness to the bank. This example shows clearly the fallacy of the argument that some critics of cash value insurance have made, namely, that the company unfairly charges you interest for borrowing your own money and "steals" your cash value if you die. The treatment of policy loans clearly makes sense, once it is recognized that the insurance company is performing a banking service for the customer and is not simply paying interest on an ordinary savings account.

If the bank did not disclose the rate of interest it was paying to its customers, could we use the statement above to calculate it? Clearly the answer is yes. We know how much

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the savings fund was at the beginning of year i, namely, EF_{i-1}. To that we add the deposit (call it d_i). If we divide the end of the year fund amount (EF_i) by the sum $EF_{i-1} + d_i$, we get 1+r. It is the same calculation we would do for any savings account.

But the example tells us more. If we want to find out what rate of interest an insurance company is paying its customers on their savings funds accumulating through cash value policies, we perform basically the same simple analysis. From the premium flows going into the insurance company, we need to subtract out the cost of the year's term insurance, as well as any dividends or funds withdrawn due to contract cancellation.[4] The remainder is treated as a deposit, added to the beginning period savings account and divided into the end of year account. The result is one plus the rate of interest.

[4] Policy loans, however, should not be reflected either in the size of the account itself, or in the flows between the company and its customers.

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Relation Between the "Bank Rate" and the "Linton Yield"

Suppose an individual is trying to decide between the bank's constant payment contract and paying the rising annual renewable term insurance premiums each year. To help in making the decision, he computes the Linton yield on the bank's level premium contract. Will the Linton Yield, for each duration, equal the bank rate? We show here that, still assuming that insurance premiums are "actuarially fair" (no expenses or profits), that the answer to the question is yes. Under these conditions, the bank rate and the Linton Yield for every holding period are one and the same. We caution that this result may not hold when premiums are not assumed to be actuarially fair.

The bank's total insurance fund at the end of the (i + 1)st policy year, or the year in which each member of our cohort is x + 1 years old, is given by:

$$EF_{i+1} = \left[\sum_{j=0}^{i} (P_x - TR_{x+j}) \cdot {}_jE_x\right] \cdot \left[l_x\,(i+r)^{i+1}\right]$$

The fund, per surviving policyholder, at the end of year is simply $\frac{EF_{i+1}}{l_{x+i+1}}$

or

$$(A)\quad \frac{EF_{i+1}}{l_{x+i+1}} = \frac{1}{{}_{i+1}E_x} \cdot \sum_{j=0}^{i} (P_x - TR_{x+j}) \cdot {}_jE_x$$

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How does this compare to a fund built up under the Linton Yield assumptions? As we did for the bank example, let's assume that amount of coverage (the death estate) is $1 and that death is assumed to occur at the end of the year. The latter requires that a minor change be made in the usual Linton formulation, to hold the death estate constant at the end of the year rather than at the beginning. The individual is x years old and can buy the bank's level contract at $\$P_x$ per year, or buy renewable term insurance and invest the difference.

The conditions are:

(1) the death estate must be the same under either alternative or; ${}_iProt_x$ (Protection at age x + i) must be equal to $1 minus the side fund accumulated at the end of the (i + 1)th policy year (SF_{i+1}).

$$ {}_iProt_x = 1 - SF_{i+1},\ i=0,\ 1\ .\ .\ .\ T-X-1 $$

(2) The cash outlay under the two alternatives must be the same, that is

$$ P_x = TR_{x+i} \cdot {}_iProt_x + d_{i+1} $$

where d_{i+1} is defined to be the "deposit" made to the side fund at the beginning of the (i + 1)th policy year.

(3) The side fund at the end of the (i + 1)th policy year is equal to the sum of the deposit made at the beginning of the year and the preceding year's side fund times one plus the rate of interest.

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$$SF_{i+1} = (SF_{i*} + d_{i+1})(1+r^*)$$

(4) Let the terminal year for the yield calculation be the (t + 1)st policy year. The Linton Yeild is defined to be that rate of interest, r^*, that makes the side fund accumulation (SF_{t+1}) equal to the "cash value" or "refund" under the bank's contract.

$$SF_{t+1} = \frac{EF_{t+1}}{1_{x+t+1}} = ({}_{t+1}CV_x)$$

Rearranging equation 2 and substituting for ${}_iProt_x$ from equation 1, we get

(4) $d_{i+1} = P_x - TR_{x+i} \cdot {}_iProt_x$

$= P_x - TR_{x+i} + TR_{x+i} \cdot SF_{i+1}$

Now substitute (4) into (3)

$SF_{i+1} = (SF_i + P_x - TR_{x+i} + TR_{x+i} \cdot SF_{i+1})(1+R^*)$

Group terms involving SF_{i+1} on the left side and simplify.

(5) $SF_{i+1} = \frac{1+r^*}{1-TR_{x+i}(1+r^*)} \cdot (SF_i + P_x - TR_{x+i})$

Equation 5 is a linear first order difference equation and may be solved recursively to eliminate the "SF" terms on the right hand side. To simplify the exposition, let us introduce two auxillary variables.

$a_i = P_x - TR_{x+i}$, $i = 0, 1 \ldots t$

$b_i = 1 - (TR_{x+i})(1+r^*)$, $i = 0, 1 \ldots t$

Equation 5 can now be rewritten as

(5) $SF_{i+1} = \left(\frac{SF_i}{b_i} + \frac{A_i}{b_i}\right)(1+r^*)$

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But (5) holds for i = o, 1 ... t

So

$$SF_{i+1} = \left[\frac{1}{b_i}\left(\frac{SF_{i-1}}{b_{i-1}} + \frac{a_{i-1}}{b_{i-1}}\right)(1+r^*) + \frac{a_i}{b_i}\right](1+r^*)$$

$$= \frac{SF_{i-1}}{b_i \cdot b_{i-1}}(1+r^*)^2 + \frac{a_{i-1}}{b_i \cdot b_{i-1}}(1+r^*)^2 +$$

$$\frac{a_i}{b_i}(1+r^*)$$

Continuing this process back to the first policy year we get,

$$SF_{i+1} = \frac{a_o (1+r^*)^{i-1}}{b_o b_1 \cdot \cdot \cdot b_i} + \frac{a_1 (1+r^*)^i}{b_1 \cdot b_2 \cdot \cdot \cdot b_i} + \cdot \cdot \cdot$$

or,

$$(6) \quad SF_{i+1} = \sum_{j=0}^{i} \frac{a_j (1+r^*)^{i+1-j}}{\prod_{s=j} b_s}$$

Now the a_j in equation 6 is also contained in the equation for the bank fund, but in the latter it is multiplied by the pure endowments j E_x. Is there any relationship between the product of the b_j's in the denominator and these pure endowments? In our particular case, the surprising answer is yes. Suppose for the moment that r* = r, that the Linton Yield for duration t + 1 is equal to the bank rate. Then

$$TR_{x+s} = \frac{1}{(1+r^*)} \frac{d_{x+s}}{l_{x+s}}$$

and

$$b_s = 1 - TR_{x+s}(1+r^*) = 1 - \frac{d_{x+s}}{l_{x+s}} = \frac{l_{x+s+1}}{l_{x+s}}$$

Therefore

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$$\prod_{s=j}^{i} b_s = \frac{l_{x+j+1}}{l_{x+j}} \cdot \frac{l_{x+j+2}}{l_{x+j+1}} \cdot \cdots \frac{l_{x+i+1}}{l_{x+i}} = \frac{l_{x+i+1}}{l_{x+j}}$$

The complicated product in the denominator of the term involving a_j reduces to the simple ratio of the number of survivors of age x + i + 1 to the number of survivors at the younger age x + j. Now simplify equation 6.

$$SF_{i+1} = \left[\sum_{j=0}^{i} (P_x - TR_{x+j}) \cdot \frac{l_{x+j}}{(1+r^*)^j}\right] \times \left[\frac{(i+r^*)^{i+1}}{l_{x+i+1}}\right] \times \left[\frac{l_x}{l_x}\right]$$

But

$$jE_x = (1+r^*)^j \frac{l_{x+j}}{l_x}$$

so

$$(8) \quad SF_{i+1} = \left[\sum_{j=0}^{i} (P_x - TR_{x+j}) \cdot jE_x\right] \cdot \left[\frac{1}{E_{x\ i+1}}\right]$$

But the right hand side of 8 is exactly the same as the r.h.s. of equation (A) or

$$SF_{i+1} = \frac{EF_{i+1}}{l_{x+i+1}}$$

Thus, when term insurance is available on an "actuarially fair" basis, the Linton Yield and the bank rate are the same for all durations.

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The Interest Adjusted Surrender Index: Biased Against Term Insurance--Why It Should Not Be Used to Compare Dissimilar Policies

While the NAIC Buyer's Guide advises that the IAC index should not be used to compare "dissimilar" policies, it is nowhere explained why one should not, nor is it said whether the index is biased in such comparisons and, if so, which way. Using the equivalent whole life and term policies we have developed here, we show that a straightforward comparison of interest-adjusted surrender costs is strongly and always biased against term insurance.

The observed similarity in cost between term and whole life policies in such publications as the New York State Shopper's Guide should not be taken as an indication that the two types cost about the same.

Proof:

$$ {}_tIAC_x = \frac{\sum_{s=1}^{t} {}_sP_x \, (1+r)^{t-s+1} - {}_tCV_x}{\ddot{s}_{n\,i}} $$

But

$$ {}_tCV_x = {}_{t+1}E_x^{1} \left(\sum_{s=1}^{t} (P_x - TR_{x+s}) \cdot {}_sE_x \right) $$

(See Appendix II for a derivation of this equation.)

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For a whole life policy, $_sP_x = P_x$, that is, the premium is level. For term policies, $_sP_x = TR_{x+s}$ and $_tCV_x = 0$. Subtract the whole life interest adjusted cost from the term cost.

$_tIAC_x$ (Term) - $_tIAC_x$ (whole life) =

$$1/ \quad \left[\sum_{s=1}^{t} TR_{x+s} (1+r)^{t-s+1} - \sum_{s=1}^{t} P_x (1+r)^{t-s+1} + {}_tCV_x \right]$$

rearranging and substituting for $_tCV_x$ from the equation above, we have [within the brackets].

$$\left[\sum_{s=1}^{t} (P_x - TR_{x+s}) \cdot {}_sE_x - {}_{t+1}E_x \sum_{s=1}^{t} (P_x - TR_{x+s}) (1+r)^{t-s+1} \right]$$

or

$$\sum_{s=1}^{t} (P_x - TR_{x+s}) \left(\frac{{}_sE_x}{{}_{t+1}E_x} - (1+r)^{t-s+1} \right)$$

But

$$\frac{{}_sE_x}{{}_{t+1}E_x} = \frac{(1+r)^{-s}}{(1+r)^{-(t+1)}} \frac{l_{x+s}}{l_{x+t+1}} = (1+r)^{t-s+1} \frac{l_{x+s}}{l_{x+t+1}}$$

So the term in brackets now becomes

$$\left[\sum_{s=1}^{t} (P_x - TR_{x+s}) \cdot (1+r)^{t-s+1} \left(\frac{l_{x+s}}{l_{x+t+1}} - 1 \right) \right]$$

Since $s < t + 1$ for all $s = 1, 2, t$, $l_{x+t} > l_{x+t=1}$ and the last term in parenthesis will be positive in every term. Since initially, and then for long periods of time (15 to 20 years), the differences between P_x and TR_{x+s} are positive, the whole expresion will be positive. Thus the comparison (falsely!) suggests that whole life is less costly than term--<u>when they are constructed to</u> be exactly equivalent.

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The bias against term insurance arises primarily because the amount of protection declines steadily in the whole life contract, but not in the term contract. Thus, comparing policies of the same face amount produces a bias against the term insurance contract. That this bias is likely to be large, can be seen from the following example. Compare two equivalent policies; a whole life policy constructed from the 1958 CSO mortality table using an interest rate of 3-1/2% and a term policy whose rates are equal to the mortality rates in this table and with the difference in the whole life and term premiums invested at 3-1/2%. The level premium for the whole life policy issued to a man aged 25 would be $10.16 per $1000 of face amount,[5] whereas the term premium would start at $1.93 and increase steadily thereafter. The cash value (assuming the latter equal to the "net level reserve" for each year) at the end of the 20th year is $245.41 per $1000 of face amount. The 20-year interest adjusted surrender cost for the whole life policy can be shown to be $3.53 per $1000 as compared to $5.30 for the term policy. Thus, the whole life policy appears to be 33% cheaper (!) than the equivalent term policy. At higher interest rates, the bias would be even larger.

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5 See table 3-4, p. 52 in R. Mehr, Life Insurance: Theory and Practice (revised edition 1977). The same table shows the "cash values" or net level reserves for this policy in column 8.

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APPENDIX IV: THE RELATIONSHIP BETWEEN POLICY COST AND SALES, AND PREMIUMS AND COST

This Appendix provides additional information concerning two subjects discussed in the report: (1) the relationship between policy cost and sales; and (2) the relationship between premiums and cost.

The relationship between cost and sales

To test the relationship between cost and market share a unique size classification was assigned to each of 349 whole life policies in Senator Hart's 1973 survey.[1] All policies of a given size classification and type were then ranked by their 20-year Company Retention index values.[2] Policies were grouped by cost deciles. The least costly policies were assigned to the first decile, and the most costly to the tenth decile. Table 1 shows total sales by face amount by decile for $10,000 whole life policies issued to males age thirty-five.[3]

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[1] This was done by dividing total number of new issues for each ordinary policy into total face value of sales for 1973. Since data was collected for sizes 5,000, 10,000, 25,000 and 100,000, each policy was assigned the size category that came closest to the above quotient. For example, if a company sold 2,000 "Executive Specials," with an aggregate face value of $30,000,000, then the average policy had a face value of $15,000. This is closer to $10,000 than $25,000, so it was assumed that all "Executive Special" sales had face value equal to $10,000.

[2] For example, among the 193 nonparticipating policies in this sample, 70 were classified as "size 10,000." The most costly policy had a Company Retention value of $132.46 and was ranked "70." The next most costly had a value of $71.31 and was ranked "69." The least costly policy had a value of $45.82, and was ranked "1." Company Retention values were computed for a 20-year period, assuming male issue age 35, a 5 percent rate of interest, and Moorhead's "Table S" lapse rates.

[3] A similar table for $25,000 policies is contained in the report at pages 61-62.

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Table 1

Sales by Cost Decile Ranked by Company Retention,
Size 10,000

Nonparticipating Policies

Decile	Face Value of Sales (000)	No. of Policies in Decile	Median Index Value
1	$ 71,946	7	$52.73
2	379,235	7	55.89
3	151,340	7	57.91
4	135,713	7	59.37
5	113,376	7	60.60
6	179,852	7	62.30
7	320,164	7	62.97
8	131,378	7	63.94
9	153,477	7	67.76
10	73,745	7	70.64
Total	$1,710,217	70	

Participating Policies

1	$1,300,059	7	38.75
2	616,636	7	42.14
3	4,158,364	7	46.04
4	670,248	7	49.61
5	393,138	7	52.16
6	122,263	7	55.71
7	105,957	7	59.42
8	78,862	7	61.51
9	565,789	7	66.11
10	101,557	8	71.05
Total	$8,112,873	71	

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Table 2 shows the Pearson correlation coefficient between sales and various measures of cost. The Pearson correlation coefficient measures the degree to which two variables behave in a similar way. For example, if the differences in sales among the 70 non-participating policies were perfectly mirrored by differences in the Company Retention Index, the Pearson coefficient would be 1. If the two variables behaved exactly opposite, then the coefficient would be -1. If there was no systematic relationship between sales and Company Retention, then the coefficient would be near zero. Table 2 shows that there is a weak, but positive relationship between high sales and low cost.

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Table 2

Pearson Coefficients for $10,000 Whole Life Policies[4]

Nonparticipating Policies

Correlated Variables	Pearson Coefficient
Sales vs. Company Retention	-.055
Sales vs. Savings Yield	.083
Sales vs. Interest Adjusted Cost	-.056
Sales vs. Premiums	-.059

Participating Policies

Sales vs. Company Retention	-.175
Sales vs. Savings Yield	.172
Sales vs. Interest Adjusted Cost	-.173
Sales vs. Premiums	-.024

Pearson Coefficients for $25,000 Whole Life Policies

Nonparticipating Policies

Correlated Variables	Pearson Coefficient
Sales vs. Company Retention	-.368[5]
Sales vs. Savings Yield	.401
Sales vs. Interest Adjusted Cost	-.366
Sales vs. Premiums	-.301

Participating Policies

Sales vs. Company Retention	-.101
Sales vs. Savings Yield	.200
Sales vs. Interest Adjusted Cost	-.232
Sales vs. Premiums	-.016

---

[4] A rate of interest of 4 percent was used for Interest Adjusted Cost calculations. All indices were calculated on a 20-year basis from issue age 35. The Savings Yield calculations employ the term rates used by Massachusetts Mutual in analyzing the Hart data.

[5] A negative coefficient for Company Retention, Interest Adjusted Cost and Premiums means that there is a positive relationship between the variables because the lower the index the lower the cost of the policy. The opposite is true for Savings Yield since the higher the yield the lower the cost of the policy.

The relationship between premium and cost

Part III.B. (page 70) discussed the relationship between premium and cost. As stated in the report, premiums are a fairly good measure of cost when looking solely at non-participating policies and are a much less reliable guide for participating policies. This is confirmed by Table 3 which shows the Pearson correlation coefficients between premiums and various cost indices.

Table 3

Pearson Correlation Coefficients Between Premiums and Various Cost Indices

Type Policy	Premiums Correlated With		
	Savings Yield	Interest-Adjusted Cost	Company Retention
Non Par, 10,000	.746	.820	.836
Par, 10,000	.321	.289	.363
Non Par, 25,000	.684	.652	.594
Par, 25,000	.55	.260	.310

Part III.B. (page 50) shows that when both participating and nonparticipating policies are compared, premiums are a totally unreliable measure of cost. This is demonstrated by Table 4 which shows correlation coefficients between premium and cost for all 307 $25,000 whole life policies in the Hart data base that were available to males, age 35, making no distinction between participating and nonparticipating policies.

Table 4

Correlation Coefficients Relating Premiums and Cost for All Whole Life Policies in Size 25,000[1]

Correlated Variables	Pearson Coefficient	Kendall Coefficient
Premiums vs. Company Retention	.066	.063
Premiums vs. Savings Yield	.254	.146
Premiums vs. Interest Adjusted Cost	-.125	-.054

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Table 4 shows that when both participating and nonparticipating policies are being compared picking a policy with a low premium will often lead to the purchase of a high cost policy. The Kendall coefficient presented in Table 4 can be used to determine the probability that two policies will be ranked in a similar way using two different measures of cost. Technically, it is the difference between the probability that they will rank in the same way and the probability that they will rank differently. Therefore, the Kendall coefficient of .146 between premiums and savings yield can be expressed as .573 - .427. If policies A and B are selected randomly from our sample, and if policy A has a lower premium, then 57% of the time it will also have a lower savings yield.

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APPENDIX V: CONSUMER LOSS DUE TO EARLY LAPSATION

Consumers lost an estimated $212 million from first-year lapse of ordinary permanent policies purchased in 1977. Since a permanent policy which lapses in the first year (before cash values accrue) buys only an equivalent amount of term insurance, the loss to the lapsing policyholder is the difference between the premiums paid on the permanent policy and the value of the death protection which was received while the policy was in force.

Several calculations and assumptions were made to estimate this loss. First, the staff determined how much of the $3.314 billion in first year ordinary premiums was paid for permanent insurance and how much for term insurance.[1] Then, to calculate the amount of premiums on lapsed permanent policies, a lapse rate of 20 percent and a 5.6 month duration was assumed.[2] Next, the value of the death protection provided by the lapsed policies while they remained in force was estimated by using representative

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[1] Actually the $3.314 billion figure refers to receipts by U.S. life companies on first year business. American Council of Life Insurance, Life Insurance Fact Book 59 (1978). Technically, it is slightly different than first-year premiums paid by U.S. citizens.

[2] The duration figure is based on data submitted to the Hart Subcommittee by 18 companies. Each gave a mean duration for ordinary permanent policies lapsed in the first year. The unweighted mean for all companies was 5.6 months.

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term rates. Finally, this value was subtracted from the amount of premiums paid on lapsed permanent policies to determine the total consumer loss from first-year lapse.

The staff used data from LIMRA's 1975 Buyer Study to estimate the first-year premium payments spent on term insurance:

Table 1[3]

Premium Expenditures on Term Products

	Percentage of Ordinary Premiums Paid on Term Products by Sex				Percentage of All Ordinary Premiums Paid by Sex	Percentage of All Term Premiums Paid by Sex
	Level Term	Decreasing Term	Term Portion of Permanent Policies	Total		
(a)	(b)	(c)	(d)	(e)	(f)	(e)x(f)
Male	7%	5%	4.4%	16.4%	79%	12.9%
Female	4%	3%	3.9%	10.9%	17%	1.9%
Juvenile	.3%	0	2.4%	2.7%	4%	0.1%
Total						14.9%

Table 1 indicates that 14.9 percent of first-year ordinary premiums was spent for term products. The staff next assumed that the remainder of first-year ordinary premiums (85.1) percent was spent for permanent insurance.

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[3] Data for this table were compiled from LIMRA, The 1975 Buyer Study, 8, 19, 22, 26 and 32. The figures for the term portion of permanent policies are not directly available in the text. However, we used the data on page 22 to calculate that 66.7 percent of the volume of these policies was term volume. Using this figure, and assuming that all term portions are level, we derived the figures in column (d) of Table 1.

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Assuming the same proportion of first-year premium dollars was spent in 1977 for term insurance, $2.817 billion ($3.314 billion x 85.1 percent) was for first-year ordinary permanent insurance in 1977. Assuming the lapse rate was 20 percent[4] and the duration of the lapsed policies was 5.6 months, approximately $295 million was spent on lapsed policies in 1977.[5]

This $295 million does not represent a total loss because buyers received the equivalent of term insurance protection while their policies remained in force. To estimate the value of this term coverage, the staff analyzed the lapse data submitted to the Hart Subcommittee by 16 companies. Each company had provided data on annualized premiums for lapsed and non-lapsed permanent business, average duration of permanent ordinary policies lapsed in the first year, and age and size breakdowns of these lapses.

The staff calculated a loss ratio for each company of the value of term protection received to the annualized premiums on permanent policies lapsed in the first year. A sample calculation for one company and one age group follows:

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4 Other estimates of first-year lapse rates on permanent ordinary business range from 14.2 percent (LIMRA figure based on the 1972-73 experience of nine companies) to 22.4 percent (unweighted mean of 24 companies submitting data to the Hart Subcommittee).

5 Let NL represent premiums on non-lapsed policies and L represent annualized premiums on lapsed policies. Then $\$2.817B = NL + \frac{5.6L}{12}$. If the lapse rate is 20 percent, then $NL = 4 \times L$. Solving, we get: $NL = \$2.522B$ and $\$2.817B - \$2.522B = \$295$ million = amount spent on permanent ordinary lapsed policies.

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Table 2

Value of Term Protection for Lapsed Policies

Size (a)	Average[6] Size (b)	Term[7] Rate (c)	No. of Policies Lapsed[8] (d)	Value of Term Protection ((b)(c)(d))
$0-4,999	$ 2,500	$8.57	1,010	$ 21,639.25
5,000	5,000	5.57	3,814	106,219.90
5,001-9,999	7,500	5.57	313	13,075.58
10,000	10,000	4.57	5,645	257,976.50
10,000-24,999	17,500	4.57	1,371	109,645.73
25,000	25,000	3.57	83	7,407.75
Over 25,000	25,000	3.57	33	2,945.25
			Total	$518,909.96

6 FTC figures.

7 Rates used by Massachusetts Mutual in calculating Linton Yield figures using the Hart data. These rates are similar to the "Average Yearly Renewable" rates prepared by E.J. Moorhead. See The Society of Actuaries, Analysis of Life Insurance Cost Comparison Methods 192 (1974).

8 Data for one age group (15-24) submitted by one company (Allstate). Age categories used were: 15-24; 25-34; 35-44; 45-54; and 55 and over.

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For all age groups, purchasers of permanent ordinary life insurance which lapsed in the first year received annualized benefits of $1,196,971.77. This represents 32.2 percent of annualized premiums received by this company for permanent ordinary policies lapsed in the first year. The average for all 16 companies was 28 percent. Since only 28 percent of the premium on the lapsed policies purchased the equivalent of term protection, the remaining 72 percent was lost. Thus, the loss from first-year lapse of permanent ordinary policies purchased in 1977 is $212 million ($295 million x 72 percent).[10]

The only other comparable loss calculation of which the staff is aware is Dean Sharp's estimate made during the Hart Subcommittee hearings. He estimated a $505 million loss due to lapse of policies sold in 1970 and lapsed within two years.[11] Sharp had limited data at his disposal.[12] Aside from the different lapse period used, Sharp's calculations differed from the staff's method in a number of ways. Most significantly, he assumed that all policies which lapsed within two years

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10 In an effort to determine how sensitive this estimate is to the choice of lapse rate, the staff performed similar calculations using lapse rates of 15 and 25 percent. These loss figures were $156 million and $275 million respectively.

11 The "one-year" data is actually for policies not renewed within 13 months.

12 Details of Sharp's calculation can be found in The Life Insurance Industry: Hearings Before the Senate Subcommittee on Antitrust and Monopoly, 93rd Cong., 1st Sess. 211 (1973).

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remained in force for the full two year period before they were dropped, and that cash values at the end of two years were zero.[13] The staff has been able to use the data assembled by Sharp for the Hart Subcommittee to estimate the duration of lapsed policies to be 5.6 months. Therefore, the staff's estimate is much smaller than his.[14]

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[13] Sharp's calculations differed in other ways as well. He employed average data for all ordinary insurance. He did not distinguish between lapse of term and lapse of permanent business, or take into account different lapse behavior for different policy size groups, and age groups. He used an average premium per $1,000 figure without distinguishing between term and permanent business. Finally, he assumed a term value of $4 per $1,000 regardless of policy size or age of the insured.

[14] The staff calculation, based on $1.869 billion first-year premiums paid on ordinary business in 1970, would be a loss of $120 million in that year. If the lapse period was expanded to two years, and a 5 percent lapse rate was assumed in the second year, the loss calculation for 1970 would be about $255 million.

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APPENDIX VI: TECHNICAL NOTES ON THE DIFFERENT COST MEASURES USED IN THIS REPORT

The purpose of this Appendix is to provide, for the financially and/or actuarially sophisticated reader, a more complete explanation of the company retention index, the premium breakdown that can be derived using the company retention index, the average annual rate of return (Linton Yield), and the cash accumulation method that we described in the report. For each of these major financial disclosures the Appendix provides (a) a brief technical explanation of the measure; (b) references to published works concerning the measure; (c) the mathematical formulas for these measures; and (d) the actual interest rate, mortality, lapse and term premium rate assumptions used in computing these measures in this report. The computer program that was used to calculate the Linton Yields in this report is also included.

A. The Company Retention Index

(1) The "company retention index" is essentially the present expected value of all premiums, less the present expected value of all death benefits, policy dividends and cash values, over a given period of time, say 20 years. It is a "present" value because an interest rate is used to discount every future cash flow back to the present. For example, a $1 dividend to be received at the end of the year has "present" (beginning of the year) value of about 95 cents. It is an "expected" value because each future premium, dividend, cash value, death benefit, etc., is weighed by the probability that it will actually be paid.

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Each cash flow is weighed by a probability that reflects the fact that payments are contingent on whether the insured lives or dies and whether the insured "surrenders" or allows his policy to "lapse."

The actual mortality and lapse probabilities used are industrywide averages and will not necessarily be good predictors of any individual company's future mortality and lapse experience. For the sake of comparing the cost of one policy to another, however, it is important to use the same interest, mortality and lapse assumptions. Finally, the company retention index is expressed on a level annual basis, as is the premium for a whole life policy.

(2) References on the Company Retention Index

The "Company Retention" method is described and illustrated in Joseph Belth, "The Relationship Between Benefits and Premiums in Life Insurance," 36 J. of Risk and Insurance 19-39 (1969.

Much useful information about this and other methods is contained in Analysis of Life Insurance Cost Comparison Methods, prepared by the Society of Actuaries Committee on Cost Comparison Methods and Related Issues (Special), September 1974.

(3) Mortality: The "1957-60 Ultimate Basic Mortality for Males" table (Transactions of the Society of Actuaries, 1962) was adjusted by Mr. E.J. Moorhead to reflect the recent decline in mortality and "selection" factors were employed. The tables used are set forth later in the appendix.

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Lapse: Moorhead's table "S".

Interest Rate: 5%

Duration: 20 years from issue.

Timing of Cash Flows: It is assumed that premiums are paid at the beginning of the year and that any dividends, cash values or face amounts are paid at the end of the year. Terminal dividends are assumed payable on death or surrender.

B. The Premium Breakdown

(1) The premium breakdown figures are simply the components of the company retention index shown separately. They are the expected present value of premiums, protection, dividends, savings and company retention, all expressed on a level annual basis as explained in section one above. "Protection" for any given year is defined to be the face amount of the policy plus any terminal dividend, less the cash value for that year. "Savings" in any given year are defined to be the difference between the cash value at the end of the year and the previous year's cash value augmented by one year's interest.

(2) Same as 1.b.

(3) Same as 1.c.

C. The Average Annual Rate of Return (Linton Yield)

(1) In the insurance literature this rate of return is known as the "Linton Yield." It is one example of what economists and financial analysts call an "internal rate of return." In essence, the method consists of subtracting a "cost of protection" from each year's premium (net of dividends) and treating the remainder as a "saving deposit." The 20-year

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average annual rate of return is then that rate of interest which would make the balance in the "savings account" at the end of 20 years equal to the cash value of the whole life policy at the end of 20 years. The "cost of protection" depends on the yearly renewable term premiums used and the amount of protection purchased. The term rates assumed are given in the appendix and the amount of protection purchased is calculated in such a way that the sum of the saving account and the face amount of the term insurance policy is equal to the face amount of the whole life policy.

The Society of Actuaries has described the "Linton Yield" as follows: "The method solves for a level, effective, annually compounded interest rate or yield. This yield is determined by equating the cash available at the end of n years from two different protection/savings programs, each with identical yearly death benefits, and then solving for the annual yield that must be achieved on the separate savings fund of the second program in order to produce the cash equivalency with the first program. The two programs compared are:

(a) A life insurance policy on, normally but not necessarily, some permanent plan. The cash used at the end of the nth year is the policy's guaranteed cash value.

(b) A combination of a savings fund and Yearly Renewable Term (YRT) insurance. The amount deposited in the savings fund each year is assumed to be equal to the annual premium

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payable for the alternate program for the permanent life insurance policy (less any dividend payable at the end of the preceeding year) less any assumed premium payable for YRT insurance. The amount of YRT purchased each year is that which would be adequate to bring the combined death benefit from the saving plan and the YRT to the same as that payable under the permanent life insurance policy. The cash used for comparison with the permanent policy is the amount accumulated in the savings fund at the end of the nth year See Analysis of Life Insurance Cost Comparison Methods, pp. 28-29.

(2) References:

Belth, Joseph. "The Rate of Return on the Savings Element in Cash-Value Life Insurance," The Journal of Risk and Insurance, Vol. 35, #4 (December 1968), pp. 569-81.

(3) Term Insurance Rates.

In the report, the term insurance rates used were computed by using the Society of Actuaries mathematical formula for low yearly renewable term rates (Actuaries Report, p. 187) together with the mortality rates (adjusted for selection, id. p. 188). This mortality table is reproduced in this appendix as Table 1. The term insurance rates produced by this process are somewhat lower than the rates used in the Actuaries Report.

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This is because the FTC staff used the mortality table that reflects the improved mortality experience that companies achieve through selective underwriting, whereas the Actuaries Report used the same mortality table, but without adjustments for selection. We think it is appropriate to use these somewhat lower term rates for two reasons. First, the Actuaries Report was published in 1974 and the low term rates used reflected prices available for individual policies in 1973. Since that time, however, term rates have declined. Therefore the rates used in the Actuaries Report are no longer representative of low cost term rates available in the market. Second, the rates used in the Actuaries Report were chosen to be representative of low cost individual term insurance alone. Since about half of all insurance in force is group term and much more than half of all term insurance premiums are paid for group term policies, we think it is necessary, in selecting term rates for Linton Yield calculations, to reflect the relatively lower rates for group term policies as well as for individual term policies. When group term rates are considered, the rates used in the Actuaries Report simply do not reflect low cost term insurance rates available in the market in 1977. In contrast, the rates used in this report better reflect low cost term insurance rates available in that year. For completeness, however, we have also calculated rates of return using term rates identical to those used in the Actuaries Report. These appear in Appendix VI Tables 4-6.

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The draft regulation (Appendix X) contains the mortality table without the selection adjustment and, in conjunction with the formula, will produce the term rates used in the Actuaries Report. The "select" table could not be used, since selection factors were only available for four issue ages (25, 35, 45 and 55), whereas rates of return must be computed for any issue age. As previously discussed, we believe the term rates so produced are no longer representative of low cost term insurance. Therefore the term rates implicit in the draft regulation are more for illustrative purposes than for actual use. We recommend that any state, considering adoption of rate of return disclosure regulations, conduct a study to determine rates representative of low cost individual and group term insurance policies in that state and use those in their regulation.

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Table 4

Average Rates of Return (Tax Free) on Whole Life Insurance Policies
1973 and 1977

Age at Issue	Face Amt of Policy	If Policy is Held For	1973 Dividend Paying	1973 Nondividend Paying	1977 Dividend Paying	1977 Nondividend Paying
25	$10,000	5 years	-11.17%	-16.68%	-11.34%	-18.10%
		10 years	1.03	- 0.29	2.60	- 0.41
		20 years	3.94	2.68	4.94	2.82
	25,000	5 years	-10.85%	-17.08%	-11.25%	-16.30%
		10 years	0.34	- 0.87	1.77	0.07
		20 years	3.50	2.41	4.46	2.98
	100,000	5 years	-11.74	-17.24	-11.52	-15.68
		10 years	- 0.18	- 1.13	1.47	0.28
		20 years	3.26	2.29	4.32	3.11
35	10,000	5 years	- 8.87	-12.31	- 7.59	-13.06
		10 years	0.79	- 0.49	2.23	- 0.57
		20 years	3.61	2.29	4.66	2.44
	25,000	5 years	- 8.57	-12.21	- 7.76	-11.11
		10 years	0.40	- 0.67	1.79	0.21
		20 years	3.35	2.22	4.37	2.77
	100,000	5 years	- 9.19	-12.24	- 7.93	-10.52
		10 years	0.04	- 0.78	1.63	0.48
		20 years	3.19	2.18	4.31	2.94
45	10,000	5 years	- 7.60	-10.43	- 7.18	-11.19
		10 years	0.80	- 0.56	2.22	- 0.67
		20 years	3.33	1.88	4.42	1.99
	25,000	5 years	- 7.11	-10.01	- 6.63	- 8.81
		10 years	0.65	- 0.50	2.16	0.40
		20 years	3.22	1.94	4.36	2.49
	100,000	5 years	- 7.57	- 9.93	- 6.61	- 8.09
		10 years	0.39	- 0.51	2.09	0.75
		20 years	3.12	1.94	4.34	2.71

NOTE: Term rates used for calculation of rates of return include no selection factors.

