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Introduction to Symposium

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Introduction

In the last few years attention of regulators and much of the life insurance industry has focused on the problems that have occurred when insurance is marketed with the aid of an illustration that shows with columns of numbers how a policy might perform projecting the current experience into the future. Some agents have given, and some purchasers have gotten, the impression that this was almost a guarantee of what would happen in the future, and the insured could take as truth the illustration that his premiums would "vanish" at a set time in the future. When many of these illustrations were prepared, interest rates were at record highs. In the last couple of years, the illustrated results have not come to pass, and when policies lapse or premiums resume, this fact is brought home to the insured. Regulators heard complaints, insurers heard complaints, consumer groups heard complaints. Everyone agrees that something must be done.

This symposium addresses the concerns of regulators and examines the possible solutions to the problems created when consumers do not understand what an illustration is and is not.

Review of Legal and Regulatory Background

There was much discussion of life insurance and how to purchase a good policy in the 1970s. Joseph Belth launched the *Insurance Forum*

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at a time when regulators and consumer groups were focusing on helping consumers compare the costs and benefits of various life insurance policies to get the best buy. Dr. Belth charged that consumers did not have enough information on which to base purchase decisions and compare policies. The NAIC had considered the issue intermittently throughout the 1970s and by 1974 had a Cost Comparison Task Force working on development of a disclosure regulation to help consumers compare the returns on different types of policies. The model regulation developed by the NAIC included various indices that helped measure return, in an attempt to facilitate comparison. The regulatory group considered a requirement that every policy be sold with a ledger illustration, and that insurers be required to prepare comprehensive data displays for marketed policies.

In February 1973 the U.S. Senate Antitrust and Monopolies Subcommittee launched a massive life insurance pricing study. In 1979 the Federal Trade Commission (FTC) issued a report to the Senate Commerce Committee that was a major attack on whole life insurance. The FTC charged that minimal or no competition existed between the life insurance industry and alternative savings media and within the insurance industry. The report said whole life was not a good investment because it had a low rate of return, and that this fact was not made clear to policyholders. It charged that consumers were unable to determine the real cost of insurance because they were uninformed about life insurance. The insurance industry responded that whole life was not an "investment," and tried to focus on the protection element of insurance.

By the mid-1980s the focus on many sales presentations of life insurance seemed to be on life insurance as an investment. The high interest rates being offered by other investment alternatives meant money was being taken out of insurance. One insurer described market competition this way: "In sales presentations death benefits are often almost an afterthought. Guarantees are rarely discussed. We see a trumpeting of interest rates and a dazzling array of six-and seven-figure pots of gold . . ." He went on to caution: ". . . the quality of information being utilized in the marketing of life insurance has deteriorated. Some of the deterioration results from an increased use of gimmickry in policy illustrations and advertising. For example, interest rates are featured prominently, but charges made to the policyowner are not . . . The quoted interest rates may relate neither to performance nor to

any other valid basis, but may simply be picked out of the air" (Rohm, 1986).

In response to the changed market, the NAIC revised the Life Disclosure Model Regulation and adopted a regulation specifically for universal life insurance. The provisions were complex, and few states adopted them. Many in the industry and others called for more responsible illustrations and sales practices in the industry. Articles in *Best's Review* with such titles as "The Coming Consumer Backlash" and "Sanity in Policy Illustrations" were signs of the times.

By the 1990s it was clear to almost everyone that change was necessary. The Senate Judiciary Subcommittee on Antitrust, Monopolies and Business Right held hearings on misleading sales tactics. The National Association of Life Underwriters appointed a Sales Illustrations Task Force that called for changes. The Society of Chartered Life Underwriters created a questionnaire to request insurers to provide illustration information to agents so they could provide more accurate sales illustrations to prospects. The American Academy of Actuaries appointed a Task Force on Life Illustrations that issued a report suggesting changes. All these groups identified abuses and suggested ways to correct the problems. The NAIC appointed a working group to help states develop a regulatory response.

Current State of Regulatory Policy

Most state laws are based on the NAIC 1976 model disclosure regulation that advocates use of indices to compare policies. Few states deal with illustrations specifically or include many of the disclosure requirements of the current NAIC Life Disclosure Model Regulation. The 18 states that have adopted provisions based on the NAIC Rules Governing the Advertising of Life Insurance use the requirements for illustrations contained there. The rest of the states deal with abuses in sales illustrations using the definition of an unfair trade practice, which includes a sales presentation that misrepresents the benefits, advantages and terms of a life insurance policy. There is sufficient authority to deal with abuses, but enforcement between, and often within, states is not uniform.

Most of the states represented on the NAIC Life Disclosure Working Group have committed to adoption of new illustration rules as

soon as the working group has completed them. They recognize the need for clear rules and accountability in illustrations.

Tensions and Controversies Between Industry and Regulators

The life disclosure working group developed and adopted standards to be met by the model regulation being developed. A review of these standards discloses the issues that the insurance industry and regulators are working through to develop the model regulation.

Scope

The model regulation will not require that a company must provide sales illustrations with a product. It does require that if a company chooses to provide sales illustrations for a given product, then it must provide sales illustrations for all sales of that product. The illustration can be provided when the application is taken and no further illustrations are required unless the policy is issued other than as applied for. Then a revised illustration reflecting the issued policy must be provided. If not provided at the time of application, a sales illustration must be provided with the policy.

The primary focus of the current project is sales illustrations for life insurance products. These products include traditional life insurance and interest-sensitive life insurance. At issue is whether sales illustrations for variable life insurance should be included in the model. These products are also regulated by the Security and Exchange Commission (SEC). The SEC regulation includes some restrictions on portions of the sales illustration, but not on the entire document. The working group is collaborating with the SEC to provide consistency of illustrations between fixed and variable products. Most of the insurance industry supports this combined activity. Sales illustrations for annuity products will be developed after the model regulation for life insurance is finished.

Understandability

The working group feels strongly that the sales illustration should be used as a consumer education aid, in contrast with using it strictly as

a sales tool. There is a definite movement towards allowing companies more latitude in developing products in exchange for consumers being provided useful comparative information. This clearly places a heavier burden on all to significantly increase the reliability and understandability of sales illustrations.

Standardization of Presentation

The sales illustration is to be presented to an applicant for insurance in the form of a basic illustration and, potentially, one or more concept illustrations. The basic illustration will be in a standard format that all companies will use. The components include personal information (name, age, etc.), basic information about the policy (amount, type of plan, etc.) and summary product values.

The values will be shown on three bases: guaranteed, disciplined current scale and sensitivity scale. The guaranteed values are the minimums to be provided by the policy. The disciplined current scale is discussed below under "Assumptions." The sensitivity values are between the other two and provide the reader with an added degree of conservatism in anticipating future values.

The basic illustration must be provided to all consumers who are given an illustration. In addition, the company may provide concept illustrations (split dollar, key-person, etc.) but the values illustrated must be consistent with the values provided in the basic illustration.

Assumptions

This key section deals with the basis that company actuaries will use in developing values to illustrate under the disciplined current scale. Non-guaranteed elements must be based on separate assumptions for interest, mortality, lapse and expenses such that each assumption is not more favorable to the applicant than the more conservative of the current scale and the most recent experience on the policy block.

The concept of disciplined current scale is in reaction to companies' aggressive projections of values in sales illustrations, especially for the last 15 years. Many of these projections were greater than the developing experience. Consumers have been misled, needed coverage has not been provided, and insurer credibility has suffered. The discipline

inherent in this new scale will reduce a company's ability to provide unreasonable projections.

Another key prohibition is that lapse-supported pricing may not be illustrated. Lapse-supported pricing takes many forms, but it always involves not providing values to policy owners in early years so that higher values may be illustrated in later years, especially years 10 and 20. These years are often used for comparative purposes. This is an example of products being developed with a special eye towards how they illustrate!

Persistency bonuses may also not be illustrated. These are usually developed in conjunction with lapse-supported pricing. These are usually paid only in certain years (again 10 and 20) to enhance the apparent performance of the policy.

Actuarial Standards

The Actuarial Standards Board (ASB) of the American Academy of Actuaries is developing a standard that will provide direction to actuaries in implementing the model regulation. This will give the company actuary increased "clout" when dealing with company management in the product development and pricing process, and should reduce the projection abuses of recent years.

Responsibility

A key component of the model is that the company, the illustration actuary and the producer are to provide certification that the illustration has been prepared in accordance with the standards in the model regulation.

The illustration actuary is to be directly responsible to the board of directors of the company for sales illustrations. He or she is to certify that the elements of the illustration are accurate and prepared according to standards of the model and the ASB. The producer is to sign the sales illustration indicating adherence to the letter and spirit of the model.

Annual Reports

An annual report is to be provided to all policy owners that can be used to compare the illustrated values with the developing ones. Upon

request, the owner can receive an illustration providing values based on actual history to date and company projection for the future.

Summary of the Papers in Symposium

The three authors participating in this symposium are all actuaries, but their viewpoints and their contributions represent a wide divergence in opinions as to the issues that need to be addressed in life insurance illustration practice and regulation.

