

Do Product Disclosures Inform and Safeguard Insurance Policyholders?

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DO PRODUCT DISCLOSURES INFORM AND SAFEGUARD INSURANCE POLICYHOLDERS?

Abstract: The effectiveness of insurance product and price disclosures has not been evaluated for more than 20 years during which time product designs have become vastly more complicated and public reliance on disclosure tools has increased substantially. Performance impact studies in the financial services industry and elsewhere demonstrate that disclosure must overcome a number of severe obstacles—many of which are endemic to the life and health insurance environment and are illustrated in this report. The psychology of communication plays a pivotal role and even with disclosure rules, insurers may manipulate consumers to their detriment. Barriers to effective disclosure are examined and ideas for research and policy development are outlined.

I. INTRODUCTION

For almost 50 years, now, the NAIC and the states have enacted disclosure rules defining what insurers may and may not say to consumers about product features, pricing and other elements of life and health insurance. These rules have taken a number of forms including specific language and formatting requirements, the distribution of buyers' guides and the prohibition of certain representations.

As insurance instruments have evolved, product disclosures have increased in scope and complexity. For example, the states which adopted the earliest NAIC disclosure model—the 1956 accident and sickness advertising regulation—focused exclusively on the truthfulness, clarity and accuracy of advertising and personal sales representations. Thirty-one years later, the states which endorsed the first long-term care model regulation set far more ambitious goals: 1) truthful, non-deceptive communication between buyer and seller to promote transparency in marketplace transactions, 2) more complete consumer understanding of insurance products, and 3) the ability of prospective buyers to make accurate coverage comparisons.¹

Despite a lengthy history and considerable field experience with product disclosures in the insurance industry, very little is known about how well these protections actually work for ordinary consumers.² As regulatory modernization leads to even greater reliance on product disclosures, the need for critical, in-depth examination becomes that much more compelling. It is significant, therefore, that the NAIC has for the first time charged a working group to look into the question of disclosure effectiveness.

The purpose of this paper is to provide an overview of insurance disclosure as a mode of consumer protection and as an instrument for informing consumer choice. The paper will identify various goals of disclosure and focus on potential obstacles to successful information-transfer initiatives. It will then suggest some candidates for a disclosure research and public policy agenda. Since there is very little empirical literature dealing directly with the issue of disclosure in the insurance industry, the paper will consider literature drawn from related fields.

¹ Compare, Advertisements of Accident and Sickness Insurance Model Regulation (I-40) and Long-Term Care Insurance Model Regulation (IV-641).

² Disclosure provisions are an integral part of NAIC model acts and/or regulations dealing with credit and debit life, long-term care and Medicare supplement, accident and sickness, life insurance and annuities, and viatical settlements among other products.

II. OBJECTIVES AND OVERVIEW OF DISCLOSURE

For purposes of this paper, the principal objectives of disclosure (as reflected in various model laws and regulations adopted by the NAIC) can be grouped into three somewhat overlapping categories.

- (1) To inform consumers about the main features of the insurance products being offered to them in order to facilitate knowledgeable choice, minimize unexpected outcomes and improve the chances of long-term satisfaction. (Product Understanding)
- (2) To provide consumers an accurate means for making price, product and quality comparisons in order to stimulate competitive behavior in the market. (Comparison Shopping)
- (3) To make certain that insurers and producers provide full and accurate information about all relevant issues and that they communicate it in a manner which consumers will interpret properly. (Fairness and Transparency)

Given these objectives, does disclosure appear to work? Are policyholders getting accurate or distorted price and product information? Does disclosure help consumers understand enough about product features to make reasonably informed choices? Does it facilitate accurate comparison shopping, increase product satisfaction, reduce bad surprises? Is one type of approach, e.g., mandatory language or formatting requirements more effective than another? We begin by exploring the limited literature dealing with insurance disclosure.

Roger Formisano's study of the model life insurance solicitation regulation remains the most detailed empirical evaluation of a NAIC disclosure rule found in the peer-reviewed literature. Although 20 years old and somewhat limited in scope, it provides good reason for suspending judgment about the efficacy of product disclosure. The study, conducted under the aegis of the Federal Trade Commission, found that the model life insurance solicitation regulation failed to reach the mainstream of its target audience and had little appreciable impact on consumer knowledge of product characteristics or comparative prices.³

The few other empirical studies found in the published literature largely complement the Formisano report:

- Insurance buyers, as a group, tend to have relatively little prior experience with insurance products and do not expend a great deal of time and effort in the shopping process.⁴
- Consumers seriously underestimate the magnitude of price and product differences that are available between brands in the market and are therefore not especially motivated to shop.⁵
- Consumers pay little attention to disclosures such as the buyers' guides insurers/producers are required to distribute and those who are aware of them do not find them to be of very much use.⁶
- Disclosures do not contribute very much to improved price and product understanding.⁷
- Inaccurate and intentionally deceptive product and price information is a material factor in the marketplace.⁸

Based on this limited evidence, it has not yet been possible to get a good sense of whether the observed impact of disclosure has been anemic primarily because the disclosures themselves (e.g., shoppers' guides) have been poorly designed and executed or because the overall approach is inherently flawed.⁹

It is important to note that the capacity of disclosure to actually achieve transparency, foster product knowledge and facilitate comparison shopping has typically been assumed as a matter of common sense—even amongst the most sophisticated students

³ Formisano, Roger, "The NAIC Model Life Insurance Solicitation Regulation: Measuring the Consumer Impact in New Jersey," 48 *Journal of Risk and Insurance*, (1) 1981.

⁴ Formisano, Roger, Olshavsky, R. and Tapp, S., "Choice Strategy in a Difficult Task Environment", 8 *Journal of Consumer Research* (4) (1982).

⁵ Maynes, E. Scott, "Informationally Imperfect Consumer Markets: Empirical Findings and Policy Implications", 16 *Journal of Consumer Affairs* (1) (1982).