Table 5

Variation in Rates of Return on $25,000 Whole Life Insurance Policies Issued in 1973 and 1977

Dividend Paying Policies

Age at Issue	Year of Issue	Duration of Holding Period	Average Rate	Lowest Rate	Highest Rate	Standard Deviation	Coefficient of Variation
25	1973	5 years	-10.85%	-28.06%	1.70%	7.53%	69%
	N=	10 years	0.34	- 6.02	4.22	2.11	-
	(139)	20 years	3.50	- 0.02	5.02	0.76	22
		30 years	3.87	1.00	5.05	0.65	17
	1977	5 years	-11.16	-46.40	1.93	8.66	77
	N=	10 years	1.78	- 2.58	6.71	1.95	111
	(94)	20 years	4.45	1.01	7.78	0.93	21
		30 years	4.77	2.28	7.98	0.78	16
35	1973	5 years	- 8.57	-21.87	1.35	5.60	65
	N=	10 years	0.40	- 6.02	3.60	1.84	-
	(145)	20 years	3.35	- 0.32	4.68	0.74	22
		30 years	3.71	0.67	4.81	0.65	18
	1977	5 years	- 7.76	-28.40	1.54	4.81	62
	N=	10 years	1.79	- 2.72	6.30	1.68	94
	(129)	20 years	4.37	1.25	8.07	0.89	20
		30 years	4.72	1.95	8.15	0.71	15
45	1973	5 years	- 7.11	-19.62	1.78	4.87	68
	N=	10 years	0.65	- 5.99	3.46	1.79	-
	(145)	20 years	3.22	- 0.93	4.66	0.82	25
		30 years	3.49	- 0.01	4.84	0.72	21
	1977	5 years	- 6.63	-69.77	9.30	8.15	123
	N=	10 years	2.16	- 3.63	7.89	1.84	85
	(92)	20 years	4.36	0.31	8.76	1.07	25
		30 years	4.55	0.54	8.70	0.99	22

NOTE: In those instances when the average rate of return was close to zero, a coefficient of variation was not computed. Turn rates used for calculation of rates of return include no selection factors.

Variation in Rates of Return on $25,000 Whole Life Insurance Policies Issued in 1973 and 1977

Non-Dividend Paying Policies

Age at Issue	Year of Issue	Duration of Holding Period	Average Rate	Lowest Rate	Highest Rate	Standard Deviation	Coefficient of Variation
25	1973	5 years	-17.08%	-56.06%	2.85%	8.79%	5%
	N=	10 years	- 0.87	-20.80	6.10	2.80	-
	(162)	20 years	2.41	- 2.90	4.65	0.99	41
		30 years	2.64	- 0.36	6.33	0.68	26
	1977	5 years	-16.30	-38.06	4.59	9.59	59
	N=	10 years	0.07	- 8.95	4.91	2.71	-
	(57)	20 years	2.98	- 0.86	5.00	1.22	41
		30 years	3.11	1.03	4.61	0.80	26
35	1973	5 years	-12.21	-44.53	1.27	5.83	48
	N=	10 years	- 0.67	-19.65	5.68	2.27	-
	(162)	20 years	2.22	- 3.54	4.64	0.87	39
		30 years	2.44	- 1.01	4.23	0.57	23
	1977	5 years	-11.11	-26.05	2.98	5.94	53
	N=	10 years	+ 0.21	- 6.68	3.52	2.05	-
	(59)	20 years	2.77	- 1.05	4.33	1.11	40
		30 years	2.94	0.33	4.66	0.86	29
45	1973	5 years	-10.01	-41.55	1.17	4.89	49
	N=	10 years	- 0.50	-21.11	4.97	2.38	-
	(161)	20 years	1.94	- 5.26	4.18	1.05	54
		30 years	2.11	- 3.70	3.88	0.78	37
	1977	5 years	- 8.81	-19.60	1.69	4.82	55
	N=	10 years	0.40	- 4.92	3.69	1.92	-
	(57)	20 years	2.49	- 1.50	5.18	1.30	52
		30 years	2.52	- 1.07	4.74	1.07	42

NOTE: In those instances when the average rate of return was close to zero, a coefficient of variation was not computed. Term rates used for calculation of rates of return include no selection factors.

Table 6

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D. The Cash Accumulation Method

(1) The cash accumulation method is a variant of the Linton Yield method. As previously discussed, the Linton Yield method involves constructing a term insurance plus side fund alternative to a particular cash value policy that is in some sense, equivalent to the cash value policy.

By "equivalent" is meant that the death estate (at the beginning of the year) and the cash outlay are the same, regardless of whether the cash value policy or the term plus side fund package is purchased. Any method that holds death benefits and cash outlay constant, can be referred to as a "Linton type" method. The Linton yield itself is simply the rate of interest that equates the accumulated deposits (uniquely defined by holding 1 and 2 constant) with the cash value of the whole life policy at the end of the terminal year. If the rate of interest by which to discount the flows over time is assumed, then it is possible to compute how much money there would be in the side fund at the end of each year and compare it to the cash value specified in the alternative policy. The amounts in the two savings accounts are the only significant items that can differ between the two alternatives and so a comparison limited to the "savings" element alone is valid. This is what the cash accumulation does.

(2) References:

The cash accumulation method is described in Murray, "Analyzing the Investment Value of Cash Value Life Insurance," 43 J. Risk & Ins. 121 (1976).

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It is also discussed in the Moss Subcommittee Report, Subcommittee on Oversight and Investigations Report on Life Insurance Marketing and Cost Disclosure, 95th Cong., 2d Sess. 13-14 (1978).

(3) The term rates used in the calculation are the same as those used for the Linton Yield.

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Mathematical Formulas

1. Company Retention Index and the Premium Breakdown.

Consumer Cost Index = $CC_x = \left(\frac{nCR_x}{PREM}\right) \cdot \left({}_tP_x\right)$

Protection = $\frac{PROT}{PREM} \cdot ({}_tP_x)$

Savings = $\frac{SAV}{PREM} \cdot ({}_tP_x)$

Dividends = $\frac{DIV}{PREM} \cdot ({}_tP_x)$

Company Expenses and Profit = CC_x

where, ${}_mCR_x = PREM - PROT - SAV - DIV$

$$PREM = \sum_{t=1}^{n} ({}_tP_x)\ (V)^{t-1}\ {}_{t-1}g_x$$

$$PROT = \sum_{t=1}^{n}) F + {}_tTD_x^{1} - {}_tCV_x)\ (V^t)\ ({}_{t-1}g_x)\ ({}_{x+t-1}q^{d})$$

$$SAV = \sum_{t=1}^{n} [{}_tCV_x - ({}_{t-1}CV_x)(1+i)]\ (v^t)({}_{t-1}g_x)$$

$$DIV = \sum_{t=1}^{n} [{}_tD_x + ({}_tTD_x)({}_{x+t-1}q^{w})]\ (V^t)({}_{t-1}g_x)$$

and,

n = duration of index, here 20 years from date of issue.

x = issue age.

${}_tP_x$ = annual premium at beginning of year t for issue age x.

${}_tCV_x$ = cash value at end of year t for issue age x, excluding any terminal dividend payable upon surrender.

${}_tD_x$ = annual dividend at end of year t for issue age x.

${}_tTD_x$ = terminal dividend payable on surrender at the end of year t for issue age x

${}_tTD_x^{1}$ = terminal dividend payable on death in year t for issue age x.

F = amount payable on death, excluding terminal dividend (assumed constant).

i = assumed rate of interes (here 5 percent).

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$^{d}q_{x+t-1}$ = probability a person age x+t-1 will die before age x+t

$$v^{t} = \frac{1}{(1+i)^{t}}$$

$_{t-1}g_{x}$ = probability of surviving and persisting from age x to age x+t-1

$$= \prod_{s=1}^{t-1} (1 - q^{d}_{x+s-1} - q^{w}_{x+s-1})$$

where, q^{w}_{x+s-1} = probability a person age x+s-1 will lapse or surrender before age x+s.

and $\prod_{s=1}^{t-1} f(s)$ = the product of some function of s, where s=1,2,3, . . . t-1.

and $_{0}g_{x} = 1$.

2. The nth year Average Annual Rate of Return (Linton Yield).

This rate of return is calculated by recursively solving the following system of simultaneous equations.

(a) $_{t}BFUND_{x} = {}_{t-1}EFUND_{x} + {}_{t}P_{x} - {}_{t-1}D_{x}$

(b) $_{t}PROT_{x} = {}_{t}F_{x} - {}_{t}BFUND_{x}$

(c) $_{t}EFUND_{x} = ({}_{t}BFUND_{x} - {}_{t}TCHG_{x})\ (1+r)$

(d) $$_{t}TCHG_{x} = \frac{({}_{t}PROT_{x})\ ({}_{t}YRT_{x})\ (.001)}{1 - [({}_{t}YRT_{x})(.001)]}$$

(e) $_{n}EFUND_{x} = {}_{n}CV_{x}$

The last equation (e) is solved for that rate of return (r) that makes the quality (e) hold. These five equations may be combined to produce the following polynominal, which will be familiar to those who use internal rates of return.

$$_{n}CV_{x} = \sum_{t=1}^{n} \frac{(1+r)^{t}\ [{}_{n-t+1}P_{x} - {}_{n-t}D_{x} - (F)(n-t+1YRT_{x})(.001)]}{\prod_{j=1}^{t} [1 - ({}_{n-j+1}YTR_{x})(.001)]}$$

where

$_{t}P_{x}$, $_{t-1}D_{x}$ and $_{n}CV_{x}$ are as defined in (1) above, and

$_{t}BFUND_{x}$ = savings fund at the beginning of year t

$_{t}EFUND_{x}$ = savings fund at the end of year t

$_{t}FROT_{x}$ = insurance protection needed in year t

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${}_tTCHG_x$ = term insurance charge for insurance protection in year t

${}_tYRT_x$ = yearly renewable term premium per $1000 at attained age $x+t-1$

r = the rate of return to be solved for.

3. Cash accumulation method

1. Death benefits are to be the same at the beginning of each year whether one buys the whole life policy or the term plus saving fund package.

$$F_t = PROT_t + E_{t-1} + d_t$$

where F_t = face amount of the whole life policy in year t (in dollars)

$PROT_t$ = face amount of annual renewable term insurance bought at beginning of year t (in dollars)

E_t = the amount of dollars in the side fund at the end of year t.

d_t = the "deposit" in the side fund made at the beginning of year t (in dollars).

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Equation can be solved for the protection amount,

$$(1') \quad PROT_t = \begin{cases} F_t - (E_{t-1} + d_t), & \text{if } F_t > E_{t-1} + d_t \\ 0, & \text{if } F_t \leq E_t + d_t \end{cases}$$

The above form takes explicit account of the fact that one buys no further term insurance once the savings fund equals or exceeds the face amount of the whole life policy. Beyond this point, one of the fundamental conditions mentioned above is violated, namely, the death benefits under the term plus side fund option exceed those under the whole life option.

2. Cash outlays are the same for both options.

$$(2) \quad (P_t - D_{t-1}) \quad F_t = TR_t \cdot PROT_t + d_t$$

where P_t = the premium on the whole life policy in year t in dollars per dollar of face amount.

D_t = dividend paid at the end of year t on the whole life policy, in dollars per dollar of face amount.

TR_t = the premium rate for annual renewable term insurance in year t, in dollars per dollar of face amount.

3. Side fund accumulation.

$$(3) \quad E_t = (E_{t-1} + d_t) \quad (1 + r)$$

where r = the assumed rate of interest.

The above equations can be solved simultaneously to obtain a single expression for E_t in terms of the basic policy parameters.

i. Using equation 1', substitute for $PROT_t$ in equation (2).

$$d_t = (P_t - D_{t-1}) \cdot F_t - TR_t \cdot (F_t - E_{t-1} - d_t)$$

or,

$$(4) \quad d_t = \frac{(P_t - D_{t-1} - TR_t) \cdot F + TR_t \cdot E_{t-1}}{1 - TR_t}$$

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ii. Now substitute d_t from equation (4) into equation (3).

$$E_t = \frac{(P_t - D_{t-1} - TR_t) \cdot F_t + TR_t \cdot E_{t-1} + E_{t-1} - TR_t E_{t-1}}{1 - TR_t} \times (1 + r)$$

or,

$$(6) \qquad E_t = \frac{E_{t-1} (1 + R)}{1-TR_t} + \frac{(P_t - D_{t-1} - TR_t) \cdot F (1 + r)}{1-TR_t}$$

Note that (6) is in a very convenient recursive form for computer computation.

iii. Using (6), you can solve for E_{t-1} in terms of E_{t-2} and the basic parameters. Continuing the process, you obtain an expression for E_t in terms of E_1 and the basic parameters. Now solve for E_1.

$$E_1 = d_1 (1 + r) \quad \text{since } E_o = 0$$

from equation (4),

$$d_1 = \frac{(P_t - TR_1) \cdot F_1}{1-TR_1} \quad \text{since } D_o = 0$$

hence,

$$E_t = \frac{(P_t - TR_t - D_{t-1}) \cdot F_t (1 + r)}{1 - TR_t}$$

$$+ \frac{(P_{t-1} - TR_{t-1} - D_{t-2}) \cdot F_{t-1} (1 + r)^2}{(1-TR_t)(1-TR_{t-1})}$$

$$+ \ldots$$

$$+ \frac{(P_1 - TR_1) \cdot F_1 (1 + r)^t}{(1-TR_t)(1-TR_{t-1}) \ldots (1-TR_2)(1-TR_1)}$$

or more compactly,

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$$(7)\quad E_t = \sum_{j=1}^{t} \frac{a_j\ (1+r)^{t-j+1}}{\prod_{i=j}^{t} (1 - TR_i)} \qquad \text{where } a_j = (P_j - D_{j-1} - TR_j)$$

where $\prod_{i=j}^{t} f(i)$ = the product of some function of i, where i=j, $j+1_1$ .. t

4. E_t from equation (7) should be compared to $(CV_t + TD_t + D_t)$ F_t for the whole life policy, where

CV_t = cash value of whole life policy at end of year t, in dollars per dollar of face amount.

TD_t = terminal surrender dividend of whole life policy at end of year t, in dollars per dollar of face amount.

MORTALITY RATES (PER 1,000) USED IN COST COMPARISION METHODS

Policy Year	Issue Age 25	Issue Age 35	Issue Age 45	Issue Age 55
1	.53	.71	1.81	3.72
2	.63	.89	2.48	5.37
3	.77	1.16	3.11	7.32
4	.80	1.32	3.69	8.67
5	.80	1.48	4.17	9.47
6	.81	1.70	4.85	11.22
7	.85	1.99	5.49	13.13
8	.88	2.26	6.10	14.34
9	.96	2.59	6.70	15.58
10	1.05	2.98	7.50	17.41
11	1.17	3.37	8.38	19.08
12	1.27	3.81	9.66	22.55
13	1.40	4.47	11.11	26.44
14	1.57	5.04	12.65	30.72
15	1.72	5.71	14.45	35.34
16	1.91	6.25	15.92	38.61
17	2.12	6.80	17.60	41.80
18	2.39	7.49	19.45	44.96
19	2.72	8.28	21.38	48.35
20	3.10	9.08	23.25	52.34
21	3.56	9.90	25.19	
22	4.06	10.85	27.31	
23	4.58	11.93	29.74	
24	5.14	13.14	32.33	
25	5.71	14.45	35.34	
26	6.25	15.92	38.61	
27	6.80	17.60	41.80	
28	7.49	19.45	44.96	
29	8.28	21.38	48.35	
30	9.08	23.25	52.34	
31	9.90	25.19		
32	10.85	27.31		
33	11.93	29.74		
34	13.14	32.33		
35	14.45	35.34		
36	15.92	38.61		
37	17.60	41.80		
38	19.45	44.96		
39	21.38	48.35		
40	23.25	52.34		
41	25.19			
42	27.31			
43	29.74			
44	32.33			
45	35.34			
46	38.61			
47	41.80			
48	44.96			
49	48.35			
50	52.34			

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MODIFIED HOORHEAD TABLE S LAPSE RATES USED IN COST COMPARISON METHODS

Policy Year	Issue Age 25	Issue Age 35	Issue Age 45	Issue Age 55
1	.2250	.2250	.2250	.2250
2	.0450	.0450	.0450	.0450
3	.0350	.0350	.0350	.0350
4	.0300	.0300	.0300	.0300
5	.0275	.0275	.0275	.0275
6	.0260	.0260	.0260	.0260
7	.0250	.0250	.0250	.0250
8	.0245	.0245	.0245	.0245
9	.0240	.0240	.0240	.0240
10	.0235	.0235	.0235	.0235
11	.0230	.0230	.0230	.0230
12	.0225	.0225	.0225	.0225
13	.0220	.0220	.0220	.0220
14	.0215	.0215	.0215	.0215
15	.0210	.0210	.0210	.0210
16	.0205	.0205	.0205	.0205
17	.0200	.0200	.0200	.0200
18	.0190	.0190	.0190	.0190
19	.0180	.0180	.0180	.0180
20	.0170	.0170	.0170	.0170
21	.0160	.0160	.0214	
22	.0150	.0150	.0248	
23	.0150	.0150	.0282	
24	.0150	.0150	.0316	
25	.0154	.0150	.0350	
26	.0174	.0180	.0380	
27	.0193	.0210	.0410	
28	.0212	.0240	.0440	
29	.0230	.0270	.0470	
30	.0250	.0300	.0500	
31	.0260	.0320		
32	.0270	.0340		
33	.0280	.0360		
34	.0290	.0380		
35	.0300	.0400		
36	.0300	.0420		
37	.0300	.0440		
38	.0300	.0460		
39	.0300	.0480		
40	.0300	.0500		
41	.0320			
42	.0340			
43	.0360			
44	.0380			
45	.0400			
46	.0420			
47	.0440			
48	.0460			
49	.0480			
50	.0500			

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YEARLY RENEWABLE TERM PREMIUMS PER $1000 FOR $25,000 POLICY (INCLUDING POLICY FEE)*

Age	Low Scale	Average Scale	High Scale
25**	$ 2.97	$ 3.39	$ 3.80
26**	2.97	3.39	3.80
27**	2.97	3.39	3.80
28**	2.97	3.39	3.80
29	2.97	3.39	3.80
30	2.99	3.41	3.82
31	3.06	3.48	3.90
32	3.12	3.54	3.97
33	3.15	3.59	4.02
34	3.17	3.61	4.04
35	3.23	3.67	4.11
36	3.32	3.76	4.21
37	3.42	3.88	4.34
38	3.56	4.04	4.51
39	3.71	4.21	4.70
40	3.91	4.43	4.94
41	4.14	4.68	5.21
42	4.43	4.99	5.56
43	4.77	5.37	5.97
44	5.18	5.82	6.47
45	5.66	6.36	7.05
46	6.18	6.94	7.69
47	6.74	7.54	8.35
48	7.32	8.20	9.07
49	7.92	8.86	9.79
50	8.49	9.49	10.48
51	9.08	10.14	11.19
52	9.80	10.94	12.07
53	10.64	11.86	13.08
54	11.49	12.79	14.10
55	12.35	13.75	15.15
56	13.36	14.86	16.37
57	14.50	16.12	17.75
58	15.77	17.53	19.29
59	17.16	19.06	20.97
60	18.71	20.77	22.84
61	20.47	22.73	24.98
62	22.43	24.89	27.35
63	24.46	27.14	29.81
64	26.44	29.32	32.20
65	28.49	31.59	34.69
66	30.72	34.06	37.39
67	33.29	36.89	40.50
68	36.02	39.92	43.81
69	39.21	43.43	47.66
70	42.66	47.25	51.84
71	46.03	50.97	55.92
72	49.36	54.66	59.95
73	52.93	58.61	64.28
74	57.15	63.27	69.38

* To obtain per $1000 premiums for $5,000 policy add $4; for $10,000 policy add $1.50; for $100,000 policy deduct $.75.

** Premiums for $x < 29$ equal premium for $x = 29$.

PROGRAM: LINTON

(Linton Yield Program)

1. Introduction

The funds used to purchase a whole life insurance policy are used instead to purchase term insurance with the remainder deposited in a savings account, such that the total of term insurance plus savings fund at the beginning of year equals the face amount of the whole life insurance policy. The Linton yield is the rate of interest which would have to be paid on the savings deposits to equate the savings balance at the end of the N^{th} year to the N^{th} year cash value of the whole life policy.

Mathematically, the following recursive equation is solved for r:

$$E_t = (E_{t-1}+(P_t-D_{t-1}-Y_t)F_t)(1+r)/(1-.001Y_t)$$

$t = 1,\ldots,N$

subject to $(C_N+D_N+T_N)F_N = E_N$

where r is the Linton yield and

E_t is the value in dollars of the savings account in time t, and $E_0 = 0$,

P_t is the whole life insurance premium in time t, expressed in cost per thousand dollars of face value

D_t is the dividend per thousand dollars of face value in time t, and $D_0 = 0$

Y_t is the term insurance premium in time t, expressed in cost per thousand dollars of face value.

F_t is the face value of the policy in time t, expressed in thousands of dollars.

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N is the time period for which the yield is computed

C_N is the cash value of the whole life policy in year N, per thousand dollars of face value

T_N is the terminal dividend in year N, per thousand dollars of face value

The Linton yield program calculates r using the Mueller iteration method, given user-supplied policy issue age, whole life premium, dividends, face value and cash value. The last variable includes any terminal dividends. Optionally, the user may supply term rates, the time periods for which the returns are to be computed, upper and lower bounds for the Linton yield, a tolerance level of the estimate, the number of iterations, and if more than one set of data is used, whether these options change for subsequent data sets. In addition, the option cards may be on a separate file from the data sets.

At least one option card must be supplied. If a field on the option card is blank, default values are assumed. If the same options are to apply to all data sets in the job, only one option card need be supplied.

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OPTION CARD FORMAT

COLS	VARIABLE	DESCRIPTION	DEFAULT VALUE
1-2	IYR	Number of years of data in the data set(s)	20
3-4 5-6 7-8	IPER	The period(s) for which the yield(s) is (are) to be computed. Up to 3 periods may be selected (but see note on cash value on DATA SET FORMAT). If fewer than 3 periods are selected, enter the periods in the leftmost fields. For example, if returns are to be computed for 15 and 20 years, enter '15' in cols 3-4, '20' in cols 5-6 and nothing in cols 7-8	5 10 20
9-16	XLI*	Leftmost bound of yield	-1.0 (-100%)
17-24	XRI*	Rightmost bound of yield	.10 (+10%)
25-32	EPS*	Tolerance level of the estimate (i.e., $\|(C_N + D_N + T_N)F_N - E_N\| <$ EPS)	.001
33-35	IEND	Number of iterations	20
36	IART	If zero or blank, term rates are calculated for issue age 25, 35, 45 or 55 from mortality tables in core using the following formula: $Y_t = .95M_{t,a} + .90 + 25000/F_t$ where $M_{t,a}$ is the entry in the mortality table for year t, age a If 1, a mortality table is to be read in following this option card, and term rates are to be calculated as above If 2, term rates are to be read in with the data set, and there is no age restriction.	See default mortality table, below

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OPTION CARD FORMAT (cont'd)

COLS	VARIABLE	DESCRIPTION	DEFAULT VALUE
37	IFV	If zero or blank, face value is fixed over time	
		If 1, face value changes over time	
38	IPREM	If zero or blank, premium is level over time	
		If 1, premium changes over time	
39	IOPT	If zero or blank, no more option cards are to be read	
		If 1, an option card is to be read for the subsequent data set	
40	IT	This is used only if the data sets are not on the same file as the option cards	
		If zero or blank, yields are to be computed for all years for which data are available	
		If 1, yields are to be computed for periods determined by IPER	

* If any of these fields are overridden, the decimal point must be keyed in explicitly.

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DEFAULT MORTALITY RATES USED WHEN IART=0

Policy Year	Issue Age 25	Issue Age 35	Issue Age 45	Issue Age 55
1	.53	.71	1.81	3.72
2	.63	.89	2.48	5.37
3	.77	1.16	3.11	7.32
4	.80	1.32	3.69	8.67
5	.80	1.48	4.17	9.47
6	.81	1.70	4.85	11.22
7	.85	1.99	5.49	13.13
8	.88	2.26	6.10	14.34
9	.96	2.59	6.70	15.58
10	1.05	2.98	7.50	17.41
11	1.17	3.37	8.38	19.08
12	1.27	3.91	9.66	22.55
13	1.40	4.47	11.11	26.44
14	1.57	5.04	12.65	30.72
15	1.72	5.71	14.45	35.34
16	1.91	6.25	15.92	38.61
17	2.12	6.80	17.60	41.80
18	2.39	7.49	19.45	44.96
19	2.72	8.28	21.38	48.35
20	3.10	9.08	23.25	52.34
21	3.56	9.90	25.19	
22	4.06	10.85	27.31	
23	4.58	11.93	29.74	
24	5.14	13.14	32.33	
25	5.71	14.45	35.34	
26	6.25	15.92	38.61	
27	6.80	17.60	41.80	
28	7.49	19.45	44.96	
29	8.28	21.38	48.35	
30	9.08	23.25	52.34	
31	9.90	25.19		
32	10.85	27.31		
33	11.93	29.74		
34	13.14	32.33		
35	14.45	35.34		

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DEFAULT MORTALITY RATES (cont'd)

Policy Year	Issue Age 25	Issue Age 35	Issue Age 45	Issue Age 55
36	15.92	38.61		
37	17.60	41.80		
38	19.45	44.96		
39	21.38	48.35		
40	23.25	52.34		
41	25.19			
42	27.31			
43	29.74			
44	32.33			
45	35.34			
46	38.61			
47	41.80			
48	44.96			
49	48.35			
50	52.34			

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OPTIONAL MORTALITY TABLE FORMAT (used when IART=1)

If an optional mortality table is to be read in, the data for an age is read with one FORTRAN read statement using a format of 11X,17F4.2. The number of observations read in for an age is the minimum of the number of years specified in IYR (see OPTION CARD FORMAT, above) and 75 minus the age, for example, if IYR is 30, then 30 observations would be read for ages 25, 35 and 45 and 20 observations for age 55. All data is assumed to be available.

Example of optional mortality table data for IYR = 30:

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EXAMPLE

COLS. 1-11	COLS. 12-79
ANYTHING	50 60 80 80 80 80 90 90 100 110 120 130 140 160 170 190 210
YOU WANT	240 270 310 360 410 460 510 570 630 680 750 830 910
MAY APPEAR	70 90 120 130 150 170 200 230 260 300 340 390 450 500 570 630 680
IN THESE	750 830 9101090119013101450159017601950214023 30
COLUMNS	180 250 310 370 420 490 550 610 670 750 840 9701110127014501590176 0
THEY ARE	19502140233025202730297032303530387041804500484057 30
NOT READ	370 540 730 880 9501120131014301560174019102260254030703530386041 80
BY PROGRAM	450048405230

The optional mortality table follows the option card which specified that the table is to be read.

COLS.	VARIABLE	DESCRIPTION
1-11		These columns are not read and may contain comments, if desired.
12-15 16-19 20-23 24-27 28-31 32-35 36-39 40-43 44-47 48-51 52-55 56-59 60-63 64-67 68-71 72-75 76-79	ART(Year,Age)	For each age, 25,35, 45 and 55, use as many cards as needed to contain mortality data. The decimal point is assumed to be between the second and third column of each field. Each age starts on a new card.
80		blank

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DATA SET FORMAT

If the data sets are to be read from the same file as the option cards, the following formats apply:

The first card contains a company number, form number of the policy, kind of policy, issue age, and up to three cash values, which correspond to the last year(s) of the period(s) for the Linton yield calculation(s). The FORTRAN format statement is I3,A4,A2,I2,3F8.2. If the three cash values are blank or zero, then it is assumed that the Linton yield calculations are to be performed for each year from year 1 through IYR, and the next set of cards following the first card contains the cash values from years 1 to IYR. The FORTRAN format statement which reads this data is 11X,8F8.2.

The next set of cards contain the face value. If the face value is constant (IFV=0 or blank on the option card) only the one face value is keyed in columns 12-19, otherwise this set of cards contains the face values from years 1 through IYR. The FORTRAN format statement which reads the face values is 11X,8F8.0.

Following the face value is the set of premiums. If the premium payment is level (IPREM=0 or blank on the option card), only one premium is keyed in colums 12-15, otherwise this set contains the premiums from years 1 through IYR. The FORTRAN format statement which reads the premiums is 11X,17F4.2

Following premiums is the set of dividends for years 1 through IYR. The FORTRAN format statement which reads the dividends is 11X,17F4.2.

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IDENTIFICATION RECORD

COLS	VARIABLE		DESCRIPTION
1-3	ICO		Company number (numeric)
4-7	IFORM		Policy form number (alphmeric)
8-9	IKIND		Kind of policy (alphameric)
10-11	IAGE		Issue age (numeric)
12-19	CV(1)	--	Cash values per thousand
20-27	CV(2)	--	dollars of face value corresponding
28-35	CV(3)	--	to the last year(s) of the periods for the Linton Yield calculations. The decimal point is assumed between the 6th and 7th column of each field. If columns 12-35 are blank or zero, it is assumed that cash values for all years follow this card.

CASH VALUES

COLS	VARIABLE	DESCRIPTION
1-11		These columns are not read and may contain comments if desired.
12-19	CV(year)	
20-27	"	Cash values per thousand dollars
28-35	"	of face value. Use as many cards
36-43	"	as needed to contain the data. The
44-51	"	decimal point is assumed between the
52-59	"	6th and 7th column of each field.
60-67	"	
68-75	"	
76-80	blank	

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FACE VALUES

COLS	VARIABLE	DESCRIPTION
1-11		These columns are not read and may contain comments if desired
12-19	FV(1) or FV(year)	Face values in dollars. Use as many cards as needed to contain the data. No decimal point is assumed.
20-27	blank or FV(year)	
28-35	"	
36-43	"	
44-51	"	
52-59	"	
60-67	"	
68-75	"	
76-80	blank	

PREMIUMS

COLS	VARIABLE	DESCRIPTION
1-11		These columns are not read and may contain comments if desired
12-15	PREM(1) or PREM(year)	Premiums per thousand dollars of face value. Use as many cards as needed to contain the data. The decimal point is assumed between the second and third column of each field.
16-19	"	
20-23	"	
24-27	"	
28-31	"	
32-35	"	
36-39	"	
40-43	"	
44-47	"	
48-51	"	
52-55	"	
56-59	"	
60-63	"	
64-67	"	
68-71	"	
72-75	"	
76-79	"	
80	blank	

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DIVIDENDS

COLS	VARIABLE	DESCRIPTION
1-11		These columns are not read and may contain comments if desired
12-15	DIV(year)	Dividends per thousand dollars of face value. Use as many cards as needed to contain the data. The decimal point is assumed between the second and third column of each field.
16-19	"	
20-23	"	
24-27	"	
28-31	"	
32-35	"	
36-39	"	
40-43	"	
44-47	"	
48-51	"	
52-55	"	
56-59	"	
60-63	"	
64-67	"	
68-71	"	
72-75	"	
76-69	"	
80		blank

TERM PREMIUMS

COLS	VARIABLE	DESCRIPTION
1-11		These columns are not read and may contain comments if desired
12-15	ART2(year)	Term premiums per thousand dollars of face value. Use as many cards as needed to contain the data. The decimal point is assumed betwen the second and third column of each field.
16-19	"	
20-23	"	
24-27	"	
28-31	"	
32-35	"	
36-39	"	
40-43	"	
44-47	"	
48-51	"	
52-55	"	
56-59	"	
60-63	"	
64-67	"	
68-71	"	
72-75	"	
76-79	"	
80		blank

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If the option cards are read from a separate file from the data sets, then a subroutine called READT must be supplied which reads input from unit 10. The subroutine must supply values for the same variables listed above and must have two returns, one a RETURN and the other a RETURN 1 which indicates end of file on the data set.

Each call to the subroutine returns a new data set; these values are transmitted in labelled common blocks. The form of the subroutine is

```
SUBROUTINE READT(*)
COMMON/COM1/PREM(50),DIV(51),FV(50),CV(50)
COMMON/COM4/IYR,IPER(3),XLI,XRI,EPS,IEND,IART,IOPT,IFV,IPREM
COMMON/COM5/ITEMP(50),IPIND,NPER,XNA,IYIND,IY,IREPT
COMMON/COM7/ICO,IFORM,IAGE,IKIND
REAL*8 PREM,DIV,FV,CV,XLI,XRI,XNA,ART2
Subroutine
     .
     .
RETURN
end of file routine
RETURN 1
```

Note that dividends are dimensioned 51. This is because the dividends lag the other variables by one period. The dividends for years 1 through IYR are stored in DIV(2) through DV(IYR+1). DIV(1) is set to zero in a block common subroutine.

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IYIND and IY are used to convey to the main program the number of years to use. If IYIND is zero, the number of years is taken from IYR (specified on option card), otherwise the number of years is given by IY.

ITEMP, NPER and IPIND convey the time periods to the main program. If IT (specified on option card) is not zero, then NPER is set to 3 and ITEMP (1), (2) and (3) as determined by the option card.

If IT is zero, then NPER=IY and ITEMP(I)=(I) for I from 1 through IY.

If IPIND is not zero, this indicates that these values have been set by the subroutine and that they are not to be changed in the main program.

The subroutine READT that exists in program LINTON reads the HART insurance file. The subroutine READT in program LINTON77 reads the FTC insurance files.

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APPENDIX VII: LIFE INSURANCE AGENTS

Part III of the report discusses the impact of the agent and the importance of the two-tier commission structure. This Appendix provides additional information concerning the number of agents, their incomes, and commission structures.

LIMRA statistics indicate that there were approximately 287,000 full time life insurance agents in the United States in 1975. These can be broken down as follows:

Table 1

Full-Time Life Insurance Agents, 1975[1]

Full-time Career Ordinary Agents	145,000
Personal Producing General Agents	16,000
Multiple Line Exclusive Agents	39,000
Combination Agents	87,000
Total	287,000

In addition, there were approximately 42,000 part-time agents and 48,000 district heads, managers and supervisors. Women accounted for 4 percent of the sales force in 1975.

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[1] Table assimilated from data in LIMRA publications, Census of Life Insurance Sales Personnel 2, 6 (1976), and Census of Life Insurance Sales and Support Personnel 2 (1975). The latter publication indicates that companies define such terms as "full time" and "life insurance agent" in different ways. Id. at 6. No attempt was made to standardize different definitions for purposes of this table.

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Table 2

1973 Total Personal Income of Full-Time Ordinary U.S. Agents 2

Time in Business	Less than $10,000	$10,000-14,999	$15,000-19,999	$20,000-24,999	25,000+
1 - 3 years	39%	35%	14%	6%	6%
3 - 5 years	24	17	30	8	21
5 years +	4	12	20	13	51

Additional data comes from a study of agent income made by a relatively large mutual company located in the Northeast in 1974. Table 3 gives average incomes for this company's agents by number of years in the business. The data is generally consistent with data from Table 2.

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2 First Report of the Industry Advisory Council Committee to the Agents' Compensation Systems Task Force of the NAIC C-3 Life Insurance Subcommittee, 34 (1976) (hereinafter cited as Agents Report]. This table refers to agents with 75-100 percent of their income from the sale of individual life insurance and/or annuities It is based on the Survey of Agent Opinion conducted by the NALU and LIMRA in 1974. Approximately 1,300 among 5,500 randomly selected agents elected to respond to the survey.