Commissioner Dwight K Bartlett, III, an insurance regulator for the state of Maryland and chair of the NAIC's Life Insurance Committee, has a historical perspective. His very scholarly and informative article is designed to help the reader understand earlier attempts by regulators and the industry to help consumers evaluate the policies they were purchasing. Commissioner Bartlett points out some of the challenges that have come about because of the many new types of products now available.

James H. Hunt of the Consumer Federation of America has focused on the difficulties of providing clear information to consumers in a way that will assist in making purchasing decisions. While Mr. Hunt has been following the work of the NAIC and participating in the deliberations on life insurance illustrations, he is pessimistic that the problems he identifies will be remedied by the new regulation being developed by the NAIC. Where Commissioner Bartlett talks about empowering the actuary, Mr. Hunt is concerned about reining in the actuary.

Anthony T. Spano, an actuary employed by the American Council of Life Insurance, has a much more positive message. He agrees problems have occurred but focused his attention on ways the industry is addressing those problems. Mr. Spano points out efforts to educate companies and consumers and details elements he feels are important to include in any NAIC model regulation.

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Life Cost Disclosure

Prospects for True Reform

James H. Hunt*

Abstract

In the last ten years, life insurance consumers have endured unprecedented raiding of their policy cash values by replacing agents, have suffered through insolvencies of major companies, have been promised more than could be delivered in computer illustrations and agents' sales pitches, and still lack any tools to comparison shop for cash value life insurance policies. Litigation is rampant; the lawyers have discovered new targets. The image of the business appears at its lowest ebb since the Armstrong Investigation of 1905. Insurance commissioners are at work to devise remedies for some of these problems, but appear to lack power to effect meaningful reforms. Life insurers retain the upper hand politically, which gets in the way of necessary reforms that put consumers first. Until consumers are served, rather than manipulated, life insurers will continue to lose market share to the mutual fund business.

Introduction

Among financial writers of the last decade, perhaps none is better known than Jane Bryant Quinn, *Newsweek*'s personal finance columnist and a syndicated writer for the *Washington Post*. In a special Newsweek article she quoted from a report on the life insurance business as follows:

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[Editor: paper was invited for this symposium]

> The business is riddled with self-defeating, unsound investments, unsuitable policies, high-pressure selling and unbridled sales expenses. Consumers take large losses when they drop expensive coverage they shouldn't have bought and can't afford.

The excerpt was from a 1905 investigation of life insurance practices by a New York State Commission chaired by State Senator William Armstrong. Quinn called the Armstrong report as "fresh today as it was then." She added that "[no] other financial institution has so little restraint on deceptive sales" (*Newsweek*, February 7, 1994).

Nearly seventy-five years after the Armstrong report, the Chairman of the Federal Trade Commission testified before Congress on an FTC staff report entitled, "Life Insurance Cost Disclosure." In his opening paragraph, he stated:

> Each year [American consumers] spend over 30 billion dollars on life insurance 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 (Michael Pertschuk, July 10, 1979).

Except for the expenditures, which now exceed $75 billion, that paragraph is as fresh today as it was in 1979. Life insurance executives probably consider the FTC report to be discredited, since the business subsequently lobbied the Congress to rein in the FTC's investigative powers over the insurance business. It is a pity, however, that the FTC report led to no reforms, for it was followed by a decade arguably unprecedented in the abuse heaped on life insurance consumers since the rapacious decade that preceded the Armstrong report in 1905. The following examples support this statement.

Universal Life

Catching the rising tide of high interest rates far exceeding anything seen in United States history, Universal Life (UL) policies, first intro-

duced in 1977, exploded on the American life insurance scene, capturing a 50% market share (by amount of face cash value life insurance) as early as 1983. Such policies were touted by misguided financial writers of that time as superior to suddenly old-fashioned whole life contracts. While some early UL versions were consumer-friendly, the reason was that commissions were lower. It did not take long before a kind of reverse competition set in: the highest commission, least consumer-oriented contract won the loyalty of agents. Low commission UL contracts ended.

But it was the following oft-described attribute of UL policies that caused so much consumer harm: UL was the "perfect replacement vehicle." UL's premium flexibility meant that cash values of existing policies could be "rolled over" into a UL policy. The cannibalizing of existing whole life policies reached a zenith in the mid-1980s when one in every two sales of a cash value policy was a replacement.

In a very high percentage of replacements, consumers gave up policies against their own best interests. It took no genius to see that dividend-paying, existing policies in companies using portfolio dividend interest rates would in time outperform new UL policies, and of course that occurred rather quickly, by the late 1980s.

Trends in policy terminations in the last 50 years help make this point:

Year	Policies in Force less than 2 years	Policies in Force 2 Years or More	All Policies in Force
1955	11.4%	2.5%	3.8%
1965	15.4	3.5	5.1
1975	20.9	4.5	6.7
1985	20.9	8.3	12.3
1993	17.4	5.8	7.6

Losses to American consumers from the unbridled replacements of existing cash value life insurance policies in the 1980s were enormous. Regulations put in place in many states, ostensibly to protect consumers, seemed to have no such effect. Indeed, they may have accelerated replacement activity since a replacing agent following the procedures had the imprimatur of the state placed on his activity, regardless of its merits. The replacement regulations served as "How-to-do-it Kits" for agents and brokers.

Vanish Premium Sales

Marketing whole life policies with level premiums payable until age 95 or 100 as "paid-up" after five to ten years by use of non-guaranteed dividends was both a response to and accelerated by the premium flexibility of UL. When, predictably, interest rates dropped and so did dividend scales, the failure of agent promises about how many years of payments would be needed to make the policy "paid-up" garnered immense adverse publicity for the industry and has led to many lawsuits. (There is some irony in this, since little financial harm was done to consumers—only optimistic expectations were dashed.) The vanish premium marketing scheme was a deception that could be understood by all: "The agent said I would only have to pay seven years, and now he tells me it's 12 years."

An old-timer in the life insurance business, returning to this country after a few decades abroad, might wonder: What's all the fuss about? Why didn't the agents 10-pay life policies? The writer has reviewed more than 2,500 life insurance illustrations—proposals and in-force ledgers—for consumers in the last five years. Only one was for a limited payment, whole life policy; it had ten annual premiums guaranteed to make the policy paid-up in that time.

The ultimate vanish premium deception was to present a single payment illustration that in fact contractually required annual premiums to be paid for life. Here, commissions were several-fold higher than in true single payment policies (that our old-timer would remember) and chances that the policy would perform as illustrated low. One may also note that the percentage commission on a 10-pay life policy is generally lower in the first year than that for a vanish premium sale with the same number of illustrated payments.

Company Insolvencies

It may be unfair to associate the unfortunate demise of so many life insurers with "abuse of consumers," but two aspects of the insolvencies deserve comment. First, one might reflect on the reasons why the life insurance business contains hundreds of competing companies, making it more likely that failures will occur; could it be that the lack of price competition that consumers can understand and measure has failed to weed out the inefficient players? Unlike most businesses, the largest companies don't have the lowest costs. These inefficiencies are of course paid for by consumers.

Second, guaranty fund rescues are more consumer unfriendly than mere reference to moratoria on access to cash values make it appear. Two examples: Executive Life policyholders have had their mortality charges raised to the maximum permitted by contract—a 66 year-old male nonsmoker I counseled was forced to pay $65 per $1,000 per year when normal charges would have been $15/$1,000/year; and, one is not permitted to exercise the reduced paid-up option in his contract. These two items are not unrelated, of course, but they are certainly abusive, especially the first. Raising mortality charges to levels higher than industry averages, say, really breaks faith with the unfortunate victims of insolvencies. It can be gotten away with for the same reasons that marketing and pricing abuses are gotten away with: consumers have little ability to deal with the complexities of cash value life insurance and have been supplied with no means of measuring their relative values.

Illustration Malpractices

In testimony before the National Association of Insurance Commissioners' (NAIC) Life Disclosure Working Group early in 1994, the writer identified three reasons why life insurance illustrations can be misleading and/or deceptive. A fourth reason is added to that list below.

Use of Above Market Interest Rates Long-term illustrations of cash value life insurance policies are highly influenced by the underlying interest rate. Such rates are not normally disclosed by dividend-paying life insurers. For nearly ten years portfolio yields of such insurers have been falling, yet the interest rates they use in illustrations ("dividend interest rates") remain above current market yields (after investment expenses and profit margins). Traditionally, and legally for New York-admitted companies, illustrations of dividend-paying policies must be consistent with current dividend scales. Use of illustrations based on current scales, when dividend interest rates exceed currently available net returns, can thereby be misleading. This is especially true for vanish premium sales. A company, faithful to all actuarial and regulatory precepts in its illustrations and conservative in its mortality assumptions, can still mislead.

Lapse-supported Pricing When insurers define policy forms with minimum face amounts of $100,000 or $250,000, or market exclu-

sively in such higher amounts, substantial gains can arise on early terminations. This is, at least in part, because expense allowances in minimum nonforfeiture laws, whose genesis goes back more than fifty years, were designed for average-sized policies. The practices noted violate the spirit of the nonforfeiture laws, which is to return to terminating policyholders what actuaries call the "asset share" for the policy.