⁶ Alexih, L.M.B. et. al., "Can Regulation Improve Long-Term Care Insurance? Lessons from the Medigap Experience", 7 *Journal of Aging and Social Policy* (2) 1995.

⁷ Formisano (1981) supra.

⁸ Egler, F. and Malak, P. "The Individual Life Insurance Sales Practice Case: A Litigation Primer" 50 FICC Quarterly (1) 1999.

⁹ Knutson, et. al. found that health plan report cards had little impact on consumer product knowledge but they could not rule out the possibility that design inadequacies contributed to the findings. "Impact of Report Cards on Employees: A Natural Experiment", 20 *Health Care Financing Review* (1) 1998.

of financial services regulation.¹⁰ The notion that “if you say something in plain English, it will be clearly understood in the intended manner by all” captures the essence of this common assumption.¹¹

Historically, the NAIC has focused its efforts almost exclusively on prompting the industry to “get its message right,” that is, to make complete and truthful disclosures about product features such as limitations, guarantees and pricing in plain English. This can be seen, for example, in the long (and continuing) history of debates on the appropriate measures of rate of return and cost to be incorporated in life insurance illustrations. And it reflects a widely shared view that the accuracy of the message far more than any other factor is the key to policyholder protection.¹² As Professor Joe Belth has observed on more than one occasion, “the solution to the problem of deceptive practices [in life insurance]...lies in disclosure....”¹³ While the states have generally subscribed to this axiom, it is interesting to note that at least a few have raised questions about efficacy at one time or another.¹⁴

Another, more nuanced interpretation of disclosure visualizes the process as being a two-way form of communication in which the impact of disclosure is “fruitless” if the message does not get through to consumers.¹⁵ This recognition that the audience is the equal counterpart of the message reflects the reality that even literally truthful, complete and properly articulated disclosure messages may be short-circuited if consumer factors are not adequately addressed. Along these lines, former commissioner Jim Hunt has alluded to the question: what are reasonable goals for life insurance disclosure in an environment characterized by extraordinarily complex products and inexperienced buyers.¹⁶ Is it conceivable that disclosure is being asked to do too much under this set of circumstances?

III. BARRIERS TO THE DESIGN OF EFFECTIVE DISCLOSURES

A cost-benefit framework provides a useful way of thinking about the kinds of obstacles that may be encountered in the design of effective disclosure tools; it also helps to distinguish those which may be remedied from others which are immutable.

Theory and practice suggest that consumers acquire, process, recall and use product-related information more effectively when they perceive the costs to them of information search and processing to be low relative to the benefits derived. In this context, costs include the amount of time and effort consumers believe they need to spend on information search and processing activities including, in the insurance context, pre-purchase time spent with insurance agents.¹⁷ Hadfield and colleagues have presented an insightful conceptual analysis of disclosure from a cost-benefit perspective with a good discussion of regulatory

¹⁰ For example, Charles Calomiris and Robert Litan observed in their op-ed piece “Homeownership That’s Too Important to Risk”, *New York Times*, Aug. 20, 2001, that disclosure is a “sensible way” to reduce predatory lending. But Litan, the eminent head of economic studies at the Brookings Institution, readily acknowledged that this proposition was entirely intuitive. (Personal communication with the author, Aug. 21, 2001).

¹¹Wilkie, William and Gardner, David, “The Role of Marketing Research in Public Policy”, 38 *Journal of Marketing* (1974).

¹² Testifying before a Senate subcommittee, former commissioner David Lyons summarized the serpentine course of life insurance disclosure from 1975 onward. Lyons showed that almost without exception, the theme of the debate over the numerous model laws and regulations related to the scope and content of the measures to be illustrated—not to the meaning extracted by consumers or their impact on product understanding or on shopping behavior. See, “When Will Policyholders Be Given the Truth About Life Insurance?”, Hearing, Senate Judiciary Committee, Subcommittee on Antitrust, Monopolies and Business Rights, 103rd Congress, May 25, 1993.

¹³ Belth, Joseph, “The Disclosure Approach to the Problem of Deceptive Practices in the Life Insurance Industry”, 21 *Insurance Forum* (8) 1994.

¹⁴ In *Omega National Insurance Company v. Marquardt*, 799 P. 2d 235 (1990) for example, the Washington Supreme Court upheld a decision by the insurance department banning the sale of small industrial life insurance policies which failed to meet the minimum loss ratio standards. The rationale for this prohibitory approach reflected the Department’s view that purchasers of small life insurance policies, preponderantly the elderly, were vulnerable to being misled about the value of the products offered and that alternative remedies, most notably disclosure, would be ineffective and difficult to enforce. Similarly, the Massachusetts Supreme Judicial Court ratified the decision of the state insurance department to prohibit the sale of stand-alone cancer insurance policies as being unfair and deceptive and the alternative remedy of consumer disclosure as being inadequate. See, *American Family Life Assurance Co. v. Commissioner of Insurance*, 388 Mass. 468 (1983).

¹⁵ Bartlett, Dwight, “Life Insurance Cost Disclosure”, 13 *Journal of Insurance Regulation* (4) 1995; This is reflected in the study of Truth-in-Lending reported by Lee, J. and Hogarth, J., “The Price of Money: Consumers’ Understanding of APRs and Contract Interest Rates”, 18 *Journal of Public Policy and Marketing* (1) 1999.

¹⁶ Hunt, James, “Life Cost Disclosure: Prospects for True Reform”, 13 *Journal of Insurance Regulation* (4) 1995.