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Table 3

1974 Income of Agents of One Large Mutual[3]

Number of Years in Business	Average Total Income from all Insurance Sources
1 but less than 3 years	$11,344
3 but less than 5 years	14,934
5 but less than 10 years	25,115
10 but less than 20 years	32,188
20 years or more	46,611

Due to inflation agents' incomes have probably increased substantially since 1973 and 1974.[4] On the other hand, the data in Table 2 and 3 represent gross income. Approximately 30 percent of this income must be used to meet business expenses.[5] Therefore, the data in Tables 2 and 3 representing agents' gross incomes in 1973 and 1974 probably come reasonably close to approximating their net incomes in 1979.

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3 Agent's Report, supra n. 2 at 36.

4 The Consumer Price Index increased 52 percent from 1973 to November 1978, and 37 percent from 1974 to November 1978. Economic Report of the President 239 (1979).

5 Agent's Report, supra n. 2 at 38. A million dollar round table survey showed that expenses accounted for approximately 36 percent of earnings for agents earning less than $25,000 and 32 percent of earnings for agents earning more. The company providing data for Table 3 estimated expenses to be between 20 and 30 percent of earnings for its agents.

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As noted in Part III.E.2 there is an extremely high turnover rate among agents. LIMRA research indicates that in 1975 28 percent of the agent sales force "turned over" from the beginning of the year to its end, 39 percent of agents were in their first year, and only 14 percent of agents who had entered the profession four years earlier were still in it.[6] Therefore, a large majority of agents are relatively inexperienced and most must struggle to earn a living. As discussed in Part III these facts exacerbate the impact of the two-tier commission structure.

The remainder of this Appendix consists of an analysis of agent contracts submitted to Hart's Subcommittee in 1974. There is a great deal of variance among companies with regard to both commission schedules and vesting policy.

First year commissions on one, five and ten year term policies range from 15 to 60 percent, with most companies falling in the 30 to 45 percent range. Renewal commissions are generally 4 to 7 percent for the first ten years. However, some companies pay high second-year commission (10 to 15 percent), others pay higher commissions on specific renewals (such as the 6th and 11th years of renewable term policies), and others pay first year rates on renewals, based on the increase in premiums.

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6 LIMRA, The Manpower and Production Survey 10 (1975).

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First year commissions on whole life policies are generally in the 35 to 75 percent range, with 55 percent most common. First year commissions tend to be higher for companies not licensed in New York State. The most common renewal schedule is 5 percent in years two through ten. However, most companies deviate from this pattern in one way or another. Many pay larger commissions in years two and three, smaller in later years.

Companies vary substantially in their vesting policies. Some companies vest commissions immediately. Others require 20 years of service before renewal commissions are fully vested. Often conditions for vesting are tied to sales performance. All companies make some kind of exception for death or retirement if commissions would not otherwise be fully vested.

Table 4 provides a detailed company-by-company breakdown of commission schedules and vesting policy for whole life and term policies in 1973.

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Table 4 - Company-by-Company Breakdown of Commission Schedules and Vesting Policy in 1973 Term Policies

COMPANY	NO.	POLICY	FIRST YEAR	RENEWAL COMMISSIONS 2 3 4 5	6 7 8 9 10	
Aetna Life Insurance Co.	002	5-Yr. Renewable & Convertible Policy	40%	5%	25% 5%	
All American Life & Casualty Co.	005	1-Yr. Renewable Term to Age 70	30 to 50%	5%	5%	
American General Life Ins. Co.	011	1-,5-,10-,15-Year Term & Term to 30	45%	35% 10% & 5%	35% 5%)	
American Heritage Life Ins. Co.	012	1-Yr. Renewable & Convertible Term	15%	4%	4%	
American National Insurance Co.	015	5, 10, 15-Yr. policies & riders	32½%	8%		
American United Life Ins. Co.	019	5-Yr. Renewable Term	25%	5%	2%	Additional commission of 15% on renewal premium of 6th & 11th yr.
Bankers Life & Casualty Co.	020	5-Yr. Level Renewable & Convertible Term	35%	10% 2%	20% 2%	
Bankers Life Company	021	5 & 10 Yr. Convertible & 5-Yr. Renewable & Convertible Age 45 Age 45	40%	6% 4%	4%	
Bankers National Life Ins. Co.	023	5-Yr. Renewable & Convertible Term	37%	5%	5%	
Central Life Assurance Company	032	Yearly Renewable Term Policy	40%	7%	7%	No. of renewal commissions is a function of 1st yr. commissions paid in contract yr.

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COMPANY	NO.	POLICY	FIRST YEAR	RENEWAL COMMISSIONS 2 3 4 5	6 7 8 9 10	
Coastal States Life Ins. Co.	036	5-Yr. Term Renewable & Convertible	35%	15% 7½%	7½%	No renewal commissions on Term plans for less than $5000.
Combine Insurance Co. of Am.	043	Little Giant Life Ins. Policies	$7 for each $2400 face value policy, plus 20% of the first semi-annual premium collected by agent.			Renewals: 10% of all premiums collected by the representative
Commercial Union Life Ins. Co. of America	045	5-Yr. Convertible & Renewable	40%	5% 5%	20% 5%	
Connecticut General Life Insurance Company	048	5-Yr. Renewable & Convertible Term Age 50 Age 50	31%	9% 6% 4% 4%	see box at rt. 2%	Commission in a renewal yr. will = ½ the 1st yr. rate applicable at insured's age.
Connecticut Mutual Life Ins. Co.	049	5-Yr. Renewable Term	30%	8% 4%	4% Fees on 1st & subsequent renewable premiums 2%	
Convenant Life Insurance Co.	Not On List	5-Yr. Renewable & Exchangeable Term	45%	5%	5%	A non-vested service fee = to 45% of the 1st renewal premium will be paid in 6th renewal yr.
Equitable Life Assurance Society of the United States	054	5-Yr. Renewable Term	17½%	5%	10% 5%	1th & later policy yr. 2%
Farmers New World Life Ins, Group	059	5-10-Yr. Renewable & Convertible Term	50%	10% 5%	50%	
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COMPANY	NO.	POLICY	FIRST YEAR	RENEWAL COMMISSIONS 2 3 4 5	6 7 8 9 10	
Fidelity Life Association &/or Federal Kemper Life Ins. Co.	Not On List	5-Yr. Renewable & Convertible Term	50%	10% 5%	50%	
Franklin Life Ins. Co. of Springfield	063	Term Policies	15 to 50%			No renewal commission on policies of 5-yrs. or less
General Services Life Ins. Co.	065	Decreasing Term 15, 20, 25 Yr.	40%			Monthly Income & Production Bonuses Provided
General United Life Insurance Co	066	5-Yr. Renewable & Convertible Term	25%	10% 5%	5%	
Georgia International Life Ins. Company	068	10-Yr. Convertible Level Term	40%	10% 5%	5%	
Globe Life & Accident Ins. Co.	069	Convertible & Renewable Term	40 to 50%	5%	5%	
Hamilton National Life Ins. Co.	079	Level Term Life	15 to 80%	7%	7%	Premiums payable: 1) premiums payable
Home Life Insurance Co.	082	5-Yr. Renewable Term ($5000 min)	35%	35%*	35%*	*On increase in premium
International Life Insurance Company of Buffalo	Not On List	Term*	35 to 50%	5%	5%	Commission on 5-yr. renewable & convertible term in 6th yr. is same as 1st yr. On 4yr. ren.& convt., it will be same as 1st yr. in the 5th.

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COMPANY	NO.	POLICY	FIRST YEAR	RENEWAL COMMISSIONS 2 3 4 5	6 7 8 9 10	
Jefferson National Life Ins. Co.	094	5-Yr. Renewable & Convertible Term	30%	5%		1st yr. % payable on each 5th yr. renewal
Jefferson Standard Life Ins. Co.	095	5-Yr. Renewable & Convertible Term	40%	4% 4% 2%	2%	
John Hancock Mutual Life Ins. Co.	096	5-Yr. & 5-Yr. Renewable Term	35%	7% 5%		See sect. 21 in spec. agent's commission agreement
LaFayette Life Ins. Co.	101	5-Yr. Convertible Term	45%	6% 4.5%	4.5% 4%	
The LaNar Life Ins. Co.	102	5-Yr. Renewable & Convertible Term	60%	4%*	4%	Additional commissions of 36% in the 6th policy yr.

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COMPANY	NO.	POLICY	FIRST YEAR	RENEWAL COMMISSIONS 2 3 4 5	6 7 8 9 10	
Liberty National Life Ins. Co.	104	5 & 10 Yr. Convertible Term	45%	5%	5%	
Lincoln National Life Ins. Co.	115	5, 10 & 15 Yr. Convertible Term & 5-Yr. Renewable Term	30 to 35%	5% 5%	5%	
Minnesota Mutual Life Ins. Co.	125	1-Yr. Renewable & Convertible Term	10%	10%		
Mutual Benefit Life Ins. Co.	129	1 & 5 Yr. Renewable Term Ins.				See contract for renew commission & formula in in Tables 3 & 4. No 1st yr. rates given.
Mutual Life Insurance Company of New York	130	5-Yr. renewable term	35%*	5% 5%	5%	*Renewal commission at the 1st yr. commission rate applies to increase in premium & rate of renewable commission
National Investors Life Ins. Co.	134	5-Yr. renewable & convertible Term	30%	5% 3%	3%	
National Life Insurance Co.	137	Term Policies	30%	5%	50%	
National Old Line	138	5-Yr. Term, renewable convertible	40%	4%	4%	
Nationwide Life Ins. Co.	142	5-Yr. Term	35%	3%	3%	
New England Mutual Life Ins. Co.	143	Renewable & Convertible Term at issue & subject to increase in premium at renewal	35%	5%	5%	See Commission schedule for more information
Massachusetts Mutual Life Ins. Co.	119	Term Policies	31.5%	5%	5%	In yrs. of renewal, the 1st yr. commission rate applies only to the increase in premium. Renewal rates apply to balance.
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COMPANY	NO.	POLICY	FIRST YEAR	RENEWAL COMMISSIONS 2 3 4 5	6 7 8 9 10	
Metropolitan Life Insurance Co.	120	Level-Term-Renewable, Convertible Other than 1-yr. Term	25 to 45%	10%	10%	
Northwestern National Life Ins. Co.	148	5-Yr. Renewable & Convertible Term	40%	15% 5%	2%	
North Atlantic Investors Life Insurance Company	Not On List	5-Yr. Convertible Term	60%	5%	0%	
New York Life Insurance Co.	144	5-Yr. Renewable Term	40%	5%	5%	Age of issuer determines the number of renewals allowed.
Occidental Life Insurance Co. of California	149	5-Yr. Convertible & Renewable Term Policy	50%	5%		See section on commission modification.
Ohio State Life Insurance Co.	152	5-Yr. Convertible - Renewable	*	10% 3%	3%	All renewable term policies are considered as
Pacific Mutual Life Insurance Company	157	Annual Renewable & Convertible Term	30%	8% 6% 4% 2%	2%	
Penn Mutual Life Ins. Co.	159	5-Yr. Renewable Term (Initial Period)	35%	15% 10% 7½%	3%	
Phoenix Mutual Life Ins. Co.	164	5-Yr. Term	30%	5% 5%	5%	A 5% renewal commission will be paid on subsequent premiums including automatic renewal of the policy contract (A6)
Provident Life & Accident Ins. Co.	169	5-Yr. renewable & convertible Term	30%	3%		

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COMPANY	NO.	POLICY	FIRST YEAR	RENEWAL COMMISSIONS 2 3 4 5	6 7 8 9 10	
Provident Mutual Life Ins. Co.	169	Renewable Level 5-Yr. Term (on initial issue)	35%	6½% 6%	6%	
Republic National Life Ins. Co.	175	5-Yr. Term Renewable & Convertible	40%	20% 10% 5%	5%	From Form A-3039-173 (75%)
Security Life & Accident Co.	181	1, 5, & 10 Yr. Renewable & Convertible Term	40%	5%	5%	1st commission paid only once
Southwestern Life Insurance Co.	187	Term policies & Renewable & Convertible Term to Age 60	40%	10% 5%	5%	
State Farm Life Insurance Co.	191	5-Yr. Term - 10-Yr. Term	30%	Scale A 8% Scale A 4% Scale B 4% Scale B 2%		
State Life Insurance Co.	192	Term Policies	30 to 40%	15% 10% 5%	Service Fees	
State Mutual Life Assurance Co. of America	193	Term: 2 Premium & over	35%	5%	5%	
Travelers Insurance Company	201	Select 5-Yr. Term Renewable to Age 70 Convertible to Age 65	40%	6% 3%	2%	
Union Central Life Ins. Co.	202	All Term Plans	40%	5%	5%*	*except increase in 6th yr. premium only on which 40% is payable.
United Benefit Life Ins. Co.	205	Term Insurance (Except 10-Yr. Term	40%	5%	5%	

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COMPANY	NO.	POLICY	FIRST YEAR	RENEWAL COMMISSIONS 2 3 4 5	6 7 8 9 10	
United Founders Life Insurance Co.	208	5-Yr. Renewable & Convertible	50%	5%	5%	
United Investors Life Ins. Co.	Not On List	All Term Policies	50%	5%	5%	

Table 4- Whole Life Policies

Company	No.	Policy	Commissions 1	2 3 4 5	6 7 8 9 10	All Full Vested	Conditions for Full Vesting
Aetna Life Insurance Co.	002	Wholelife	50%[a]	10-10-3	3%	After 15 yrs or death or disability	1st year - fully vested 2 - 4 - vested if with co. 4 years before termination 5 - 10 - vested if with co. 15 years before termination (all fully vested if termination by death or total disability)
All American Life & Casualty Co.	005	Non-part. Ordinary Life	55%	5%	5%	After 3 yrs.	1st year - fully vested No renewal comm'sn if terminates during year in which agents life, accident & sickness commiss'n are $200. If less than 3 yrs, agent can get 1 yr's renewal for each full contract year of service. If > than 3 yrs - commission for 2-10 vest. All vested upon death, or total, permanent disability after 3 yrs.
		Participating Ord. Life	60%	5%	5%		
American Heritage Life Insurance Co.	012	"Citadel" Whole Life	65%	5%	5%	After 2 yrs (conditions attached)	1 yrs - fully vested 2-10 - vested after 2 consecutive yrs under the contract.
		LPU at 90	65%	5%	5%		
American General Life Insurance Company	011	Whole Life Series (10 - 20 more premiums)	55 to 75%	45 to 55% (10 - 5%)	45 to 55% (5%)	Termination	All commissions vested with death or disability. If terminated for other reasons, comm'sn vested if averaging > $10 per month.

[a] 5% additional will be paid for each policy of $5,000 or more written up to and including age 60.

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Company	No.	Policy	Commissions 1	2 3 4 5 6 7 8 9 10	All Full Vested	Conditions for Full Vesting
American National Insurance Company	015	Non-part. Whole Life	35 - 57½	8%	--	All 1st yr commsns cease upon termination All renewal commsns cease upon termination of service
		Part. Continuous Premium Whole Life	47½	8%	--	" " "
American United Life Insurance Company	019	Ordinary Life, Shielder (less than 60 yrs)	65%	15-10-49	4%	All vested with death or disability. Otherwise, for each full year of continuous service, commissns will be paid as follows: Yrs. of Service — Vesting 1 — 1 policy year 2 — 2 " 3 — 3 " 4 — 4 " 5 or more — 9 "
		Ord. Life, over 60 yrs.	35-65%	5 5 60 60 4 4% 15 10	4%	
Bankers Life & Casualty Co.	020	Whole Life	65-70%	25 - 2%	2%	After 10 yrs, or age 65 or death or disability	1st yr. premiums - fully vested 2-10 yrs: vested after 10 yrs, or at age 65 or upon death or disability if > $200 per year.
		LPU at 95	60%	15 - 2%	2%	
Bankers Life Company of Iowa	021	Ordinary & Whole Lifes	50 to 55%	7%	7% to eighth policy year	All vested at 9 yrs.	1st yr. vested < 3 yrs service, no comm'sns 2nd yr commssn vested at 3 yr 3rd " " " " 4 4th " " " " 5 5th " " " " 6 6th " " " " 7 7th " " " " 8 8th " " " " 9

Company	No.	Policy	Commissions 1	2 3 4 5	6 7 8 9 10	All Full Vested	Conditions for Full Vesting
Bankers National Life Insurance Company	023	Ordinary & Modified "10" Whole Life	60%	5%	5%		1st yr. vested 2-10 yr. vested if due to death, disability, or termination of General Agent's agreement. 2-10 yr. lost if terminated for any other reason.
Central Life Assur. Co.	032	Whole Life Graded Premium Life LPU at 95: < $25,000 ≥ $25,000	55[a] 45 55 40	7 14 [2] 7 10 [3]			
Coastal States Life Ins. Co.	036	Whole Life Forms	4 to 80%	0 to 27½	0 to 7½	0 to 7½	After 5 years	No renewal commissions unless Agent has in force policies of > $100,000. If contract outstanding for 1 yr & has produced new business each month, then 2nd renewal vests renewal thru 4th yr. 3 to 5 yrs sixth renewal 5 yr. vests the last renewal.
Combined Ins. Co of America	043	Little Giant Life Insurance Policies	$3.50 of each $1,200 face value policy, plus 20% of 1st semi-annual premium. Renewals: 10% of all premiums collected by the Representative			No rts. at termination.	No commissions vest.

[a] Number of Renewal commission determined by amount of coverage.
[2] 7% after 5th year.
[3] ≥ $25,000 drops to 7%.

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Company	No.	Policy	1	Commissions 2	3	4	5	6	7	8	9	10	All Full Vested	Conditions for Full Vesting
Commercial Union Life Ins. Co. of America	045	Whole Life & LPU at 95	40 to 60%	10%	5%			5%					At termination	Commissions vest at termination.
Conn. General Life Ins. Co.	048	Ordinary & Whole Lifes	45	15	10	5	5	5	5	6	2	2	After 20 years	a. Termination Yrs of Service — Policy Yrs 0-1 — 1 2-4 — 2 5 or more — 3 b. Death Yrs of Service — Policy Yrs 0- 9 — 4 10-14 — 6 15-19 — 8 20-more — 10
Conn. Mutual Life Ins. Co.	049	LP Life Whole Life LPE 95 Econo Live Under 61	50%	10	10	5	5	5	5		2%			1st vests in any event 2nd & 3rd vest in any event 4th - 7th vest as provided by contract Remainder are non vested
Covenant Life Ins. Co.	Not on List	Covenant 25 - Full Life Paid at 95	55%		5%				5%				At any time	All commssn's vest except where agent performs a criminal act against the company.
Equitable Life Assurance Society of the U. S.	054	Adjustable Whole-Life ≤ 55 yrs. ≥ 56 yrs.	55 52	15	10	5	5	5	2	2	2	2	After 15 years.	All vest at death Period of Yrs — Vested as to 3 — 2nd policy or or contract year subj. to collection 5 — 2nd & 3rd " " " 15 or retirement — 2nd to 10th " " "

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Company	No.	Policy	Commissions 1	2	3	4	5	6	7	8	9	10	All Full Vested	Conditions for Full Vesting
General American Life Ins. Co.	064	Double Protection to Age 70	60			5%			5%*				See next box	At termination renewals vest only so long as agen has $100,000 of individua life insurance business remains in force on a premium paying basis. At death or disability, commissions will vest wit certain stipulations
		Joint Ordinary Life (2 lives)	50			5%			5%*					
General Services Life Insurance Co.	065	Preferred Risk and Juvenile Whole Life	60%											No renewal commissions. Company has a system of semi-annual production bonuses.
General United Life Insurance Co.	066	Various Whole Life Plans	30 to 65%	5 to 10%		2½ to 5%			2½ to 5%				Upon contingencies	All renewals vest upon termination if 1) agent has completed 1 yr under the contract and 2) the total in commissions for 12 consecutive months exceeds $240.
Georgia International Life Insurance Co.	068	Non-part. Whole Life Plans	60 to 100%	10		5%			5%				At 9 years	1st year fully vested then no renewals if < 2 yrs continuous service, then renewal commission vest equal to number of full yrs of service. Ex: 5 yr service entitles agent to 5th yr renewal.
		Participating Ordinary Life	55	5		5%			5%					

* 2% for 11th & subsequent years upon contingencies.

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Company	No.	Policy	Commissions 1	2 3 4 5	6 7 8 9 10	All Full Vested	Conditions for Full Vesting
Globe Life & Accident Insurance Co.	069	Ordinary Life	70%	5%	5%	No Commssn's Survive Termination	Termination cancels agents right to receive commission
Hamilton National Life Insurance Company	079	Ordinary Life	50 to 90%	10%	10%	Upon Contingencies	After termination, renewal commissions are payable only if Personal Net Annualized Premium in force is not less than $10,000 or if Agency net Annualized Premium in force is ≥ $20,000.
Home Life Insurance Co.	082	Whole Life*	45 to 50%	2-4 10%		After 1 yr & $1500 in 1st yr.	Renewals vest at death or disability. Otherwise, renewal commissions vest after 1 yr. of service & $1500 in 1st yr. commssn's.
International Life Insurance Co. of Buffalo	Not on List	Modified Whole Life	50%	10%	10%	At any time	All commissions are vested subject to three divesting clauses; commission lost at death
Jefferson National Life Insurance Co.	094	Life Paid Up at 90 - Non Pan & Other Whole Life Plans	50	10%	10 2%	After 5 years	At death or disability, renewals vest if agent has ≥ $10,000 in premiums in force. If termination is before 5 yrs, only 1st commsn vest. After 5 yrs, agent & commissions become vested.
			45 to 60	7 - 10%	10 2%		

* Figures are for a field underwriter.

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Company	No.	Policy	Commissions 1	2	3	4	5	6	7	8	9	10	All Full Vested	Conditions for Full Vesting
Jefferson Standard Life Insurance Co.	095	Part. Whole Life & LPU at 85	50 to 55%		15%	10%	2%	2%					After seven years	After 5 yrs, 1st year 2 1 renewal are vested. After 6 yrs, 2 renewals are vested After 7 yrs, all renewals are vested.
		Non-Part: Whole & LPU at 90, 95	55 to 60%		12 to 15%	10	2%	2%						
John Hancock Mutual Life Insurance Co.	096	Life Paid Up at Age 85 Policies	20 to 45%			4½%			4½%					No vesting until 2 consecutive years Conditions attached.
John Hancock Mutual Life Insurance Co.	096	Life Paid Up at 85 & Limited Payment Life Policies Excluding Signature 25 Policies	25 to 55%			5%			5%					No vesting until 2 consecutive years. Conditions.
Lafayette Life Insurance Co.	101	Whole Life Plans	40 to 60%		2-4 / 6 to 8%		5 / 4.5 to 6%		6-7 / 4.5 to 6%		8-10 / 4 to 5%			At death all renewal commissions are vested so long as the total for any year is ≥ $120. Termination for reasons: will vest according to specific contingencies as to gross volume of premiums & total amount due exceeds $120.

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Company	No.	Policy	Commissions 1	2 3 4 5	6 7 8 9 10	All Full Vested	Conditions for Full Vesting
Lamar Life Insurance Co.	102	Ordinary Life & Life Paid Up at 95 Plans, Par & Non-Par	50 to 70%	5%	5%	After 10 yrs.	If terminated with cause, only first year commissions vest. If less than 2 yrs, & w/o cause, on 1st yr. commissions vest. If more than 2 yrs, right to renewal based on length of service. E.g., 5 yrs service = 5 renewals.
Liberty National Insurance Co.	104	Whole Life	70%	5%	5%	After 2 yrs.	After 2 full years, at termination by death or otherwise, company will continue to pay renewal commissions until such amount to ≤ $10 for 4 consecutive mos.
Lincoln National Life Insurance Co.	115	Ordinary Life Plans Par & Non-Par	30 to 50% 35 to 55%	5%	5%	After 9 yrs.	Renewal Commissions vest according to # of yrs. worked. E.g. r yrs. completed makes agent eligible for 5 renewals at termination.
		LPU at 95 (Par) (Non Par)	25% 55%	10%	10%		
Minnesota Mutual Life Insurance Co.	125	LPU at Age 90	40	3½ to 5%	3½ to 5%	After 5 yrs.	1st yr. commissions fully vested. Renewal Commissions become vested only after 5 yrs. & may be extinguished after falling below $120 for a 1 yr. period.
		Whole Life & Adjustable Life	50%				

* Subject to some contingencies.

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Company	No.	Policy	1	Commissions 2	3	4	5	6	7	8	9	10	All Full Vested	Conditions for Full Vesting
Mutual Benefit Life Insurance Co.	129	Ordinary Life & Life Paid Up at 70 Plans	31 to 50%	Determined by Formula. See Agent's contract.									at 15 years.	If terminated < 2 yrs. - no renewals ≥ 2 yrs & < 11, 4 renewals ≥ 11 yrs & < 12, 5 renewals ≥ 12 yrs & < 13, 6 renewals ≥ 13 yrs & < 4, 9 renewals < 14 yrs, 8th yr renewal ≥ 15 yrs, 9th yr renewal.
Mutual Life Ins. Co. of New York	130	Whole Life Plans	50 to 55%	2-5 to 8%	3-4 to 5%					4 to 5%			After 20 yrs.	1st year commissions are fully vested. 1st & 2nd renewals are vested after three years. 3rd - 9th renewals are vested after 20 years.
National Investors Life Insurance Co.	134	Whole Life - Premiums Payable	30 to 75%	7½ to 20%	5 to 20%	3%				3%			See next box.	If, at termination, the annualized life insurance premium in force, with some exclusions, is ≥ $10,000, renewal commission will be paid until this amount drops to < $5,000.
National Life Insurance Co.	137	Life Plans	30 to 45%		2-4 5%	2%				2%			After 17 yrs.	At 12 yrs. of service, 5th policy vests At 13 yrs. " " 6th " At 14 yrs. " " 7th " At 15 Yrs. " " 8th " At 16 yrs. " " 9th " At 17 yrs. " " 10th "

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Company	No.	Policy	Commissions 1	2	3	4	5	6	7	8	9	10	All Full Vested	Conditions for Full Vesting
National Old Line Insurance Co.	138	Various Whole Lifes	60 to 70%	4%				4%					After 1 yr.	1st year commission is vested. ∠ 1 yr service, renewal commissions are extinguished. > 1 yr service renewals vest with charges and contingencies.
Nationwide Life Insurance Co.	142	Whole Life & Modified 3-10 Whole Life	55%	2-3 10%		3%		3%					Vesting only under contract.	No vesting after termination.
New England Mutual Life Ins Co.	143	Ordinary Life & Life Paid Up at 85	55%	5%										See questionnaire for details. Apparently years 1-5 are fully vested with subsequent renewals depending upon years of service & total production produced.
Massachusetts Mutual Life Insurance Co.	119	No Whole Life Listed												At death, all commissions are vested. Termination for other reason with ∠ 1 yr service: No renewal commssns. Termination after 1 yr.: Basic vested renewal 1 commissions plus earned vested commission determined by years service.

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Company	No.	Policy	Commissions 1	2	3	4	5	6	7	8	9	10	All Full Vested	Conditions for Full Vesting
Metropolitan Life Insurance Co.	120	Whole Life Plans	35 to 55%	2-4 11%									Upon retirement only.	No vesting whether active or terminated. But if agent belongs to the Retired Metropolitan Field Force, 3 11% renewals for 2nd - 4th yrs., are vested.
Northwestern National Life Insurance Co.	148	Various Whole Life Plans	30 to 55%	2 25%	5 to 10%				2%				After 7 yrs.	If terminated before 7 yrs. For other than death or disability, no further commissions will be paid. If terminated after 7 yrs., then 1st commissns are payable in full; 2nd - 5th yrs. will be paid at 80% of value; later commissions will not vest unless due to retirement.
Northwestern Mutual Life Insurance Co.	147	Whole Life & E.O.L	41 to 50%	2 10 to 20%	3 10 to 15%	4-5 10%							After 9 yrs,	1st year commissions are fully vested. Renewal Yr. / Years of Service Required for vesting: 1-3 None; 4 10; 5 11; 6 12; 7 13; 8 14; 9 15. All renewals vest if termination is due to death, disability or agent becom employee.

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Company	No.	Policy	Commissions 1	2	3	4	5	6	7	8	9	10	All Full Vested	Conditions for Full Vesting
North Atlantic Investors Life Insurance Co.	Not on List	LPU at 90 & Executive Whole Life	50 to 75%	2 5%	5%			6 5%		1%			After 10 yrs.	1st yr. commissions fully vested. No renewals vest if terminated within 36 months. After three years, will be vested for # of actual yrs of service. E.g., 5 yrs. service entitles agent to the 5th renewal. No vesting after 10th renewal.
New York Life Insurance Co.	144	Various Whole Lifes*	40 to 55%	2 15%	3 5% Con-ditional								At any time.	Commissions on permanent plans of life insurance and endowment policies ... for policy years 1 & 2 are generally fully vested However, any conditional third year renewal commissions payable on such policies are not generally vested.
Occidental Life Insurance Co. of California	149	Guaranteed & Decreasing Whole Life	65%	2 25%	3 15%		10%						After 5 yrs.	If terminated for other than specified reasons in ¶3, 17, renewal commissions for yrs. 2-5 will be paid to agent, after 5 yrs service the service requirement as to disability or death is 3 yrs.

* From the field Underwriter's contract.

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Company	No.	Policy	Commissions 1	2	3	4	5	6	7	8	9	10	All Full Vested	Conditions for Full Vesting
The Ohio State Life Insurance Company	152	Various Ordinary Lifes & LPU at 95	50%	2 20%	3%[a]				3%[a]				After 9 yrs.	No renewals when terminated for cause all vest at death or disability. Yrs. Under K — Completed Policy yrs. 2 — None 3 but 4 — 4 4 but 5 — 5 5 but 6 — 6 6 but 7 — 7 7 but 8 — 8 8 but 9 — 9 9 — 12
Pacific Mutual Life Insurance Company	157	Whole Life	60%	2 12%	3 10%	4 8%	5 2%		2%				After 15 yrs.	1st yr. commissions are vested. Commissions for yrs. 2-4 are vested if termination is due to death, disability, or comes after 15 yrs. service.
The Penn Mutual Life Insurance Company	159	Whole Life	50%	2 15%	3 10%		7½%		3%					If terminated within the first two years, no renewal commissions paid. If terminated for cause, no 1st yr. or renewals will be paid. After 2 yrs, renewal commissions appear to vest.

[a] 3% of 3rd year premium.

Company	No.	Policy	Commissions 1	2	3	4	5	6	7	8	9	10	All Full Vested	Conditions for Full Vesting
Phoenix Mutual Life Insurance Company	164	Ordinary Life Plans	* 40 to 55%		2-4 8 to 10%		5 4 to 10%		6-7 4 to 10%		8-10 4 to 10%		After 15 years.	The 1st-3rd renewals vest after 3 yrs service. The 4th-6th renewals vest after 9 yrs service. The 7th-9th renewals vest after 15 yrs service There are production requirements which can alter the above.
Provident Life & Accident Insurance Co.	168	Whole Life Plans	65%			5%			5%				Contingent upon amount produced.	Termination by death or disability vest renewal commissions thru 8th yr. If terminates for another reason & leaves in force ≥ $500,000 (with some exclusions) the commissions continue through year 8, subj. to a fee. Otherwise, no renewals vest
Provident Mutual Life Insurance Company	169	Whole Life Plans	35 to 55%		2-3 10%		5%		5%				After 20 yrs, 1-5 vest.	All vest upon death or retirement. Termination for other reasons: < 10 yrs - 1st yr. commission only ≥ 10 yrs but 15 - yrs 1 & 2 ≥ 15 yrs but 20 - yrs 1 - 3 ≥ 20 - yrs 1-5.

* Number of renewals is determined by amount of coverage. For ≥ $3,000, there are 9 renewals.

Company	No.	Policy	Commissions 1	2	3	4	5	6	7	8	9	10	All Full Vested	Conditions for Full Vesting
Republic National Life Insurance Company	175	Whole Life Plans	90%	2 15%		7½%			7½%					If terminated within 1 yr. only 1st commission will vest. Death or disability through yr. 10. Otherwise, after 1 yr, all renewals vest as long as > $500 yearly.
Security Life & Accident Co.	181	Whole Life Plans	35 to 65%			5%			5%				After 5 yrs & $12,000	Death or disability; all commissions vest. Termination for cause; no commissions. Termination for other reasons; first yr. commission vest & if after 5 yrs of service & at least $12,000 in premiums, renewal commissions also vest, subj. to min. amount stipulation.
Southwestern Life Insurance Company	187	Whole Life	75%	2 10%	3 5%	5%			5%				After 3 yrs.	Death or disability; all commissions vest. If less than 3 yrs, no commissions; If more than 3 yrs, then 1 commission per year worked. e.g. 5 yrs, then 5 commissions. There must be $100,000 premiums outstanding.

* For general agent.

Company	No.	Policy	Commissions 1	2	3	4	5	6	7	8	9 - 10	All Fully Vested	Conditions for Full Vesting
State Farm Life Insurance Co.	191	Life Paid Up at 85	30 to 50%	2-3/4 to 10%		4-5/2 to 5%						Do not vest.	Termination by death or otherwise; any unpaid compensation then due will be paid. All other commissions are extinguished.
State Life Insurance Co.	192	Whole Life	55 to 65%	2 10%		3-4 10%		5 5%			Service Fees computed 2%	After 3 yrs.	If less than 3 yrs, compensation will be paid that falls due within 1 yr. of termination. After 3 yrs, all renewals will be paid. No renewals if termination for fraud, etc.
State Mutual Life Assurance Co. of America	193	Whole Life	50 to 55%	5%							5%	After 12 or more years.	Death or disability; all companies vest. If no provisions are breached, then the # of commissions is determined by years of service in accordance with schedules A & B. See contract.
The Travelers Insurance Co.	201	Ordinary Life Plans	40 to 55%	2-3 10%		4 7	5 5%	6 5%				See next box	1st yr. & first 2 renewals are vested. Remainder are vested if agent produced no less than $1500 in new life premium including single premium in the year the policy was sold.

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Company	No.	Policy	Commissions 1	2	3	4	5	6	7	8	9	10	All Full Vested	Conditions for Full Vesting
Union Central Life Insurance Company	202	Ordinary Life Plans	25 to 65%	5 to 10%					5 to 10%				After 3 years	All commissions vest after three years. If less than 3 years, commission will vest if agent has in force $1,000,000 or more of ordinary life business at termination.
United Benefits Life Insurance Company	205	Whole Life Plans	60%	5%					5%				After 3 years	After 3 yrs, renewals will be paid if 1. policy was sold in a year when agent produced at least $150,000 of issued & paid for business. 2. At the specified rates.
United Founders Life Insurance Company	208	Ordinary Life	65%	7.5%		5%			5%					Renewals shall be paid to agent provided 1. annualized premiums are ≥ $20,000 at termination; & 2. that a minimum persistency of 80% is maintained each year.
United Investors Life Insurance Company	Not on List	Ordinary Life	60%	5%					5%				All vested subj. to a min. total	After termination, if the total 1st yr. & 1st renewal commission is < $100, then all subsequent commissions are lost.