In actuarial pricing models, some or all of these gains can be carried forward at assumed interest rates and lapse rates (which can combine to act like a 15 percent interest rate, say) and used to enhance later illustrated values, often those in the 15th to 20th policy years. For example, $1 of gain in an early policy year becomes $2.75 15 years later at 7 percent interest; when lapse is added, $2.75 turns to about $8. In the hands of aggressive actuaries, illustrations can be "juiced up" substantially. Such illustrations are referred to as "lapse-supported."

Consumers have no understanding of how these pricing tactics influence their purchases. If they did, 50 percent of cash value policies wouldn't be lapsed in the first ten years.

Gross Actuarial Manipulations Lapse-supported pricing is common even among mainstream companies, but when done aggressively and combined with not-generally accepted actuarial techniques, highly misleading results can occur. The writer has called this "cheating" and believes that the techniques are not well understood by regulatory actuaries. Or it may be that regulatory actuaries lack support in effecting corrections. Often these techniques combine extreme lapse-supported pricing and mortality improvement assumptions. Or they may include unwarranted interest rate assumptions. One company illustrated values based on an interest rate that could only have been attained by investing 100 percent of that policy form's assets in junk bonds.

Fraudulent Illustrations It is frequently alleged that agents manipulate company-supplied software to generate enhanced illustrations. While some agents may do this, the writer has never seen such an illustration in his practice. But he has seen many improper company-authorized illustrations. A recent example from a prominent company involved "financed insurance," in which systematic policy loans were to be used to pay premiums. The variable policy loan rate,

linked to Moody's Corporate Bond Average, was assumed to continue at a lower rate than the dividend interest rate throughout the prospective insured's life. This type of illustration, the inappropriateness of which any actuary would immediately notice, is the subject of current litigation.

Dial-a-Commission Practices

Following the Armstrong report, anti-discrimination laws were enacted by all states prohibiting life insurers from favoring one class of insureds over another. Until the 1980s these laws seemed effective. In recent years they have been flouted with impunity, particularly by or at least initially by, universal life companies. It is now unremarkable for two policyholders, similarly situated in the same underwriting class, to receive differing prices from the same insurer. The in-the-know buyer can demand a low commission policy while the neophyte receives a high commission policy, all of which is completely undisclosed in the sales process.

The existence of such "legal rebates" can be traced to a little noticed aspect of the life insurance business: commission schedules that do not include declining percentages as the face amount sold increases. Agents expect to make about ten times as much selling a $1,000,000 policy as a $100,000 policy. Truly competitive markets, such as group employer life insurance, do not allow this kind of excessive sales compensation.

One could of course deem the advent of "legal rebates" a positive one for consumers. Perhaps it is, but its existence shouldn't be hidden.

Concerns about life insurance consumers in this century were of course not limited to the Armstrong investigation and the FTC report. This writer began his life insurance career in 1955, a time of calm in the business—witness the low lapse rates in the table above. It was about this time that companies first dared to give modest policy discounts for larger policies—quantity discount factors as they were called by some, later policy fees. It was thought previously that such a practice violated the anti-discrimination laws. Shortly thereafter, rates were split by sex, though the means was a three-year set-back of male rates despite evidence that a six-year set-back could have been justified. These developments created no public controversy among insurance professionals or regulators, but in 1966 Professor Joseph Belth published *The Retail Price Structure in American Life Insurance* in which

he suggested a uniform system of information disclosure. He also catalogued a series of deceptions he saw in the sale of life insurance, most having to do with the failure to impute interest to various measures of cost in cash value life insurance illustrations.

In 1968, U.S. Senator Phillip Hart became concerned that Vietnam veterans were being sold conversion life insurance policies upon termination of military service without any means of comparing relative costs of those policies. He suggested a Truth-in-Life- Insurance Bill modeled after the then recently enacted Truth-in-Lending Bill. About this time the Office of Consumer Affairs in the White House evidenced an interest in comparative price information in life insurance.

These developments inspired the two major industry trade associations to appoint a joint committee of industry actuaries and others. In 1970, it recommended that the traditional "net-cost" method of comparing policy projections of future values be replaced by the "interest-adjusted" method. Nothing happened, however, until 1972 when Commissioner Denenberg of Pennsylvania published shoppers' guides containing price comparisons using the interest-adjusted method. The guides received considerable publicity.

Senator Hart, in early 1973, held hearings on life insurance price disclosure. Later that year, the NAIC developed the first model solicitation regulation incorporating the indexes, which was succeeded by a somewhat more elaborate model in 1976. By the late 1970s, more than 30 states had adopted the model and most life insurers were using it throughout the United States. Disclosure under the solicitation regulation continues essentially unchanged to this day.

Professor Belth has described disclosure under the 1976 Model Solitation Regulation as "pseudo (fake) disclosure." Among his reasons are that it fails to "require disclosure of: (1) price information that would disclose the magnitude of the front-end load; (2) price information beyond 20 years; (3) information about the rate-of-return on the savings component; and, (4) information on an annual basis to owners of existing policies."

The interest-adjusted method of comparing costs has always been flawed, both actuarially and as a consumer tool. The actuarial problem is that it fails to control for differing amounts at risk in policies that are compared. This led to the rule in the Regulation's required *Buyers Guide* (but not on illustrations) that comparison of interest-adjusted indexes should be restricted to "similar plans of life insurance" and to the advice that the "closer policies are to being identical the more

reliable the cost comparison will be." This deficiency led one NAIC group to conclude that the system of relative cost disclosure was "fatally flawed and seriously defective." From the consumer's viewpoint, the index disclosures are completely mysterious. They include no frame of reference, no implicit or explicit "yardstick," as do "Annual Percentage Rates" under Truth-in-Lending, for example, or energy ratings on appliances. Thus, consumers have no sense of what constitutes a low cost index number or a high cost index number. If they have studied the *Buyer's Guide*, they are instructed that lower is better, but if they are looking at indexes of two companies, both of which are high, they only know that A is better than B, even though both are poor values.

With the advent of UL, policies were "closer to identical" only by an accident. Further, higher interest rates favored not only higher premium policies (per $1,000 of face amount) but also encouraged lapse-supported pricing to lower 20-year surrender cost indexes. Today, even the National Association of Life Underwriters (NALU) has called for abolishing the indexes. Evidently NALU has been joined in its stance by the American Council of Life Insurance (ACLI). NALU and ACLI recently co-published a new booklet, "What You Should Know About Buying Life Insurance," that makes no reference to use of the indexes to compare relative costs. Neither of these organizations has suggested an alternative means of allowing consumers to compare relative costs of cash value life insurance policies, however.

In the last fifteen years, three sets of oversight hearings have been held in the Congress on life insurance consumer issues, all under the aegis of Senator Howard Metzenbaum. In 1979, the hearings focused on life insurance cost disclosure. In 1984, replacements were the main topic. Most recently, the 1992/1993 hearings dealt with illustration issues. The hearings were useful in spotlighting these issues, and it is possible that NAIC action spurred by the last set of hearings may eventually result in new illustration rules in one or more states.

Following the 1993 hearing, the NAIC released its "white paper" on reforming life insurance illustrations. This report had a determined quality that drew praise from Senator Metzenbaum, who journeyed to the Boston NAIC meeting in September 1993 to encourage the NAIC to continue its work. Eighteen months later, the NAIC is still working on a model regulation. No state has issued any rules governing illustrations in the interim, even though each state has an Unfair Trade Practices Act that could have been used, at a minimum, to prohibit

some of the most egregious illustration practices. At this writing, the activities of the NAIC's Life Disclosure Working Group represent "the only game in town" for those interested in regulatory reform of the life insurance business.

The Life Insurance Illustrations Model Act and Regulation

The Life Disclosure Working Group (LDWG) is a group of commissioners and insurance department staffers designated by the NAIC's Life Insurance Committee in September 1992 to study the problems in the business and formulate solutions. It is currently chaired by Commissioner Robert Wilcox of Utah, a life insurance actuary, and it is assisted by the Technical Resource Advisors, dominated by industry actuaries and lawyers. It does include the author and one other consumer representatives, .

Some of the illustration problems identified in the LDWG's White Paper of August 1993 were:

1) Inappropriate use of illustrations to estimate future performance and to compare performance of different policies;

2) Lack of a standardized illustration format;

3) Lack of standard definitions, assumptions and methodology in illustrations; and

4) Lack of company or agent accountability.

Alternative solutions to be explored were:

1) Use of standardized assumptions in illustrations;

2) Prohibition of illustrations of future values; only illustrations of past performance—the "mutual fund model" —would be allowed;

3) Adoption of a universal format and definitions; and

4) Promulgation of uniform rules that provide clear disclosure of the use of illustrations and their assumptions.

The white paper's outline of the problems and possible solutions provided a good framework for the work of the LDWG. Unfortunately

the group focused on the "mutual fund model" for about a year before being finally persuaded by the life insurers that it was an impracticable goal.

At this writing, the LDWG is heading in a direction that combines elements of solutions 1, 3 and 4 above. Standards would be set for "Basic Illustrations" and "Supplemental and Concept Illustrations." While actuarial assumptions would not be standardized, they would be subject to some form of supervision. This issue appears to be difficult for the LDWG to deal with, both politically and technically.