¹⁷ Unless the insurance applicant or policyholder has occasion to access a fee-based information source, the expenses that are bound to be most obvious to them relate to their own time and effort.

roles and guidelines for instrument design.¹⁸ Mazis, et. al. applied cost-benefit principles to advertising regulations promulgated by the Federal Trade Commission and the Food and Drug Administration and drew relevant lessons.¹⁹

Russo and Leclerc studied the impact of 28 product information programs covering such areas as energy conservation, product safety, financial services, nutrition and unit pricing. Applying a "strict criterion" of program success that called for measurable changes in actual purchasing behavior or consumption, the authors found that the best and most consistent predictor of success was the ratio of perceived benefits to costs.²⁰ They concluded that where "benefits were sufficient to justify information use, effort reduction increased that use. And where effort was roughly constant, benefit differences determined whether a PIP [product information program] was successful or not." Using a similar cost-benefit framework, Moorman evaluated the impact of new content labeling requirements under the Federal Nutrition Labeling and Education Act. She found that approaches which successfully reduced the cost of information use to buyers (by making them less time consuming and laborious) tended to improve consumer understanding and the amount of information processed.²¹

IV. BARRIERS TO ACHIEVING PRODUCT UNDERSTANDING AND COMPARISON SHOPPING GOALS

Focusing on disclosures that fall into the product understanding and comparison shopping categories, a short list of factors affecting the acquisition and processing costs perceived by buyers would include the:

- amount and complexity of information presented in the disclosure
- perceived credibility of that information
- formatting and display of the disclosure (ease of use)
- amount of prior product familiarity and other consumer factors

A. Amount and Complexity of Information

The amount of product information consumers can acquire, store in memory, retrieve as required and process for decision-making is quite limited.²² Of course, some decisions require more intensive information activity than others. An example might be the choice of a complex product which called for the buyer to balance a number of performance characteristics and consider multiple brands.²³ But the principle of information overload suggests that the amount and complexity of information communicated to consumers (e.g., as per a disclosure requirement) should generally not exceed the peak level of benefits to be derived in a given case.²⁴ Beyond that, additional information inputs tend to have the paradoxical effect of confusing and degrading the quality of decision-making.

A number of NAIC models run counter to the principle of information conservation by requiring the disclosure of extensive amounts of complex information, expressed in unfamiliar, technical language and relating to obscure issues.²⁵ For example, the model life insurance illustration regulation calls for insurers/producers to communicate a minimum of a dozen technical facts to applicants ranging from a description of coverages and contract premiums to the insurer's illustrated scale of non-guaranteed elements and surrender values. Similarly, the long-term care insurance rule requires a disclosure of renewability, policy limitations, benefit triggers, premium increase provisions, federal taxation, reimbursement definitions and the like. (See Table 1)

¹⁸ Hadfield, G.K., Howse, R. and Trebilcock, M.J., "Information-Based Principles for Rethinking Consumer Protection Policy", 21 *Journal of Consumer Policy* (2) June 1998.

¹⁹ Mazis, M.B. et. al., "A Framework for Evaluating Consumer Information Regulation", 45 *Journal of Marketing* (Winter) 1981.

²⁰ For instance, changes in purchasing prices or amounts consumed (as opposed to measurable changes in consumer attitudes or knowledge).

²¹ Russo, J.E. and Leclerc, F. "Characteristics of Successful Product Information Programs", 47 *Journal of Social Issues* (1)1991; Moorman, Christine, "A Quasi Experiment to Assess the Consumer and Informational Determinants of Nutrition Information Processing Activities: The Case of the Nutrition Labeling and Education Act", 15 *Journal of Public Policy and Marketing* (1) Spring 1996.

²² Although experts continue to debate the precise limits of information loads, there is a consensus that they are quite modest. For a summary of the debate, see, Jacoby, J., Speller, D.E. and Kohn, "Brand Choice Behavior as a Function of Information Load", 11 *Journal of Marketing Research* (1974); Russo, J.E., "More Information is Better: A Re-evaluation of Jacoby, Speller, and Kohn", 1 *Journal of Consumer Research* (December) 1974.

²³ In general, Bettman, J.R., Luce, M.F. and Payne, J.W., "Constructive Consumer Choice Processes", 25 *Journal of Consumer Research* (3) 1998. See also, Hibbard, J.H., Slovic, P, and Jewett, J.J., "Informing Consumer Decision in Health Care: Implications from Decision-Making Research", 75 *Milbank Quarterly* (3) 1997 for evidence that more complex managed care report cards are less informative than simpler formats. But Murphy, John and Richards, Jef found that more extensive rental car agreements were neither more nor less useful to renters than more abbreviated contracts. "Investigation of the Effects of Disclosure Statements in Rental Car Advertisements", 26 *Journal of Consumer Affairs* (2) 1992.

²⁴ The amount of information that an individual will be able to use profitably will also depend on such factors as prior familiarity with the product category, demographic characteristics, attitudes, etc. This suggests that some thought needs be given to the issue of customizing information disclosure programs.

²⁵ Alexih, L. et. al., "Can Regulation Improve Long-Term Care Insurance? Lessons from the Medigap Experience", 7 *Journal of Aging and Social Policy* (2) 1995.

Table 1. The Complexity of NAIC Disclosure Models

Model	# Required Disclosures	Example of Concepts	Example of Terminology
Life Insurance Illustrations	More than 12 substantive issue	Guaranteed and non-guaranteed elements; accumulation and surrender values; application of non-guaranteed values and dividends to defray policy charges and contract premiums; illustrated scale.	Section 7(C)(1)(c) The numeric summary shall show: "Insurer's illustrated scale used but with the non-guaranteed elements reduced as follows: (iii) All non-guaranteed charges, including but not limited to, term insurance charges, mortality and expense charges, at rates that are the average of the guaranteed rates and the rates contained in the illustrated scale used."

B. Perceived Credibility of Message Content

When exposed to product claims, consumers appraise the source of information communicated as a cue to the trustworthiness of message content. It has been shown that consumers tend to be more skeptical about product claims made by parties having a direct interest in transactions such as commercial sellers. For example, in studies dealing with the perceived quality of managed health care plans, information conveyed by the plans, themselves, evoked particular skepticism and was discounted as being biased.²⁶ Perceived credibility is especially important in the case of products which are unfamiliar or are deemed to be high risk by buyers, e.g., in terms of the probability and consequences of failed performance or price expectations or because of financial volatility.²⁷ Insurance products such as interest-sensitive life policies would fall into the high risk category for both of these reasons.