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	(1) Est. Amt. of Life Ins. in force as survivor benefit under OASPI as of beginning of Yr. ($ billions)	(2) Private Life Ins. in force ($ billions)	(3) Total Life Ins. in force ($ billions)	(4) Total Disposable Personal Income in current dollars ($ billions)	(5) Ratio of Private Life Ins. in force to Disposable Personal Income	(6) Ratio of total life Ins. in force to Disposable Personal Income
1940	$37	$112	$149	$75.2	1.49	1.98
1951	170	234	404	224.8	1.04	1.80
1955	345	334	679	273.4	1.22	2.48
1961	547	586	1,133	362.9	1.61	3.12
1962	585	629	1,214	383.9	1.64	3.16
1966	700	901	1,601	510.4	1.77	3.14
1968	930	1,080	2,010	588.1	1.84	3.42
1970	1,100	1,285	2,385	685.9	1.87	3.48
1972	1,310	1,503	2,813	801.3	1.88	3.51
1973	1,760	1,628	3,388	901.7	1.81	3.76
1974	2,040	1,778	3,818	984.6	1.81	3.88
1975	2,269	1,925	4,254	1,084.4	1.83	3.92
1976	2,556	2,140	4,696	1,185.8	1.80	3.96
1977	2,829	2,343	5,172	1,308.6	1.79	3.95

Sources: Col. (1) - Date from 1940-1974 from Robert J. Myers, Social Security 395, table 10.37, (1975). The remaining figures come from Kevin Wells, Estimated Amount of Life Insurance In Force As Survivor Benefits Under OASI 1975-77, Office of the Actuary, Social Security Administration, Actuarial Study No. 79, November 1978. Various other Federal government insurance programs such as Veterans life insurance and Civil Service Commission insurance are not included.

Col. (2) - Fact Book, supra note 9 at 18. Includes ordinary, group, industrial and credit life insurance, but excludes fraternals and savings bank life. To correspond to column (1), the figures are given as of the beginning of the year. The Fact Book figures are as of the end of the year. Therefore the figure given in column (2) above is listed in the Fact Book as the total for one year earlier.

Col. (3) - Col. (1) + Col. (2).

Col. (4) - Economic Report of the President, 1978, table B-22, p.283.

Col. (5) - Col. (2)/Col. (4).

Col. (6) - Col. (3)/Col. (4).

APPENDIX VIII: STATE REGULATIONS WHICH MAY BE ANTICOMPETITIVE

In explaining why the life insurance industry is beset with consumer problems, Section III focuses on the lack of consumer information and on conflicts of interest built into the current agency system. This appendix outlines other, possibly very important reasons for the problems detailed in Section II. Most involve state regulations or laws which may curtail vigorous competition. While we are unaware of any detailed examination of the impact of state regulation, serious questions are raised by some aspects of regulation designed: (1) to discourage replacing old life insurance policies with new ones; (2) to insure company solvency; (3) to prohibit agents from rebating any part of their commission to a client; and (4) to limit agent compensation. Although this appendix does not attempt to assess the precise importance of these regulations, we believe they deserve further study.

1. Regulation Designed to Discourage Replacing Old Insurance Policies

Virtually all states have "replacement" regulations that are intended to provide the policyholder with sufficient information to make an informed decision as to whether to drop one policy in favor of another. While laudable in spirit, many of these laws may not benefit consumers. These laws are premised on the assumption that "replacement" will generally not be in the policyholder's interest: that is, he will have to pay the heavy "front end" load again, he will be subject to a new period of "contestability," and so on. This premise is now under question. Professors Scheel

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and Van Derhei, in the most comprehensive study of replacement activity to date, found that the majority of replacements were "acceptable," that is, represented a cost saving for the policyholder.[1] In those cases (22 out of the 70 studied) where a term insurance policy replaced a cash value policy, all of the replacements were cost saving to the policyholders. The authors conclude that "the data offer no support for the caveats approved by insurance departments that replacements generally are undesirable," but they caution that "the data may not be representative of a general cross-section of existing insurance."[2]

Scheel and Van Derhei are also highly critical of present replacement regulations and of the NAIC model regulation. They state that, "The failure of the present NAIC Model Replacement to present clear and concise information that is relevant and easily used is exceeded only by its failure to provide the right kind of information," and that, "The

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[1] Scheel and Derhei, "Replacement of Life Insurance: Its Regulation and Current Activity," 45 Journal of Risk and Insurance (1978). Their research is discussed in Coyle, "How to Save $7000 on Your Life Insurance," Money Magazine 75-82 (July 1978).

[2] Id. at 205.

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overwhelming omission in the present replacement regulations is guidelines for the manner in which the data are to be used, integrated and interpreted. There is little argument that the most important reasons that can be given for policy replacement hinge on cost considerations. The argument that cost is unimportant is indefensible for a replacement situation. Yet, no replacement regulation in effect today provides for disclosure of cost or offers a methodology by which costs can be compared validly. Cost disclosure is as important for policy replacement situation as for original issues."[3] Their final appraisal of the present system of replacement regulations is a harsh one. They write, "Until meaningful cost disclosure is embodied into replacement regulations, one could conclude with justification that they are a facade instigated and perpetuated by the distribution system of life insurance and designed for the self-interest of insurance agents who are more concerned with the preservation of their commissions than a dispassionate, professional assessment of the merits of individual policy replacement situations."[4]

2. Regulations Designed to Insure Company Solvency

Almost every state sets minimum cash value guarantees and certain other solvency requirements through a statute known as the "Standard Nonforfeiture Law."[5] This statute was generally

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3 Id. at 206.

4 Id. at 207.

5 See C.F.B. Richardson, "Expense Formulas for Minimum Non-Forfeiture Values" 29 Transactions of the Society of Actuaries 33-34 (1977).

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enacted in response to the Guertin Committee's Report to the National Association of Insurance Commissioners in 1941. A new committee has recently recommended various revisions in this statute that could have very important implications for life insurance pricing.[6] As part of the effort to revise this statute, the NAIC asked Mr. Charles Richardson to make new estimates of expense allowances that would be used in computing minimum cash values. Commenting on the changes that have taken place in the business since 1940, Mr. Richardson writes:

> The consumer movement has become a powerful force in many sectors of private business, and neither the life insurance industry nor the regulators can safely ignore it. Today it does not seem politically feasible to base minimum values on expense factors that would accommodate the expense rates incurred by marginal or high-cost companies, as was the objective of the formulas in the Guertin laws.[7]

While such regulations do not result in uniformly high costs for consumers, they may well set a "floor" below which prices cannot fall. For example, some states have interpreted the law to make it impossible for companies to charge premium rates as low as they might want to on renewable term insurance policies. To do so, the company would have to put up the capital to cover a so-called "deficiency reserve" that may run as high as 2000 per-

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6 Id at 35-36.

7 The "Unruh Committee" Report can be found in 27 Transactions of the Society of Actuaries 549-633 (1975).

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cent of the first year premium.[8] Also, the impact of solvency/ cash value regulations appears to be extremely important in determining premiums charged and cash values offered by the life insurance industry. Proposed changes in the solvency laws allowing companies to use higher interest rates in calculating reserves and minimum cash values would drastically change the way deficiency reserves are calculated.[9] According to some industry experts, these changes will enable the life insurance industry to:

> · Sell very competitively priced permanent insurance at lower rates than any companies have used in the past.
>
> · Sell permanent insurance to policyholders who otherwise would have been receptive only to term insurance.
>
> · Provide commission revenues to agents exceeding that which can be realized from conventional term policies. 10

These experts give some figures to show the possible impact of these changes on whole life premium rates. For example, under the new regulations, they show that a $15,000 (non-par) whole life policy could generate a reasonably healthy 13 percent

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8 See Holland, "NAIC Actuarial Guidelines," Best's Review (Life/ Health Ed.) 26 (September 1978).

9 The NAIC adopted a set of revisions to the Standard Valuation and Nonforfeiture Laws at its December 1976 meeting. For a discussion of the proposed changes and their probable impact, see Curlee and Collett, "New Standard Valuation and Nonforfeiture Laws," 78 Best's Review (Life/Health Ed.) 22 (September 1977), and Hill and Greenberg, "Permanent Insurance Beckons--Should the Industry Respond?", 78 Best's Review (Life/Health Ed.) 10 (November 1977).

10 Hill and Greenberg, supra n. 7, at 10.

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profit margin with a premium rate of about $13.50 per thousand at age 35.[11] Current premiums for such policies average about $17.50 per thousand. A premium rate of $13.50 would represent a reduction of over 20 percent. Because the first year premiums in 1977 exceeded $3 billion, the proposed changes in the solvency laws could save consumers hundreds of millions of dollars each year. Additionally, they might permit more agents to be hired, higher commission to be paid or higher profits for the companies. This is an area that needs to be examined from the consumer's point of view.

3. Regulation Designed to Prohibit Agents from Rebating Any Part of Their Commission

Most states have "anti-rebate" statutes that prohibit agents from rebating any part of their commission to the policyholder, although it is legal to rebate to another agent. These laws inhibit agents from competing on a "price" basis with one another. Indeed, they appear to be similar in impact to the so-called "fair trade" laws which inhibit price competition among retailers. In particular, they make it illegal for an agent to try to decrease the price for his service in the hope of increasing volume. When the average agent is making less than one sale per week, any law which appears to inhibit productivity increases ought to be very carefully examined.

4. Regulations Designed to Limit Agent Compensation

A few states have set limits on the percent of the first

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11 Id. at 54 (Table).

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year premium that an agent can receive in commissions. For example, Section 213 of the New York insurance law sets the maximum rates at roughly 55 percent for whole life and 37 percent for term insurance. Significantly, this law affects the operations in all states of those companies licensed to do business in New York and many companies have elected not to operate in New York or only through a subsidiary.[12] As to those companies operating in New York the law is thought by some industry observers to create a bias in favor of whole life.

The actual effect of the New York law on whole life and term commission rates is unclear. In comparing the first year commission rates of those companies licensed to operate in New York with those not licensed to operate in New York, the latter pay higher first year commissions on whole life.[13] The New York licensed companies, however, may circumvent the law by paying more of their agents' expenses. In fact, under a recent clarification of the New York regulation, the companies can give an agent 96 percent of the first year's premium in first year commissions and total expense reimbursements.[14] Also, the New York companies may pay

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12 Rappaport, "Consumerism and Agent's Compensation" 26 Transactions of the Society of Actuaries 560 (1974) [hereinafter cited as Rappaport].

13 See, e.g., id. at 561.

14 Id. at 562.

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their agents larger renewal commissions.[15] Thus, Rappaport hypothesizes that companies not licensed in New York may not have higher total agency costs.[16] Moreover, it seems unlikely that the New York licensed companies, which include many of the larger and better known firms,[17] would remain licensed in New York if doing so placed them at a competitive disadvantage in their whole life operations in all other states.

Similarly, the effect of the New York law on term commission rates appears negligible or small. An independent analyst found that the average "New York" term rate was only 3 percent lower than the "non-New York" figure.[18] (In contrast, he found an almost 10 percent spread between the two groups of companies for whole life).[19] Likewise the Hart Committee found no difference in average term rates:

> The effect of Section 213 is not apparent in term commissions as it was in whole life. New York companies pay about the same com-

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15 Id. at 540.

16 Id. at 560.

17 Dorfman, "Reformation in Life Insurance Agent Compensation," 43 Journal of Risk and Insurance 449 (1976).

18 Id. at 450.

19 Id.

Agent Commission (5-year renewable) Term Insurance:
New York Operations, mean = 36%
No " " " " = 39%
Agent Commission Whole Life Insurance
New York Operations, mean = 54%
No " " " " = 62%

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mission [as non-New York companies].[20]

Overall, there appears to be little difference in total commission rates paid between New York licensed companies and non-New York licensed companies. This does not necessarily mean, however, that the New York law has had little effect on the average commission rates paid on cash value policies and on term policies. Companies licensed in New York account for roughly 56 percent of the total volume of sales in the entire United States.[21] Since, outside of New York State, both sets of companies are competing with each other to attract agents, it is not surprising that, on average, commission rates are similar. Nonetheless, non-New York licensed companies may be able to attract agents by paying commission rates only marginally higher than those being paid by the other companies. If it were true that non-New York licensed companies were able to pay even slightly higher commission rates, they would be able to attract more agents and thus grow more rapidly than the New York licensed companies. Eventually, the New York companies would lose their dominant market shares and then the New York expense "cap" would cease to affect non-New York commission rates. This scenario is consistent with the observed facts for cash value insurance, but not for term insurance. As noted above, term commission rates do not differ between the

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20 The Life Insurance Industry, Hearings Before the Subcomm. on Antitrust and Monopoly of the Senate Judiciary Comm. 93d. Cong., 2d Sess. 2859 (1974) [hereinafter cited as Hart Subcommittee Hearings].

21 See S. Weisbart, Extraterritorial Regulation of Life Insurance 8 (1975).

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two classes of companies.[22] Thus, given the available evidence, we cannot conclude that the operation of the New York expense limitation law explains the wide disparity in cash value and term commission rates, but this question deserves further study.[23]

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22 It is possible that the average figures conceal some important differences between the two groups. For example, it may well be that only a relatively few companies are actively interested in selling term insurance, that these have much higher commission rates on term products, and that none are licensed in New York State. These few companies could be writing a large portion of the new "term" business and their share of this market could be expanding. Their high term commission rates would be submerged in an average dominated by more traditional companies whose low term commission rates reflect a lack of interest in the market, rather than the expense limitation law.

23 Three other factors may account for the substantial difference in commission rates paid on cash value policies relative to term policies. First, because the companies face reduced price competition from other savings media, they might structure the commission system to encourage sales of cash value insurance.

Second, another explanation for the relatively low term commission rates, offered by Senate Antitrust Subcommittee staff, is that "nobody seems to be competing to pay agents to sell term insurance." Hart Subcommittee Hearings, supra n. 18, at 2859. While this may be true of many companies, there are several large companies (such as Federal Kemper, Occidental Life of California and the Old Line Life Insurance Company of America) that write much more term than cash value insurance. None of these are licensed in New York and all pay much higher than industry average commission rates on term sales. It is not known, however, what share of the term market such companies have captured, nor whether their share is expanding.

Third, an explanation somewhat contradictory to the preceding has been offered by an actuary, Mr. Peter Hutchings. In commenting on Ms. Rappaport's paper, supra n.10, at 580, he wrote:

> One of the many valuable insights in this paper is the relating of field compensation practices to the lack of

(Footnote Continued)

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In short, a number of state regulations may partially

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23 (Footnote Continued)

effective price competition in life insurance. Today's agent has an excellent understanding of his commission agreement; today's customer has, at best, an imperfect understanding of his insurance product. Companies compete for agents and let the agents compete for customers. In the past this imbalance led to abuse, and abuse led to section 213. As the paper suggests, no such regulation would be needed if the product were less confusing.

Consider those products which, by their nature, are "self-disclosing." These products are so simple that any informed consumer can understand their price without needing an advanced degree. Three examples are yearly renewable term, immediate annuities, and mutual funds. By and large, these kinds of products have the following characteristics: (1) very low commission for agents, (2) very low (and/or negative) profits for companies, and (3) very low spread between cheapest and most expensive product.

For an interesting example of the relationship of price disclosure to commission level, compare the treatment of flat extras for substandard cases with class extras. The easiest life insurance price to understand is an extra of $5 per thousand-ask any private pilot! On the other hand, substandard class 2 whole life is at least as confusing as regular old whole life. It is not uncommon for flat extras to carry low marginal commissions while class 2 extras are on a full-commission basis.

Very few New York companies would run a section 213 risk by selling their yearly renewable term with a 50 percent commission (since this test is aggre-

(Footnote Continued)

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explain the problems staff sees in the life insurance market. At this point, we can only recommend that they receive further examination.

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23 (Footnote Continued)

gate in nature). Excellent arguments can be made for adopting such an approach to partially equalize the agent's incentive. However, relatively few companies have taken this approach, presumably because the market will not tolerate such a load.

Mr. Hutchings' explanation does not appear to be consistent with the fact that the three companies mentioned above (as well as others) seem to sell a lot of term insurance even though two of the three provide first-year commissions of at least 50% on such products. One reason is that in spite of higher commission rates, these companies often market term products at premium rates lower than those offered by the more traditional companies.

To summarize, several explanations for the observed wide disparity in commission rates between the two types of insurance have been offered, but none are well documented.

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APPENDIX IX: THE PURDUE STUDIES

Introduction

To determine which of several disclosure systems--including the NAIC model--is most understandable to consumers and most likely to be used by them, the Commission in 1977 contracted with Purdue University to conduct two consumer research studies.[1] The first attempted to determine what information consumers actually use when they purchase life insurance and how they can be motivated to make greater use of cost information. The second study compared the relative effectiveness of several life insurance cost disclosure systems in helping consumers select appropriate life insurance policies. It tested the following systems: the NAIC model, a system developed by Professor Joseph Belth of Indiana University and several variants of a system prepared by the FTC staff for purposes of the experiment. The study employed disclosure packages which had two parts: a buyer's guide and a policy summary from one of the above disclosure systems. Some packages contained only a policy summary.[2]

It is necessary to emphasize three points before discussing the results of the Purdue research studies: first, the research

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1 Dr. Jacob Jacoby of Purdue University directed the research studies. He is an experienced researcher in measuring consumers' ability to use information, and with the problem of confusing consumers with too much information, and is well respected throughout the research community.

2 A buyer's guide is a booklet which addresses various questions that consumers face in buying life insurance. A policy summary is a sheet which contains basic financial and cost information concerning the policy.

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studies were experimental studies conducted in a controlled environment with a limited number of subjects. Many factors present in an actual sales situation were not incorporated into the experimental design. The most important of these factors was the impact of the agent. Consequently, we recognize that the findings of the studies cannot be directly translated to actual sales presentations in the marketplace. These limitations are common to most social science research, and are not critical here since the studies were designed primarily to isolate those elements of a cost disclosure system which affect its understandability and use.[3]

Second, although understandability is extremely important, it is only one factor that must be considered in determining what information should be contained in a cost disclosure system. It is equally important to find out what information the consumer needs to make an informed purchase decision and the feasibility and cost of providing this information.

Third, the materials prepared by the FTC were developed solely to test the understandability and effectiveness of and various alternatives to the NAIC disclosure system. Partially as a result of the Purdue studies, the draft disclosure materials

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3 The FTC, in cooperation with the New Jersey Department of Insurance, conducted a study of the effectiveness of the NAIC disclosure system in New Jersey. This study consist of personal interviews with approximately 200 recent purchasers of insurance in New Jersey who received the NAIC disclosure materials. For further discussion of this New Jersey study see Part 4.C.

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in Appendix 10 differ in several ways from those tested in the studies. We do not think the fact that the disclosure system recommended in this report differs from that tested is particularly important because, as previously mentioned, the purpose of the studies was not to judge disclosure systems but rather to use what was learned from the studies to prepare disclosure materials that may be more effective than the NAIC, FTC or other systems that were tested.

This appendix summarizes the methodology and major findings of the two studies that pertain to our recommendations; it does not review all the findings. The major findings are:

1. cost-related factors were accessed less frequently than other factors but received significant weight in the simulated purchase decisions;

2. the Savings Yield was the cost dimension accessed most frequently and many subjects appear to have used it to comparison shop;

3. buyer's guides and trigger statements caused greater use of cost-related factors;

4. the FTC experimental disclosures increased the selection of lower cost policies compared to the NAIC disclosure;

5. the simple single page policy summary is almost as effective in enabling consumers to select low-cost policies as more elaborate disclosure systems.

6. It is possible to have a buyer's guide that is more comprehensible to consumers than the NAIC guide.

I. The First Purdue Study

A. Purpose and Design of the First Study The first Purdue study sought to find out what types of information were most

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useful to consumers.[4] Using a simulated purchase decision experiment, this study attempted to measure to what extent:

(1) consumers use cost indices, premiums and other related information;

(2) written motivational or "trigger" statements increase consumer use of cost information; and

(3) use of cost information leads to greater selection of lower cost policies.

To answer these questions, the study drew a sample of over 200 individuals between the ages of 25 and 45 from in and around Lafayette, Indiana. Furthermore, each participant had at least one dependent under 15 years old to assure an insurable interest. The proporation of individuals in the sample who had life insurance in force and contacts with agents was similar to the national average.[5]

Next, this sample was divided into six groups. After a brief introduction to the experiment, each group was given a different set of disclosure materials to review prior to the simulated insurance purchase decision. One group received an NAIC buyer's guide; one group received an experimental FTC

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4 The second part of the first study attempted to evaluate the effectiveness of five different yardstick formats. Study I at 52. Some of the formats were in color, some were black and white, some were open-ended, and others provided the answers. Although significant differences were found in completion times, this study found no overall statistically significant differences across these five formats in the ability of participants to rank policies in terms of increasing costs. Id. at 56-60.

5 Study I, 6. The basic sociodemographic characteristics of the sample are set out at p. 7.

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buyer's guide; one group received an NAIC buyer guide plus a trigger statement; one group received the FTC buyer's guide plus a trigger statement;[6] one group received only a trigger statement; and one group received no additional material. For an illustration see table below.

GROUP	1	2	3	4	5	6
Buyer's Guide	None	NAIC	FTC	None	NAIC	FTC
Trigger	Absent	Absent	Absent	Present	Present	Present
Number	40	40	39	40	41	38

After reviewing these disclosure materials, each participant was asked to pick from among three $10,000 policies:[7] half of each group chose from three whole life policies and half chose from two whole life policies and one term policy.[8] To assist them in making their decisions, participants were given a list of 37 types of information about life insurance policies. From the list, participants could then request access to the

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6 A "trigger" is a brief statement alerting the consumer to the facts that he (she) might be able to save appreciable amounts of money by shopping around.

7 Study I, 14.

8 Id. at 12.

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information on each of the three policies. In total, these facts summarize most of the relevant information needed to evaluate these policies. Out of the 37 types of information available, ten are directly cost related, that is, examination of one of these factors gives an accurate picture of cost. They are savings yields, company retention index, surrender cost index, net payment cost index, company retention yardstick, breakdown of premiums, year-by-year payments and benefits, surrender cost yardstick, year-by-year cost of protection and rate of return, and the net payment cost yardstick. Three types of information are indirectly cost related: premium, cash values, and illustrated dividends. They are only indirect cost factors because they must be considered together to estimate net cost.

The participants were able to acquire (at no cost) as much or as little of this information as they wished prior to making their purchase decision. By determining which of the types of information participants requested access to, the study was designed to measure the factors that may be relevant to the life insurance purchase decision. Since the participants were given different disclosure materials, the study also provides data on the impact particular disclosure materials had on consumers' understanding of what factors are most relevant. The average total number of facts considered or "accessed" did not differ significantly with the type of disclosure.[9] The average

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9 Id. at 18.

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for all participants was 17.85.[10]

B. Results of the First Study We believe three salient conclusions can be safely drawn from the results of this experiment: (1) the participants accessed cost related factors less frequently than other factors but placed more weight on them when purchasing insurance; (2) the buyer's guides and trigger statements improved participants' use or "access" ranking of cost related factors; and (3) the NAIC written statements should in certain respects be improved so as to effect better disclosure.

1. Consumer Use of Cost Related Factors

The accessing results indicate that fewer participants chose to find out what the cost indices were than chose to find out about other policy characteristics, but that those who did pick them used the indices effectively. Many participants did not use the factors most directly related to the cost of a policy. For example, savings yields received the highest access ranking of the ten facts considered to be directly cost related --tenth.[11] The other nine such facts were ranked 16, 17, 21, 25, 29, 31, 32, 34 and 35.[12] The median rank of the cost related facts was 27.5. These figures are particularly troublesome if one remembers

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10 Id. It should be noted, however, that in terms of unique items acquired, the researchers found that these participants accessed considerably more items than were accessed by comparable groups of consumers making breakfast cereals, margarine, and analgesic decisions. Id.

11 Study I, 24.

12 Id. at 20 (Table 5a).

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that there are only 37 facts and the average number of facts accessed for all participants was 17.85.[13]

In contrast, the ranks for those facts indirectly related to cost are 1, 3, and 23.[14] Although these facts are important to consumers in deciding whether they can meet premium payments or in choosing savings goals, they are of limited utility to most consumers when they attempt to measure actual costs. Indeed, focusing on one or two of these facts can in some instances lead to poor selections.[15]

Therefore, it appears that the participants tended to turn first to those factors which offer only limited guidance and turn last if at all to those factors specifically designed to rank similar policies by costs. The following table presents the rankings for all 37 facts by the percent of participants who accessed the information.

Accessing Rates for Different Types of Life Insurance Information

Rank	Dimension Name	% of Participants That Accessed.
1.	Premiums	86
2.	Name of Company	85
3.	Cash Value	74
4.	Accidential Death	73
5.	Financial Rating	71
6.	Guaranteed Insurability	66
7.	Waiver of Premium	66
8.	Policy Loan Interest Rate	63
9.	Passing Physical Exam Required	58

13 Id. at 18.

14 Id. at 20 (Table 5a).

15 See § III of Report.

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10. Savings Yield	58
11. Settlement Options	57
12. In Business Since	56
13. Mutual or Stock Company	55
14. New York License	55
15. Dividend Payment	55
16. Company Retention Index	54
17. Surrender Cost Index	47
18. Other Kinds of Insurance Sold	46
19. Monthly, Quarterly, Semi-Ann'l Premium	46
20. Conditions for Reinstatement	45
21. Net Payment Cost Index	44
22. Convertability	43
23. Illustrated Dividends	43
24. Nat'l Rank in Assets	42
25. Co. Retention Yardstick	37
26. Assets	36
27. Agent's Commission	35
28. Investment Portfolio	34
29. Yr-by-Yr Payments & Benefits	34
30. Renewability	34
31. Breakdown of Premiums	33
32. Yr-by-Yr Cost of Protect'n & Rate of Return	27
33. Premium for Renewal	27
34. Surrender Cost Yardstick	26
35. Net Payment Cost Yardstick	24
36. Sales Volume	23
37. Nat. Rank in Sales Volume	23

The cost related factors, however, were important to the participants in the actual decision making process. When asked "why did you choose the policy you did?", cost dimenisions tended to be among the 6th-10th reasons given.[16]

Dimension Chosen as Reason	Number of Respondents	% (N = 238)
Premium	95	40
Financial Rating	88	37
Cash Value	78	33
Accidental Death Provision	59	25
Dividend Payment History	53	22
Company Retention Index	52	22

16 This was question 9 of Study I. These results are not tabulated in the report.

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Mutual or Stock	51	21
Savings Yield	46	19
Surrender Index	36	15
Illustrated Dividends	36	15

Also, it appears that many subjects used cost indices as a convenient means to comparison shop. This is evidenced by the large percentage of subjects who accessed a particular cost dimension for all three policies they examined.

Comparison Shopping Rates for Four Cost Dimensions

Group	1	2	3	4	5	6
Source	Control	NAIC	FTC	FTC	NAIC	FTC
Trigger	Absent	Absent	Absent	Present	Present	Present
Buyer's Guide	Absent	Present	Present	Absent	Present	Present
N	40	40	39	40	41	38
Company Retention	10.3%	20.0%	30.8%	52.5%	12.2%	39.2%
Savings Yield	28.2	30.0	30.8	25.0	22.0	28.9
Surrender Cost	10.3	32.5	12.8	20.0	29.3	18.4
Net Payment	10.3	30.0	12.8	25.0	29.3	5.3

The FTC subjects in groups 3, 4 and 6 received literature highlighting the Company Retention Index, 41.0% of these subjects used Company Retention to comparison shop. Similarly, 30.9% of the NAIC subjects used the Surrender Cost Index for comparison shopping and 29.6% used the Net Payment Index.

Of particular interest is the fact that 27.4% of all subjects used the Savings Yield to comparison shop. This percentage held steady across all six test groups, despite the fact that Savings Yield was never mentioned in any NAIC literature, and discussed only briefly in the FTC Buyer's Guide. The control group used the Savings Yield for comparison shopping almost three times as frequently as any other cost dimension. The implication is that subjects in all groups considered the savings

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feature of life insurance to be very important in choosing among policies.

2. The Effect of Disclosure This study shows that buyer's guides and trigger statements increased participants' accessing of those items considered directly cost related. Table 7 illustrates the change in rankings between those receiving the written statements--trigger statements and buyer's guides--and those receiving none. Looking at only those items which changed rank by five or more places, the groups receiving the written statements devoted less attention to the following facts: settlement options, conditions for reinstatements, year-by-year cost of protection and rate of return, and sales volume.[17] Conversely, these groups gave more attention to the following facts: company retention index, surrender cost index, company retention yardstick, and surrender cost yardstick.[18] In other words, the written statements tended to shift participants' attention from non-cost facts to cost related facts.

Table 7. Comparing Rank Orders of Information Assessed by Groups Receiving no Written Statements (N=40) vs. the Remaining Subjects (n=198).

Dimension Name	Net Change
Financial Rating	-7
Monthly, Quarterly, Semi-Ann'l Premium	-10
Conditions for Reinstatement	-5

17 Study I, 25-27.

18 A yardstick is a representation of the range of values a given index may assume. Thus a yardstick can enable a person to determine whether a policy is low, high, or average cost relative to other similar policies.

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Mutual or Stock Company?	+6
Yr-by-Yr Cost of Protect'n & Rate of Return	-14
Yr-by-Yr Payments & Benefits	-7
Company Retention Index	+15
Surrender Cost Index	+9
Sales Volume	-6
Company Retention Yardstick	+8
Surrender Cost Yardstick	+5

An analysis of the relationship between direct cost information accessed by participants and selection of low cost policies also provides some support that cost disclosure is useful. The table below sets forth the policy choices broken out by 16 possible combinations of the four indices chosen by the 115 participants who were presented with three whole life policies to choose from. The data in this table show whether participants who accessed one or more of the four indices picked the lower cost policies more often than the other participants.

Table 12. The Association Between Cost Indices Accessed and Cost of Policy Selected.

		COST OF POLICY Low (B)	Medium (E)	High (C)	Total
COST INDICES ACCESSED					
1. None	N	8	2	1	11
	%	72.7	18.2	9.1	9.6
2. Company Retention	N	8	0	2	10
	%	80.0	0	20.0	8.7
3. Savings Yield	N	7	1	2	10
	%	70.0	10.0	20.0	8.7
4. Surrender Cost	N	5	1	0	6
	%	83.3	16.7	0	5.2
5. Net Payment	N	1	0	0	1
	%	100.0	0	0	.9
6. Company Retention & Savings Yield	N	7	2	1	10
	%	70.0	20.0	10.0	8.7

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7. Company Retention & Surrender Cost	N	3	0	1	4
	%	75.3	0	25.0	3.5
8. Company Retention & Net Payment	N	9	0	0	9
	%	100.0	0	0	7.8
9. Savings Yield & Surrender Cost	N	1	1	0	2
	%	50.0	50.0	0	1.7
10. Savings Yield & Net Payment	N	6	1	1	8
	%	75.0	12.5	12.5	7.0
11. Surrender Cost & Net Payment	N	6	0	0	6
	%	100.0	0	0	5.2
12. Company Retention & Savings Yield Surrender Cost	N	9	0	0	9
	%	100.0	0	0	7.8
13. Company Retention & Net Payment & Savings Yield	N	5	0	1	6
	%	83.3	0	16.7	5.2
14. Company Retention & Surrender Cost & Net Payment	N	1	0	0	1
	%	100.0	0	0	.9
15. Savings Yield & Surrender Cost & Net Payment	N	5	2	0	7
	%	71.4	28.6	0	6.1
16. All 4 Indices	N	12	1	2	15
	%	80.0	6.7	13.3	13.0
	Ns	93	11	11	115
	%	80.9	9.6	9.6	100.0

The low cost policy was selected 81% of the time and even those participants who did not access any cost index information selected the lowest cost policy in 8 out of

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11 cases.[19] We do not believe, however, that this figure should be construed as demonstrating that there is no need for cost index disclosure. First, these results are based on a small number of participants. The group that accessed no cost index included only 11 participants. This small number does not provide a basis for any statistically significant conclusions. But more importantly the study was designed primarily to examine whether information accessing behavior, not policy selection behavior, varied by disclosure format.[20] Consequently, the three whole life policies from which the participants could choose differed in important respects besides cost. Although the low cost policy had the highest annual premium, it also was the only policy offered by a mutual company, the only participating policy, the issuing company had the highest financial rating, and the policy had the highest 20-year cash value.[21] Cash values, financial rating, mutual or stock company, and dividend payment were each accessed by more than half of all the participants.[22]

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19 Id. at 36.

20 Id.

21 See Appendix B of Study I. Another possible explanation for the high absolute scores is that the participants did not treat the experiment as a real purchase decision. In other words, when asked to choose or decide on one of three policies, they chose the most expensive product. In this case, if they equated high premium with high quality they would select the lowest cost policy. Furthermore, some participants may have avoided one of the high cost policies because it was offered by Business Men's Assurance Company.

22 Study I, 20 (Table 5a).

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Furthermore, as noted above, the participants stated that premium, financial rating, and cash value were the three most important dimensions explaining their purchase decisions. Therefore, the fact that 82 percent of those accessing cost indices chose the lowest cost policy may in large part be explained by these other policy differenc Therefore, the high selection rates of the lowest cost policy do not support an inference that consumers do not need cost information.[23]

II. The Second Purdue Study

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23 Id. at 35 (Table 12).

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A. Purpose of the Second Study The second study was designed to compare the effectiveness of several life insurance disclosure systems in aiding consumers when purchasing insurance. Gathering a comparable sample from the same area as the first study,[24] the second study also employed the simulated purchase technique. The participants were tested on how well they succeeded in selecting lower cost policies from a representative sample of whole life policies. Subsequently, they were asked and tested on how well they understood the various disclosure formats.

It should be noted at the outset that we do not attempt to summarize all of the second study's findings. Some findings are beyond the scope of the present discussion. Other findings are not statistically significant and do not warrant discussion. The role playing scenarios, for example, did not result in statistically significant differences among disclosure formats.[25] We highlight only those findings that bear directly on the suf-

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24 See Study II at 4-10 for this sample's general demographic characteristics and page 5 for its insurance related characteristics.

25 In the role playing segment, the participants were given four written scenarios depicting hypothetical characters confronted with life insurance purchase decisions. Asked to assume the role of the hypothetical person, each participant selected the "best" of three policies offered. As constructed by the FTC staff, each scenario had only one correct answer. Of the participants exposed to the FTC buyer's guide, 72.8 percent selected the best policy. Only 66.2 percent of the participants using the Belth buyer's guide made the "best" choice and 61.1 percent of those exposed to the NAIC buyer's guide made the correct choice Study II, 84-85. These results, however, miss (barely) being statistically significant and we do not discuss them in the text. Id. at 84.

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ficiency of the NAIC disclosure format vis a vis other possible disclosures.

B. The Simulated Shopping Decision The first segment of the study measured the relative impact of six different disclosure systems on the ability of participants to make good purchase decisions. The participants were divided into six groups, each receiving a different disclosure package:

Group 1: no buyer's guide, no yardstick;
Group 2: no buyer's guide, FTC yardstick;
Group 3: FTC buyer's guide, no yardstick;
Group 4: FTC buyer's guide, FTC yardstick;
Group 5: NAIC buyer's guide, no yardstick, and
Group 6: Belth buyer's guide, no yardstick.