A Consumer Advocate's View

What has been particularly distressing during the last several years has been the complete reluctance of insurance commissioners to deal with the well-known illustration excesses. Every commissioner has an Unfair Trade Practice Act that could be invoked to proscribe the more egregious illustration practices, yet none has done so.

There has been some tendency to blame problems on "rogue agents," which neatly sidesteps the problem. The superintendent of insurance in New York, the one regulatory state with special powers over the life insurance business flowing out of its extra-territorial limits on acquisition expenses, issued a bulletin, brave in tone, asking companies to investigate and report on "Questionable Marketing and Sales Practices." The bulletin failed to ask that the companies also investigate the products their actuaries were offering to their marketing departments. Plenty of regulatory energy was devoted to the activities of Metropolitan's rogue agent in Florida, who sold whole life policies, neither lapse-supported nor containing actuarial tricks, to nurses by disguising them as retirement plans, a marketing trick, deserving of regulatory sanction, but only partly related to illustration malpractices.

The NAIC's LDWG made an early decision that the path to reform lay in first developing a model *law*. If enacted in any state, it would give power to the commissioner to promulgate a regulation governing life insurance sales illustrations, despite the contention of some that such powers were already held by commissioners. When it was in the life insurance industry's interest to secure development of a system of relative cost disclosure in the 1970s, the Unfair Trade Practices Acts were sufficient authority for action. True, commissioners may need authority to require all life insurers to use the same illustration format

or to use standardized actuarial assumptions, but they do not need further authority to clean up illustration practices that mislead and deceive. Accordingly, the LDWG got bogged down in trying to come up with both sanctions against malefactors and the perfect tool by which consumers could be better informed about the policies they buy. This was a tall order, and many have labored diligently in the effort. Meanwhile illustration excesses continue.

As a former insurance commissioner, the writer came to understand that a regulator frequently has two courses of action: regulate the products or regulate the sellers. In auto and homeowners coverages, the product is regulated (standardized) and competition among sellers works pretty well to minimize prices in those states that don't regulate them. In life insurance, the product is essentially unregulated, neither standardized nor subject to effective price competition. Trying to restrain a free-wheeling market like life insurance by regulating the sellers (agents) is an impossible task. It is better to place limits on the products.

The NAIC's LDWG operates at a disadvantage. The industry can muster greater technical talent, and it has long had the political clout to get its own way at the state level.

When the life insurance business faced superior power in the right of the Securities and Exchange Commission to regulate variable products, it was forced to play by someone else's rules. The result has been a much healthier market. There are no lapse-supported variable life illustrations, for example, because there are no opportunities under SEC rules governing cash surrender values to make substantial gains on terminating policies, as there are under the states' nonforfeiture laws. The reality of the life insurance industry's power forces consumer advocates to acknowledge that the only hope for reform lies within the industry itself. Fortunately, there is a great deal of good will and determination in the life insurance industry to achieve reforms. This is partly motivated by a desire to head off future litigation. Whether this can be translated into action at the state level remains to be seen.

It is likely the LDWG will come up with a model regulation that includes:

1) Rules for illustration formats—a requirement, for example, that guaranteed values be shown first;

2) A requirement that the insurer's "illustration actuary" sign off on all illustrations, following the development of professional

guidelines to be established by the Actuarial Standards Board, a private body within the American Academy of Actuaries; and

3) Possibly, a rule that illustrations be "self-supporting" and that they contain neither "lapse-supported pricing" nor "persistency bonuses."

Trying to design an illustration format that harmonizes both life insurers' needs to sell and consumers' needs to understand is probably impossible. If we could turn back the clock forty years to an era of low interest rates and plain vanilla whole life contracts, there would be a chance of success. The advent of universal life, however, allowed a complete "differentiation of the product," the goal of all businesses and the bane of all consumers. There is only a limited range of consumer disclosures that could be useful when all "life insurance is sold and not bought" and there is no way to "kick the tires." A blazing orange sticker prominently affixed to the first page of every cash value policy declaring, "If you drop this policy in the first five years you will lose a bloody fortune," could be effective. What chance of industry acceptance does that have?

In the early work of the NAIC's LDWG, there was some sentiment to limit illustrations to guaranteed values only. Illustration of guarantees only would greatly reduce the blizzard of figures accompanying virtually all illustrations today. Consumers would have a better chance to notice the zero surrender values in the first year or two. In Japan, for example, all life insurers play out of the same rate book, competing on dividend performance, a system that, by definition, limits deception by illustration. Propose a guarantees-only system for the U.S., however, and you will be met by a chorus of complaints that this would prevent life insurers from showing clients "how the policy really works." Guaranteed values are not realistic they would say. Yet neither are even honestly illustrated current values that have not been deflated for the inexorable decline in the purchasing power of the dollar. Showing consumers huge cash surrender values at age 65 is a very big selling tool, enhanced in recent years by highlighter pens. Never mind that most consumers have no ability to deflate those numbers to present values.

There is no chance regulators will come up with any measures designed to affect significantly prevailing sales practices in the U.S. There is a chance that they will come up with a better illustration format, and there is some chance that such a format will enhance

consumer understanding a bit. The real question is whether the regulators can rein in the actuaries.

The LDWG's goals of prohibitions on lapse-supported pricing and persistency bonuses and of self-supporting illustrations, all policed by the company's illustration actuary, are highly ambitious. Lapse-supported pricing arises out of nonforfeiture laws, conceived in an entirely different era, that give rise to large windfalls on early terminations when companies design whole life products with minimum issue limits of $100,000 or $250,000 or market universal life policies unheard of decades ago. Lapse-supported pricing is practiced by virtually all life insurers to some degree. The dicey task is to say when some lapse-support is too much. Certain companies with great reliance on lapse-supported pricing have not been conspicuous in the deliberations of the LDWG. One may expect them and their agents to take notice if a model regulation crafted by a voluntary association looks like it has a chance of becoming law in a state where such companies have political influence. Universal life companies can be expected to note that some very solid mutual life insurers have paid termination dividends, persistency bonuses by another name, for decades. It will be a small miracle if these prohibitions stick.

The work of the LDWG that goes to the heart of actuarial product design has been handed over, surprise, to the actuaries. The Actuarial Standards Board (ASB) would be empowered by regulation to set guidelines for illustration actuaries. Some actuaries have already noticed that existing ASB standards relevant to product design are ignored by practitioners. The LDWG is rightly concerned that a professional body cannot make the hard decisions needed, no matter the diligence and integrity of those involved. This example may suggest why.

Persistency bonuses at their simplest might, for example, add an extra .5 percent interest to the current interest rate of a universal life policy after 10 policy years, add another .25 percent after 15 years, and add another .25 percent after 20 years. These bonuses are routinely disclosed in illustrations. While they raise doubts about whether they will later be financed by reducing current interest rates below normal, one can at least see that they exist. Aggressive mortality assumptions, on the other hand, are never disclosed as such and, unless extreme, may defy expert analysis.

Suppose Art Actuary is under pressure from management to produce illustrations matching after 20 years those of companies currently using higher interest rates in their dividend scales ("dividend interest

rates"). Art has heard that the relatively new preferred nonsmoker class shows mortality in the first 5 policy years 30 percent below normal. He decides, therefore, to price his competitive product using 70 percent of his observed nonsmoker experience *for all policy years.* But no one knows what preferred mortality beyond 5 years will look like since the class hasn't been in existence long enough. The careful actuary will assume preferred mortality will tend to approach normal nonsmoker mortality, but if Art assumes this his company's illustrations will fall short of the target. Art is going to buckle his knees.

One life insurer, in the top ten by assets and very highly regarded, appears to use in its illustrations preferred nonsmoker mortality rates 30 percent lower than another equally regarded insurer with a dividend interest rate about .75 percent higher. It is obvious that these undisclosed practices need either disclosure or regulation. But disclosure may involve proprietary information.

How does the ASB, a private professional organization, deal with this problem? One way is to issue its usual guidelines: actuaries will be subject to professional discipline if, upon challenge, they are unable to justify their preferred nonsmoker assumptions. How does the ASB conclude that Art Actuary is wrong? Alternatively, the ASB can set down minimum standards for mortality assumptions: a rate below $10 per $1,000 per year at duration 10 for an issue age 60 male preferred nonsmoker may not be illustrated, for example. Would there be anti-trust implications in such ASB activity? On the other hand, commissioners either have the authority to set minimum actuarial standards for illustrations or could acquire it by the sort of model law the LDWG earlier drafted.

The matter of actuarial guidelines or state-set actuarial standards is under active debate at this writing. It is difficult and contentious. Inability to deal with the issue effectively will tend to vitiate any other measures. But suppose the LDWG recommends to the NAIC a model regulation giving the ASB authority to promulgate minimum mortality standards for illustration actuaries and proscribing lapse-supported pricing. Will it then be possible for any state commissioner to secure legislation, if needed, or promulgate an unpopular regulation in the face of intense opposition of the life companies?

To a large extent, tough illustration rules will work against universal life companies, generally stock-holder-owned, and thereby in favor of the "big eastern mutuals." Certain major universal life companies rely heavily on lapse-supported pricing and have a lot at stake.