To overcome credibility problems, consumers often seek out alternate (more reliable) sources of information or acquire data from multiple sources.²⁸ By definition, this strategy exposes consumers to higher information acquisition and processing costs and may dissuade some persons from making the purchase altogether. It is not known how consumers perceive the credibility of commercial data produced in response to government regulation as contrasted with ordinary commercial advertising claims. An experimental, before-and-after study of nutritional labeling indicated that consumers were as skeptical about marketers' nutritional claims after more extensive federal labeling regulations had been imposed as they were before.²⁹ But this finding does not explain whether consumer discomfort persisted because people were unconvinced that government regulation provided a sufficient warranty of the accuracy and reliability of commercial data. Nor, is there any head-to-head comparison with consumer attitudes toward data supplied directly by a public source such as an official shoppers' guide.

For the most part, NAIC disclosure models establish broad standards for sales information practices but leave insurers ample leeway to tailor the language of specific messages. The likelihood exists, therefore, that consumers will be wary of those marketer claims they have no way of independently authenticating and which they feel may be susceptible to being skewed in one direction or another. Table 2 provides a few examples of the kind of provisions which delegate discretion to insurers (as to language, format, etc.) and which deal with contingencies which ordinary consumers are unequipped to evaluate, independently.

Table 2. Guidelines Governing Certain Representations

Long Term Care Insurance Regulation	An insurer shall provide: "An explanation of potential future premium rate revisions..." "The insurer may, in a fair manner, provide additional explanatory information related to the rate increases."
Life Insurance Illustrations Regulation	The illustration must clearly disclose "that a charge continues to be required and that, depending on actual results, the premium payer may need to continue or resume premium outlays."

²⁶ Edgman-Levitan, S. and Cleary, P. "What Information Do Consumers Want and Need?", 15 *Health Affairs* (4) 1996.

²⁷ Grewal, D., Gotlieb, J and Marmorstein, H., "The Moderating Effects of Message Framing and Source Credibility on the Price-Perceived Risk Relationship", 21 *Journal of Consumer Research* (1) 1994.

²⁸ Where consumers have formed opinions regarding the reputation of alternative sellers, they have used reputation as a proxy for source credibility. Goldberg, M.E. and Hartwick, J., "The Effects of Advertiser Reputation and Extremity of Advertising Claim on Advertising Effectiveness", 17 *Journal of Consumer Research* (2) (1990).

²⁹ Moorman, supra.

C. Message Display

The way information is displayed or packaged can have a powerful effect on its utility to consumers. "There is extensive evidence from both basic and applied research that the same information presented in different formats can result in different decisions."³⁰ Efficient formatting reduces the time and effort required by consumers to organize raw data into meaningful information. And different displays also affect the accuracy of consumer understandings and the ability or ordinary consumers to make proper use of information.

Twenty-five years ago, Jay Russo and colleagues demonstrated, experimentally, that easy-to-compare displays of unit prices led to an increase in the market share of the more competitively priced items.³¹ Some additional support for this finding can be found in a Federal Reserve study of price disclosures for several types of consumer credit: mortgage loans, automobile loans and personal loans.³² More recently, the National Council on Competition and the Electric Industry sponsored an extensive research and design effort to support state-level residential energy deregulation and consumer choice reforms.³³ Extensive consumer surveys relating to alternative displays showed that comprehension of comparative price data was more than twenty percent (20%) better with uniform formats (compared with seller-designed formats meeting stipulated standards for content). And the ability of consumers to perform relevant information-based tasks (e.g., calculate monthly bills using price disclosures) varied in accuracy by four-fold across five different display options.³⁴

In addition to unit pricing and electric utilities, formatting issues have been studied in conjunction with the communication of product hazards, health warnings, gambling, financial services, the quality of health plans and nutrition labels.³⁵

These findings are germane to insurance regulation. The format provisions of important models such as the life insurance illustrations and the long-term care insurance regulations reflect a favorable disposition toward discretionary, non-standardized displays of information on matters like rate increases, policy benefits and values and guarantee features. See Table 3. This arouses concerns about perceived cost, ease-of-use and comprehensibility among members of the relevant consumer populations.

Table 3. Selected Formatting Provisions

NAIC Model	Reference	Format Requirement (Examples)
Life Insurance Illustrations	III-582	Beyond a minimum requirement, insurers have flexibility to illustrate additional years in their basic numeric display; insurers may show benefits and values in various formats; insurers may provide supplemental illustrations.
Long-Term Care	IV-641	Insurers have flexibility as to format for showing and explaining rate increases; may exclude rate increases for certain blocks of business.

D. Prior Product Familiarity and Other Consumer Factors

Differences among buyers help explain variations in the pattern of information use. Variations in personal characteristics ranging from literacy to prior familiarity with specific products exert impacts that are relevant to the design of effective consumer disclosures.

Comparative studies demonstrate that individuals with more relevant product experience know how to simplify purchasing decisions by economizing on the amount of information sought and used in the process.³⁶ Less experienced consumers, in

³⁰ Bettman, J.R., Payne, J.W. and Staelin, R., "Cognitive Considerations in Designing Effective Labels for Presenting Risk Information", 5 *Journal of Public Policy and Marketing* (1986).

³¹ Russo, J. et. al., "An Effective Display of Unit Price Information", 39 *Journal of Marketing* (2) 1975.

³² Board of Governors of the Federal Reserve System, Annual Percentage Rate Demonstration Project (March 1987). Standardized price disclosures led to a reduction in the level and dispersion of prices for mortgages and to a lesser degree for automobile financing but not for personal loans.

³³ The National Council is a joint undertaking of state legislators and state utility regulators. Project research papers are available online at www.rapmaine.org.

³⁴ Moskowitz, D., Harrington, C. and Austin, T., Synthesis Report: A Summary of Research on Information Disclosure (1998) for the National Council on Competition and the Electric Industry. Available online at www.rapmaine.org.