After receiving directions, each group was given an unlimited amount of time to read the disclosure package. Then each participant had an opportunity to examine up to eight different $25,000 whole life policies, one at a time, with a search fee charged for each policy examined.[26] In the case of the first four groups (even group 1), each policy was accompanied by an FTC designed consumer cost statement which had considerable instructional content. Unbeknownst to the participants, the policies were pre-arranged to allow the researchers to control the order in which each participant received the different policies.[27] Within each of the six groups, the policies were arranged in three structured sequences:

Sequence 1: 8, 7, 4, 3, 6, 5, 1, 2;

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26 Id. 17-18. Subjects were informed that different policies had different payoffs, the payoffs for the best being $27 (minus search fees) and the payoff for the worst being $7 (minus search fees). Id. at Appendix B, pages 3-6.

27 Id. at 17-20.

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Sequence 2: 7, 8, 4, 3, 6, 5, 1, 2; and
Sequence 3: 1, 2, 4, 3, 6, 5, 8, 7.

where 1 is the lowest cost policy and 8 is the highest cost policy.[28] One third of the group using the NAIC model buyer's guide, for example, received the policies in one of each of these three sequences. An identical approach was used in testing the participants who received the FTC and other disclosure packages. The relative inpact of the different systems was measured by comparing disparities in the selection rates of the lowest cost policy. The lowest cost policy was defined in different ways: (1) the least expensive policy, (2) the least expensive policy from those examined, and (3) the least expensive policy factoring in search fees.[29]

1. The Least Expensive Policy 47.2% of the participants who received the FTC buyer's guide and yardstick selected the least expensive policy among the eight available. The next best were those participants receiving no buyer's guide or yardstick (44.4%),[30]

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28 Id. at 15.

29 Id. at 23-24.

30 The relatively good performance of this group is the most significant finding of this study. This group only received a document that is very similar to the Preliminary Policy Summary recommended in Part IV of this report. As the researchers note this statement conspicuously provided average annual rate of return data as well as:

> [T]he Consumer Cost Index and premium, and contain[s] several paragraphs which emphasize the benefits of using the Consumer Cost Index. Each policy [summary] instructs the subject regarding what to look for and how to make the policy purchase decision. Thus, the 'control' subjects (i.e., those who saw neither a buyers guide

(Footnote Continued)

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those receiving the FTC yardstick without buyer's guide (42.6%), and those receiving the FTC buyer's guide without a yardstick (38.9%). The groups receiving the NAIC buyer's guide and the Belth buyer's guide only selected the least expensive policy 33.3 and 27.8 percent of the time, respectively.[31]

2. The Least Expensive Policy Among Those Examined. In terms of selecting the least expensive policy from among those examined, the groups receiving the FTC disclosures (groups 2-4) made the fewest errors. The next lowest error rate was in the group receiving no buyer's guide or yardstick.[32] The highest error rates were in the NAIC and Belth groups. The differences in error rates between

Group	1	2	3	4	5	6
Buyer's Guide	None	None	FTC	FTC	NAIC	Belth
Yardstick	None	FTC	None	FTC	None	None
Average Error Rate (%)	7.4	3.7	1.9	5.7	26.4	24.1

30 (Footnote Continued)

nor a yardstick) still had considerable assistance in making their decision. Id. at 54-55.

This finding indicates the potential effectiveness of the Preliminary Policy Summary.

31 See id., 27 and Table 8, at 30. The study also considers choice of policy by sequence (Table 9, p. 31)), and breaks down the data on educational attainment (Table 10, p. 33).

32 Id. at 35.

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groups 1-4 and groups 5-6 are statistically significant.[33] Indeed, the average error rate for those receiving the FTC disclosures (groups 1-4) is 5 percent or approximately one-fifth of the error rates for those receiving the NAIC and Belth disclosures.

3. The Least Expensive Policy Factoring in Search Fees

The selection rate of the least expensive policy factoring in search fees demonstrates the importance of yardsticks in comparison shopping. Given the specified payoff differences among the policies and a one dollar search fee, the only six participants making the "optimal" purchase decision were in the groups using the FTC yardstick.[34] Likewise when the search fee assessed was raised to two dollars, these two groups still outperformed the other groups.[35]

Still considering the influence of search fees on the optimal choice, the researchers standardized the results to create a common scale, a "payoff maximization statistic." This measure attempts to eliminate the effect of different sequences and search fees. For example, for the group receiving a two dollar search fee and sequence three, the maximum payoff is 25 dollars. By dividing all net payoffs (for this sequence and search fee combination) by 25, a standard scale having 1.0 as the maximum

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33 These figures were compiled from Table 11, id. at 35.

34 Id. at 45 (Table 18a).

35 Id. at 46 (Table 18b).

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score is created.[36] Similar calculations were performed for the other possible combinations of sequences and search fees. The following table presents the average payoff maximization statistic by disclosure format.[37] The best scores were achieved by the

Group	1	2	3	4	5	6
Buyer's Guide	None	None	FTC	FTC	NAIC	Belth
Yardstick	None	FTC	None	FTC	None	None
Payoff Statistic	.804	.817	.823	.834	.703	.729

three FTC related groups.[38] Further, the groups using the NAIC and Belth buyer's guides did less well than the baseline provided by the group receiving no buyer's guide.[39] Indeed, given the average number of policies examined, the NAIC payoff statistic is not substantially higher than it would have been if policies were picked by random. That is, random choice among policies might yield a payoff maximization statistic as high as .659.[40] In this light, the NAIC figure (.703) is even

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36 Id. at 47.

37 This table is compiled from Table 19, id. at 48.

38 Id. at 47.

39 Id. at 50.

40 To illustrate, assume 56 persons select at random from among the possibilities after three searches and 44 persons select from among the possibilities after four searches (the reason

(Footnote Continued)

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more troublesome.

4. Conclusions The groups receiving the expermental FTC disclosure packages outperformed the other groups--particularly the NAIC group--on the basis of all three definitions of best choice. Particularly significant is the fact that those subjects who received only the one page summary performed almost as well as those persons who received the more extensive disclosure.

C. Post Decision Reactions After the purchase decisions, the participants were requested to give their reactions. First, in answer to an open-ended question, participants gave general reasons for deciding on the policy selected. Of those groups receiving FTC disclosures (groups 1-4), over 25 percent of the participants said their choices of policies were based upon

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40 (Footnote Continued)

for choosing 56 and 44 is that the average number of policies searched by for all participants was 3.44). In this case, the random payoff statistic by sequence would be:

SEQUENCE	8-7	.454
	7-8	.454
	1-2	.666
AVERAGE		.525

On the other hand, if these 100 persons copy the search behavior of the participants in their sequence (rather than that of all other participants, regardless of sequence) then the payoff statistic by sequence would be:

SEQUENCE	8-7	.614
	7-8	.614
	1-2	.749
AVERAGE		.659

In sum, the NAIC payoff statistic of .703 is not substantially higher than the result if policies are picked by random.

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the Consumer Cost Index either alone or in combination with one or more cost-related indices. Fifteen percent of the FTC participants based their choice on the highest average annual rate of return. In contrast, about six percent of the NAIC participants referred to surrender cost data discussed in the NAIC buyer's guide. An additional twenty-two percent of the NAIC participants did refer to an index which they could not name.[41]

Next, the participants were queried on the buyer's guides. They were asked for their general reactions to their respective buyer's guides[42] and how well they understood specific sections.[43] In general, most participants stated that their buyer's guide was helpful and understandable. But as the researchers state: "it is clear that subjects using the FTC buyers guide (groups 3 and 4) reported it to be significantly easier to comprehend than did subjects exposed to either the NAIC or Belth buyers guides."[44]

In the same vein, the only section of any buyer's guide that a substantial number of participants said they found hard to understand was the section in the NAIC buyer's guide on how cost indices are computed and used. Out of a total of 72 responses,

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41 Id. at 58, Table 23.

42 Id. at 62.

43 Id. at 71.

44 Id.

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41 persons (56.9%) said they had difficulty understanding the cost index section of the NAIC buyer's guide.[45] Only 3.8 percent and 3.7 percent respectively, had difficulty understanding the cost index sections of the FTC and Belth buyer's guides.[46]

In sum, it appears that it is possible to develop a buyer's guide that is more comprehensible than the NAIC guide.

D. Comprehension Quiz In the final phase of testing, each participant completed a 21-item comprehension quiz. The quiz included true-false and multiple choice questions about life insurance. Three quizzes were used, corresponding to the three buyer's guides (NAIC, FTC and Belth). Fifteen of the 21 questions, however, were common to all three quizzes.[47] The participants were not allowed to refer to their buyer's guides during the first administration of the comprehension quiz. Subsequently, the quiz was re-administered and then participants were permitted to refer to their buyer's guides for help in answering the quiz questions. Participants not receiving any buyer's guide up to that time were allowed to use the FTC's buyers guide for help in taking the quiz.

Comparing the quiz results by buyer's guide, the table below shows that the NAIC groups in both quizzes scored significantly

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45 Id. at 75 (Table 34).

46 Id.

47 Id. at 91.

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lower.[48] Assuming no difference in intelligence[49] between the "NAIC" and other participants, these data suggest either that the six unique items on the NAIC quiz were more difficult or the NAIC buyer's guide was the least explanatory.[50]

Group	1	2	3	4	5	6
Buyer's Guide	None	None	FTC	FTC	NAIC	Belth
Yardstick	None	FTC	None	FTC	None	None
Quiz I (% Correct)	84.3	82.9	91.9	91.0	84.8	87.6
Quiz II (% Correct)	94.3	92.4	95.2	92.4	89.0	91.0

In contrast, the groups receiving the FTC buyer's guide in both quizzes did better than all other groups. This was true even for groups 1 and 2 who received no buyer's guides for the first quiz and the FTC buyer's guide in the second quiz.[51]

In particular, the researchers found that in quiz I the participants receiving no buyer's guide and the NAIC buyer's guide scored significantly lower than those receiving the FTC buyer's guide.

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48 Id. at 92. The table was compiled from Table 44, id. at 93.

49 Id. at 92.

50 Id. at 96.

51 Id.

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It should also be noted that the group receiving no buyer's guide did virtually as well as those groups receiving the NAIC and Belth buyer's guides. In Quiz II group (1) and FTC-No yardstick group (3) both were significantly higher than the NAIC group mean. (No other pairs of means differ significantly).[52] Again, the results indicate that it is possible to develop a buyer's guide that is more comprehensible than the NAIC model guide.

III. Conclusions Drawn from the Two Purdue Studies

The major conclusions drawn in this appendix are:

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52 In the closing section of Study II, the authors wrote:

> In conclusion, while some of the data suggest that subjects exposed to a disclosure system (particularly the FTC buyers guide) will fare better than those not exposed to such a system, the differences were not as striking nor as conclusive as expected. (Study II, 114)

This statement might well be interpreted to mean that none of the disclosure systems tested make much difference in the subjects' performance in choosing low-cost policies. This interpretation is not correct. As shown earlier in this Appendix, all four of the groups who received the FTC material had higher payoff maximization statistics (from 80% to 83%) than the Belth or NAIC groups (73% and 70% respectively).

A letter from Professor Jacoby (to Michael Lynch, FTC, March 1, 1979) clarified what he and his colleagues meant in the paragraph quoted above. There he writes that the surprising finding was that the FTC groups 1 and 2, which did not receive a buyer's guide. Groups 1 and 2 did have the one-page "consumer cost statements," however, and these apparently proved almost as effective as the buyer's guide plus yardstick plus cost statement. We regard this finding as one of the most important and hopeful results of the Purdue studies. In our view, it underlines the importance and potential effectiveness of providing the "preliminary policy summary."

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Study 1

1. Although cost dimensions are accessed much less frequently than other policy dimensions, they play a significant role in the final choice among policies.

2. Exposure to written statements (triggers and buyers guides) increased access to the targeted cost information for all subject groups.

3. The Savings Yield was the cost dimension accessed most frequently and many subjects appear to have used it to comparison shop.

Study 2

1. The participants receiving the FTC disclosure materials appear to have engaged in more intelligent search behavior than their counterparts.

2. Very few (5%) of FTC participants failed to choose the least costly policy among those they examined. A substantial portion (25%) of the NAIC and Belth subjects failed to choose the least costly policy.

3. A simple one sheet disclosure statement like the Preliminary Policy Summary recommended in Part IV of this report offers good promise in achieving meaningful disclosures.

4. It appears possible to develop a buyer's guide that is more comprehensible than the NAIC model guide.

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APPENDIX X: BUYER'S GUIDE, SUGGESTED STATE REGULATION, AND NAIC AND STATE REGULATIONS

BUYER'S GUIDE TO LIFE INSURANCE

The purpose of this booklet is to give you general information that will help you select a satisfactory life insurance policy for your needs. It is not intended to be an endorsement of any policy or insurance company.

Since the information is general, if you have unusual insurance problems, you should seek professional advice. The Guide is not designed to assist in the evaluation of your existing policies.

Buyer's Guide to Life Insurance

IMPORTANT: Many people think all similar life insurance policies cost about the same. They don't. Reading this Buyer's Guide may save you many hundreds or thousands of dollars over a twenty-year period by helping you find a low-cost policy that best fits your needs.

The main purpose of life insurance is to provide financial security after your death for those who depend on you. Life insurance can also be used to pay off your mortgage or provide for other large debts, pay education expenses, provide savings and retirement income. It can also be used to pay for funeral and last illness expenses. In addition, life insurance can be valuable protection against the premature death of a spouse who raises the children and maintains the household.

This guide will help you to determine the amount of protection your family needs. It will also help you learn which kind of policy best provides that protection. You'll learn how to select a policy that gives you the most coverage at the lowest cost.

Read the guide carefully and never forget that when buying insurance, being a careful shopper can give you the most protection at the least expense.

WHAT IS LIFE INSURANCE

Every life insurance policy is a contract. In return for your paying premiums, an insurance company promises to pay a specified amount of money when you die to a person you name in the policy. The person who is to receive the money is called the beneficiary.

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The money to be paid is called the proceeds or death benefits, and its amount is often referred to as the face amount of the policy.

BASIC TYPES OF LIFE INSURANCE

All life insurance policies promise to pay a stated amount of money when you die. There are two basic types of life insurance: term and whole life. While they may go by different names, most life insurance policies are either one of these types or a combination of both. However, all policies of the same type do not necessarily cost the same or provide the same kind of protection. In fact, buying a policy that fits your needs and your budget can save you hundreds or even thousands of dollars over your lifetime.

TERM INSURANCE

Term insurance insures your life for a fixed period of time or term such as 1, 5, or more years. Death benefits are payable only if you die within the term, provided, of course, the policy is still in effect. At the time of purchase, term insurance generally provides the largest death protection for your premium dollar. You can usually renew term insurance policies for one or more terms without having to pass a medical examination to get the renewal. But be careful: not all term policies are renewable. You should be sure about this feature before buying. If the policy is renewed for another term, the premium will be increased because you will be older during the additional term. Some term policies may be renewed through age 100. However, the premiums on term insurance are very expensive after age 65.

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You can also buy term policies whose premiums stay level but whose death benefit declines each year. These are called decreasing term policies. A decreasing term policy may be useful if you are young and currently responsible for a mortgage or other large debt.

Before you consider buying an individual life insurance policy check with your employer, labor union, or professional association on your eligibility for group term insurance. Group insurance often costs much less than either individual term or individual whole life, especially if your employer pays part of the premiums. In addition, you can usually buy group insurance without passing a medical exam. There are, however, some things to watch for. Like individual term insurance, group insurance is usually renewable only through age 65 or 70. Also, there may be a limit on the amount of group insurance you'll be able to buy. And if you switch employers or drop your union or professional association membership, your group coverage may end. If that happens, you're usually guaranteed the right to convert that coverage to an individual whole life policy--but at a higher premium. Still, all things considered, group insurance may provide a solid, relatively inexpensive foundation for your personal insurance program.

WHOLE LIFE INSURANCE

Whole life insurance is also referred to as "ordinary life" or "straight life" insurance. It differs from term insurance in two important ways. First, although the premiums start out at a

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higher level than term insurance for the same amount of insurance protection, they remain level and do not increase with age. Second, whole life policies develop cash values that increase every year.

You should understand that if you buy a whole life policy, a substantial portion of your premiums will go into the savings element (cash value) of the policy. During the early years of a whole life policy, the premiums are much more than the amount needed to buy term insurance for a person of the same age. The insurance company puts most of the extra dollars into a fund, called the policy's cash value. This cash value grows steadily over the years, and as it grows, it reduces the amount of actual death protection the company must provide to pay the face amount. In fact, you can think of whole life insurance as a combination of an increasing savings element (cash value) and a decreasing amount of pure life insurance protection.

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You can get the cash value if you cancel your policy. However, if you keep the policy, the insurance company will pay only the face amount of the policy if you die, not the face amount plus the cash value. For example, if you bought a $25,000 whole life policy at age 35, it might have a cash value of $10,000 by the time you're 65. Yet, if you die at age 65, your beneficiary will get only $25,000, no matter how large or small the cash value.

Besides making it possible to have affordable life insurance beyond age 65, cash values can be useful to you in other ways. Many people find buying a whole life policy a convenient way to save for retirement or other purposes. Each time you pay your premium, a part of the premium automatically goes to build up the policy's cash value. You can get the full amount of the cash value by simply canceling your policy. But if you do, you'll, of course, lose your death protection. You can also borrow up to the full amount of the cash value in the form of a policy loan. You will have to pay interest on this loan at the annual percentage rate fixed in the policy, but this rate is often lower than other rates available. If the loan is still outstanding when the policyholder dies, the policy loan amount will be deducted from the payment made to beneficiaries.

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OTHER TYPES OF POLICIES

In addition to whole life policies, there are many other policies on the market with savings elements. "Life paid up at age 65" is just what the name implies: after age 65 no more premiums are due. "Twenty-pay life" is a policy with 20 annual premiums after which time the policy stays in force without additional payments. An "endowment policy" is one in which the cash value equals the policy's face amount at the end of a limited period, usually 20 or 30 years. Endowment insurance has a greater savings component than whole life policies, but it gives you less death protection for your premium dollar. Although the premium on all of these types is higher than simple whole life, they may be useful for certain special needs. But most people's insurance needs can be met by either term or whole life or a combination of the two.

TERM OR WHOLE LIFE INSURANCE

In deciding whether to buy term or whole life insurance, you ought to consider these three questions: (1) How much insurance coverage does my family need against my premature death; (2) How long do I want to keep my insurance in force; and (3) Do I want to use my insurance policy as a way to save?

HOW MUCH INSURANCE TO BUY

You should remember: THE MAIN PURPOSE OF LIFE INSURANCE IS TO PROVIDE FINANCIAL SECURITY FOR DEPENDENTS WHEN A WAGE-EARNER OR SERVICE-PROVIDER DIES PREMATURELY.

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It is important to establish the amount of money your dependents will need if certain income or services are no longer available because of premature death. Life insurance is a source of cash for paying a family's living expenses, education costs, mortgages, and other debts. A comprehensive life insurance program should come as close as you can afford toward providing the funds your family and dependents would need over and above the assets you have acquired and can leave to them and what would be available to them through social security or other protection.

When you're young and your insurance needs are generally greatest, term insurance gives you three to five times more protection for your premium dollar than whole life. For example, a 25-year old person who can afford to spend $300 a year on life insurance could buy either $20,000 worth of whole life or $100,000 worth of term insurance. Many people--especially those with young children--can get the amount of insurance they need only by buying a term policy. On the other hand, if you expect to carry that amount of insurance no matter how old you become, term insurance will become expensive after age 65.

HOW LONG TO KEEP YOUR POLICY IN FORCE

Remember that the main purpose of life insurance is to replace income lost when a family's breadwinner dies prematurely. This suggests that when a person approaches retirement, the need for life insurance may diminish. Whole life insurance can, of course, be used to meet a person's long-term insurance needs through age 65. But so can renewable term insurance. Though the term policy's

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premium will go up with each renewal, the process is slow. For example, if you buy a renewable term policy at age 35, it will take about 20 years for the premium of your renewable term policy to become larger than the level premium you would have had paid if you had bought a whole life policy. By that time, however, you may need less insurance and can reduce the insurance you carry.

On the other hand, whole life policies kept in force even after retirement can be used to pay for funeral expenses, medical bills, and death taxes. They can also provide money for the surviving members of the family. Though some term policies are renewable through age 100, remember that their premiums become very expensive after age 65.

COMBINING TERM AND WHOLE LIFE

If you think you'll want some insurance after age 65 but you can't afford enough whole life insurance to give your family adequate protection while you're young, there are several things you can do. One is to buy a renewable term policy that is also "convertible." This means that any time before the end of the conversion period, you can trade the policy in for a whole life policy of the same or lesser face amount without having to pass a medical exam. Premiums for the new policy, however, will be higher than you have been paying for the term insurance.

People with young children often find this type of insurance program attractive because it lets them buy a larger amount of death protection when they're young at a price they can afford. At the same time they preserve their option to buy a whole life policy if they decide they want some insurance in force after age 65. You can also buy a combination of term and whole life

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insurance by purchasing either separate policies or a whole life policy with a term policy attached to it (this is called a "term rider"). In either case you'll have insurance that will remain in force after you turn 66 plus you will have some additional death protection during your younger years when you need it most.

Because your income and the number and needs of your dependents may change, it is important to review your life insurance program periodically. As a part of this process you should consider the effect of inflation on your assets and on your family's future needs.

SAVING THROUGH LIFE INSURANCE

If you want protection for your family while you're young and a source of money as you grow older, there are two things you can do. You can buy a whole life policy with its built-in savings program. Or you can buy a term policy and each year invest the difference between the whole life premium and the term premium in a savings account, U.S. savings bonds, or some other safe investment. If you buy a term policy and you're the kind of person who can save regularly, and many people are, you'll build up a sizeable sum of money by the time you're 65. You can then use this sum for the same purposes as the cash value of a whole life policy. This could reduce your need for life insurance in your later years.

Consider the Annual Rate of Return. If you are considering whole life as a way of saving, you should compare its features with other types of savings programs, especially savings accounts. The best way to make a comparison is to look at a policy's average

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annual rate of return. The average annual rate of return will, to a large extent, depend on how long you keep a policy in effect. It is calculated by breaking down the cost of the premium according to where the premium dollar goes. Part of the premium goes for relatively inexpensive death protection. The rest can be considered a "savings deposit". The rate of return is expressed as a percentage and is equal to the interest rate that will make the "savings deposit" grow into an amount equal to the policy's cash value. For example, a policy with a rate of return of 3.2 percent means that the savings element of your premium, if deposited in a bank, would need to earn 3.2 percent after taxes for the depositor to be as well off with either alternative.

You'll find a policy's average annual rate of return for 5, 10, 20 and 30 years on the PRELIMINARY POLICY SUMMARY an insurance agent must give you before asking you to sign a policy application. Remember though that the average annual rate of return is based on estimates of how much it will cost you to purchase term insurance. The chart below shows term insurance rates used in making the rate of return calculations.

Average Yearly Renewable Term Rates per $1,000

	Amount of Insurance		
Age	$10,000	$25,000	$100,000
25	$ 4.47	$ 2.97	$ 2.22
35	4.73	3.23	2.48
45	7.16	5.66	4.91
55	13.85	12.35	11.60

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If you can find term insurance that costs less than what is on the chart, the actual average annual rate of return on a whole life policy you are considering will be somewhat lower than the rate disclosed on the PRELIMINARY POLICY SUMMARY. In any case, whether you are merely comparing term and whole life or considering setting up an insurance package made up mainly of term insurance, you should be able to find a term policy that costs as little as the one in the chart. Don't forget that the annual rates shown are per $1,000 of coverage. Multiply these rates by the number of thousands of dollars of coverage you want to get. For example, at age 25 multiply $4.47 times 10 to get the total annual cost for a $10,000 insurance policy.

A little difference means a lot. If your reaction to all this talk of rates of return is to say "What difference can a percent or so make?," the answer is--a lot! A difference of only 1 percent in a rate of return is extremely significant. When compounded over 30 years (which can be how long a whole life policy lasts), this seemingly small difference can amount to a lot of money. The chart below illustrates this by showing how many pre-tax dollars you would have, at the end of 30 years, if you deposited $500 each year in bank accounts paying various interest rates:

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Impact of Different Interest Rates on a $500 Per Year Investment for a 30-Year Period

Rate of Interest	Value After 30 Years
2%	$20,284
3%	23,788
4%	28,042
5%	33,219
6%	39,529
7%	47,230

TAX CONSIDERATIONS

You may also want to consider the possible tax advantage of saving with a whole life policy. Interest earnings credited to the "savings deposit" feature of a whole life policy are not taxed until you surrender the policy; even then, the taxable amount may be zero or quite small. It is important to compare rates of return with the after-tax return that you could get from other savings or investment programs. For example, if you are in a 20 percent tax bracket, a 4 percent rate of return from the "savings deposit" feature of the whole life policy is equal to a 5 percent return on fully taxable investments. Here's why--on a $100 fully taxed investment paying 5 percent, you would get $5.00. But 20 percent of that--$1.00--would go for taxes. This means you would end up with the same $4.00 you would get from a policy with a 4 percent rate of return.

OTHER BENEFITS OF WHOLE LIFE

Finally, many whole life policies offer benefits (other than cash values) that are not found in term insurance combined with a savings or investment program. These include the right to stop

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paying premiums and use the accumulated cash value to purchase paid up insurance or extended term insurance. Whole life policies also contain guarantees with respect to annuity purchase rights. Additionally, you can borrow against your cash value at a favorable interest rate. These other benefits of a whole life policy might make it a desirable purchase even if its rate of return is lower than you could receive elsewhere.

A WORD OF CAUTION ABOUT WHOLE LIFE

It's a costly mistake to buy a whole life policy only to drop it after a year or two. If you do, you'll usually get next to nothing back. It's true that few people plan to drop a whole life policy soon after buying it. Yet about one in five new policyholders actually does just that. Moreover, because of the cost elements involved, the cash value of a whole life policy builds up very slowly during the policy's early years, making whole life insurance a very uneconomical way to save for short-term needs. Therefore, you shouldn't buy a whole life policy unless you plan to keep it at least 10 years.

"PAR" OR "NON-PAR" POLICIES

Some term and whole life policies pay dividends (participating or "par" policies), while others do not (non-participating or "non-par" policies). Dividend-paying policies generally have higher premiums than nondividend-paying policies, but often cost less in the long run, especially if their dividends are paid each year. The amount a company expects to pay each year are known as "illustrated" dividends. These "illustrated" dividends are not

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guaranteed. The exact amount a company actually decides to pay in dividends each year depends upon a number of factors, including the company's investment income for that year. These factors simply can't be predicted with complete accuracy several years in advance. In recent years, however, the actual dividends paid on most "par" policies have been higher than those illustrated at the time the policies were sold.

HOW TO FIND A LOW-COST POLICY

Once you've decided on the type and size of policy you want, use the Surrender Index to find a low-cost policy. This index is found on the PRELIMINARY POLICY SUMMARY. Don't pick a policy just because it has a low premium. Premiums only measure what you pay for a policy. They don't measure a policy's benefits. Those benefits, which may include cash values and dividends as well as death protection, vary by large amounts among policies with similar premiums sold by different companies. The Surrender Index takes premiums, cash values, dividends, and interest into consideration. It is called the Surrender Index because it compares cost as if at some future point in time you were to surrender the policy and take its cash value. THE MOST IMPORTANT THING TO REMEMBER WHEN USING THE SURRENDER INDEX IS THAT A SMALL NUMBER IS GENERALLY A BETTER BUY THAN A COMPARABLE POLICY WITH A LARGER INDEX NUMBER.

The table below illustrates the range of 20-year Surrender Indices for four commonly sold participating policies sold to males at the ages indicated. One-fourth of all policies are at or below the "Low Cost" figure. The "Average Cost" figure is in the middle of the range--half of all policies of that type are cheaper and half are more expensive. One-fourth of all policies are more expensive than the "High Cost" figure.

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Policy Type	Size	Range of Costs	Surrender Index Age 25	Age 35	Age 45
Whole Life	$10,000	Low Cost	$3.69	$5.39	$ 9.95
		Average Cost	4.50	6.43	11.51
		High Cost	5.54	7.59	13.05
Whole Life	$25,000	Low Cost	2.76	4.56	8.82
		Average Cost	3.53	5.39	10.10
		High Cost	4.20	6.35	11.39
Term	$25,000	Low Cost	3.42	5.62	12.38
		Average Cost	3.64	5.86	12.93
		High Cost	4.19	6.71	13.91
5 Year Renewable & Convertible Term	$50,000	Low Cost	3.49	6.00	12.90
		Average Cost	3.87	6.31	13.71
		High Cost	4.36	6.94	14.54

As this table shows, the cost for similar policies varies widely. These differences in cost can be very important to you. For example, if a person were to buy a $25,000 whole life policy with a Surrender Index of $3 per $1,000 instead of one with a Surrender Index of $6 per $1,000, the saving would be about $75 per year on the average ($6 - $3 x 25 = $75). If a person were then to deposit this $75 per year in a bank account at 5 percent interest, the balance at the end of the 20 years would be almost $2,500.

The range of Surrender Indicies given on the table only apply to the particular policies and ages given. To find out if the cost of a particular policy is high or low you should call up a number of competing companies and ask for the 20-year Surrender Index (at your current age) for their comparable policies.

When using the Surrender Index to look for a low-cost policy, remember the following:

1. The index is only approximate. Rather than search for

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the lowest-cost policy on the market, use the index to find a group of relatively low-cost policies from which to make your final choice. Differences of less than 50 cents per $1,000 can usually be ignored and may be offset by other policy features or by differences in the quality of service you may expect from the company or its agent.

2. The Surrender Index is only useful in comparing the costs of similar policies, those which provide essentially the same basic benefits and require payments for approximately the same period of time. The more similar the policies, the more reliable the cost comparison will be. For example, don't use the Surrender Index to compare the cost of a term policy to that of a whole life policy; instead, base your choice of term versus whole life on factors mentioned earlier in this Buyer's Guide.

3. The Surrender Index for a dividend-paying policy assumes that dividends on the policy will be paid exactly as illustrated at the time the policy was issued. This, however, rarely happens. Since the exact amount of a "par" policy's dividends isn't guaranteed, the policy's actual cost may turn out to be higher or lower than that indicated by the Surrender Index. Remember, however, in recent years the actual dividends paid on most "par" policies have been higher than those illustrated at the time the policies were sold. As long as you recognize that "par" policies' dividends are not guaranteed, you can use the Surrender Index to compare the costs of dividend-paying and nondividend-paying policies.

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POINTS TO REMEMBER

1. KNOW YOUR RIGHTS. The laws of this state provide that anyone who buys a life insurance policy from an agent can return the policy to the company for any reason within 10 days after the policy is delivered and receive a full return of all money paid. If the policy was bought through the mail, you have 30 days after delivery to return it and receive a refund.

2. BUY ONLY WHAT YOU CAN AFFORD. If you drop your whole life policy within the first 10 years because the premiums turn out to be more than you can afford, you may lose a substantial portion of the money you have paid in.

3. GROUP INSURANCE. If you are eligible for such coverage, check it out carefully. It may be the easiest and least costly way to meet your basic life insurance needs.

4. TRY NOT TO LEAVE YOURSELF UNDERINSURED. Remember: during your younger years, when your insurance needs are generally greatest, term insurance will provide you with several times more insurance protection than whole life for the same premium dollar.

5. SHOP AROUND. Many people think that all similar policies cost about the same. They don't. Before you buy a life insurance policy, check to see if it has a low Surrender Index.

6. CHECK THE RATE OF RETURN. If you are thinking about using whole life insurance as a way to save, be sure to check its rate of return and compare it with other policies and alternative savings or investment programs.

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7. SHOP FOR A GOOD AGENT AS WELL AS A GOOD POLICY. You can't overestimate the value of a well-informed agent. Inexperienced agents often lack detailed knowledge about their company's policies. They may not even realize that the costs of similar policies differ greatly from company to company. In addition, because agent commissions are tied to premium size, there may be an incentive for some agents to sell costlier policies that may not fit your needs. So shop around. Talk to two or three agents, including agents who represent several companies. Compare the advice each one gives you and the Surrender Indices and rates of return of the policies each one recommends.

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PRELIMINARY POLICY SUMMARY

IMPORTANT: Many people think all similar life insurance policies cost about the same. They don't. The cost of similar policies varies sharply. You can save many hundreds or even thousands of dollars by choosing a low-cost policy. To find out how this particular policy ranks, compare its Cost Index (found below) to the range of cost indexes for similar policies. For further information on cost comparison and examples of the range of cost indexes for a number of policies, see pages in the [state] Buyer's Guide to Life Insurance which you should have received with this policy summary.

Company:
Type of Policy:
Name of Policy:
Face Amount:
Policyholder's Sex and Age at Issue:

YEARLY PREMIUM _____ (per $1,000 of face amount)

20-YEAR SURRENDER INDEX:
(per $1,000 face amount)

AVERAGE ANNUAL RATE OF RETURN: if you keep the policy 5 years
if you keep the policy 10 years
if you keep the policy 20 years
if you keep the policy 30 years

How To Use This Preliminary Policy Summary

Surrender Index: To find a low-cost policy, look at the policy's 20-year surrender index, not its premium. Premiums only measure what you pay for a policy. The benefits you receive from policies with similar premiums vary widely. The Surrender Index takes premiums, cash values, and dividends into consideration. In doing so, it provides a much more complete measure of the cost of similar life insurance policies than premiums. A policy with a low Surrender Index is generally a better buy than a similar policy with a higher index number. The Surrender Index should only be used to compare the cost of similar policies. Don't use it to compare the cost of a term policy to that of a whole life policy.

Average Annual Rate of Return: Part of each premium you pay buys you death protection and part can be viewed as a deposit which builds up the savings (or cash value) portion of your policy. The Average Annual Rate of Return shows you approximately what rate of return you'll get on the savings portion of this policy if you keep it for 5, 10, 20 or 30 years. The rate of return is one factor you should consider in deciding whether to buy term or whole life insurance. There are other benefits in a whole life contract that are not generally available in term insurance contracts. Therefore a whole life policy may be a desirable purchase even if its rate of return is lower than you could receive elsewhere. For a discussion of this and other factors, see pages of your Buyer's Guide.

_____ _____
Signature of Agent Date

(This form should be used for whole life and endowment insurance).

PRELIMINARY POLICY SUMMARY

IMPORTANT: Many people think all similar life insurance policies cost about the same. They don't. The cost of similar policies varies sharply. You can save many hundreds or even thousands of dollars by choosing a low-cost policy. To find out how this particular policy ranks, compare its Cost Index (found below) to the range of cost indexes for similar policies. For further information on cost comparison and examples of the range of cost indexes for a number of policies, see pages in the [state] Buyer's Guide to Life Insurance which you should have received with this policy summary.

Company:
Type of Policy:
Initial Face Amount:
Policyholder's Sex and Age at Issue:
Length of Term:
Renewable:* Yes ___ No ___. If yes, through what age? ___
Convertible: Yes ___ No ___. If yes, through what age? ___

20-YEAR SURRENDER INDEX:
(per $1,000 face amount) _____

Policy Years	Annual Premium	Premium for $1,000 of face amount	Face Amount	Dividends

NOTE: Companies (or intermediaries) should enter in this space the appropriate information for representative policy years.

How To Use This Preliminary Policy Summary

Surrender Index: To find a low-cost term policy, look at the policy's 20-year Surrender Index, not just its first-year premium. That's because the premiums for some term policies go up faster than others. In addition, many term policies pay dividends. When they do, that lowers the cost of those policies. The Surrender Index takes both dividends and later-year premiums into consideration and thus gives a better measure of a term policy's cost than the first-year premium alone. A policy with a low Surrender Index is generally a better buy than a similar policy with a higher index number.