In any stock/mutual battle at the state level, the stock companies are likely to have plenty of clout.

Relative Cost Disclosure in Life Insurance

It is dismaying that none of the extensive deliberations of the LDWG over the last two years has sought to supply consumers with an effective means of comparing cash value life insurance policies either to each other or to the alternative of buying term life insurance. This issue, by unstated agreement, is "off the table." While any illustration regulation will accommodate continued disclosure of the interest-adjusted payment and surrender cost indexes of the NAIC model solicitation regulation, which are required to be given to consumers in a majority of states and which insurers supply voluntarily in all states except California, there appears to be little contention by any party that the disclosures do any measurable good. The National Association of Life Underwriters (NALU) in testimony before the LDWG made a number of recommendations including:

> Delete the interest-adjusted costs indexes . . . because these indexes are no longer useful for today's products. These indexes can be useful for historical purposes, but there is no index that can be devised to adequately compare policies. This is because indexes are based on illustrations [that] cannot be satisfactorily used to compare policies (Robert M. Nelson, March 8, 1993).

While NALU got the first part of its statement right (for cash value policies, since the method is acceptable for term life policies), the implied conclusion that comparisons of cash value policies are impossible if illustrations must meet carefully crafted standards (or even if they don't) is questionable.

The interest-adjusted method of comparing cash value policies is actuarially flawed, since it does not adjust for differing amounts at risk. A preeminent actuary wrote a paper for the Society of Actuaries (Charles Trowbridge, 1980) suggesting one way to correct this flaw, but it never received the attention it deserved. The life insurance business evidently prefers a flawed relative cost disclosure system to any system that might work accurately.

Because the NAIC adopted a "Yield Index" model regulation in 1989, the LDWG in its work on illustration reforms has a defensible position in ignoring the lack of effective relative cost disclosure for cash value policies. Effective in November 1994, California became the first state to require routine disclosures of Yield Indexes on cash value policies. Such indexes can be used to compare policies to each other and, when currently proposed amendments fine-tune certain assumptions, to the alternative of buying term life insurance. The industry has opposed the California initiative on various grounds: that it adds to insurer expense, that it can be misleading in certain instances, and, ludicrously, that since cash value life insurance is not an investment, an index labelled a "yield" should not be associated with it. The NAIC Model Yield Index Regulation substitutes disclosures like these for the interest-adjusted surrender cost indexes:

If Policy Kept	Yield Index
5 Years	−4.7%
10 Years	3.2
20 Years	6.3

This pattern might apply to a universal life illustration with a current interest rate of 7 percent. Yield Indexes have these advantages over surrender cost indexes:

1) The calculation imputes market costs of term life insurance to successive amounts at risk each policy year (death benefit less surrender value) and thereby overcomes the flaw in the calculation of the surrender cost index;

2) The disclosures come with a "yardstick," that is, the indexes have some intrinsic meaning, particularly with some consumer education, while the surrender cost indexes are meaningless numbers;

3) The method, due to the first advantage noted, can be used on in-force policies, a critical need when consumers have no means of countering the activities of replacement artists;

4) The negative returns for fully-commissioned policies in the first five years warn consumers that they need to keep their policies a long time to make them pay off; and

5) The long-term returns establish the investment advantages of cash value policies, particularly when agents explain the tax advantages of life insurance.

The Yield Index is a variant of the "Linton Yield" method of analyzing the investment returns of a cash value policy. The answers would not differ in any significant way. It is worth noting that Albert Linton was an actuary and president of a life insurance company who devised the method to show the investment advantages of life insurance over comparably safe investments.

The Linton Yield method has been used in recent years by the Federal Trade Commission in its 1979 study, by *Consumer Reports* magazine in its periodic studies of life insurance, and by the writer in the Rate of Return Service offered consumers by the National Insurance Consumer Organization during the last ten years.

Conclusions

For years life insurers have been losing market share to alternative investment media. This has occurred despite the tax advantages held by the business, which became greater with the closure of tax shelters and the elimination or reduction of favorable capital gains tax treatment. As one who talks to many financial reporters, my perspective is that the business is held in low esteem. "Legalized thievery," said one, who is not known to be anti-business in general. Perhaps the industry's political power over its regulators produces a paradoxical result: reforms tolerated by the industry can never be cleansing enough to remove the stains built up over such a long time. So it is with little hope that the following recommendations are offered as a means by which consumers can better be served. Only if consumers are put first will life insurers enjoy their confidence.

- *Illustration reform* The reform of illustration formats alone will help little; consumers cannot be expected to become life insurance experts. Either effective actuarial rules must be laid down, or if this is impossible, disclosures must reveal pricing games like lapse-supported policy values or covert mortality improvement assumptions. One way to do this is by providing one-year rates of return on illustrations, a powerful technique in revealing actuarial tricks.

- *Rate of Return Disclosure* The industry needs to abandon its schizophrenia about whether it sells investments or not. It does. Consumers are entitled to get some idea of the return on their cash value life insurance premiums; universal life's early popularity suggests they will respond favorably to such disclosures. Such disclosures should extend to in-force policies.
- *Commission disclosure* Buyers of variable life insurance can learn from the prospectus what commissions the selling agent receives. Commission disclosure has gone into effect in the United Kingdom and Australia. It can have a beneficial effect in the U.S. An alternative, probably less effective, would be limitations on sales compensation, as in New York.
- *Suitability Requirements* Variable life sellers are under a legal duty to find that sales of such policies are suitable for the buyers, a small burden that appears not to have hampered such sales. Similar requirements should extend the replacement of existing cash value contracts.

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Life Insurance Industry Enhances Market Conduct Efforts

Anthony T. Spano*

Abstract

Sales malpractices and economic changes have created market conduct problems for the life insurance industry. After a brief discussion of these problems, this paper describes several industry efforts to address them. These have involved individual company initiatives as well as collaborative efforts with other companies and state insurance regulators. A major objective has been to assure company compliance with market conduct laws and regulations. Also, the major industry trade association has published a consumer booklet on life insurance that has been well-received. Finally, the industry has been working with the state regulators to help develop a producer database and introduce discipline into the sales illustrations process.

Causes of Market Conduct Problems

To some extent, the market conduct issue became prominent because of certain highly publicized sales malpractices. We can classify these incidents into two overlapping categories. One of them might be labeled "inappropriate or misleading sales." We've all heard of the insurance policies passed off as retirement plans, with no reference to premiums but rather to "deposits," and of the limited partnerships

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and joint ventures offered with inadequate disclosure by unlicensed salespeople.

The other category involved the replacement of existing policies with new policies. Many factors have to be considered when weighing a replacement. The conscientious agent will review these with the policyholder. Unfortunately, in some situations it appeared that a new commission for the agent was a prime motivation for the transaction.

While newsworthy, these episodes alone would not have kept the market conduct issue in the forefront for long. Misleading sales approaches and inappropriate replacement were not new phenomena and, despite the heavy publicity, only a tiny fraction of life insurance policyholders were directly touched by them. Something else happened, and it affected many policyholders.

For many years, insurance companies and their policyholders reaped the benefits of increasing interest rates. Combined with the steady decrease in mortality rates, the higher interest rates enabled companies to reduce the costs of insurance policies and to illustrate very attractive benefits to prospective policyholders. For a long time, the benefits actually paid to life insurance policyholders not only met the illustrative figures but usually exceeded them. Agents and their customers were conditioned to think that illustrated benefits reflected current scales, but that tomorrow would be better.

The drop in interest rates in the nineties changed this picture profoundly. Companies were forced to cut dividend scales and interest crediting rates, and in many cases could not provide the benefit amounts illustrated. The effect was particularly noticeable for insureds who had been sold policies on a "vanishing premium" concept, under which illustrated dividends or interest credits would eventually be large enough to pay the entire policy premium so that the policyholder would have no out-of-pocket outlay beyond a certain duration. The changed interest rate environment confronted policyholders with the reality that premiums would not "vanish" as early as had been expected, or of seeing premiums that had briefly vanished suddenly reappear. The resulting consumer disappointment was intense and widespread.

Even companies that had been particularly diligent in controlling sales practices and conservative in their sales illustrations realized that some review and possible adjustment of procedures was necessary to better serve the insurance-buying public. Acting on their own or as part of an industry-wide effort and in some cases jointly with state

insurance regulators, life insurance companies have been attempting to seriously enhance market conduct performance. We'll discuss some major efforts.

Compliance Efforts

State laws and regulations cover different aspects of market conduct, such as unfair trade practices, advertising, and cost disclosure. Variations exist in the extent to which these laws and regulations have been adopted by the states, and the provisions can differ significantly from state to state. For companies operating in more than a few states, keeping track of all these requirements is challenging, but necessary. The recent market conduct problems impressed on companies the importance of having procedures in place to assure compliance with all applicable laws and regulations.

In this connection, companies have strengthened and given greater authority to their compliance organizations. Many companies formed or expanded compliance departments and appointed compliance officers. Sales materials and procedures were reviewed, and in some cases companies suspended the use of all sales materials until they could be carefully scrutinized and approved.