³⁶ Popper, E.T. and Murry, K.B., "Communication Effectiveness and Format Effects on In-Ad Disclosure of Health Warnings", 8 *Journal of Public Policy and Marketing* (1989); Sprott, D.E., Hardesty, D.M., and Miyazaki, A., "Disclosure of Odds Information: An Experimental Investigation of Odds Format and Numeric Complexity", 17 *Journal of Public Policy and Marketing* (1) 1998; Task Force on the Future of the Canadian Financial Services Sector, "Empowering Consumers", Background Paper 3, September 1998; McGee, J. et. al., "Making Survey Results Easy to Report to Consumers: How Reporting Needs Guided Survey Design in CAHPS", 37 *Medical Care* (3) 1999; Moorman, C., supra.

contrast, must spend vastly more time and effort to achieve comparable results. In part this can be attributed to what Hibbard and colleagues refer to as the contextual framework for decisions: the latticework of product-related terms and concepts that enables the consumer to develop a situationally appropriate decision-making strategy.³⁷ Without an adequate contextual framework, data remain data and consumers can often be heard to lament what they perceive of as “inadequate information.”

Dulebohn’s recent study of investment risk preferences among university employees hints at important questions pertaining to the relationship of individual differences to disclosure design.³⁸ He found that having more knowledge and information about financial instruments and investment risk did not appear to help individuals allocate their retirement portfolios more suitably. It remains to be seen from additional research Dulebohn has under way whether a more customized information-transfer strategy will help individuals improve their portfolio allocation decisions.

A scan of insurance disclosure regulations leads to the conclusion that little attention has been paid to audience factors. Although some passing examination has been made into questions of phrasing and terminology, the disclosure models reflect something of a “one size fits all” approach.³⁹

E. Perceived Salience and Utility of the Disclosure

Turning now to disclosures that may affect the way buyers perceive the benefits of information transfer, it is generally thought that price and product disclosures have more of an effect when they address the specific needs and concerns of individuals. Other things being equal, it has also been found that disclosures tend to receive greater attention 1) among lower income individuals (who may be more motivated to comparison shop and may face lower opportunity costs in terms of time), 2) in situations where consumers are aware of large price, quality and/or other between-brand disparities (and thus perceive the benefits of search), and 3) for higher priced and/or riskier products.

A Federal Reserve study of selected credit markets provides support for the finding of greater awareness of disclosures of credit terms among younger, lower income persons financing large amounts (for whom interest rates were highly salient); however, it does not provide comparable backing for the hypothesis that the same individuals are likely to conduct more intensive search activities and to process greater amounts of information.⁴⁰ It is not known just how well the study controlled for other factors such as literacy and disclosure format but it is conceivable that the relationship between income, education and information use is different/stronger than the relationship to awareness.

In a study of diverse consumer products, including insurance, Maynes finds evidence that consumers systematically underestimate the amount of price disparity in local insurance markets and, therefore, perceive little benefit to be derived from information search.⁴¹ This is not too surprising in light of Formisano’s and Saver and Doescher’s reports showing very low rates of comparison shopping for life and health insurance products.⁴²

The implications of these findings for the design of insurance product disclosure suggest that effectiveness can be improved either by reducing the cost burden of shopping time and effort or by improving the flow of benefits perceived by policyholders. With respect to perceived benefits, there is no evidence in records of the NAIC deliberative process to suggest that decisions about the content of data and information to be disclosed came from a bottom-up survey of consumer needs and concerns. Nor, that methods have been explored to customize information disclosure.

V. THE GOAL OF FAIRNESS AND TRANSPARENCY

The goal of fairness and transparency bears on two problems which are well known in the insurance industry: 1) representations which sellers know or should know to be false and misleading (as in the case of “vanishing life insurance premiums”), and 2) the more elusive but significant matter of communications which are literally true but which tend to convey deceptive or misleading meanings to the average consumer. NAIC model disclosure regulations such as the long-term care

³⁶ Bettman, J. and Park, C. “Effects of Prior Knowledge and Experience and Phase of the Choice Process on Consumer Decision Processes: A Protocol Analysis”, 7 *Journal of Consumer Research* (3) 1980; Johnson, E. and Russo, J.E. “Product Familiarity and Learning New Information”, 11 *Journal of Consumer Research* (1) 1984.

³⁷ Hibbard, Slovic and Jewett, supra.

³⁸ Dulebohn, James, “An Investigation of the Determinants of Investment Risk Behavior in Employer-Sponsored Pension Plans”, *Journal of Management* (in press); Also, see Halak, M. and Eisenhauer, J., “The Demography of Risk Aversion”, 68 *Journal of Risk and Insurance* (1) 2001 who report a high degree of variability on interpersonal measures of relative risk aversion.

³⁹ For example the Model Annuity Disclosure Regulation (II-245) calls for terminology to be defined in language that facilitates understanding by the “typical person” within the population segment to which the disclosure is directed.

⁴⁰ See, Federal Reserve, supra.

⁴¹ Maynes (1982) supra.

⁴² Formisano (1982) supra. Saver, B. and Doescher, M. “To Buy, or Not to Buy: Factors Associated with the Purchase of Nongroup, Private Health Insurance”, 38 *Medical Care* (2) 2000.

insurance rule and state unfair insurance practice laws condemn outright deception as well as the more subtle tendency to mislead. In effect, both strive for transparency in buyer-seller transactions.

Some experts believe that consumer deception is pervasive in today's economy.⁴³ As consumers enjoy greater opportunities to purchase complex products whose performance characteristics are virtually unknowable to them in advance, these analysts make the point that sellers face correspondingly strong financial incentives to manipulate consumer choice behavior. The use of subtle sales appeals to create favorable, albeit erroneous impressions about important product characteristics and performance presents an extremely complex challenge for information disclosure enforcement.

The following discussion focuses, principally, on the more problematic issue namely, the tendency to mislead and manipulate insurance buyers.

A. MISLEADING COMMUNICATIONS: OVERVIEW

Marketing communications may exert subtle but substantial influences on the formation of favorable brand attitudes and ultimately, on consumer choice.