The Surrender Index should only be used to compare the cost of similar policies. Don't use it to compare the cost of a term policy to that of a whole life policy.

*Renewability: If you're buying term insurance for long-term needs, make sure your policy is guaranteed renewable through at least age 65. Check above for the age through which this policy can be renewed. For more information on how to shop for life insurance, read your Buyer's Buide.

_____ _____
Signature of Agent Date

(This form should be used for term insurance and term riders.)

DRAFT REGULATION

(1) AUTHORITY. (Insert applicable state authority)

(2) PURPOSE. The purpose of this regulation is to require insurers to deliver to prospective purchasers of life insurance information which will improve the buyer's ability to select the most appropriate plan of life insurance for his or her needs, improve the buyer's understanding of the basic features of the policy which has been purchased or which is under consideration, improve the ability of the buyer to evaluate the relative costs of similar plans of life insurance and improve the buyer's ability to chose between dissimilar plans of insurance. This rule does not prohibit the use of additional material which is not in violation of this rule or any other [state] statute or rule.

(3) SCOPE. (a) Except as hereafter exempted, this rule shall apply to any solicitation, negotiation or procurement of life insurance or annuities occurring within this state. This rule shall apply to any issuer of life insurance contracts including fraternal benefit societies.

(b) For purposes of this regulation the term "life insurance" includes annuities except where the context indicates otherwise.

(c) Unless otherwise specifically included, this rule shall not apply to:

1. Credit life insurance.
2. Group life insurance provided at least a portion of the cost is borne by a person other than the persons insured or their beneficiaries.

3. Variable life insurance under which the death benefits and cash values vary in accordance with unit values of investments held in a separate account.

4. Group annuities provided at least a portion of the cost is borne by a person other than the annuitants or their beneficiaries.

(4) DEFINITIONS. For the purposes of this rule, the following definitions shall apply:

(a) [state] Buyer's Guide to Life Insurance. The [state] Buyer's Guide to Life Insurance is a document which contains, and is limited to, the language within the current edition of "The [state] Buyer's Guide to Life Insurance" put out by the Insurance Commissioner of the State of [ ]. A copy of which is attached hereto as Appendix 1. Insurers may purchase the Buyer's Guide at cost from the Office of the Commissioner of Insurance, or they may reproduce it themselves (subject to reasonable standards of style, size, and layout).

(b) Cash Dividend. A Cash Dividend is the current illustrated dividend which can be applied toward payment of the gross premium.

(c) Additional First Year Premium Policies. A policy requiring an additional premium payment for the first policy year, or for the first several policy years, that is substantially larger than the premium for the remainder of the policy years and providing a fixed payment at the end of a fixed term period coupled with a term insurance policy or a whole life insurance

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policy. There are several variations in the forms of such policies and are more commonly known as "deposit term", deposit whole life," or "modified whole life" policies.

(d) Equivalent Level Death Benefit. The Equivalent Level Death Benefit of a policy or term life insurance rider is an amount calculated as follows:

1. Accumulate the guaranteed amount payable upon death, regardless of the cause of death, at the beginning of each policy year for twenty years at five percent interest compounded annually to the end of the twentieth policy year.
2. Divide each accumulation of step 1 by an interest factor that converts it into one equivalent level annual amount that, if paid at the beginning of each year, would accrue to the value in step 1. The twenty year interest factor is 34.719.

(e) Generic Name. Generic Name means a short title which is descriptive of the premium and benefit patterns of a policy or rider.

(f) Life Insurance Indices

1. Surrender Index. The Surrender Index is calculated by applying the following steps:
   a. Determine the guaranteed cash surrender value, if any, available at the end of the twentieth policy year.

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b. For participating policies, add the terminal dividend payable upon surrender, if any, to the accumulation of the annual Cash Dividends at five percent interest compounded annually to the end of the twenty years and add this sum to the amount determined in step a.

c. Divide the result of step b (step a for guaranteed-cost policies) by the interest factor that converts it into an equivalent level annual amount that if paid at the beginning of each year, would accrue to the value in step b (step a for guaranteed-cost policies) over the respective period stipulated in step a. The twenty year interest factor is 34.719.

d. Determine the equivalent level premium by accumulating each annual premium payable for the basic policy or rider (if the premium includes supplemental benefits without separate identifiable charge, a reasonable adjustment may be made) at five percent interest compunded annually to the end of twenty years and dividing the result by the factor stated in step c. (This amount is the annual premium payable for a level premium plan).

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e. Subtract the result of step c from step d.

f. Divide the result of step e by the number of thousands of the Equivalent Level Death Benefit to arrive at the Surrender Index.

2. Average Annual Rate of Return Index. This index is calculated on cash value policies using the Linton Yield method.

a. The Linton Yield method solves for a level, effective, annually compounded interest rate, or yield. This yield is determined by equating the cash available at the end of a specified number of years from two different protection/savings programs, and then solving for the annual yield that must be achieved on the separate savings fund of the second program in order to produce the cash equivalency with the first program. The two programs compared are:

i. A life insurance policy on, normally but not necessarily, some permanent plan. The cash used at the end of the specified year is the policy's guaranteed cash surrender value plus the terminal dividend payable upon surrender and the dividend payable at the end of the specified year.

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ii. A combination of a savings fund and yearly renewable term (YRT) insurance. The amount deposited in the savings fund each year is assumed to be equal to the annual premium payable under the alternative program for the permanent life insurance policy (less any dividend payable at the end of the preceding year) less an assumed premium payable for YRT insurance. The amount of YRT purchased each year is that which would be adequate to bring the combined death benefit from the savings plan and the YRT to the same as that payable under the permanent life insurance policy. The cash used for comparison with the permanent policy is the amount accumulated in the savings fund at the end of the specified year.

b. Average Annual Rate of Return index figures given out in [state] by insurers or intermediaries shall be calculated separately for males and females and shall be based upon the following assumptions:

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i. As to YRT premium rates: YRT premiums = (1,000 q) (K) + $0.90 + $25/S where K equals 1.00 for ages 0 through 14 and 0.95 for ages 15 and above, S equals policy size in thousands and 1,000q equals the mortality rate for age x shown in subsection (9);

ii. As to elements entering into the calculation: Gross premiums shall include the total premiums charged for all life insurance benefits; dividends shall be total illustrated dividends excluding any separately identifiable dividends payable for benefits other than life insurance.

c. Average Annual Rate of Return index figures for additional first year premium policies defined in Section 4(c) shall be calculated in the same manner as for cash value policies. For purposes of the calculation gross premiums shall include all payments made to the company under the contract and cash values for each year shall be the total amount to which the policyholder is entitled under the contract for that year.

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d. Average Annual Rate of Return index figures for annuities shall be the annually compounded interest rate, or yield, on gross premiums paid over the selected holding period.

Note: A discussion of the Linton Yield method may be found on pages 28-30 in the Analysis of Life Insurance Cost Comparison Index Methods, prepared by the Society of Actuaries Committee on Cost Comparison Methods and Related Issues (Special), September, 1974. Further discussion on the "low" YRT rates to be used in computing the Linton Yield, which are the rates specified in this rule, may be found in Appendix E, pp. 187-192 of that same publication.

(g) Preliminary Policy Summary. For the purposes of this rule, Prelimiary Policy Summary means a document provided to the buyer of a life insurance policy which contains necessary consumer cost disclosure information, in substantially the same format for all companies, as specified by the Commissioner. Appendix 2 to this rule contains a Preliminary Policy Summary form for Whole Life and Endowment Policies. Appendix 3 contains a Preliminary Policy Summary form for Term Policies and Term Riders.

(h) Preliminary Policy Summary for Additional First Year Premium Policies. For the purposes of this rule the Preliminary Policy Summary for additional first year premium policies means a document provided to the buyer of these products which contains the following information:

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1. The name of the company and Generic Name of the policy.
2. The policyholder's age and sex at issue.
3. The annual premiums and guaranteed amount payable upon death for representative policy years.
4. The average annual rate of return for five, ten, twenty and thirty years.
5. A statement warning that early termination of the policy will result in the loss of the additional premium, if such is the case.
6. Language substantially similar to the notice located at the top of the Preliminary Policy Summaries in Appendices 2 and 3.
7. The signature of the soliciting agent and the date on which the summary was prepared.
8. Such other information that the Commissioner may determine is necessary to fully inform the purchaser of the basic features of the policy.

(i) Preliminary Policy Summary for Annuities. For the purposes of this rule the Preliminary Policy Summary for annuities means a document provided to the buyer of an annuity which contains the following information:

1. The name of the company and Generic Name of the policy.
2. The policyholder's age and sex at issue.
3. The annual premium for the policy.

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4. The average annual rate of return on gross premiums paid for five, ten, twenty and thirty years.
5. If the annuity contains both a guaranteed and current rate the average annual rate of return shall be shown for both.
6. Language substantially similar to the notice located at the top of the Preliminary Policy Summaries in Appendixes 2 and 3.
7. The signature of the soliciting agent and the date on which the summary was prepared.
8. In the case of flexible premium annuity contracts the information on the Preliminary Policy Summary shall be determined on the assumption that consideration payments will be made at the rate of $1,000 per year.

(j) Policy Summary. 1. For the purposes of this rule, Policy Summary means a written statement in substantially the same format for all companies and describing the elements of the policy including but not limited to:

a. A prominently placed title as follows: STATEMENT OF POLICY COST AND BENEFIT INFORMATION.
b. The name and address of the insurance intermediary, or, if no intermediary is involved, a statement of the procedure to be followed

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in order to receive responses to inquiries regarding the Policy Summary.

c. The full name and home office or administrative office address of the company in which the life insurance policy is to be or has been written.

d. The Generic Name of the basic policy and each rider.

e. The following amounts, where applicable, for the first five policy years and representative policy years thereafter sufficient to clearly illustrate the premium and benefit patterns, including but not necessarily limited to, the year for which the Surrender Index is displayed and at least one age from sixty through sixty-five or maturity whichever is earlier:

i. The annual premium for the basic policy.

ii. The annual premium for each optional rider.

iii. Guaranteed amount payable upon death, at the beginning of the policy year regardless of the cause of death other than suicide, or other specifically enumerated exclusions, which is provided by the basic policy and each optional rider, with benefits provided

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under the basic policy and each rider shown separately.

iv. Total guaranteed cash surrender values at the end of the year with values shown separately for the basic policy and each rider.

v. Cash Dividends payable at the end of the year with values shown separately for the basic policy and each rider. (Dividends need not be displayed beyond the twentieth policy year).

vi. Guaranteed endowment amounts payable under the policy which are not included under guaranteed cash surrender values above.

f. The effective policy loan annual percentage interest rate, if the policy contains this provision, specifying whether this rate is applied in advance or in arrears. If the policy loan interest is variable, the Policy Summary shall include the maximum annual percentage rate.

g. The annual percentage rate of interest if the premiums are paid more often than once a year.

h. Surrender Cost Index at the twentieth year. Separate indices are displayed for the

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basic policy and for each optional term life insurance rider. Such indices need not be included for optional riders which are limited to benefits such as accidental death benefits, disability waiver of premium, preliminary term life insurance coverage of less than 12 months and guaranteed insurability benefits nor for the basic policies or optional riders covering more than one life.

i. For cash value insurance policies, annuities, and additional first year premium policies, the average annual rate of return if the policy is held for five, ten, twenty and thirty years.

j. A statement that the purchaser can return the policy within 10 days after receipt of the policy and receive a full refund of all premiums paid.

k. A Policy Summary which includes dividends shall also include a statement that dividends are based on the company's current dividend scale and are not guaranteed.

l. A statement in close proximity to the Surrender Index and average annual rate of return as follows: A further explanation

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of the intended use of these indices is provided in the Life Insurance Buyer's Guide.

m. The date on which the Policy Summary is prepared.

2. The Policy Summary must consist of a separate document. All information required to be disclosed must be set out in a manner as to not minimize or render any portion thereof obscure. Any amounts which remain level for two or more years of the policy may be represented by a single number if it is clearly indicated what amounts are applicable for each policy year. Amounts in subdivision 1.a. above shall be listed in total, not on a per thousand nor per unit basis. If more than one insured is covered under one policy or rider, guaranteed death benefits shall be displayed separately for each insured or for each class of insureds if death benefits do not differ within the class. Zero amounts shall be displayed as zero and shall not be displayed as a blank space.

3. If the Policy Summary is for an annuity contract, in addition to the information listed above which may be applicable, the policy summary shall also show:

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i. The amount of the guaranteed annuity payments at the scheduled commencement of the annuity, based on the assumption that all scheduled considerations are paid and there are no prior withdrawals from or partial surrenders of the contract and no indebtedness to the insurer on the contract.

ii. On the same basis as for item i. except for guarantees, illustrative annuity payments not greater in amount than those based on (1) the current dividend scale and the interest rate currently used to accumulate dividends under such contracts, or the current excess interest rate credited by the insurer, and (2) current annuity purchase rates. A dividend scale or excess interest rate which has been publicly declared by the insurer with an effective date not more than two months subsequent to the date of declaration shall be considered a current dividend scale or current excess interest rate.

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iii. In the case of a flexible premium annuity contract, the information on the policy summary shall be determined on the assumption that consideration payments will be made at the rate of $1,000 per year.

(5) DISCLOSURE REQUIREMENTS. (a) The insurer will provide, to all prospective purchasers of any policy subject to this rule, a copy of the current edition of the [state] Buyer's Guide to Life Insurance at the beginning of any sales presentation. A properly filled out Preliminary Policy Summary for a life policy, first year premium policy or annuity, as appropriate, must be provided to all prospective purchasers prior to the time they are provided an application for a policy. If a whole life or endowment policy has a term insurance rider, a separate Preliminary Policy Summary must be provided for the basic policy and any term riders.

(b) Insurers that do not market policies through an intermediary may provide the Preliminary Policy Summary and the [state] Buyer's Guide to Life Insurance at the time of policy delivery, provided they:

1. Guarantee to the policyholder a 30-day right to return the policy for a full refund of premium, and
2. Alert the prospective policyholder, in advertisements or direct mail solicitations, of his or her right to obtain a copy of the [state] Buyer's Guide to Life Insurance and a Preliminary Policy Summary prior to sale.

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(c) The insurer shall provide a Policy Summary upon delivery of the policy.

(d) The insurer shall provide a [state] Buyer's Guide to Life Insurance and a Preliminary Policy Summary to individual prospective purchasers upon reasonable request.

(e) For policies already issued and paying premiums on the effective date of this rule, policyholders shall have the right to obtain a Policy Summary at cost. The company may charge a reasonable fee for preparing this summary, not to exceed $5.00, and may utilize reasonable assumptions in providing the cost disclosure information, so long as they are clearly disclosed.

(f) If the provisions of Sections 5(a) and (c) are fully complied with the purchaser shall have the right to return the policy and obtain a full refund of all monies paid at any time within ten days after the policy is delivered.

(6) GENERAL RULES. (a) Each insurer shall maintain at its home office or principal office, a complete file containing one copy of each document authorized by the insurer for use pursuant to this regulation. Such file shall contain one copy of each authorized form for a period of three years following the date of its last authorized use.

[Alternative Paragraph 6(a)] Each insurer shall maintain at its home office or principal office, a complete file containing one copy of the Preliminary Policy Summary and Policy Summary for each policy that it issues. Such documents shall be maintained for a period of three years after the policy is issued.

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(b) An intermediary shall inform the prospective purchaser, prior to commencing a life insurance sales presentation, that he or she is acting as a life insurance intermediary and inform the prospective purchaser of the full name of the insurance company which he or she is representing to the buyer. In sales situations in which an intermediary is not involved, the insurer shall identify its full name.

(c) Terms such as financial planner, investment advisor, financial consultant, or financial counseling shall not be used in such a way as to imply that the insurance intermediary is generally engaged in an advisory business in which compensation is unrelated to sales unless such is actually the case.

(d) Any reference to policy dividends must include a statement that dividends are not guaranteed.

(e) A system or presentation which does not recognize the time value of money through the use of appropriate interest adjustments shall not be used for comparing the cost of two or more life insurance policies.

(f) A presentation of benefits shall not display guaranteed and nonguaranteed benefits as a single sum unless they are shown separately in close proximity thereto.

(g) A statement regarding the use of the Surrender Index shall include an explanation to the effect that the index is useful only for the comparison of the relative costs of two or more similar policies.

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(h) For the purposes of this rule, the annual premium for a basic policy or rider, for which the company reserves the right to change the premium, shall be the maximum annual premium.

(7) EFFECTIVE DATE. This rule shall apply to all solicitations of life insurance which commence on or after .

(8) UNUSUAL CIRCUMSTANCES. Insurers with unique difficulties in implementing sections of this rule may petition the Commissioner for allowance to meet the requirements of the rule through alternative approaches.

(9) YEARLY RENEWABLE TERM INSURANCE MORTALITY RATES. The following mortality rates are to be used in determining YRT premiums for calculating Average Annual Rate of Return Index figures.

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MORTALITY RATES PER 1,000

Attained Age (x)	Male Lives	Female Lives	Attained Age (x)	Male Lives	Female Lives
0	5.80	4.80	48	5.71	3.20
1	1.33	1.22	49	6.34	3.52
2	0.84	0.72	50	6.94	3.84
3	0.65	0.55	51	7.56	4.15
4	0.53	0.48	52	8.32	4.48
5	0.48	0.42	53	9.20	4.84
6	0.42	0.37	54	10.09	5.23
7	0.39	0.33	55	11.00	5.67
8	0.35	0.29	56	12.06	6.16
9	0.32	0.22	57	13.26	6.70
10	0.31	0.25	58	14.60	7.27
11	0.31	0.26	59	16.06	7.87
12	0.33	0.27	60	17.69	8.52
13	0.42	0.29	61	19.55	9.21
14	0.52	0.31	62	21.61	10.00
15	0.73	0.36	63	23.75	10.83
16	0.87	0.36	64	25.83	11.81
17	1.02	0.37	65	27.99	13.07
18	1.18	0.38	66	30.34	13.72
19	1.29	0.40	67	33.04	16.80
20	1.37	0.41	68	35.92	19.28
21	1.46	0.44	69	39.27	22.28
22	1.52	0.48	70	42.90	25.69
23	1.47	0.53	71	46.45	29.43
24	1.32	0.60	72	49.96	33.43
25	1.25	0.66	73	53.72	37.30
26	1.22	0.70	74	58.16	40.72
27	1.19	0.70	75	63.36	43.59
28	1.17	0.70	76	69.04	46.36
29	1.13	0.71	77	75.09	49.38
30	1.15	0.75	78	81.98	53.45
31	1.22	0.83	79	89.68	59.01
32	1.28	0.93	80	96.68	66.03
33	1.32	1.04	81	105.42	73.80
34	1.34	1.14	82	113.40	79.38
35	1.40	1.21	83	122.90	86.03
36	1.49	1.23	84	135.00	94.50
37	1.60	1.25	85	149.17	107.40
38	1.75	1.29	86	165.94	122.80
39	1.91	1.37	87	182.12	138.41
40	2.12	1.47	88	196.71	153.43
41	2.36	1.59	89	213.16	170.61
42	2.66	1.74	90	229.66	188.32
43	3.02	1.91	91	246.98	207.47
44	3.45	2.10	92	262.03	225.34
45	3.96	2.32	93	276.79	243.58
46	4.51	2.58	94	302.02	271.82
47	5.09	2.88	95	338.33	311.26

NOTE: The mortality rates for ages 0 through 14 are from the 1965-1970 Select Basic Tables published on pages 202 and 203 of the Transactions of the Society of Actuaries Publication Year 1974, Number 3, 1973 Reports of Mortality and Morbidity Experience. The mortality rates for ages 15 and above are from the Ultimate Basic Tables, Males Lives (1957-1960 Experience), Female Lives (1957-1960 Experience) published on page 48 of the Transactions of the Society of Actuaries, Publication Year 1963, Number 2, 1962 Reports of Mortality and Morbidity Experience.

(10) PENALTY. Violations of this rule shall subject the violator to (Insert applicable state statute or regulation).

(11) SEPARABILITY. If any provision of this rule shall be held invalid, the remainder of the rule shall not be affected thereby.

1979 GOV FTC STUDY OF LIFE INSURANCE COST DISCLOSURE - Cannon - 592p - bonknote

APPENDIX 17B

NINETY-FIFTH CONGRESS

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BERNARD A. THOMAS
MINORITY COUNSEL

October 12, 1978

Mr. E. J. Voorhis
Commissioner of Insurance
State Board of Insurance
1110 San Jacinto
Austin, Texas 78786

Dear Mr. Voorhis:

Thank you for your letter of September 25, 1978 concerning the life insurance hearings conducted by this Subcommittee. As you note, your letter to me of July 24, 1978 was used by Subcommittee counsel during questioning of the National Association of Insurance Commissioners (NAIC) representative.

In all honesty, I do not believe that the portions of your letter quoted during the hearing tended to mislead the NAIC witness concerning control of policy manipulation by your department. However, I certainly agree with you that the printed hearing record should show the complete text of your letter. I will include your September 25 letter of clarification in the record as well.

Please be assured also that at the time the Subcommittee counsel commenced questions concerning your July 24 letter, a complete copy of it was provided to the NAIC witness, the members of the Subcommittee, press representatives, and anyone else then present in the hearing room.

I appreciate your interest in our hearing. If you have any further concerns in this regard, please do not hesitate to contact me.

Sincerely,

JOHN E. MOSS
Chairman
Subcommittee on
Oversight and Investigations

JEM:jss
cc: Mr. Richard A. Hemmings
General Counsel
National Association of Insurance Commissioners
633 W. Wisconsin Avenue
Milwaukee, Wisconsin 53203

APPENDIX 18

The Commonwealth of Massachusetts
Division of Insurance
100 Cambridge Street, Boston 02202

JAMES M. STONE
COMMISSIONER OF INSURANCE

August 4, 1978

Life Insurance Association of Massachusetts
11 Beacon Street
Boston, Massachusetts 02108

American Council of Life Insurance
1730 Pennsylvania Ave., N.W.
Washington, D. C. 20006

Chapter 801 of the Acts of 1977 (Section 2B. of Chapter 175, M.G.L.) specifies certain standards of readability for most life insurance policy forms filed in Massachusetts after June 30, 1978. Policy forms approved or deemed approved prior to July 1 of this year may not be used after June 30 of next year, unless they conform to the new law.

It is the purpose of this letter to give advance indication of the procedures the Division of Insurance intends to use in reviewing life insurance policy forms subject to the new law. It is expected that our standards for review will include the following:

(1) All policy forms must conform to the objective standards of the law with respect to readability and format.

(2) A policy summary satisfactory to the Division of Insurance must be a part of all policy contracts issued after July 1, 1979.

(3) An actuarial memorandum must accompany each submission. We expect to require in such memoranda Yearly Information and Summary Information similar to that proposed by Professor Joseph M. Belth in the December 1975 Drake Law Review Insurance Law Annual.

Attached to this letter is a draft of a whole life policy summary we believe is "conducive to understandability of the form." (Section 2B.(f) of Chapter 175). An analogous summary would apply to endowments. A different summary would be necessary for term policies. No summary can be accepted if it is

less informative than the enclosed example.

We feel the most important contribution to understandability that can be made by a whole life summary is the disclosure of meaningful cost information. For that reason, the policy summary includes rates of return on the savings portions of whole life policies calculated by the well-known Linton Yield Method. It will be recalled that on June 7, 1978, Commissioner Stone indicated an intention to follow this format during a meeting attended by representatives of your respective associations; he invited comments at that time.

We realize that a Rate-of-Return (ROR) disclosure system differs from the NAIC Interest-Adjusted Method (IAM) currently being urged upon the states by the life insurance industry. We believe ROR to be superior in understandability for these principal reasons:

(1) ROR may be used in comparing dissimilar policy forms; IAM may not be.

(2) ROR produces indices which have a convenient frame of reference for the public. A 4.5% return, for example, has an independent meaning to the average buyer, while $4.00 per $1,000 per year, for example, is meaningful only in the context of a range of costs for a particular plan of insurance, a particular age at issue and a particular policy size.

(3) Both methods depend on assumptions. IAM requires the assumption of an interest rate; 5% is the current standard. ROR requires the assumption of a schedule of term insurance rates. If term insurance rates are more stable in the future than interest rates, ROR will in this sense be more consistent over time than IAM.

We continue to welcome your comments on the proposed policy summary. It is likely the policy summary can be improved upon scrutiny by actuaries, insurance lawyers and marketing experts. My staff and I are available to meet with you in Boston at your convenience.

We would appreciate your communicating the sense of this letter to your respective memberships.

Very truly yours,

James H. Hunt

James H. Hunt
Director, State Rating Bureau

JHH:bw

Massachusetts Whole Life Policy Summary

This is a summary of your life insurance policy. A life insurance policy is a legal contract between you as the owner and the company as the insurer. Its purpose is to provide an amount of money upon your death, or the insured's death if you are not the insured, to the person you designate. In exchange for that benefit, you agree to pay premiums when due. Check the last page of this policy summary to make sure the type of policy and amount of insurance you requested are correct.

In this policy summary, some of the basic concepts of your life insurance policy are explained. All life insurance policies, however, are complex. Not everything can be explained here. Massachusetts law requires that most personal insurance policies be written in clear, readable English. If you have any questions about your policy that are not answered in this summary, the policy itself may contain the answers. If not, ask the agent or the company. They are available to help you.

You have ten days after receipt of this policy to review it. If you decide you don't want to keep it, return it to the agent or the company within the ten-day period and you will receive a refund of all premiums paid.

Understanding Whole Life Insurance

This particular policy is a whole life policy. That means it insures you throughout your lifetime as long as you pay premiums when due. The most popular form of whole life insurance is called Ordinary Life. Premiums for an Ordinary Life policy remain the same from year to year and are payable as long as you live.

The other major form of life insurance is called term insurance. It insures you for a term of one or more years. Death benefits are paid only if you die within that period of time. Term insurance in its simplest form -- annual renewable term insurance -- gives you the right each year to renew the policy for one more year, but at a higher premium. A more common form of term insurance is five year renewable term insurance, on which premiums increase only once every five years.

All whole life policies have this in common: you buy less life insurance for your premium dollar initially than with a term policy, but the premium does not increase when you get older as the term policy premiums would. For example, if you buy a $10,000 policy at age 35, the whole life premium might be $200 and the term premium $60. By the time you are 55, however, the term premium would have increased to about $200; by 65 it might be $450.

Whole life insurance policies are sometimes known as cash value insurance. This is because, during the early years, the premium is much higher than the amount needed to pay death claims. Most of the excess goes to develop a fund, called the cash value, which grows over the years. Interest earnings on this fund help pay for the cost of death protection each year. If you die, the company will use the cash value to pay a part of the policy's death benefit. For example, if you buy a $10,000 policy at age 35, by age 65 the policy might have a cash value of about $5,000. The company then needs only an additional $5,000 from its own funds to make up the $10,000 face amount. If you keep the policy beyond age 65, the cash value continues to increase and the additional amount the company will need to pay a death claim continues to decrease.

Whole life policies, then, can be viewed as a combination of an increasing savings element and a decreasing amount of pure life insurance protection. This is the main reason why the premium does not increase as one grows older.

Although premiums on a whole life policy are usually payable for life, they may instead be paid in higher amounts over any term of years. A policy whose premiums are payable until age 65 is called Life Paid Up at 65; if premiums are payable for 20 years, the policy is called Twenty Payment Life. In either case, coverage continues after

the policy is paid up. Cash values under these forms build up faster than under Ordinary Life, so the amount of the pure life insurance protection is correspondingly less. For example, after fifteen years of payments on a $10,000 Ordinary Life policy issued at age 35, the cash value would be about $2,200, but, under a Twenty Payment Life policy, it would be about $3,600. The last page of this summary shows the payment period for this policy.

Although whole life policies are designed to provide insurance protection for life, many policyholders surrender their policies when they reach retirement age in order to use the cash value to purchase a monthly income during retirement. One of the features of a whole life policy is that the company guarantees a minimum monthly income in the settlement option section of the policy. This guarantee also applies to the proceeds of a death claim.

Amount of Insurance

Most life insurance policies provide a level face amount of insurance from year to year; many policies, however, are designed so that the face amount varies. There are endless variations.

On the last page of this summary, the face amount of insurance is shown. If the face amount varies in any way, this will also be shown. If you have agreed to add any kind of term insurance rider to the policy, the total death benefit will be shown, including any year by year variation.

Premiums

The yearly premium on your policy is shown on the last page of this summary. Any year-by-year variation in premiums is also shown. If you were charged an extra premium due to a health problem or for any other reason, that too is shown. You usually have the right to pay premiums more often than once a year -- monthly, quarterly or semi-annually. There are extra charges for this right because expenses are higher and because the company cannot earn as much interest as it would if it received the full premium at the beginning of the year. If the cost for this right exceeds an Annual Percentage Rate of 12%, the rate is shown on the last page of this summary.

Although premiums are due on a particular date or dates during the year, the law allows you to pay any premium without penalty during a grace period of thirty days after the due date. Most companies allow thirty-one days. If you forget to pay the premiums within the grace period, your policy will lapse unless any accumulated dividends are sufficient to pay the premium or you have elected the Automatic Premium Loan provision. If the policy lapses, you have the right to reinstate the policy -- put it back in full force. Most companies allow reinstatement without a health statement and without charge except for premiums due for a period of time -- usually a month -- after the end of the grace period, if the insured is alive. An explanation of these provisions is contained in the policy.

Policy Loans

All whole life policies have a policy loan feature. This means that after the policy has a cash value you may borrow on your policy for any purpose you wish. The maximum amount that can be borrowed is generally the amount of the cash value on the next premium due date less interest payable on that date. The policy loan interest rate is shown on the last page of this summary. This rate may be compared with Annual Percentage Rates required by the Federal Truth-in-Lending Act to be disclosed on consumer credit transactions. Interest is charged only for the actual number of days the loan is outstanding. There are no hidden loan charges. There is no requirement that the loan be repaid but interest is due annually.

The amount of any outstanding loan and interest on it will be deducted from the policy proceeds if you die or surrender the policy.

Dividends

More than eighty percent of policies sold in Massachusetts pay dividends. Such policies are called participating. Check the last page of this summary to see if this is a participating policy.

In calculating premium rates for a policy, the company's actuary must make assumptions about future mortality rates, interest rates and costs of doing business. It is, of course, impossible to predict the future accurately so companies selling participating policies make assumptions they know are quite safe and use dividends to adjust premiums in accordance with actual experience in the future.

Dividends can be paid in cash or they can be used in a number of other ways, such as the purchase of additional insurance. The choices you have are outlined in the policy.

Life insurance policy dividends, unlike dividends received from credit unions and savings and loan associations or from corporations, are not taxable when received. Instead they are considered premium refunds.

Exclusions

There are certain situations in which the company can refuse to pay the death benefit under this policy. Suicide within two years of the date of issue of the policy is generally not covered. If you gave a material false statement when you applied for this policy and die within two years from its date of issue, the company may contest the validity of the policy. These are the two principal exclusions under a whole life policy. Occasionally, a company may add a rider to the policy excluding certain causes of death. The last page of this summary tells you if any such riders apply to you.

Rates of Return

Whole life policies differ from one another in how much they cost. Sometimes the differences are very large. Because whole life policies include widely varying mixtures of pure life insurance protection and savings, comparing relative costs between policies and among companies is difficult. By making an assumption about what the pure life insurance portion of a whole life policy would cost if purchased as a separate policy, however, it is possible to compute Rates of Return on the savings portion of a whole life policy. The technique is to deduct from the whole life premium each year (less any dividend) the amount it would cost to buy as much term insurance as is represented by the policy's pure insurance portion. The difference can be considered as a savings deposit. The Rate of Return, then, is the interest rate required to accumulate these deposits to the cash value of the policy at the end of the period of years chosen for the computation.

On the last page of this summary are shown Rates of Return for this policy over periods of five, ten and twenty years.

The Rates of Return shown are intended to assist you in two ways: to determine whether to purchase a whole life policy rather than term insurance; and to decide which of two or more companies is lowest in cost. If the Rates

of Return shown for this policy are high in comparison to another investment alternative, this policy may be considered more favorable in that respect. If they are higher than another company's policy you may be considering, this policy is probably going to be lower in cost over the years.

In comparing Rates of Return with the interest rate you could earn on a savings account or other safe investment, you should remember that interest earnings credited to the savings element of a whole life insurance policy are not taxed until you surrender the policy; even then, the taxable amount may be zero or quite small. For this reason, you may wish to compare the Rates of Return shown with after-tax returns on other investments. For example, if you are in a 20% tax bracket, a 4% Rate of Return under a whole life policy is about the same as a 5% return that is fully taxable.

Quite often, the Rate of Return for the early years of a policy is negative. This is a reflection of the company's costs in selling and issuing the policy. Whole life insurance is not meant for short term needs. A negative Rate of Return suggests you should not buy a whole life policy unless you intend to keep it for at least 10 and probably 20 years.

It is also important to understand that the Rates of Return shown depend on assumptions about what it would cost to buy term insurance. Term rates from a study by the Society of Actuaries were used to make this estimate. Samples of these rates are shown below. If you have access to term insurance that costs less, the Rates of Return on the whole life policy you are considering would be decreased somewhat.

Average Yearly Renewable Term Rates per $1,000

	Amount of Insurance		
Age	$10,000	$25,000	$100,000
25	$ 4.47	$ 2.97	$ 2.22
35	4.73	3.23	2.48
45	7.16	5.66	4.91
55	13.85	12.35	11.60

If this is a participating policy, the company used its current dividend schedule in figuring Rates of Return. Such dividends are not guaranteed. You should keep this in mind in comparing Rates of Return on participating policies with the guarantees offered by non-participating policies.

LIFE INSURANCE SOLICITATION MODEL REGULATION

May 4, 1976

(As Adopted by the NAIC)

Section 1. Authority.

This rule is adopted and promulgated by (title of supervisory authority) pursuant to sections [4(1) (a) of the Unfair and Deceptive Acts and Practices in the Business of Insurance Act] of the insurance code.

Section 2. Purpose.

(A) The purpose of this regulation is to require insurers to deliver to purchasers of life insurance, information which will improve the buyer's ability to select the most appropriate plan of life insurance for his needs, improve the buyer's understanding of the basic features of the policy which has been purchased or which is under consideration and improve the ability of the buyer to evaluate the relative costs of similar plans of life insurance.

(B) This regulation does not prohibit the use of additional material which is not in violation of this regulation or any other (state) statute or regulation.

Section 3. Scope.

(A) Except as hereafter exempted, this regulation shall apply to any solicitation, negotiation or procurement of life insurance occurring within this state. This regulation shall apply to any issuer of life insurance contracts including fraternal benefit societies.

(B) Unless otherwise specifically included, this regulation shall not apply to:

1. Annuities.

2. Credit life insurance.

3. Group life insurance.

4. Life insurance policies issued in connection with pension and welfare plans as defined by and which are subject to the federal Employee Retirement Income Security Act of 1974 (ERISA).

5. Variable life insurance under which the death benefits and cash values vary in accordance with unit values of investments held in a separate account.

Section 4. Definitions.

For the purposes of this regulation, the following definitions shall apply:

(A) Buyer's Guide. A Buyer's Guide is a document which contains, and is limited to, the language contained in the Appendix to this regulation or language approved by (title of supervisory authority).

(B) Cash Dividend. A Cash Dividend is the current illustrated dividend which can be applied toward payment of the gross premium.