Companies also have strengthened agent training and monitoring programs to help ensure field-force compliance with legal requirements and ethical marketing practices. In addition, procedures for investigating and resolving consumer complaints, particularly those relating to sales practices, have been reviewed and improved.

We at the American Council of Life Insurance (ACLI) have been assisting our companies in their compliance efforts. In July 1994, we held a compliance seminar to underscore the importance of ethical marketplace activity and to provide information about market conduct requirements and how to assure compliance with them. Before the seminar, it was unclear how well it would draw, particularly on short notice in the middle of the summer and in light of many similar programs that were being presented by other organizations around the country. Preliminary estimates were for an attendance of perhaps 150 people. We drew nearly 500! Furthermore, the attendees found the seminar so helpful that we immediately started getting questions about when we would hold another one. We plan to schedule two of these

a year for some time, which leads to the subject of ACLI's new Compliance Section.

The purpose of the Compliance Section is to identify market conduct compliance topics, to provide for the distribution of compliance information and ideas, and to prepare papers and studies on compliance topics. The Compliance Section will also be responsible for planning and running the compliance seminars, the second of which was conducted in March before another large group of company compliance officers.

Finally, we are busily preparing a comprehensive manual of market conduct laws and regulations. We are hoping to complete the manual and distribute copies to our members later this year. Pending completion of this massive effort, we have distributed a series of compilations on some of the pertinent market conduct topics.

Consumer Booklet

The ACLI also has published a consumer booklet, "What You Should Know About Buying Life Insurance." This easy-to-read reference provides consumers with basic information about the major life insurance products and includes questions for the consumer to ask agents when buying life insurance. We developed the booklet with input from companies, agents, and consumers.

Several positive media stories have appeared about the booklet, including one in *The New York Times* and a segment on the CBS "This Morning" program. In addition, the U.S. Office of Consumer Affairs has agreed to endorse the publication, allowing the Consumer Information Center to distribute it from its Pueblo, Colorado facility.

Member companies are ordering copies of the booklet printed with their logos. The ACLI will continue to promote this booklet aggressively with the media, third-party groups, and the public.

Producer Database

In addition to market conduct actions it has taken on its own, the life insurance industry has been involved in two major efforts with the National Association of Insurance Commissioners (NAIC). The first concerns the development of a producer database by the NAIC for

use by state insurance departments and insurance companies. National in scope, the database will include information regarding disciplinary actions taken by insurance departments and other authorities against producers—information that often has been difficult for companies to obtain. Availability of this information will help companies considerably in screening applications when recruiting agents. The industry has furnished input regarding the items that would be helpful to include in the database and continues to assist in its development.

The second major effort concerns the control of sales illustrations, discussed next.

Control of Sales Illustrations

Background

For over 20 years, regulators and industry have devoted considerable effort toward helping life insurance consumers make informed purchase decisions. The early activities focused on providing prospective purchasers with basic narrative and numerical information about life insurance products. This resulted in the adoption by about three-quarters of the states of life insurance cost disclosure regulations based on NAIC models. These regulations provide for furnishing prospective purchasers with:

- A Buyer's Guide containing narrative information to assist the purchaser in determining how much and what kind of insurance to purchase, and how to compare the relative costs of different policies.
- A Policy Summary providing numerical and other information regarding policy premiums and benefits as well as cost indexes for comparing the relative cost of different policies.

These cost disclosure regulations were in place by the early 1980s, but the product revolution and accompanying market changes that began about 1980 caused the regulatory focus to switch to the nature and credibility of advertising and sales illustrations. Since then, the control of sales illustrations and other advertising for life insurance products has been an active issue within the NAIC, especially during the last several years. Among the reasons for this:

- The increased competitiveness and product complexity within the marketplace has generated creative efforts to enhance illustrations.
- Companies and agents have ready access to increasingly sophisticated computer technology.
- Lower market interest rates have forced companies to reduce dividend scales and interest crediting rates, causing disappointment among policyholders who had been furnished illustrations of vanishing premiums and high policy values based on higher market interest rates in effect at the time of sale.

We will now turn to the main features the industry feels should be included in any regulation controlling sales illustrations. They involve the concepts of a "disciplined current scale" and a "sensitivity test."

Disciplined Current Scale

The NAIC model advertising rules require that illustrated nonguaranteed values be based on the insurer's "current scale." At first blush, it would seem that extravagant illustrations could be eliminated simply by having all states enact this provision of the model rules. The problem with this reasoning is that the term "current scale" has never been precisely defined and some creative interpretations are therefore possible. To attempt to solve this problem, the industry is promoting the concept of a "disciplined current scale" (DCS) as a regulatory restraint on sales illustrations.

As its name suggests, the DCS approach seeks to introduce discipline into the illustrations process. Illustrations of nonguaranteed amounts would have to be based on historical events that have actually taken place, and the scale would have to be logically and reasonably related to actual recent historical experience. For a company, "actual recent historical experience" could be the company's recent experience if the company has enough experience for it to be credible, or recent industry experience or experience from other recognized sources if the company is small or industry experience for the particular risk is lacking. The scale would have to conform to standards established by the Actuarial Standards Board, and each company would be required to have a qualified actuary certify at least annually that the company's illustrations meet those standards.

A few examples may clarify what types of assumptions could or could not be used in determining a company's DCS:

- If a company actually splits its new business into smoker and nonsmoker classes, it could determine its DCS for nonsmokers on a logically and reasonably based reduction in mortality from the recent mortality experience of its combined business. However, the certifying actuary would also have to show an appropriate increase in the mortality rates underlying the DCS for its new smoker business.
- If a company actually lowers commission rates on a policy, it could reflect the resulting future reduction in policy expense rates in its DCS. On the other hand, a company would be prohibited from improving its DCS by assuming that future unit expense charges would drop because of an anticipated increase in new business.
- If a company has actual evidence that its mortality improved by one percent over the past year, it could incorporate that one year's improvement into its DCS. However, it would be prohibited from assuming that the mortality continues to improve each year into the future. Likewise, interest improvements extrapolated from recent historical trends in the company's interest earnings would be prohibited. In other words, any trends of improvements in nonguaranteed amounts must be based on actual historical experience, and additional improvements in the future could not be assumed.

A vital piece of the DCS concept is the reliance on standards developed by the Actuarial Standards Board. Development of these standards will not be easy, since they will have to be specific enough to be effective but broad enough to accommodate differences in types of products and in methods of developing nonguaranteed scales. The project is scheduled for completion in the spring of 1996.

Sensitivity Test

We also feel it would be useful to give purchasers some idea of the sensitivity of the illustrations to changes in nonguaranteed assumptions. This can be accomplished in several ways. Under one proposal, each DCS illustration would have to be accompanied by an illustration

using an interest factor that is one percentage point less than the factor in the DCS. Alternative approaches include: 1) reducing the interest factor by an amount that varies depending on the level of the factor, i.e., by a larger amount if interest rates are high and by a smaller amount if interest rates are low, 2) using an interest factor that is the average between the guaranteed factor and the DCS factor, and 3) changing other nonguaranteed factors in addition to the interest factor. An additional advantage of requiring a sensitivity test is that it would serve to impress further on the consumer the nonguaranteed nature of the illustrated values.

Conclusion

The life insurance industry has long been committed to helping the consumer understand life insurance and make an informed purchase decision. The recent market conduct problems have given additional stimulus to these efforts. Companies have vigorously attempted to ensure compliance with legal requirements, and the recently published consumer booklet should be an additional aid to prospective life insurance purchasers. The industry also has been helping state insurance regulators in designing laws and regulations to improve the quality and accuracy of consumer information, particularly that contained in sales illustrations. The development of a producer database is another significant example of the industry working with the regulators to enhance market conduct efforts. We look forward to continuing this productive process.

Life Insurance Cost Disclosure

A Regulatory Viewpoint

Dwight K. Bartlett, III*

Abstract

The paper reviews the issues with which regulators have been concerned, in many cases over many decades, with respect to effective cost disclosure to consumers for life insurance policies. These issues include who should regulation cost disclosure, how is "cost" to be defined for life insurance, what types of manipulation can occur depending on how cost is defined and how these issues have been affected by the introduction of interest-sensitive products, primarily Universal Life. The author suggests that many of the regulators' concerns should be addressed by vigorous action by the actuarial profession in developing and enforcing relevant standards of practice for its members.

Introduction

The question of how to make useful cost disclosure of life insurance products to consumers has been of concern to regulators for many decades. The core issues have been present over the years, although the specific proposals have changed as the business environment has changed, such as the changing sophistication of consumers, improved

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technology, evolution of the distribution system, and, perhaps most importantly, changes in life insurance product design.

This article is not intended to be a definitive, exhaustive history of the regulation of life insurance cost disclosure, but rather it is an attempt to identify the principal issues with which regulators have had to deal and to discuss some of the proposed and/or implemented solutions. Interested readers may wish to review various versions of the model regulation that have emerged over the years.[1]

Whose Responsibility

While it is not appropriate to review the whole history of state vs. federal regulation of the insurance industry, it is worth noting that, in the McCarran-Ferguson Act of 1945, the federal government agreed to defer to state government as the primary insurance regulator, and to stay its hand where there is active state regulation. This latter provision has produced, over the years, a substantial degree of tension between federal and state governments since it introduces an area of judgment as to what is adequate regulation.