To illustrate, consider two alternative claims: "this brand of sliced ham is 96% fat free" versus "this brand has a 4% fat content." Despite the fact that the two are factually identical, marketers understand that consumers tend to associate the "fat free" presentation with lower fat content than the "4% fat" format. Here, then, is the paradigm case of a factually accurate representation conveying an erroneous impression.

Since consumers find it difficult and time consuming to evaluate product—especially those which are unfamiliar or whose performance cannot be directly observed—they frequently employ mental shortcuts to simplify decision-making. As in the illustration, above, these cognitive shortcuts can be triggered by marketing messages. While insurance regulators have traditionally been riveted on the factual accuracy of sales messages (advertising, illustrations, personal sales) marketers have long known that it is not only what you say but how you say it that is influential.

In a sentence, the central problem posed by this type of communication is that it leads ordinary consumers—availing themselves of normal decision-making shortcuts—to draw erroneous conclusions from otherwise accurate words, phrases and images.

B. BARRIERS TO ACHIEVING THE GOAL OF FAIRNESS AND TRANSPARENCY

There are a number of ways insurance marketers can use communications to influence consumer behavior. The discussion that follows focuses on a few of the principal ways in which marketing communications may cause a distortion in the way consumers perceive products and understand their performance. Psychologists give this type of distortion the label cognitive bias.

Framing Bias. The pioneering cognitive psychologists, Daniel Kahneman and Amos Tversky found that people respond differently to precisely equivalent messages depending upon whether they are posed (framed) as risks or gains.⁴⁴ This has obvious implications for the insurance industry where marketers are always conveying information to buyers about premiums, benefits, values and other product features all of which embody varying degrees of uncertainty. Jon Hanson and Douglas Kysar, two of the leading legal authorities on this subject, conclude that framing is "the most obviously exploitable of the biases, capable, for instance, of causing dramatic preference reversals based on an entirely non-substantive shift in terminology."⁴⁵

Of most importance in the insurance context is the fact that marketers can frame sales claims in such a way as to give policyholders a skewed impression of product risks and product benefits. For instance, cognitive psychology tells us that people tend to be more sensitive to the probability of a loss than to an equal gain and therefore, they react more strongly to risk-framed messages than to those framed in terms of gains. The classic example is the very strong response people will give to a message revealing that a particular airline has a 5% failure rate compared to their tepid reaction to a notice of a 95% safety record. This is simply a manifestation of human risk aversion.

A life insurer can utilize this principle to elicit a favorable perception about the stability of annual dividends. Faced with the option of presenting 1) a 10-year sequence of annual dividends which would tend to reflect some year-to-year volatility, or 2) precisely the same data displayed as 5 and 10 year average dividend rates, the marketer might prefer the latter since the volatility in this second display is smoothed by the averaging process. Benartzi and Thaler, in an experimental study of retirement investment preferences, reported that the group which was shown the "risk" display (i.e., showing more volatile

⁴³ Hanson, J.D. and Kysar, D.A., "Taking Behavioralism Seriously: The Problem of Market Manipulation", 74 NYU Law Review (1999). ; Penzer, Jason, "Grading the Report Card: Lessons from Cognitive Psychology, Marketing, and the Law of Information Disclosure for Quality Assessment in Health Care Reform", 12 Yale Journal on Regulation (1) 1995; Jolls, Christine et. al. "A Behavioral Approach to Law and Economics", 50 *Stanford Law Review* (1998).

⁴⁴ Tversky, A. and Kahneman, D., "The Framing of Decisions and the Psychology of Choice", 211 *Science* (4481) 1981.

⁴⁵ Hanson, J.D. and Kysar, D.A., *supra*.

year-to-year investment returns) allocated a greater proportion of their retirement fund to bonds while those reacting to the display of smoothed averages allocated more to equities.⁴⁶

Psychologists have also shown that people have a greater tendency to evaluate product performance as a percentage change (plus or minus) from some initial starting point rather than as an absolute change. So, for instance, people will commonly go across town to pick up a 10% saving on a \$250 microwave but will not react at all to a \$25 saving on a new automobile. They have also found that people weight a 10% loss more heavily than a 10% gain.

An insurer, therefore, can influence the perception of product benefits by framing gains (e.g., an increase in last year's dividends) on a percentage basis (even if the impact in absolute terms is trivial) while downplaying losses by framing them in absolute terms.

A corollary to the observation that consumers react more strongly to losses than gains is that a marketer can hope to influence product evaluations favorably by segregating gains while integrating losses.⁴⁷ Toward this end, good results should be featured while bad results should be offset by good ones. Thus, a producer will prefer to emphasize those cases in which current life insurance dividends exceed the guaranteed scale but will choose to blend above-average and below-average earnings wherever loss messages are called for.

Disclosure regulations have a strong bearing on the issue of framing bias. The examples just given suggest that wherever data displays are required, e.g., to show historical or projected results, insurers and producers can fashion their presentations to elicit favorable perceptions or downplay adverse reactions.⁴⁸ Thus, for example, while an accurate historical table of actual dividends and guaranteed scales are doubtlessly necessary, the more significant question is what message consumers draw from the seller's presentation.

Anchoring Bias. Anchoring is a type of mental shortcut people use to make estimates under conditions of uncertainty. In the anchoring algorithm, individuals apply an objective measure, say the CPI, as an adjustment to some starting (anchoring) point. The consequence is that the ultimate probability estimate is inevitably biased toward the initial anchor value. This places a heavy burden on the reasonableness of the starting value—a burden which is often unfulfilled.

A good example of the anchoring bias in action can be found in the context of health insurance rate disclosures. Where a long-term care insurer does not pre-fund premiums but instead sets going-in rates at a low, "select" level, the ordinary consumer may estimate expected renewal rates as the initial premium (anchor) rolled forward for inflation.⁴⁹ To the extent that the seller is not required to disclose renewal rates and the buyer is not forewarned that rates are not levelized, the anchoring bias will result in an underestimate of future costs.