(C) Equivalent Level Annual Dividend. The Equivalent Level Annual Dividend is calculated by applying the following steps:

1. Accumulate the annual cash dividends at five percent interest compounded annually to the end of the tenth and twentieth policy years.

2. Divide each accumulation of Step 1. by an interest factor that converts it into one equivalent level annual amount that, if paid at the beginning of each year, would accrue to the values in Step 1. over the respective

periods stipulated in Step 1. If the period is ten years, the factor is 13.207 and if the period is twenty years, the factor is 34.719.

3. Divide the results of Step 2. by the number of thousands of the Equivalent Level Death Benefit to arrive at the Equivalent Level Annual Dividend.

(D) Equivalent Level Death Benefit. The Equivalent Level Death Benefit of a policy or term life insurance rider is an amount calculated as follows:

1. Accumulate the guaranteed amount payable upon death, regardless of the cause of death, at the beginning of each policy year for ten and twenty years at five per cent interest compounded annually to the end of the tenth and twentieth policy years respectively.

2. Divide each accumulation of step 1. by an interest factor that converts it into one equivalent level annual amount that, if paid at the beginning of each year, would accrue to the value in step 1. over the respective periods stipulated in step 1. If the period is ten years, the factor is 13.207 and if the period is twenty years, the factor is 34.719.

(E) Generic Name. Generic Name means a short title which is descriptive of the premium and benefit patterns of a policy or a rider.

(F) Life Insurance Cost Indexes.

1. Life Insurance Surrender Cost Index. The Life Insurance Surrender Cost Index is calculated by applying the following steps:

a. Determine the guaranteed cash surrender value, if any, available at the end of the tenth and twentieth policy years.

b. For participating policies, add the terminal dividend payable upon surrender, if any, to the accumulation of the annual Cash Dividends at five percent interest compounded annually to the end of the period selected and add this sum to the amount determined in step a.

c. Divide the result of step b. (step a. for guaranteed-cost policies) by an interest factor that converts it into an equivalent level annual amount that, if paid at the beginning of each year, would accrue to the value in step b. (step a. for guaranteed cost policies) over the respective periods stipulated in step a. If the period is ten years, the factor is 13.207 and if the period is twenty years, the factor is 34.719.

d. Determine the equivalent level premium by accumulating each annual premium payable for the basic policy or rider at five percent interest compounded annually to the end of the period stipulated in step a. and dividing the result by the respective factors stated in step c. (this amount is the annual premium payable for a level premium plan).

e. Subtract the result of step c. from step d.

f. Divide the result of step e. by the number of thousands of the Equivalent Level Death Benefit to arrive at the Life Insurance Surrender Cost Index.

2. Life Insurance Net Payment Cost Index. The Life Insurance Net Payment Cost Index is calculated in the same manner as the comparable Life Insurance Cost Index except that the cash surrender value and any terminal dividend are set at zero.

(G) Policy Summary. For the purposes of this regulation, Policy Summary means a written statement describing the elements of the policy including but not limited to:

1. A prominently placed title as follows: STATEMENT OF POLICY COST AND BENEFIT INFORMATION.

2. The name and address of the insurance agent, or, if no agent is involved, a statement of the procedure to be followed in order to receive responses to inquiries regarding the Policy Summary.

3. The full name and home office or administrative office address of the company in which the life insurance policy is to be or has been written.

4. The Generic Name of the basic policy and each rider.

5. The following amounts, where applicable, for the first five policy years and representative policy years thereafter sufficient to clearly illustrate the premium and benefit patterns, including, but not necessarily limited to, the years for which Life Insurance Cost Indexes are displayed and at least one age from sixty through sixty-five or maturity whichever is earlier:

   a. The annual premium for the basic policy.

   b. The annual premium for each optional rider.

   c. Guaranteed amount payable upon death, at the beginning of the policy year regardless of the cause of death other than suicide, or other specifically enumerated exclusions, which is provided by the basic policy and each optional rider, with benefits provided under the basic policy and each rider shown separately.

   d. Total guaranteed cash surrender values at the end of the year with values shown separately for the basic policy and each rider.

   e. Cash Dividends payable at the end of the year with values shown separately for the basic policy and each rider. (Dividends need not be displayed beyond the twentieth policy year.)

   f. Guaranteed endowment amounts payable under the policy which are not included under guaranteed cash surrender values above.

6. The effective policy loan annual percentage interest rate, if the policy contains this provision, specifying whether this rate is applied in advance or in arrears. If the policy loan interest rate is variable, the Policy Summary includes the maximum annual percentage rate.

7. Life Insurance Cost Indexes for ten and twenty years but in no case beyond the premium paying period. Separate indexes are displayed for the basic policy and for each optional term life insurance rider. Such indexes need not be included for optional riders which are limited to benefits such as accidental death benefits, disability waiver of premium, preliminary term life insurance coverage of less than 12 months and guaranteed insurability benefits nor for basic policies or optional riders covering more than one life.

8. The Equivalent Level Annual Dividend, in the case of participating policies and participating optional term life insurance riders, under the same circumstances and for the same durations at which Life Insurance Cost Indexes are displayed.

9. A Policy Summary which includes dividends shall also include a statement that dividends are based on the company's current dividend scale and are not guaranteed in addition to a statement in close proximity to the Equivalent Level Annual Dividend as follows: An explanation of the intended use of the Equivalent Level Annual Dividend is included in the Life Insurance Buyer's Guide.

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10. A statement in close proximity to the Life Insurance Cost Indexes as follows: An explanation of the intended use of these indexes is provided in the Life Insurance Buyer's Guide.

11. The date on which the Policy Summary is prepared.

The Policy Summary must consist of a separate document. All information required to be disclosed must be set out in such a manner as to not minimize or render any portion thereof obscure. Any amounts which remain level for two or more years of the policy may be represented by a single number if it is clearly indicated what amounts are applicable for each policy year. Amounts in item 5 of this section shall be listed in total, not on a per thousand nor per unit basis. If more than one insured is covered under one policy or rider, guaranteed death benefits shall be displayed separately for each insured or for each class of insureds if death benefits do not differ within the class. Zero amounts shall be displayed as zero and shall not be displayed as a blank space.

Section 5. Disclosure Requirements.

(A) The insurer shall provide, to all prospective purchasers, a Buyer's Guide and a Policy Summary prior to accepting the applicant's initial premium or premium deposit, unless the policy for which application is made contains an unconditional refund provision of at least ten days or unless the Policy Summary contains such an unconditional refund offer, in which event the Buyer's Guide and Policy Summary must be delivered with the policy or prior to delivery of the policy

(B) The insurer shall provide a Buyer's Guide and a Policy Summary to any prospective purchaser upon request.

(C) In the case of policies whose Equivalent Level Death Benefit does not exceed $5,000, the requirement for providing a Policy Summary will be satisfied by delivery of a written statement containing the information described in Section 4(G), items 2, 3, 4, 5a, 5b, 5c, 6, 7, 10, 11.

Section 6. General Rules.

(A) Each insurer shall maintain at its home office or principal office, a complete file containing one copy of each document authorized by the insurer for use pursuant to this regulation. Such file shall contain one copy of each authorized form for a period of three years following the date of its last authorized use.

(B) An agent shall inform the prospective purchaser, prior to commencing a life insurance sales presentation, that he is acting as a life insurance agent and inform the prospective purchaser of the full name of the insurance company which he is representing to the buyer. In sales situations in which an agent is not involved, the insurer shall identify its full name.

(C) Terms such as financial planner, investment advisor, financial consultant, or financial counseling shall not be used in such a way as to imply that the insurance agent is generally engaged in an advisory business in which compensation is unrelated to sales unless such is actually the case.

(D) Any reference to policy dividends must include a statement that dividends are not guaranteed.

(E) A system or presentation which does not recognize the time value of money through the use of appropriate interest adjustments shall not be used for comparing the cost of two or more life insurance policies. Such a system may be used for the purpose of demonstrating the cash-flow pattern of a policy if such presentation is accompanied by a statement disclosing that the presentation does not recognize that, because of interest, a dollar in the future has less value than a dollar today.

(F) A presentation of benefits shall not display guaranteed and non guaranteed benefits as a single sum unless they are shown separately in close proximity thereto.

(G) A statement regarding the use of the Life Insurance Cost Indexes shall include an explanation to the effect that the indexes are useful only for the comparison of the relative costs of two or more similar policies.

(H) A Life Insurance Cost Index which reflects dividends or an Equivalent Level Annual Dividend shall be accompanied by a statement that it is based on the company's current dividend scale and is not guaranteed.

(I) For the purposes of this regulation, the annual premium for a basic policy or rider, for which the company reserves the right to change the premium, shall be the maximum annual premium.

Section 7. Failure to Comply.

Failure of an insurer to provide or deliver a Buyer's Guide, or a Policy Summary as provided in Section 5 shall constitute an omission which misrepresents the benefits, advantages, conditions or terms of an insurance policy.

Section 8. Effective Date.

This rule shall apply to all solicitations of life insurance which commence on or after (Insert a date at least six months following adoption by the regulatory authority.)

APPENDIX

Life Insurance Buyer's Guide

The face page of the Buyer's Guide shall read as follows:

Life Insurance Buyer's Guide

This guide can show you how to save money when you shop for life insurance. It helps you to:

– Decide how much life insurance you should buy,

– Decide what kind of life insurance policy you need, and

– Compare the cost of similar life insurance policies.

Prepared by the National Association of Insurance Commissioners

Reprinted by (Company Name)
(Month and year of printing)

The Buyer's Guide shall contain the following language at the bottom of page 2:

The National Association of Insurance Commissioners is an association of state insurance regulatory officials. This association helps the various Insurance Departments to coordinate insurance laws for the benefit of all consumers. You are urged to use this Guide in making a life insurance purchase.

This Guide Does Not Endorse Any Company or Policy.

The remaining text of the Buyer's Guide shall begin on page 3 as follows:

Buying Life Insurance

When you buy life insurance, you want a policy which fits your needs without costing too much. Your first step is to decide how much you need, how much you can afford to pay and the kind of policy you want. Then, find out what various companies charge for that kind of policy. You can find important differences in the cost of life insurance by using the life insurance cost indexes which are described in this guide. A good life insurance agent or company will be able and willing to help you with each of these shopping steps.

If you are going to make a good choice when you buy life insurance, you need to understand which kinds are available. If one kind does not seem to fit your needs, ask about the other kinds which are described in this guide. If you feel that you need more information than is given here, you may want to check with a life insurance agent or company or books on life insurance in your public library.

Choosing the Amount

One way to decide how much life insurance you need is to figure how much cash and income your dependents would need if you were to die. You should think of life insurance as a source of cash needed for expenses of final illnesses, paying taxes, mortgages or other debts. It can also provide income for your family's living expenses, educational costs and other future expenses. Your new policy should come as close as you can afford to making up the difference between (1) what your dependents would have if you were to die now, and (2) what they would actually need.

Choosing the Right Kind

All life insurance policies agree to pay an amount of money if you die. But all policies are not the same. There are three basic kinds of life insurance.

1. Term insurance
2. Whole life insurance
3. Endowment insurance

Remember, no matter how fancy the policy title or sales presentation might appear, all life insurance policies contain one or more of the three basic kinds. If you are confused about a policy that sounds complicated, ask the agent or company if it combines more than one kind of life insurance. The following is a brief description of the three basic kinds:

Term Insurance

Term insurance is death protection for a "term" of one or more years. Death benefits will be paid only if you die within that term of years. Term insurance generally provides the largest immediate death protection for your premium dollar.

Some term insurance policies are "renewable" for one or more additional terms even if your health has changed. Each time you renew the policy for a new term, premiums will be higher. You should check the premiums at older ages and the length of time the policy can be continued.

Some term insurance policies are also "convertible". This means that before the end of the conversion period, you may trade the term policy for a whole life or endowment insurance policy even if you are not in good health. Premiums for the new policy will be higher than you have been paying for the term insurance.

Whole Life Insurance

Whole life insurance gives death protection for as long as you live. The most common type is called "straight life" or "ordinary life" insurance, for which you pay the same premiums for as long as you live. These premiums can be several times higher than you would pay initially for the same amount of term insurance. But they are smaller than the premiums you would eventually pay if you were to keep renewing a term insurance policy until your later years.

Some whole life policies let you pay premiums for a shorter period such as 20 years, or until age 65. Premiums for these policies are higher than for ordinary life insurance since the premium payments are squeezed into a shorter period.

Although you pay higher premiums, to begin with, for whole life insurance than for term insurance, whole life insurance policies develop "cash values" which you may have if you stop paying premiums. You can generally either take the cash, or use it to buy some continuing insurance protection. Technically speaking, these values are called "nonforfeiture benefits". This refers to benefits you do not lose (or "forfeit") when you stop paying premiums. The amount of these benefits depends on the kind of policy you have, its size, and how long you have owned it.

A policy with cash values may also be used as collateral for a loan. If you borrow from the life insurance company, the rate of interest is shown in your policy. Any money which you owe on a policy loan would be deducted from the benefits if you were to die, or from the cash value if you were to stop paying premiums.

Endowment Insurance

An endowment insurance policy pays a sum or income to you –the policyholder– if you live to a certain age. If you were to die before then, the death benefit would be paid to your beneficiary. Premiums and cash values for endowment insurance are higher than for the same amount of whole life insurance. Thus endowment insurance gives you the least amount of death protection for your premium dollar.

Finding a Low Cost Policy

After you have decided which kind of life insurance fits your needs, look for a good buy. Your chances of finding a good buy are better if you use two types of index numbers that have been developed to aid in shopping for life insurance. One is called the "Surrender Cost Index" and the other is the "Net Payment Cost Index". It will be worth your time to try to understand how these indexes are used, but in any event, use them for comparing the relative costs of similar policies. LOOK FOR POLICIES WITH LOW COST INDEX NUMBERS.

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 a cash value, your cost is smaller than the premium.

The cost of some policies can also be reduced by dividends; these are called "participating" policies. Companies may tell you what their current dividends are, but the size of future dividends is unknown today and cannot be guaranteed. Dividends actually paid are set each year by the company.

Some policies do not pay dividends. These are called "guaranteed cost" or "non participating" policies. Every feature of a guaranteed cost policy is fixed so that you know in advance what your future cost will be.

The premiums and cash values of a participating policy are guaranteed, but the dividends are not. Premiums for participating policies are typically higher than for guaranteed cost policies, but the cost to you may be higher or lower, depending on the dividends actually paid.

What Are Cost Indexes?

In order to compare the cost of policies, you need to look at:

1. Premiums
2. Cash Values
3. Dividends

Cost indexes use one or more of these factors to give you a convenient way to compare relative costs of similar policies. When you compare costs, an adjustment must be made to take into account that money is paid and received at different times. It is not enough to just add up the premiums you will pay and to subtract the cash values and dividends you expect to get back. These indexes take care of the arithmetic for you. Instead of having to add, subtract, multiply and divide many numbers yourself, you just compare the index numbers which you can get from life insurance agents and companies:

1. Life Insurance Surrender Cost Index. This index is useful if you consider the level of the cash values to be of primary importance to you. It helps you compare costs if at some future point in time, such as 10 or 20 years, you were to surrender the policy and take its cash value.

2. Life Insurance Net Payment Cost Index. This index is useful if your main concern is the benefits that are to be paid at your death and if the level of cash values is of secondary importance to you. It helps you compare costs at some future point in time, such as 10 or 20 years, if you continue paying premiums on your policy and do not take its cash value.

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There is another number called the Equivalent Level Annual Dividend. It shows the part dividends play in determining the cost index of a participating policy. Adding a policy's Equivalent Level Annual Dividend to its cost index allows you to compare total costs of similar policies before deducting dividends. However, if you make any cost comparisons of a participating policy with a non participating policy, remember that the total cost of the participating policy will be reduced by dividends, but the cost of the non participating policy will not change.

How Do I Use Cost Indexes?

The most important thing to remember when using cost indexes is that a policy with a small index number is generally a better buy than a comparable policy with a larger index number. The following rules are also important:

(1) Cost comparisons should only be made between similar plans of life insurance. Similar plans are those which provide essentially the same basic benefits and require premium payments for approximately the same period of time. The closer policies are to being identical, the more reliable the cost comparison will be.

(2) Compare index numbers only for the kind of policy, for your age and for the amount you intend to buy. Since no one company offers the lowest cost for all types of insurance at all ages and for all amounts of insurance, it is important that you get the indexes for the actual policy, age and amount which you intend to buy. Just because a "Shopper's guide" tells you that one company's policy is a good buy for a particular age and amount, you should not assume that all of that company's policies are equally good buys.

(3) Small differences in index numbers could be offset by other policy features, or differences in the quality of service you may expect from the company or its agent. Therefore, when you find small differences in cost indexes, your choice should be based on something other than cost.

(4) In any event, you will need other information on which to base your purchase decision. Be sure you can afford the premiums, and that you understand its cash values, dividends and death benefits. You should also make a judgement on how well the life insurance company or agent will provide service in the future, to you as a policyholder.

(5) These life insurance cost indexes apply to new policies and should not be used to determine whether you should drop a policy you have already owned for awhile, in favor of a new one. If such a replacement is suggested, you should ask for information from the company which issued the old policy before you take action.

Important Things To Remember - A Summary

The first decision you must make when buying a life insurance policy is choosing a policy whose benefits and premiums most closely meet your needs and ability to pay. Next, find a policy which is also a relatively good buy. If you compare Surrender Cost Indexes and Net Payment Cost Indexes of similar competing policies, your chances of finding a relatively good buy will be better than if you do not shop. REMEMBER, LOOK FOR POLICIES WITH LOWER COST INDEX NUMBERS. A good life insurance agent can help you to choose the amount of life insurance and kind of policy you want and will give you cost indexes so that you can make cost comparisons of similar policies.

Don't buy life insurance unless you intend to stick with it. A policy which is a good buy when held for 20 years can be very costly if you quit during the early years of the policy. If you surrender such a policy during the first few years, you may get little or nothing back and much of your premium may have been used for company expenses.

Read your new policy carefully, and ask the agent or company for an explanation of anything you do not understand. Whatever you decide now, it is important to review your life insurance program every few years to keep up with changes in your income and responsibilities.

ORDER OF THE OFFICE OF THE COMMISSIONER OF INSURANCE

Repealing and Adopting Rules

RECEIVED AND FILED

OCT 3 1978

Pursuant to authority vested in the Commissioner of Insurance by section 601.41 (3), Wis. Stats., the Commissioner of Insurance hereby repeals and adopts rules as follows:

Sections Ins 2.14 and 2.15 of the Wisconsin Administrative Code are repealed and section Ins 2.14 is adopted to read:

Ins 2.14 Life Insurance Solicitation. (Sections 601.01 (3), 601.41 (3) and 628.34, Wis. Stats.) (1) PURPOSE. The purpose of this rule is to require insurers to deliver to purchasers of life insurance information which will improve the buyer's ability to select the most appropriate plan of life insurance for his or her needs, improve the buyer's understanding of the basic features of the policy which has been purchased or which is under consideration and improve the ability of the buyer to evaluate the relative costs of similar plans of life insurance. This rule does not prohibit the use of additional material which is not in violation of this rule or any other Wisconsin statute or rule. This rule interprets and implements, including but not limited to the following Wisconsin Statutes: sections 601.01 (3) (b), (c), (g) and (j) and 628.34.

(2) SCOPE. (a) Except as hereafter exempted, this rule shall apply to any solicitation, negotiation or procurement of life insurance occurring within this state. This rule shall apply to any issuer of life insurance contracts including fraternal benefit societies and the State Life Insurance Fund.

(b) Unless otherwise specifically included, this rule shall not apply to:

1. Annuities.

2. Credit life insurance.

3. Group life insurance.

4. Life insurance policies issued in connection with pension and welfare plans as defined by and which are subject to the federal Employee Retirement Income Security Act of 1974 (ERISA).

5. Variable life insurance under which the death benefits and cash values vary in accordance with unit values of investments held in a separate account.

(3) DEFINITIONS. For the purposes of this rule, the following definitions shall apply:

(a) Wisconsin Buyer's Guide to Life Insurance. The Wisconsin Buyer's Guide to Life Insurance is a document which contains, and is

limited to, the language within the current edition of "The Wisconsin Buyer's Guide to Life Insurance" put out by the Insurance Commissioner of the State of Wisconsin. This pamphlet shall be reviewed periodically for accuracy and appropriateness. Prior to the publication of a revised pamphlet, it shall be submitted to the Life Subcommittee of the Forms and Classifications Advisory Council for public hearing and review. Insurers may purchase this pamphlet at cost from the Office of the Commissioner of Insurance, or they may reproduce it themselves (subject to reasonable standards of style, size, and layout).

(b) Cash Dividend. A Cash Dividend is the current illustrated dividend which can be applied toward payment of the gross premium.

(c) Equivalent Level Death Benefit. The Equivalent Level Death Benefit of a policy or term life insurance rider is an amount calculated as follows:

1. Accumulate the guaranteed amount payable upon death, regardless of the cause of death, at the beginning of each policy year for ten and twenty years at five percent interest compounded annually to the end of the tenth and twentieth policy years, respectively.

2. Divide each accumulation of step 1 by an interest factor that converts it into one equivalent level annual amount that, if paid at the beginning of each year, would accrue to the value in step 1 over the respective periods stipulated in step 1. If the period is ten years, the factor is 13.207 and if the period is twenty years, the factor is 34.719.

(d) Generic Name. Generic Name means a short title which is descriptive of the premium and benefit patterns of a policy or a rider.

(e) Life Insurance Indexes.

1. Surrender Cost Index. The Surrender Cost Index is calculated by applying the following steps:

a. Determine the guaranteed cash surrender value, if any, available at the end of the tenth and twentieth policy years.

b. For participating policies, add the terminal dividend payable upon surrender, if any, to the accumulation of the annual Cash Dividends at five percent interest compounded annually to the end of the period selected and add this sum to the amount determined in step a.

c. Divide the result of step b (step a for guaranteed-cost policies) by an interest factor that converts it into an equivalent level annual amount that if paid at the beginning of each year, would accrue to the value in step b (step a for guaranteed-cost policies) over the respective periods stipulated in step a. If the period is ten years, the factor is 13.207 and if the period is twenty years, the factor is 34.719.

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d. Determine the equivalent level premium by accumulating each annual premium payable for the basic policy or rider (if the annual premium includes supplemental benefits without separate identifiable charge, a reasonable adjustment may be made) at five percent interest compounded annually to the end of the period stipulated in step a and dividing the result by the respective factors stated in step c. (This amount is the annual premium payable for a level premium plan).

e. Subtract the result of step c from step d.

f. Divide the result of step e by the number of thousands of the Equivalent Level Death Benefit to arrive at the Surrender Cost Index.

2. Net Payment Cost Index. The Net Payment Cost Index is calculated in the same manner as the comparable Surrender Cost Index except that the cash surrender value and any terminal dividend are set at zero.

3. Equivalent Level Annual Dividend. The Equivalent Level Annual Dividend is calculated by applying the following steps:

a. Accumulate the annual cash dividends at five percent interest compounded annually to the end of the tenth and twentieth policy years.

b. Divide each accumulation of step 1 by an interest factor that converts it into one equivalent level annual amount that, if paid at the beginning of each year, would accrue to the values in step 1 over the respective periods stipulated in step 1. If the period is ten years, the factor is 13.207 and if the period is twenty years, the factor is 34.719.

c. Divide the results of step 2 by the number of thousands of the Equivalent Level Death Benefit to arrive at the Equivalent Level Annual Dividend.

4. Average Annual Rate of Return Index. This index is calculated on cash value policies using the Linton yield method.

a. The Linton yield method solves for a level, effective, annually compounded interest rate, or yield. This yield is determined by equating the cash available at the end of a specified number of years from two different protection/savings programs, each with identical yearly death benefits, and then solving for the annual yield that must be achieved on the separate savings fund of the second program in order to produce the cash equivalency with the first program. The two programs compared are:

i. A life insurance policy on, normally but not necessarily, some permanent plan. The cash used at the end of the specified year is the policy's guaranteed cash surrender value plus the terminal dividend payable upon surrender and the dividend payable at the end of the specified year.

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ii. A combination of a savings fund and yearly renewable term (YRT) insurance. The amount deposited in the savings fund each year is assumed to be equal to the annual premium payable under the alternate program for the permanent life insurance policy (less any dividend payable at the end of the preceding year) less an assumed premium payable for YRT insurance. The amount of YRT purchased each year is that which would be adequate to bring the combined death benefit from the savings plan and the YRT to the same as that payable under the permanent life insurance policy. The cash used for comparison with the permanent policy is the amount accumulated in the savings fund at the end of the specified year.

b. Average Annual Rate of Return index figures given out in Wisconsin by insurers or intermediaries shall be calculated separately for males and females and shall be based upon the following assumptions:

i. As to YRT premium rates:

YRT premiums = $(1{,}000\ q_x)$ (K) + \$0.90 + \$25/S where K equals 1.00 for ages 0 through 14 and 0.95 for ages 15 and above, S equals policy size in thousands and $1000\ q_x$ equals the mortality rate for age x shown in subsection (8);

ii. As to elements entering into the calculation: Gross premiums shall include the total premiums charged for all life insurance benefits; dividends shall be total illustrated dividends excluding any separately identifiable dividends payable for benefits other than life insurance.

Note: A discussion of the Linton yield method may be found on page 28 - 30 in the Analysis of Life Insurance Cost Comparison Index Methods, prepared by the Society of Actuaries Committee on Cost Comparison Methods and Related Issues (Special), September, 1974. Further discussion on the "low" YRT rates to be used in computing the Linton yield, which are the rates specified in this rule, may be found in Appendix B, pp. 187 - 192 of that same publication.

(f) Preliminary Policy Summary. For the purposes of this rule, Preliminary Policy Summary means a document provided to the buyer of a life insurance policy prior to sale which contains necessary consumer cost disclosure information, in substantially the same format for all companies, as specified by the commissioner. Appendix 1 to this rule contains a Preliminary Policy Summary form for Whole Life and Endowment Policies. Appendix 2 contains a Preliminary Policy Summary Form for Term Policies. Insurers may, upon request, incorporate Preliminary Policy Summary forms (if they are to be filled out by intermediaries) into copies of the Wisconsin Buyer's Guide to Life Insurance which they reprint.

(g) Policy Summary. 1. For the purposes of this rule, Policy Summary means a written statement in substantially the same format for all companies and describing the elements of the policy including but not limited to:

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a. A prominently placed title as follows: STATEMENT OF POLICY COST AND BENEFIT INFORMATION.

b. The name and address of the insurance intermediary, or, if no intermediary is involved, a statement of the procedure to be followed in order to receive responses to inquiries regarding the Policy Summary.

c. The full name and home office or administrative office address of the company in which the life insurance policy is to be or has been written.

d. The Generic Name of the basic policy and each rider.

e. The following amounts, where applicable, for the first five policy years and representative policy years thereafter sufficient to clearly illustrate the premium and benefit patterns, including but not necessarily limited to, the years for which the Surrender Cost Index is displayed and at least one age from sixty through sixty five or maturity whichever is earlier:

i. The annual premium for the basic policy.

ii. The annual premium for each optional rider.

iii. Guaranteed amount payable upon death, at the beginning of the policy year regardless of the cause of death other than suicide, or other specifically enumerated exclusions, which is provided by the basic policy and each optional rider, with benefits provided under the basic policy and each rider shown separately.

iv. Total guaranteed cash surrender values at the end of the year with values shown separately for the basic policy and each rider.

v. Cash Dividends payable at the end of the year with values shown separately for the basic policy and each rider. (Dividends need not be displayed beyond the twentieth policy year.)

vi. Guaranteed endowment amounts payable under the policy which are not included under guaranteed cash surrender values above.

f. The effective policy loan annual percentage interest rate, if the policy contains this provision, specifying whether this rate is applied in advance or in arrears. If the policy loan interest is variable, the Policy Summary shall include the maximum annual percentage rate.

g. Surrender Cost Indexes for ten and twenty years. Separate indexes are displayed for the basic policy and for each optional term life insurance rider. Such indexes need not be included for optional riders which are limited to benefits such as accidental death benefits, disability waiver of premium, preliminary term life insurance coverage of less than 12 months and guaranteed insurability benefits nor for the basic policies or optional riders covering more than one life.

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h. A Policy Summary which includes dividends shall also include a statement that dividends are based on the company's current dividend scale and are not guaranteed.

i. A statement in close proximity to the Surrender Cost Index (and other cost indexes) as follows: A further explanation of the intended use of this (these) index(es) is provided in the Life Insurance Buyer's Guide.

j. The date on which the Policy Summary is prepared.

2. The Policy Summary must consist of a separate document. All information required to be disclosed must be set out in a manner as to not minimize or render any portion thereof obscure. Any amounts which remain level for two or more years of the policy may be represented by a single number if it is clearly indicated what amounts are applicable for each policy year. Amounts in subdivision 1 e above shall be listed in total, not on a per thousand nor per unit basis. If more than one insured is covered under one policy or rider, guaranteed death benefits shall be displayed separately for each insured or for each class of insureds if death benefits do not differ within the class. Zero amounts shall be displayed as zero and shall not be displayed as a blank space.

(4) DISCLOSURE REQUIREMENTS. (a) The insurer shall provide, to all prospective purchasers of any policy subject to this rule, a copy of the current edition of the Wisconsin Buyer's Guide to Life Insurance and a properly filled out Preliminary Policy Summary prior to accepting the applicant's initial premium or premium deposit, except that insurers which do not market policies through an intermediary may provide the Preliminary Policy Summary and Wisconsin's Buyer's Guide to Life Insurance at the point of policy delivery, so long as they:

1. guarantee to the policyholder a 30-day right to return the policy for a full refund of premium, and

2. alert the prospective policyholder, in advertisements or direct mail solicitations, of his or her right to obtain a copy of the Wisconsin Buyer's Guide to Life Insurance and a Preliminary Policy Summary prior to sale.

(b) The insurer shall provide a Policy Summary upon delivery of the policy.

(c) The insurer shall provide a Wisconsin Buyer's Guide to Life Insurance and a Preliminary Policy Summary to individual prospective purchasers upon reasonable request.

(d) The insurer may provide information concerning life insurance cost indexes other than the surrender cost index so long as the information and its method of presentation is in conformance with this rule.

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(e) For policies already issued and paying premiums on the effective date of this rule, policyholders shall have the right to obtain a Policy Summary at cost. The company may charge a reasonable fee for preparing this summary, not to exceed $5, and may utilize reasonable assumptions in providing the cost disclosure information, so long as they are clearly disclosed.

(5) GENERAL RULES. (a) Each insurer shall maintain at its home office or principal office, a complete file containing one copy of each document authorized by the insurer for use pursuant to this rule. Such file shall contain one copy of each authorized form for a period of three years following the date of its last authorized use.

(b) An intermediary shall inform the prospective purchaser, prior to commencing a life insurance sales presentation, that he is acting as a life insurance intermediary and inform the prospective purchaser of the full name of the insurance company which he is representing to the buyer. In sales situations in which an intermediary is not involved, the insurer shall identify its full name.

(c) Terms such as financial planner, investment advisor, financial consultant, or financial counseling shall not be used in such a way as to imply that the insurance intermediary is generally engaged in an advisory business in which compensation is unrelated to sales unless such is actually the case.

(d) Any reference to policy dividends must include a statement that dividends are not guaranteed.

(e) Any sales presentation which repeatedly refers to an insurance premium or element of the insurance premium as a deposit, an investment, a savings or in any other phrase of similar import, and does not disclose the Average Annual Rate of Return Index figures for 10 and 20 years is an unfair marketing practice, within the meaning of section 628.34, Stats.

(f) The purchase or replacement of any life insurance contract or annuity shall not be recommended by any insurer or intermediary without reasonable grounds to believe that the recommendation is not unsuitable for the applicant on the basis of information furnished by such person after reasonable inquiry as may be necessary under the circumstances concerning the prospective buyers insurance and annuity needs and means.

(g) A system or presentation which does not recognize the time value of money through the use of appropriate interest adjustments shall not be used for comparing the cost of two or more life insurance policies.

(h) A presentation of benefits shall not display guaranteed and non-guaranteed benefits as a single sum unless they are shown separately in close proximity thereto.

(i) A statement regarding the use of the Surrender Cost Index shall include an explanation to the effect that the index is useful only for the comparison of the relative costs of two or more similar policies.

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(j) A Life Insurance Index which reflects dividends or an Equivalent Level Annual Dividend shall be accompanied by a statement that it is based on the company's current dividend scale and is not guaranteed.

(k) For the purposes of this rule, the annual premium for a basic policy or rider, for which the company reserves the right to change the premium, shall be the maximum annual premium.

(6) EFFECTIVE DATE. This rule shall apply to all solicitations of life insurance which commence on or after January 1, 1979.

(7) UNUSUAL CIRCUMSTANCES. Insurers with unique difficulties in implementing sections of this rule may petition the commissioner for allowance to meet the requirements of the rule through alternative approaches.

(8) YEARLY RENEWABLE TERM INSURANCE MORTALITY RATES:

The following mortality rates are to be used in determining YRT premiums for calculating Average Annual Rate of Return Index figures.

MORTALITY RATES PER 1,000

Attained Age (x)	Male Lives	Female Lives	Attained Age (x)	Male Lives	Female Lives
0	5.80	4.80	30	1.15	.75
1	1.33	1.22	31	1.22	.83
2	0.84	0.72	32	1.28	.93
3	0.65	0.55	33	1.32	1.04
4	0.53	0.48	34	1.34	1.14
5	0.48	0.42	35	1.40	1.21
6	0.42	0.37	36	1.49	1.23
7	0.39	0.33	37	1.60	1.25
8	0.35	0.29	38	1.75	1.29
9	0.32	0.22	39	1.91	1.37
10	0.31	0.25	40	2.12	1.47
11	0.31	0.26	41	2.36	1.59
12	0.33	0.27	42	2.66	1.74
13	0.42	0.29	43	3.02	1.91
14	0.52	0.31	44	3.45	2.10
15	0.73	0.36	45	3.96	2.32
16	0.87	0.36	46	4.51	2.58
17	1.02	0.37	47	5.09	2.88
18	1.18	.38	48	5.71	3.20
19	1.29	.40	49	6.34	3.52
20	1.37	.41	50	6.94	3.84
21	1.46	.44	51	7.56	4.15
22	1.52	.48	52	8.32	4.48
23	1.47	.53	53	9.20	4.84
24	1.32	.60	54	10.09	5.23
25	1.25	.66	55	11.00	5.67
26	1.22	.70	56	12.06	6.16
27	1.19	.70	57	13.26	6.70
28	1.17	.70	58	14.60	7.27
29	1.13	.71	59	16.06	7.87

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Attained Age (x)	Male Lives	Female Lives	Attained Age (x)	Male Lives	Female Lives
60	17.69	8.52	78	81.98	53.45
61	19.55	9.21	79	89.68	59.01
62	21.61	10.00	80	97.68	66.03
63	23.75	10.83	81	105.42	73.80
64	25.83	11.81	82	113.40	79.38
65	27.99	13.07	83	122.90	86.03
66	30.34	14.72	84	135.00	94.50
67	33.04	16.80	85	149.17	107.40
68	35.92	19.28	86	165.94	122.80
69	39.27	22.28	87	182.12	138.41
70	42.90	25.69	88	196.71	153.43
71	46.45	29.43	89	213.26	170.61
72	49.96	33.43	90	229.66	188.32
73	53.72	37.30	91	246.98	207.47
74	58.16	40.72	92	262.03	225.34
75	63.36	43.59	93	276.79	243.58
76	69.04	46.36	94	302.02	271.82
77	75.09	49.38	95	338.33	311.26

NOTE: The mortality rates for ages 0 through 14 are from the 1965-1970 Select Basic Tables published on pages 202 and 203 of the Transactions of the Society of Actuaries Publication Year 1974, Number 3, 1973 Reports of Mortality and Morbidity Experience. The mortality rates for ages 15 and above are from the Ultimate Basic Tables, Males Lives (1957-1960 Experience), Female Lives (1957-1960 Experience) published on page 48 of the Transactions of the Society of Actuaries, Publication Year 1963, Number 2 1962 Reports of Mortality and Morbidity Experience.