The most notorious attempt by the federal government to enter the issue of cost disclosure occurred in the form of a controversial 1979 Federal Trade Commission staff study on life insurance cost disclosure (FTC, 1979). As has occurred in other areas of regulation, this study led to no formal regulation by the federal government, but did prompt state regulators to be more aggressive as well as inducing the industry to be more vigilant in monitoring its own conduct. Since the 1979 study the federal government has generally been inactive in this area.

While not constituting governmental regulation, which is the primary focus of this article, there have also been efforts by the life insurance industry, agents' professional associations and the actuarial profession to assure ethical conduct in the matter of cost disclosure. These efforts will be commented on later in this article.

1. See, for example, the versions of the Life Disclosure Model Regulation adopted by the NAIC in December 1975, December 1983 and June 1989, as well as current proposals. In addition, various supplementary documents have been issued, applicable to Universal Life and Variable Life.

How to Define "Cost"

Effective cost disclosure requires the development of a generally accepted definition of what constitutes the cost of a life insurance policy. This definition has demanded the attention of groups with their own particular orientation, such as life insurance agents, actuaries and academics, as well as regulators.

For fixed premium, fixed face amount, traditional type policies the generally accepted measure of cost prior to the last several decades was: for each policy year, that year's gross premium less that year's policy dividend, if any, and less the increase in the cash value in that policy year, if any. This method was called simply the "net cost" method. If the resulting number should be negative, it was represented as "profit" or "gain." A prospective policyholder would typically be presented by an agent with an exhibit that would display both the components and result of this calculation, policy year by policy year, and the sum of the components over a fixed period, such as twenty years.

The author remembers well the book of such exhibits his former employer provided each of its agents for $10,000 whole life policies at each adult issue age. This book was entitled the "Gold Book" and was a primary marketing tool used by agents. Since without exception the dividends and cash value at the end of twenty years exceeded the premiums over that period, the inference was that insurance was a terrific bargain since there was no cost, but rather a profit, while providing death benefit coverage. No sensible prospect should resist such a bargain.

Of course, more sophisticated prospects, as well as industry people and regulators, recognized the misleading character of this type of presentation. To accept the gain over the fixed period of the illustration as a real profit in an economic sense, one had to accept the premise that a dollar paid in the first policy year had the same value as a dollar paid in the last policy year. Other assumptions were that the non-guaranteed dividends shown would in fact be paid, although such exhibits included a disclaimer to the effect that dividends shown were neither estimates nor guarantees but merely an illustration based on the current dividend scale. It further assumed that the policy would remain in force for the entire duration of the illustration and then would lapse at the end of the illustration period.

As long as interest rates stayed relatively low, as they did from the end of the World War II until the late 1970s, there was relatively little concern expressed about the misleading nature of the traditional net cost method. As interest rates began to accelerate during the 1970s, however, the misleading nature of the traditional method came under increasing attack. Thus began the search for a definition of cost that would address at least the most serious weaknesses of the traditional method while retaining a reasonable degree of understandability for prospects who were not familiar with the arcane aspects of life insurance.

Several decades earlier, a cost disclosure method known as the Linton Yield Method was proposed by Albert Linton, a prominent actuary who served as president of the Provident Mutual Life Insurance Company. This method calculated for each policy year of the illustration a cost of the death benefit equal to the product of a one year term insurance rate times the policy's net amount at risk for that year, i.e., the policy face amount less the year end cash value. The one year term insurance rate would be some appropriate standard that might be prescribed by regulation. The resulting yearly term insurance cost would then be subtracted from that year's gross premium, along with the dividend for that year. The residual premium would thus conceptually represent what was needed to cover policy expenses and the increase in cash value for that year. The Linton Yield would be the interest rate that would cause the accumulation with interest of the residual premiums to be just equal to the cash value at the end of the illustration period, plus any policy terminal dividend.

The Linton Yield Method was an improvement because it recognized the time value of money and the cost of the policy death benefits. It was, in fact, the method recommended by the Federal Trade Commission study referred to previously, and very recently has been adopted by the California Insurance Department. It continued to incorporate the assumption, however, that the policy would remain in force for the illustration period and then be cash surrendered at the end of the period. Such an assumption invited manipulation in the development of cash value and dividend scales, discussed in greater detail later.

The greatest weakness of the Linton Yield Method, however, was the difficulty in calculating the yield, particularly in an era before computers became available. Thus, while the Linton Yield Method was widely discussed, it was never incorporated in regulation prior to the

recent action by California. It was seldom used by insurers or their agents.

Other definitions of cost have been proposed. These methods attempt to introduce more complex assumptions as to yearly death rates and/or yearly lapse rates. They are considerably more complex both in concept and in calculation. These methods generally have been developed by academics or sophisticated consumer advocates. None of these methods have been incorporated in state regulation, nor have they been extensively used by the industry. It is beyond the scope of this paper to describe these methods in detail. Standard college text books in life insurance provide descriptions of these methods for interested readers (see Black and Skipper, 1987, Chapter 10).

In the late 1960s a method was proposed by an eminent actuary, Jack Moorhead, and later endorsed by the life insurance industry (Institute of Life Insurance, 1970) that would at least recognize the time value of money and would retain sufficient simplicity to be accessible to prospective policyholders. This is the Interest Adjusted Net Cost method. It actually consists of two separate calculations: one called the surrender cost index and the other called the net payment cost index.

To calculate the surrender cost index, the gross premiums and annual dividends are separately accumulated at a stated interest rate over the illustration period. The accumulated dividends are then subtracted from the accumulated premiums. From this figure is subtracted the cash value and terminal dividend, if any, at the end of the time period. The result of this calculation is then divided by the value of one dollar per year accumulated for the period of the illustration as well as by the policy face amount in thousands. The result can be viewed as representing the average annual cost of the policy per thousand, assuming that it remains in force for the illustration period and then is surrendered at the end of the illustration period. "Cost" implicitly is the mortality and expense cost of the policy.

The second calculation is a net payment cost index. It uses the same calculation as the surrender cost index except that the cash value and terminal dividend, if any, at the end of the illustration period is *not* deducted from the accumulated premiums less dividends. Conceptually it is the average annual cost of the policy over the illustration period assuming it is not cash surrendered at the end of the illustration period.

Because of its relative simplicity, the Interest Adjusted Net Cost method received the support of the industry and was incorporated in state regulation beginning in the mid-1970s. Initially four percent was prescribed as the stated interest rate to be used in the calculation. This rate was later raised to five percent, in response to the greatly increased interest rate environment of the late 1970s and early 1980s. This methodology is a central component of the regulatory approach to life insurance cost disclosure. It is not recommended for cost comparisons of dissimilar types of policies, e.g., policies with substantially differing net amounts at risk.

Manipulation

The methods used by the industry to illustrate cost, and incorporated in regulation, involve simplifying assumptions, as described in the previous section. Any simplifying assumption invites manipulation.

A most egregious example of efforts to use in a manipulative fashion the assumption that policy would remain in force for the duration of the illustration period was the "tontine dividend" policy that became popular in the later years of the 19th century (Stalson, 1942, pp 485–487). It arose from the intensifying competitive environment of the life insurance industry. Unlike modern dividend-paying or participating policies, which provide for the payment of dividends annually, tontine policies contemplated the payment of no dividends until a significant number of policy years (five or more) had elapsed. The divisible surplus, which had been accumulated by the insurance company over this period of years, would then be apportioned among the remaining policyholders. Policyholders who persisted to the end of the tontine period thus would receive the benefit not only of their own policy's contributions to the company's divisible surplus but also of the surplus contributions by other policies that lapsed prior to the end of the tontine period.

The tontine dividend would also exaggerate the effect of ignoring the time value of money in the traditional net cost method. The divisible surplus of the company at the end of the tontine period would have increased substantially as a result of the interest earned on that divisible surplus as it accumulated in the divisible surplus fund, rather than being paid out annually.

The tontine dividend policy abuse was brought forth as a major part of the Armstrong Investigation of the life insurance industry in New York State in 1905 and 1906. All states subsequently adopted laws and regulations that effectively outlawed tontine dividends. They required companies to determine and distribute divisible surplus annually on their participating policies.

Another potential source of manipulation was the adoption of dividend scales that would favor new business policies at the expense of old policies. The latter were presumably generating most of the divisible surplus, but those policyholders might be less attentive to the level of dividends being paid on their policies.

While not specifically required by state regulation, insurers for many years have almost universally used the so-called "contribution method" of allocating divisible surplus among their participating policies. This method requires the company to determine for each policy its contribution to the mortality, expense and interest profit of the company and to apportion the divisible surplus by policy in proportion to its contribution. The actuarial profession has reinforced the usage of the contribution principle by formally recognizing it as the only generally accepted method to be used by actuaries (Actuarial Standards, 1990). Regulators might be expected to verify that life insurers were using the contribution principle as a part of its periodic market conduct examinations of companies.