Cognitive Biases Relating to Personal Selling. Producers can have a dominant influence on consumers—often trumping insurer-written disclosures—when the two stand in contradiction to one another. Taking their affidavits at face value, a number of life insurance producers involved in vanishing premium litigation indicated that their sales approach was "needs-based" (as opposed to illustration-based) therefore suggesting the possibility of insurer-producer conflict. Studies that have attempted to quantify the influence of agents in the individual health market lend support to the conclusion that most consumers tend to rely heavily on producer representations and recommendations.⁵⁰

Several cognitive biases potentially strengthen the hand of personal sellers:

Availability Bias. "In making decisions about uncertain future events, people tend to ignore statistical data in favor of evidence that is particularly salient, vivid or easily 'available' to them."⁵¹ An applicant's recollection of a personal sales presentation or a specific agent-supplied recommendation (as opposed to some "fuzzy" tabular data) gives the producer preferential access to the buyer's decision-making process.

Representativeness Bias describes the tendency of consumers to judge the likelihood of some event in relation to its perceived similarity to some other event. An agent who is able to analogize a current downturn in reported earnings to a previous cyclical downturn can argue, with perceived authority, that "in that case performance bounced back quickly and little was lost." The personal representation enjoys a degree of authenticity that a written disclosure would find very hard to match.

⁴⁶ Benartzi, S. and Thaler, R. "Risk Aversion or Myopia? Choices in Repeated Gambles and Retirement Investments", 45 *Management Science* (3) 1999.

⁴⁷ Thaler, Richard, "Mental Accounting and Consumer Choice", 4 *Marketing Science* (1985).

⁴⁸ Additional experimental evidence on this point can be found in, Hibbard, J.H. et. al., "Increasing the Impact of Health Plan Report Cards by Addressing Consumers' Concerns", 19 *Health Affairs* (5) 2000.

⁴⁹ Kanner, Allan, "The Filed Rate Doctrine and Insurance Fraud Litigation", 76 *North Dakota Law Review* (1) 2000. These low initial rates are sometimes referred to as *teasers*.

⁵⁰ Hall, Mark, "The Role of Independent Agents in the Success of Health Insurance Market Reforms", 78 *Milbank Quarterly* (1) 2000.

⁵¹ Hanson and Kysar, *supra*.

Unlike the goals of product understanding and comparison shopping which call for cost reducing and/or benefit enhancing measures to be aimed directly at consumers, themselves, the obstacles in the path of fairness and transparency call for more active monitoring and enforcement efforts on the part of regulators.

VI. RESEARCH AND POLICY ISSUES

This report underlines the growing need to develop better information and various methods for evaluating the objective impact of insurance product and price disclosure tools rather than taking their effectiveness for granted. The NAIC Consumer Protections Working Group has taken a first step in this direction by requesting staff to compile a review of the disclosure literature. The selective research and policy agenda that follows is meant to suggest additional components of a working agenda.

Baseline Consumer Surveys

Formisano's survey of life insurance policyholders is now some 20 years old and is in dire need of updating and elaboration. An important first step would be to survey groups of recently enrolled policyholders (e.g., universal life, long-term care, credit life) who have been exposed to the current generation of NAIC model disclosures. The purpose would be to obtain baseline data about their exposure to and awareness of disclosure messages, comprehension of key disclosures, the beliefs and meanings they extract from product messages, and their ability to use disclosures correctly.

Needs Assessments and Consumer Testing

Decisions about the content and format of currently required disclosures have emerged, primarily, from the NAIC's internal deliberative process rather than from broad-based consumer consultations and testing. In recognition of the advantages to be derived from improving the cost-benefit value of product disclosure (from the user's point of view), consumer focus groups and other qualitative research could be conducted with several important cost-reducing and benefit enhancing objectives in mind: 1) to test and increase the relevance of disclosures (e.g., increasing the emphasis on easy-to-use price comparisons); 2) to test ways of reducing the sheer number of mind-numbing, technical disclosures that must now be distributed to all policyholders—without sacrificing the benefits of information transfer. (For example, experiment with the use of targeted product warnings in lieu of more detailed messages; explore the use of more standardized disclosure formats which economize on consumer time and effort; develop and test approaches like the use of a smaller number of more global measures that combine to replace several old measures); 3) to find ways of dealing, effectively, with individual differences in the user audience. (For instance, experiment with and test ways of layering information so that individual consumers can drill-down for more comprehensive explanations or background data on issues of their own choosing; explore alternative methods of providing consumer education and support including, for example, the use of interactive electronic media, information intermediaries and independent counseling programs)⁵²; 4) do psychometric testing of proposed new disclosure measures and formats where consumer surveys point to comprehension problems.

Monitoring and Enforcement

If baseline consumer surveys begin to identify an important disconnect between the disclosure messages insurers and producers put out and the beliefs and meanings buyers come away with, regulators may need to focus more on strategies for monitoring and enforcing the objectives of fairness and transparency.

Under existing ground rules, regulators probably need to identify and evaluate suspect disclosure practices and to enforce violations on a case-by-case basis. In this framework, one immediate need would be to find ways of pinpointing significant problem areas. One approach might be to use targeted market conduct examinations (TMCE) to identify observable outcomes which suggest disclosure problems. For example, policyholders of a life company reporting a high lapse or replacement rate might be surveyed (as part of a TMCE) to see if the company's communications had a tendency to mislead.⁵³

Alternatively, regulators might consider reforming the enforcement framework, itself. One model that merits consideration is suggested by the standard "margin disclosure statement" adopted for distribution by the National Association of Security Dealers.⁵⁴ The language of that standardized disclosure statement appears, on its face, to have been carefully crafted and tested to avoid framing bias and other cognitive problems such as those discussed above. A second interesting approach is embodied in the Food and Drug Administration's labeling regulations for over-the-counter products. In that case, labelers have an affirmative obligation to provide the results of cognitive testing as a pre-requisite to FDA approval.⁵⁵

⁵² Board of Governors of the Federal Reserve System and the Department of Housing and Urban Development, Joint Report to the Congress Concerning Reform to TILA and RESPA, July 1998 recommending pre-loan counseling and other consumer education initiatives to minimize foreclosures.