(9) PENALTY. Violations of this rule shall subject the violator to section 601.64, Stats.

(10) SEPARABILITY. If any provision of this rule shall be held invalid, the remainder of the rule shall not be affected thereby.

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Appendix 1

PRELIMINARY POLICY SUMMARY

IMPORTANT: Many people think all life insurance policies cost about the same. They don't. The cost of similar policies varies sharply. You can save many hundreds or even thousands of dollars by choosing a low-cost policy. To find out how this particular policy ranks, compare its Cost Index (found below) to the range of cost indexes for similar policies. For further information on cost comparison and examples of the range of cost indexes for a number of policies, see pages 4-8 in the Wisconsin Buyer's Guide to Life Insurance which you should have received with this policy summary.

Name and Address of Company: _____

Type and Name of Policy: _____

Face Amount at Time of Issue: _____ Policyholder's Sex and Age at Issue: _____

YEARLY PREMIUM: _____
This is the amount of cash you'll have to spend each year to keep the policy in force. Be sure you can afford it.

COST INDEX:
To find a low-cost policy, look at the policy's Surrender Cost Index, not its premium. Then compare that index number with the figure for other similar policies. Premiums only measure what you pay for a policy. The benefits you receive from policies with similar premiums vary widely. The Surrender Cost Index takes premiums, cash values, dividends (if any) and interest into consideration. In doing so, it provides a more complete measure of the cost of similar life insurance policies. The lower the Surrender Cost Index, the lower the policy's cost to you.

	10 Years	20 Years
SURRENDER COST INDEX (Per $1,000 face amount)		

The Surrender Cost Index should only be used to compare the cost of similar policies. Don't use it to compare the cost of a term policy to that of a whole life policy.

RATE OF RETURN:

Under most circumstances, life insurance should not be sold or purchased as "an investment." Cash values build up slowly in the first years of a whole life or an endowment policy, and for the first five or ten years, the rate of return on your money will be minimal. For further information, see the Wisconsin Buyer's Guide to Life Insurance.

_____ _____
Signature of Agent Date

Address: _____

[This form should be used for whole life and endowment insurance.]

1979 GOV FTC STUDY OF LIFE INSURANCE COST DISCLOSURE - Cannon - 592p - bonknote

Appendix 2

PRELIMINARY POLICY SUMMARY

IMPORTANT: Many people think all life insurance policies cost about the same. They don't. The cost of similar policies varies sharply. You can save many hundreds or even thousands of dollars by choosing a low-cost policy. To find out how this particular policy ranks, compare its Cost Index (found below) to the range of cost indexes for similar policies. For further information on cost comparison and examples of the range of cost indexes for a number of policies, see pages 4-8 in the Wisconsin Buyer's Guide to Life Insurance, which you should have received with this policy summary.

Name and Address of Company: _____

Type and Name of Policy: _____

Policyholder's Sex and Age at Issue: _____

Renewable* Yes _____ No _____ If yes, through what age? _____
Convertible Yes _____ No _____ If yes, through what age? _____

Policy Years	Annual Premium	Guaranteed Amount Payable on Death

NOTE: Companies (or intermediaries) should enter in this space the annual premium and guaranteed amount payable on death for representative policy years.

COST INDEX:

To find a low-cost term policy, look at the policy's Surrender Cost Index, not just its first-year premium. That's because the premiums for some term policies go up faster than others. In addition, many term policies pay dividends. When they do, that lowers the cost of those policies. The Surrender Cost Index takes both dividends and later-year premiums into consideration and thus gives a better measure of a term policy's cost than the first-year premium alone. The lower the Surrender Cost Index, the lower the policy's cost to you.

	10 years	20 years
SURRENDER COST INDEX (per $1,000 face amount)		

The Surrender Cost Index should be used only to compare the cost of similar policies. Don't use it to compare the cost of a term policy to that of a whole life policy.

_____ _____
Signature of Agent Date

Address of Agent: _____

*Renewability: If you're buying term insurance for long-term needs, make sure your policy is guaranteed renewable through at least age 65. Check above for the age through which this policy can be renewed. For more information, see page 2 of the Wisconsin Buyer's Guide to Life Insurance.

[This form should be used for term insurance.]

STATE OF WISCONSIN)
)ss.
OFFICE OF THE COMMISSIONER OF INSURANCE)

TO ALL TO WHOM THESE PRESENTS SHALL COME, GREETINGS:

I, Harold R. Wilde, Commissioner of Insurance and custodian of the official records of said office, do hereby certify that the annexed order repealing and adopting rules regarding life insurance solicitation was issued by this office October 2, 1978.

I further certify that said copy has been compared by me with the original on file in this office and that the same is a true copy thereof, and of the whole of such original.

IN TESTIMONY WHEREOF, I have hereunto subscribed my name in the City of Madison, State of Wisconsin, this 2nd day of October, 1978.

Harold R. Wilde
Commissioner of Insurance

STATE OF WISCONSIN
DEPARTMENT OF STATE
RECEIVED AND FILED

OCT 3 1978

DOUGLAS LaFOLLETTE
SECRETARY OF STATE

NOTICE OF HEARING

Commissioner of Insurance

NOTICE IS HEREBY GIVEN That, pursuant to sections 601.41 (3) and 227.021, Wis. Stats., the Commissioner of Insurance will hold a public hearing at Room 421, South, State Capitol, in the city of Madison, Wisconsin, on the 16th day of April, 1979, at 10:00a.m. or as soon thereafter as the matter may be reached to consider the amendment of Wisconsin Administrative Code section Ins 2.14 by amending the following subsections, repealing and recreating Appendices 1 and 2 and adopting Appendix 3.

Analysis by the Commissioner of Insurance

On October 4, 1978, following extensive administrative hearings, the Commissioner of Insurance promulgated and adopted section Ins 2.14 of the Wisconsin Administrative Code to apply to all solicitations of life insurance which commenced on or after January 1, 1979. This rule requires that life insurers and their representatives deliver to purchasers of life insurance information which will improve the buyer's ability to select the most appropriate plan of life insurance for his or her needs, improve the buyer's understanding of the basic features of the policy and improve the ability of the buyer to evaluate the relative costs of similar plans of insurance. This rule replaced two rules with similar purpose which had been in effect since 1972.

On February 28, 1979, the Court of Appeals, District IV, entered an Order and Decision directing the Circuit Court for Dane County to issue a temporary injunction against the enforcement of portions of section Ins 2.14 in its present form.

The following changes in section Ins 2.14 are promulgated to change the parts of section Ins 2.14 to which the Court of Appeals objected so that distribution of the Wisconsin Buyer's Guide to Life Insurance and the mandatory furnishing of a preliminary policy summary can be a part of life insurance disclosure required by Wisconsin rules.

Section Ins 2.14 (3) (a) is amended to read:

(a) Wisconsin Buyer's Guide to Life Insurance. The Wisconsin Buyer's Guide to Life Insurance is a document which contains, and is limited to, the language within the current edition of "The Wisconsin Buyer's Guide to Life Insurance" put out by the Insurance Commissioner of the State of Wisconsin. This pamphlet shall be reviewed periodically for accuracy and appropriateness. Appendix 3 to this rule contains the current edition of "The Wisconsin Buyer's Guide to Life Insurance." Prior to the publication of a revised pamphlet, it shall be submitted to the Life Subcommittee of the Forms and Classification Advisory Council for public hearing and review of other than technical or nonsubstantive changes. Insurers may purchase this pamphlet at cost from the Office of the Commissioner of Insurance, or they may reproduce it themselves (subject to reasonable standards of style, size, and layout).

Section Ins 2.14 (6) is amended to read:

(6) EFFECTIVE DATE. This rule shall apply to all solicitations of life insurance which commence on or after January 1, 1979, except that the requirements of subsection (4) (a) shall apply to solicitations which commence on or after July 1, 1979.

Appendix 1 is repealed and recreated to read:

PRELIMINARY POLICY SUMMARY
FOR WHOLE LIFE OR ENDOWMENT INSURANCE

IMPORTANT: Many people think all life insurance policies cost about the same. They don't. The cost of similar policies varies sharply. You can save many hundreds or even thousands of dollars by choosing a low-cost policy. To find out how this particular policy ranks, compare its cost index figures to the range of cost indexes for similar policies. For further information and examples on cost comparison, see "Finding A Low Cost Policy" (pages) in the Wisconsin Buyer's Guide to Life Insurance, which you should have received with this summary.

Name and Address of Company: _____

Type and Name of Policy: _____

Face Amount at Time of Issue: _____ Policyholder's Sex and Age at Issue ___

ANNUAL PREMIUM: _____
This is the amount of cash you'll have to spend each year to keep the policy in force. Be sure you can afford it.

COST INDEX:
To find a low-cost policy look at the policy's cost index figures, not just its premium. Then compare these index numbers with the figures for other similar policies. Premiums only measure what you pay for a policy. The benefits you receive from policies with similar premiums vary widely. For a description of various life insurance cost indexes and the assumptions on which they are based, see pages of the Buyer's Guide. The figures below are derived using the Surrender Cost Index. The Surrender Cost Index takes premiums, cash values, dividends (if any) and interest into consideration, and provides a measure of the relative cost of a policy, assuming its surrender at a given point in the future (e.g., 10 or 20 years). Given this assumption, the lower the Surrender Cost Index, the lower the policy's cost to you.

	10 Years	20 Years
SURRENDER COST INDEX (Per $1,000 face amount)		

The Surrender Cost Index should only be used to compare the cost of similar policies. If death would occur during the designated period, the policy with the lower index would not necessarily be the lower cost policy. All index figures for participating policies are based on illustrated dividends which are not guaranteed.

RATE OF RETURN:

Under most circumstances, life insurance should not be sold or purchased as "an investment." Cash values build up slowly in the first years of a whole life or an endowment policy, and for the first five or ten years, the rate of return on your money will be minimal. For further information, see page of the Buyer's Guide.

_____ _____
Name of Agent Date
Address of Agent: _____

PRELIMINARY POLICY SUMMARY
FOR TERM INSURANCE

IMPORTANT: Many people think all life insurance policies cost about the same. They don't. The cost of similar policies varies sharply. You can save many hundreds or even thousands of dollars by choosing a low-cost policy. To find out how this particular policy ranks, compare its cost index figures to the range of cost indexes for similar policies. For further information and examples on cost comparison, see "Finding A Low Cost Policy" (pages) of the Wisconsin Buyer's Guide to Life Insurance, which you should have received with this summary.

Name and Address of Company: _____

Type and Name of Policy: _____

Policyholder's Sex and Age at Issue: _____

Renewable* Yes ___ No ___ If yes, through what age? _____
Convertible Yes ___ No ___ If yes, through what age? _____

Policy Years	Annual Premium	Guaranteed Amount Payable on Death

NOTE: Companies (or intermediaries) should enter in this space the annual premium and guaranteed amount payable on death for representative policy years.

COST INDEX:

To find a low-cost policy, look at the policy's cost index figures, not just its first-year premium. That's because the premiums for some term policies go up faster than others. In addition, many term policies pay dividends. When they do, that lowers the cost of those policies. For a description of various life insurance cost indexes and the assumptions on which they are based, see pages of the Buyer's Guide. The figures below are derived using the Surrender Cost Index. The Surrender Cost Index takes both dividends and later-year premiums into consideration and provides a measure of the relative cost of a policy, assuming its surrender at a given point in the future (e.g., 10 or 20 years). Given this assumption, the lower the Surrender Cost Index, the lower the policy's cost to you.

	10 Years	20 Years
SURRENDER COST INDEX (per $1,000 face amount)		

The Surrender Cost Index should be used only to compare the cost of similar policies. If death would occur during the designated period, the policy with the lower index would not necessarily be the lower cost policy. All index figures for participating policies are based on illustrated dividends which are not guaranteed.

Name of Agent _____ Date _____
Address of Agent: _____

*Renewability: If you're buying term insurance for long-term needs, make sure your policy is guaranteed renewable through at least age 65. Check above for the age through which this policy can be renewed. For more information, see pages of the Buyer's Guide.

Appendix 3 is adopted to read:

WISCONSIN BUYER'S GUIDE
TO
LIFE INSURANCE

Office of the Commissioner of
Insurance
123 West Washington Avenue
Madison, Wisconsin 53702
1979

Front Cover

* * * * * * * * *

A STATE-WIDE TOLL-FREE "WISCONSIN LIFE INSURANCE COST DISCLOSURE INFORMATION LINE" WILL BE IN OPERATION THROUGHOUT 1979. THE NUMBER IS: 1-800-362-8380.

Inside Cover

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IMPORTANT:

Shopping around for life insurance can mean big savings for you. The difference between two policies offering the exact same amount of protection may add up to thousands of dollars over a period of years.

Unfortunately, it is not always easy to rate or compare policies. Premiums alone may tell you little or nothing about the actual cost of a policy. That's why the Wisconsin Office of the Commissioner of Insurance prepared this guide — and requires all life insurance agents to provide it to their customers prior to any sale. It is designed to help you make comparisons that may save you a considerable amount of money.

See the section of this guide entitled Finding a Low Cost Policy (pages) for specific details on life insurance cost comparison - and examples of cost figures on various types of policies. If you have time to read nothing else in this guide take a look at these pages first.

This guide has been prepared by the Wisconsin Office of the Commissioner of Insurance, in part using materials developed by the National Association of Insurance Commissioners.

This guide does not endorse any company or policy. It is designed to meet the needs of most consumers. Individuals with complicated or unusual financial situations are advised to seek professional advice.

If you have any questions about any of the material in this guide, a good agent or company should be willing to go over it with you.

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BUYING LIFE INSURANCE

When you buy life insurance, you want a policy which fits your needs without costing too much. Your first step is to decide how much you need, how much you can afford to pay and the kind of policy you want. Then, find out what various companies charge for that kind of policy. You can find important differences in the cost of life insurance by using the life insurance cost indexes which are described in this guide.

A NOTE ON GROUP LIFE INSURANCE

Life insurance can be purchased either as an individual or as a member of a group. Group coverage through an employer or employee group is generally less expensive than policies bought on an individual basis, because the administrative costs are low and because employers often contribute toward the premium. If you are eligible for such coverage, check it out carefully. It may be the easiest and least costly way to meet your basic life insurance needs.

If you are going to make a good choice when you buy life insurance, you need to understand what kinds are available. If one kind does not seem to fit your needs, ask about the other kinds which are described in this guide. If you feel that you need more information than is given here, you may want to check the many books and pamphlets on life insurance in your public library. Every library in Wisconsin should have basic information on life insurance cost comparison readily available.

CHOOSING THE AMOUNT

One way to decide how much life insurance you need is to figure how much cash and income your dependents would need if you were to die. You should think of life insurance as a source of cash needed for expenses of final illnesses, paying taxes, mortgages or other debts. It can also provide income for your family's living expenses, educational costs and other future expenses. Your new policy should come as close as you can afford to making up the difference between (1) what your dependents would have if you were to die now, and (2) what they would actually need.

It is important to reassess your life insurance program frequently. Needs will probably be greater if there is only one wage-earner in the family than if there are two people with substantial earning capacity. More protection will be required when your children are young than when they are older. A person with several dependents usually will need more insurance than a person with few.

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CHOOSING THE RIGHT KIND

All life insurance policies agree to pay an amount of money if you die. But all policies are not the same. There are three basic kinds of life insurance.

1. Term insurance
2. Whole life insurance
3. Endowment insurance

In recent years, various life insurance products have been developed which are "hybrids" of these basic types. Remember, no matter how fancy the policy title or sales representation might appear, all life insurance policies contain one or more of the three basic kinds. If you are confused about a policy that sounds complicated, ask the agent or company how it combines the various kinds of life insurance, and what the advantages and disadvantages of this combination are. (One possible disadvantage is that it may sometimes make meaningful cost comparison difficult.) The following is a brief description of the three basic kinds:

Term Insurance

Term insurance, as the name implies, insures your life for a specific period of time, such as one year, five years or ten years. Death benefits will be paid only if you die within that term of years. Term insurance generally provides the largest immediate death protection for your premium dollar.

Term insurance policies are usually "renewable" for one or more additional terms, even if your health has changed. Each time you renew the policy for a new term, premiums will be higher, to reflect the

higher likelihood of a person dying as he or she grows older. For "annually renewable term," this means that your premiums will increase every year; for "10 year renewable term," every ten years. (One form of term insurance, "term to 65," has only one "term," so annual premiums are level.) Since not all term policies are renewable, be sure to check on this feature before buying.

Term Insurance and "Death Protection"

People purchase term insurance to maximize the amount of death protection they can obtain for their beneficiaries for a given sum of money. How this works can best be seen using an example, based on the actual rates of a company offering various kinds of life insurance.

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For $200, a 35 year old male could obtain:

Type of Policy	Premium	Death Protection
Term (annually renewable)	$200	$77,200
Term (to 65)	200	19,500
Whole Life	200	10,900
Endowment (at 65)	200	7,200

For this one year end age, the man could get ten times as much death protection for his money purchasing annually renewable term instead of endowment insurance.

Term insurance is sometimes sold as "decreasing term." This means that you start out with a set amount of insurance which decreases over time. Instead of the premiums increasing as you get older, the coverage decreases. It is this type of policy which is often used to protect a long-term decreasing debt, such as a mortgage.

Some term insurance policies are also "convertible." This means that before the end of the conversion period, you may trade the term policy for a whole life or endowment insurance policy even if you are not in good health. Premiums for the new policy will be higher than you have been paying for the term insurance.

Whole Life Insurance

Whole life insurance is designed to give death protection for as long as you live. The most common type is called "straight life" or "ordinary life" insurance for which you pay the same premiums for as long as you live. Whole life premiums start out at a higher level than term insurance for an equivalent amount of insurance protection, but they do not increase with age; they remain level throughout the payment period. The "extra" payments made in the early years of the policy accumulate in the form of "cash values," which must be returned if a policy is surrendered, and may be borrowed while a policy is in force. At death any amount which has been borrowed (plus interest) is subtracted from the face value of the policy.

Some whole life policies let you pay premiums for a shorter period such as 20 years, or until age 65. Premiums for these policies are higher than for ordinary life insurance since the premium payments are squeezed into a shorter period.

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Whole Life as "An Investment"

Whole life insurance and other forms of life insurance which build up cash values are sometimes sold by companies and agents as "an investment," because of the cash value feature. They shouldn't be — and probably couldn't be, if the cash value "yield" of most policies was properly understood. Cash values are very low in the first years of the policy, and for the first five or ten years the rate of return on your money may actually be negative. This is a major reason that you should not contemplate purchasing a whole life policy (or any cash value policy) unless you intend to hang onto it for at least ten years, and preferably longer.

Endowment Insurance

An endowment insurance policy pays a sum of money or an income to you - the policyholder - if you live to a certain age. If you were to die before then, the death benefit would be paid to your beneficiary. Premiums and cash values for endowment insurance are higher than for the same amount of whole life insurance. Thus endowment insurance gives you the least amount of death protection for your premium dollar.

SOME WORDS OF CAUTION

Don't buy a life insurance policy unless you are sure that it's the type of policy you want and that you can afford the premiums. Few people plan to drop their whole life policies soon after buying them. Yet about one in five new policyholders do just that. (This may be especially true of young people who are talked into buying expensive policies when in college, before they have an accurate understanding of either their insurance needs or their financial capacity.)

There are many varieties of life insurance currently being marketed as part of "packages" which combine elements of term and whole life insurance, and annuities or an investment "side fund." (An annuity is a long-term investment, generally used to provide retirement income.) Some of these package policies (e.g., so-called "deposit term") have a large first year premium designed to provide a strong incentive for policyholders to stay with their term policies for a specified period — such as ten years. Early surrender of these policies can be extremely costly.

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When considering purchasing of a policy or "package" combining elements of life insurance, annuity, or "side funds," you should ask for the guaranteed rate of return on all the premiums which you pay, not just on the amounts which are left after insurance expenses (such as agent commissions) are deducted. You should carefully investigate claims made as to tax advantages and implications. While some "new" products may be a significant improvement over insurance you have purchased in the past (particularly if that insurance policy's cash value has a low rate of return), others may be designed to fall into the cracks between insurance and securities, and not be regulated adequately by any government agency.

It is a good idea to seek financial advice from several competing sources before making a major investment or insurance decision.

FINDING A LOW COST POLICY

After you have decided which kind of life insurance fits your needs, look for a good buy. Your chances of finding a good buy are better if you use the cost indexes that have been developed by actuaries to aid in comparing life insurance values. The basic life insurance cost index is called the "Surrender Cost Index." Examples and illustrations on how to use this index are given in the rest of this guide.

What is Cost?

To understand life insurance costs, start with the simplest possible example — an annually renewable term policy which builds up no cash values and pays no dividends. For this policy the cost of death protection is your annual premium payment. If you drop (surrender) the policy, you get no money back (because you've paid in nothing extra; you've purchased "pure death protection"). Premiums become progressively larger each year, to reflect the increasing actual cost of your death protection.

Now, purchase the same amount of death protection through a level premium policy, which has a higher initial expense but which also accumulates cash values. Here the concept of cost becomes more complicated. The "true" cost of this whole life policy might be one amount if you were to die and your beneficiaries were to collect the face value and quite another if you were to surrender the policy or use the cash value in some other way.

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The cost of a policy may also be affected by whether or not it pays dividends. A policy that does is called "participating." Companies that offer participating policies may tell you what their current dividends are, but the size of future dividends is unknown today and cannot be guaranteed. Dividends actually paid are set each year by the company.

Some policies do not pay dividends. These are called "guaranteed cost" or "non-participating" policies. Every feature of a guaranteed cost policy is fixed so that you know in advance what your future cost will be.

The premiums and cash values of a participating policy are guaranteed, but the dividends are not. Premiums for participating policies are typically higher than for guaranteed cost policies, but the cost to you may be higher or lower, depending on the dividends actually paid. The advantage — or the disadvantage — of a guaranteed cost policy is the certainty it provides. This should be evaluated against the flexibility provided by the participating policy, where dividends — and therefore, actual costs — may be responsive to investment and inflation trends, and changes in the average life span of policyholders.

What are Cost Indexes?

In order to compare the cost of policies, you need to look at:

1. Premiums
2. Cash Values
3. Dividends

Cost indexes use one or more of these factors to give you a convenient way to compare relative costs of similar policies. When you compare costs, an adjustment must be made to take into account that money is paid and received at different times. It is not enough to just add up the premiums you will pay and subtract the cash values and dividends you expect to get back. Index figures take care of the arithmetic for you. Instead of having to add, subtract, multiply and divide many numbers yourself, you just compare the index numbers which you can get from life insurance agents and companies.

The Basic Cost Index

This index takes into account cash values, as well as premiums, dividends, and the value of money over time. It is called the surrender cost index because it compares costs as if at some future point in time you were to surrender the policy and take its cash value.

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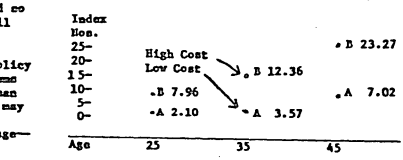
BEFORE ANY AGENT SELLS YOU A LIFE INSURANCE POLICY IN WISCONSIN, HE OR SHE MUST PROVIDE YOU WITH THE SURRENDER COST INDEX FIGURE FOR THAT POLICY AT 10 AND 20 YEARS. TO SEE HOW THAT POLICY RANKS, YOU SHOULD THEN COMPARE THAT FIGURE WITH THOSE FOR SIMILAR POLICIES FROM OTHER COMPANIES.

How Do I Use This Cost Index?

The most important thing to remember when using the surrender cost index is that, based upon the assumptions of the index, a smaller number is generally a better buy than a comparable policy with a larger index number.

To see how this works, let's look at an example. On the next page there is a table giving illustrations of the range of surrender cost indexes for four commonly sold policies, both participating ("par") and non-participating ("non-par"). (The figures given are for females: the male figures would be generally a little higher.) The graph below uses one set of figures from the table: 20 year surrender cost indexes for $25,000 non-participating whole life policies sold to females at ages 25, 35 and 45.

THE RANGE OF SURRENDER COST INDEXES:
AN ILLUSTRATION
20 Year Surrender Cost Index
Female Non-participating Whole Life $25,000



The purpose of the graph is to illustrate the wide range of cost differences on just one life insurance policy. To emphasize the importance of comparative shopping, it may be useful to give that range of cost indexes a more concrete meaning. Using the assumptions of the surrender cost index calculation, the money saved between the lowest cost policy (A) and the highest cost policy (B), if purchased at age 25 and surrendered at age 45, would be approximately $2,900; if the policy were purchased at age 35 and surrendered at age 55, the savings would be approximately $4,300.

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1979 GOV FTC STUDY OF LIFE INSURANCE COST DISCLOSURE - Cannon - 592p - bonknote

LIFE INSURANCE COST COMPARISONS*
Surrender Cost Index - Female

	Policy Type	Size	Range of Values	Age 25 10 Yr	Age 25 20 Yr	Age 35 10 Yr	Age 35 20 Yr	Age 45 10 Yr	Age 45 20 Yr
Non-Participating	Whole Life	$10,000	Low	2.80	2.96	3.51	4.63	6.06	8.54
			25th	5.40	5.11	6.53	6.92	10.04	11.60
			75th	6.76	6.20	8.27	8.59	12.32	13.76
			High	14.66	14.45	18.67	19.22	28.89	30.95
	Whole Life	$25,000	Low	.57	2.10	1.43	3.53	4.40	7.02
			25th	4.08	3.72	5.05	5.50	8.37	9.87
			75th	5.49	5.02	6.99	7.31	11.10	12.52
			High	8.64	7.96	10.66	12.34	15.77	23.27
	Term**	$25,000	Low	2.18	2.38	2.70	3.47	5.83	5.83
			25th	3.31	3.54	4.08	5.27	7.34	10.50
			75th	4.19	4.45	5.14	6.57	9.37	12.99
			High	6.15	7.53	7.53	16.24	16.24	17.60
	Term**	$50,000	Low	2.18	2.38	2.68	2.97	5.27	5.35
			25th	2.80	3.08	3.55	4.77	6.92	10.09
			75th	3.94	4.25	4.89	6.27	9.06	12.6*
			High	5.35	7.03	7.03	15.74	15.74	17.64
Participating	Whole Life	$10,000	Low	1.28	.86	2.56	1.46	3.44	2.48
			25th	4.49	3.05	5.15	4.25	7.86	7.10
			75th	6.62	5.05	7.91	6.79	11.54	10.44
			High	12.10	12.28	15.76	16.63	22.07	24.58
	Whole Life	$25,000	Low	1.56	.54	1.87	.32	2.73	1.31
			25th	3.37	2.24	4.27	3.30	6.95	6.34
			75th	5.30	3.93	6.48	5.56	10.32	9.52
			High	12.10	12.28	15.76	16.63	22.07	24.58
	Term**	$25,000	Low	1.92	1.84	2.45	3.05	4.68	4.60
			25th	3.06	3.17	3.84	5.03	7.27	10.09
			75th	3.56	3.97	4.66	6.21	8.78	12.53
			High	7.64	7.37	16.87	16.40	12.32	17.79
	Term**	$50,000	Low	1.54	1.60	2.07	2.81	4.30	4.22
			25th	2.63	2.85	3.46	4.68	6.78	9.84
			75th	3.25	3.74	4.37	5.82	8.51	12.21
			High	7.14	6.87	16.37	15.00	12.09	17.54

* The figures in the table are for illustrative purposes only. Policies with low index numbers may not always be available to all consumers because of underwriting restrictions. Surrender cost data has been taken from information supplied by insurance companies on policies sold in Wisconsin. The interest assumption used in computing surrender cost index data in Wisconsin is 5%. All values are per $1,000 face amount.

Surrender cost index figures for participating policies are based on illustrated dividends, which are neither guaranteed, nor projections of what actual dividends payable in the future will be. The experience of participating policies in general over the past 20 years has been to exceed the dividends illustrated at the time of sale.

Concerning the "range of values": "Low" means that no policy among those surveyed had a lower index. "25th" means that 25% of all policies surveyed had an index equal to or below that shown. "75th" means that 75% of all policies surveyed had an index equal to or below that shown. "High" means none of the policies surveyed had an index greater than that shown.

This table is based on data collected in November, 1978, and will be revised periodically.

** 5 year renewable and convertible.

The ranges of surrender cost indexes shown on the table only apply to the particular policies and ages given. The easiest way to find out if the particular policy you are considering is low or high is to call up a number of competing companies and ask for the 10 and 20 year surrender cost index figures (at your age) for their comparable policy — or look up these figures in the library. As you do this, you should also keep in mind the following rules:

1. Cost comparisons should only be made between similar plans of life insurance. Similar plans are those which provide essentially the same basic benefits and require premium payments for approximately the same period of time. The closer policies are to being identical, the more reliable the cost comparison will be.

2. Compare index numbers only for the kind of policy for your age and for the amount you intend to buy. Since no one company offers the lowest cost for all types of insurance at all ages and for all amounts of insurance, it is important that you get the indexes for the actual policy, age and amount which you intend to buy.

3. Small differences in index numbers could be offset by other policy features, or differences in the quality of service you may expect from the company or its agent.

4. In any event, you will need other information on which to base your purchase decision. Be sure you can afford the premiums, and that you understand the policy's cash values, dividends and death benefits. You should also make a judgment on how well the life insurance company or agent will provide service in the future to you as a policyholder.

5. This life insurance cost index is not designed for the purpose of determining whether you should drop a policy you have already owned for awhile, in favor of a new one. If such a replacement is suggested, you should ask for information from the company which issued the old policy before you take action.

Other Useful Cost Indexes

In addition to the surrender cost index, experts on insurance have developed other cost indexes which may be helpful in comparing various life insurance products. Insurers which provide these index figures must do so in accordance with standards set by the insurance Commissioner.

Life Insurance Net Payment Index.

This index does not take into account the cash surrender value (and terminal dividends, if any) that would be available to you if you surrendered the policy at the end of the period being measured by the index. It is useful if your main concern is the average annual out-of-pocket expense to you (premiums less dividends, if any) over a period of time, such as 10 or 20 years, ignoring the policy's cash surrender value build-up. Understood within this framework, a lower index generally indicates a lower out-of-pocket expense.

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The Equivalent Level Annual Dividend. This figure shows the part dividends play in determining the surrender cost index or the net payment cost index of a participating policy.

Average Annual Rate of Return Index. This index gives an approximation of the rate of return on the cash value element of a whole life policy. Because it does not lend to a significantly different ranking of policies from the surrender cost index, insurers are not currently required to provide this information to consumers. But if any agent or company attempts to sell you a whole life policy by emphasizing its investment or savings element, you should ask to see its 10 and 20 year rate of return, using this index, so that you can compare the policy's "yield" with the after tax return of alternate, "safe" investments (such as the interest you would earn on your money in a savings institution). Under most circumstances, life insurance should not be sold or purchased as an investment. The rate of return index provides you with important information necessary to make this determination for yourself.

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IMPORTANT THINGS TO KEEP IN MIND

1. BUY ONLY WHAT YOU CAN AFFORD. If you drop your whole life policy within the first 10 years because the premiums turn out to be more than you can afford, you will lose a substantial amount of the money you have paid in.

2. GROUP INSURANCE. If you have access to good group term insurance, take advantage of it.

3. TRY NOT TO LEAVE YOURSELF UNDERINSURED. Remember, during your younger years, when your needs are generally greatest, term insurance may provide you with many times as much insurance protection for your premium dollars as whole life or endowment.

4. SHOP AROUND. Many people think all policies cost about the same. They don't. Before you buy a life insurance policy, always check to see if it has a low surrender cost index. To determine whether a policy is high, medium or low cost, compared to other similar policies available in Wisconsin, check the life insurance cost comparison information on file at your local public library; call up competing companies and get their policy costs and indexes; or, if you need further assistance, contact the Wisconsin Insurance Commissioner's Office.

5. COMPARE POLICIES, NOT COMPANIES. Policyholders should look at the indexes for the particular policy which they intend to purchase. Companies vary and the company with the lowest indexes for one policy will not necessarily have the lowest indexes for all policies.

6. REASSESS YOUR LIFE INSURANCE NEEDS FREQUENTLY. Your life insurance needs will change as the number of your dependents and your income changes.

7. SHOP FOR A GOOD AGENT AS WELL AS A GOOD POLICY. You can't over estimate the value of an honest, well-informed agent. Inexperienced agents often lack detailed knowledge about their company's products and don't realize that the costs of similar policies differ markedly from company to company. In addition, because agent commissions are tied to premium size, there is some incentive for unprofessional agents to sell higher cost products where they may not be appropriate. So shop around. Talk to two or three agents including agents who represent several companies. Compare the advice each one gives you and the indexes of the policies each one recommends.

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8. BE VERY CAREFUL ABOUT SWITCHING OR REPLACING LIFE INSURANCE POLICIES. Sometimes an expensive whole life or endowment policy may be providing you with little protection for the money you spend — and a switch to much higher level of term protection for the same amount of money may make sense. In other cases, switching policies may be a mistake because you will have to pay the heavy first year expenses again, and will lose certain rights you have under the old policy.

9. LIFE INSURANCE MAY BE ONE OF THE MOST SIGNIFICANT PURCHASES YOU CAN MAKE FOR YOUR FAMILY IN A LIFE TIME. If you are buying life insurance as "an investment," be sure to check its rate of return. It's definitely worth your time (and money) to read up on life insurance and compare relative values before you make a purchase.

REMEMBER: COMPARISON SHOPPING SAVES MONEY. ANY TIME WHICH IS SPENT INFORMING YOURSELF ABOUT THE DIFFERENT TYPES OF LIFE INSURANCE POLICIES AVAILABLE — AS WELL AS COMPARING THE COSTS OF THESE POLICIES — WILL BE WELL WORTH IT. IF YOU NEED FURTHER ASSISTANCE, YOU MAY WANT TO CONSULT YOUR LOCAL LIBRARY WHICH SHOULD HAVE CURRENT INFORMATION ON COMPARATIVE LIFE INSURANCE PRICES AND INDEXES.

A STATE-WIDE TOLL-FREE "WISCONSIN LIFE INSURANCE COST DISCLOSURE INFORMATION LINE" WILL BE IN OPERATION THROUGHOUT 1979. THE NUMBER IS: 1-800-362-8380.

If you cannot get the answers you need from the agent or company, or if you have a specific complaint, contact

The Office of the Commissioner of Insurance
123 West Washington Avenue
Madison, Wisconsin 53702

(608) 266-0103 (if in Milwaukee, call 224-2925)

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Dated at Madison, Wisconsin, this 13th day of March, 1979.

Richard J. Kaintz

Richard J. Kaintz
Deputy Commissioner of Insurance

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