A third area of potential manipulation is the use of cash value scales that effectively withhold or artificially depress cash values in policy years prior to the end of the standard illustration period, typically twenty years. They then provide for a dramatic increase in the cash value at the end of the period. This is similar to the tontine dividend abuse, i.e., withholding funds from early terminating policies to benefit long persisting policies.

In recent years regulators have attempted to address this problem by adopting as a part of the life insurance cost disclosure model regulation, a "discontinuity index" (Life Insurance Disclosure, 1990, Appendix D). This method assumes that if that calculation exceeds a formula result it is reasonable to infer that the company is engaged in manipulative behavior when developing the cash value scale for the policy being tested. The formula result is the sum of the squares of the second differences in the annual increase in cash values. The success of this approach in eliminating this form of manipulation is not clear.

A fourth area of possible manipulation is related to the issue of the dividend methodology used by an insurer. As previously stated, the so-called contribution principle is used almost universally for allocating divisible surplus by policy. As a part of the contribution principle, traditionally insurers used a "portfolio interest rate" in calculating the interest contribution of each policy. This means they assumed that the assets backing the liabilities of each policy were all earning the same average company interest rate. As the differential between new money rates and portfolio rates began to widen in the 1970s, companies began to develop dividend formulas and experience rating practices that recognized that the newer policies, or at least newer fund accumulations under policies, were backed by assets earning higher investment yields than older fund accumulations. Later in the 1980s, this new methodology for allocating the interest portion of divisible surplus by policy was extended to individual ordinary life policy forms (Black and Skipper, 1987, pp 497–98).

Companies practicing this new methodology gained a competitive advantage for new business in periods in which new money rates substantially exceeded portfolio rates. The reverse, of course, was the case in periods in which new money rates were lower than portfolio rates. Thus, companies would be motivated to move to the investment generation approach at certain times and then to revert to the portfolio rate approach at other times. This raised the issue of how equitable treatment of policyholders could be maintained as a company moved back and forth between the two methodologies.

The author is not aware of any company, which having moved to the investment generation approach, has attempted to revert to the portfolio approach. If a company attempted to do so, regulators presumably would require it to file a description of its new methodology and an explanation of how that methodology would result in equitable treatment of policyholders who previously received dividends computed under the alternative methodology. Adequate disclosure to policyholders of change in methodology seems appropriate.

Interest Sensitive Products

Cost disclosure issues were many and complex for traditional life insurance products, i.e., products with fixed gross premiums and fixed

faced amount. Interest sensitive products, primarily universal life, introduced a new layer of issues.

Universal life policies normally have neither a fixed annual gross premium, nor a fixed policy face amount. Rather the policyholder is free to pay whatever amount of premium he desires within certain limits each year and can request changes in the face amount of the policy, subject only to the insurer's underwriting rules, if the face amount is being increased. The uncertainty of the future dividend payments on traditional products is further complicated by the uncertainty of premium and face amount. Furthermore, universal life policies are normally not issued as participating, i.e., dividend earning, policies but as non-participating policies with non-guaranteed elements.

The universal life concept unbundles the cost elements of the policy into a mortality charge, an expense charge, and a credited interest rate. The former two charges are subject to maximums specified in the policy form and the credited interest rate is subject to a minimum specified in the policy. The differences between the maximum charges and the actual charges and the minimum interest rate and the actual credited interest rate may be thought of as the equivalent of a dividend under a traditional participating policy.

However, the disciplines imposed on the dividend determination process for participating policies are largely absent. For interest sensitive products there is no formal requirement that divisible surplus be determined annually and be apportioned equitably, policy by policy, using the contribution principle. The absence of these disciplines has been evident to regulators and has been the genesis of pressures to revise the model life insurance cost disclosure regulation, a work which is ongoing as of this writing. It is apparent, for example, that some companies, in an effort to respond to competitive pressures, have employed credited interest rates and mortality charges on new business that are unsustainable in the long term.

Various proposals have been suggested for dealing with this problem, including at the extreme, the prohibition of policy illustrations showing anything other than projected policy values based on guaranteed costs and credited interest rates. Another proposal would be to allow companies to illustrate actual historical policy performance for comparable products. A third proposal would allow illustrations showing non-guaranteed elements on reasonable assumptions, whose sus-

tainability must be certified by an appointed actuary on the assumption of continuance of current company experience.

Still another proposal allows insurers to illustrate the policy's non-guaranteed elements on a current scale basis. However, such insurers would be required to provide automatically a new illustration of future policy performance whenever changes in the current scale of charges and credited interest rates would result in a lowering of illustrated future values. The industry has vociferously opposed this last proposal on the grounds that it is inordinately expensive to implement. The industry has also argued against the prohibition of illustrations of anything other than guaranteed values on the grounds that would put such competitive pressure on these guarantees that, in extreme cases, it might threaten company solvency.

While these discussions are going forward, the actuarial profession is coming under increasing pressure to develop more definitive standards with respect to the determination and declaration of the amount of non-guaranteed elements. Whether a single methodology will come to be accepted as the definitive standard, such as the contribution principle for dividends, remains to be seen. Obviously, regulators would welcome such a development. It's likely, however, the industry would oppose such a development as representing unnecessary interference by regulators and/or the actuarial profession in the prerogatives of company management with respect to the pricing of non-participating products.

Miscellaneous Issues

The typical consumer finds the subject of life insurance esoteric and full of unfamiliar jargon and concepts. Regulators have, therefore, concluded that efforts at improving cost disclosure would be fruitless without appropriate education of consumers. In an effort to improve this education, regulators have been requiring that proposals be accompanied by a "Buyer's Guide."[2] This guide provides simplified explanations of typical policy benefits and cost provisions. A reader of the Buyer's Guide is presumably in a better position to interpret the information being presented in a policy cost illustration. Also, states

2. The requirement of providing purchasers with a Buyer's Guide was first incorporated in the model regulation in June 1976.

generally require that policies include a "free look" provision,[3] allowing new policy owners a period of time, typically 10 days, in which to review the policy and accompanying material and decide whether they got what they thought they were buying on the basis of the illustrations and other sales material they initially received. The author is not familiar with any research done to measure the effectiveness of these measures.

Another issue concerns the alleged need for insurers to improve the control of illustrations provided to prospects by company agents. Misrepresentation of company products by agents through the use of misleading illustrations is nothing new. However, the frequency of abuses may have increased in response to increasing competitive pressures. A current proposal is that cost disclosure illustrations be certified by a company officer and the company's appointed illustration actuary.

Conclusions

The issues discussed above, related to life insurance policy disclosure and its regulation, are in most part not new. They are under intense scrutiny now by the NAIC and the life insurance industry. These issues will undoubtedly have to be revisited from time to time as new and more complex products are introduced at an ever more rapid pace. Regulators must be willing to address these issues in the interest of protecting the public.

It might be predictable that the author, as an actuary, believes strongly that the actuarial profession needs to be at the heart of defining, implementing and monitoring more effective cost disclosure. The profession, through the Actuarial Standards Boards, has indicated an interest in developing a new standard of actuarial practice that will support the principles imbedded in whatever revisions are adopted to the Life Insurance Disclosure Model Regulation.

Clearly the major new challenge is what to do about interest sensitive products. While such an approach would not be without controversy, the author supports the development and adoption of a method of disciplining the assumptions used in the illustration of interest sensitive products analogous to the disciplines imposed on div-

3. See, for example, 387C, Article 48A, Maryland Insurance Code.

idend illustrations for traditional participating policies. Hallmarks of this discipline include: equitable treatment of policyholders and sustainability of illustrated results, assuming continuation of current experience.

Absent the actuarial profession's, and by implication, the industry's willingness to adopt such self discipline, regulators are likely to adopt one or more of the more draconian proposals discussed above.

APPENDIX
Formulae for the Various Life Insurance Cost Calculation Methods Discussed in the Paper

1. Traditional Net Cost Method (Annual)

$$TNC_t = (P_t - D_t - CV_t + CV_{t-1})/F(.001)$$

$$\sum_{t=1}^{n} TNC = \text{accumulative net cost}$$

where TNC_t = traditional net cost in policy year t per M
P_t = policy premiums in policy year t
D_t = policy dividend in policy year t
CV_t = policy cash value at end of policy year t
F_t = policy face amount in policy year t

2. Linton Yield Method

$$\sum_{t=1}^{n} (P_t - D_{t-1})\,(1+j)^{n-t+1} -$$

$$\sum_{t=1}^{n} (YRT_t)\,(F_t - CV_t)\,(1+j)^{n-t+1} = CV_n + TD_n$$

where YDT_t = assumed yearly price of $1 of insurance in year t
TD_n = terminal dividend, if any, at policy surrendered at end of year n
j = yield rate needed to make equation valid

3. Interest Adjusted Net Cost Method

$$\text{IANC} = \frac{\sum_{t=1}^{n} (P\ (1+i)^{n-t+1} - D_t\ (1+i)^{n-t}) - CV_n - TD_n}{.001\ F_n \left(\sum_{t=1}^{n} (1+i)^t\right)}$$

where i = assumed interest rate

$IANC_n$ is the "net surrender cost index." If TD_n and CV_n are omitted, the formula is the "net payment index."

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