⁵³ The use of market conduct examinations to support consumer disclosure requirements has been discussed in conjunction with the Variable Life Insurance Regulation. See, Commentary to Section 7. (II-270-62).

⁵⁴ NASDR, Margin Disclosure Statement, www.nasdr.com/5700.htm#disclosure.

⁵⁵ Morris, L. et. al., "Comprehension Testing for OTC Drug Labels: Goals, Methods, Target Population, and Testing Environment", 17 *Journal of Public Policy and Marketing* (1) 1998.

VII. CONCLUSION

Disclosure plays a pivotal role in the ordering and conduct of buyer-seller transactions throughout the economy. As the number and complexity of products offered by the insurance industry increase and new players come onto the scene, the demands imposed on disclosure become ever more acute. This argues for the most rigorous and detached evaluation of disclosure tools as well as flexible new thinking regarding the design of monitoring and enforcement mechanisms. The Consumer Protections Working Group is ideally situated to provide vision and leadership in this important sphere.

ATTACHMENT FOUR

Improvements to State-Based Systems Working Group
Chicago, Illinois
December 8 & 10, 2001

The Improvements to State-Based Systems Working Group of the Executive (EX) Committee met in Chicago, IL, on Dec. 8, 2001. Lee Covington (OH) and Rhonda Davis representing Larry Mirel (DC), co-chaired the meeting. The following working group members were present: Tim Wagner, Vice Chair (NE); Sarah McNair-Grove representing Bob Lohr (AK); Lenita Blasingame and Jay Morgan representing Mike Pickens (AR); Sara Begley representing Chuck Cohen (AZ); Maureen Mason representing Harry Low (CA); Maryellen Waggoner representing William J. Kirven III (CO); Tom Gallagher (FL); Pat Matevey representing Nathaniel S. Shapo (IL); Bill Wempe representing Kathleen Sebelius (KS); Mona Carter representing Janie A. Miller (KY); Janet Glover representing Gregory Serio (NY); Jim Poolman (ND); Kathie Stepp representing Carroll Fisher (OK); Joel Ario (OR); Mary Bannister representing Alfred W. Gross (VA); Lee Barclay representing Mike Kreidler (WA); and Susan Ezalarab representing Connie O'Connell (WI).

1. Discuss Written Comments Received on the Condensed Version of the Model Law

Director Covington described the goals for the meeting. He noted that much effort has been extended to make the various operational efficiencies recommended in the Speed to Market Implementation Plan a reality. He added that it has been a year since the Implementation Plan was adopted by the NAIC membership. He stated that the working group should discuss the written comments (Attachment Four-A) received related to the Nov. 25, 2001, draft of the Property and Casualty Commercial Rate and Policy Form Model Law (Condensed Version) (see Attachment Four-C). He added that a letter was received from David "Birny" Birnbaum (Center for Economic Justice) (Attachment Four-B); however, because it was received after the written comment deadline, it was not incorporated along with the summary of written comments. He hoped that the working group would be able to adopt a model at the meeting that incorporates the regulatory framework recommendations for commercial lines products that was included in the Implementation Plan so that it could be considered by state legislatures during 2002.

Director Covington stated that the Condensed Version incorporated to the extent possible, the language developed by the Commercial Lines Re-engineering (C) Working Group that had been ably chaired by David Eley (TX). He advised that he had no intent to open discussion on the various public policy debates. These public policy decisions are cast in the Implementation Plan, he observed. He advised that not everyone would agree on every aspect of every model that passes the NAIC. He noted that this model would be no exception as there are differing and strongly held views by various parties related to the optimal level of regulation of rates and insurance policy language. He added that he did not contemplate taking action on the model law at today's meeting, but was hopeful that a vote would be taken on Dec. 10, 2001.

Mr. Barclay stated that Commissioner Kreidler sent a letter outlining various concerns that Washington has with the Condensed Version. He believed that changes in the market for property and casualty insurance products make this an inopportune time to propose relaxation of rate regulatory requirements. He voiced his support for the various operational efficiencies that had been adopted. He suggested that the policy decision on moving forward at this time be revisited. Ms. Bannister agreed. She stated that Virginia objects to having policy forms treated under a file and use system.

Director Covington observed that the Condensed Version was not a deregulation bill. It preserves authority for the states related to rates charged for commercial lines products. It gives the commissioner authority to determine that a market is not competitive and to take steps to institute a more invasive form of rate regulation if competition is lacking. When competition is present it relies on market forces to assure that insurance consumers receive a fair price for their insurance purchases. He added that the system has been implemented in Ohio and several other jurisdictions and works fine. He added that he does not believe his regulatory authority has been usurped by such a system. Alan Wickman (NE) agreed noting that there is a considerable body of literature that supports reliance on competition as the most effective regulator of insurance prices. He suggested that the working group should not back away from its decisions unless it thinks the literature is wrong.

J. Robert Hunter (Consumer Federation of America—CFA) summarized the suggestions contained in Mr. Birnbaum's letter. He hoped that the working group would adopt the Property and Casualty Rate and Policy Form Model Law (2000 Version) that was developed by Mr. Eley's Commercial Lines Re-engineering (C) Working Group instead of the Condensed Version. He noted that insurance was not a commodity like televisions or automobiles and that insurance markets do not behave like other commodities. In particular, he noted that in insurance markets, market participants are allowed to collectively establish prices and that individual insurers—not the insurance purchaser—generally gets to decide if a policy will be offered and under what terms the offer will be made. This is very different from traditional commodities markets where any customer with the financial means to make a purchase can gain access to the commodity sought. He noted that the anecdotal information on the behavior of the insurance markets after Sept. 11 shows the fallacy of relying on the type of radical deregulation offered by the Condensed