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LIFE INSURANCE MARKETING AND COST DISCLOSURE

REPORT
TOGETHER WITH DISSENTING VIEWS

BY THE

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE

HOUSE OF REPRESENTATIVES

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LETTER OF TRANSMITTAL

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS,
COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE,
Washington, D.C., December 28, 1978.

Hon. HARLEY O. STAGGERS,
Chairman, Committee on Interstate and Foreign Commerce, Washington, D.C.

Dear Mr. Chairman:

The attached report by the Subcommittee on Oversight and Investigations focuses on the marketing of life insurance. The issues addressed are important because millions of Americans spend billions of dollars every year for life insurance products. Congress has entrusted regulation of life insurance to the individual states, and our inquiry sought to ascertain whether state authorities were adequately protecting the legitimate interests of consumers.

We found that the insurance delivery system does not naturally provide life insurance purchasers with the information they need to be effective consumers. The adverse consequences for consumers are grave. The regulatory initiatives undertaken recently by the states have been too long delayed and are inadequate to the task.

We have carefully considered how best to assure that consumers receive sufficient product information, and have included in this report a detailed discussion of the disclosure system we recommend. We do not think that direct federal intervention is necessary at this time, and believe that the states should be given an opportunity to address themselves to our suggestions.

We urge that the states now act promptly to vindicate consumer interests that have too long received short shrift in the life insurance field. We hope that this report will arouse the interest of state regulators in life insurance information disclosure, and provide them with a blueprint for constructing an effective disclosure system in their respective jurisdictions.

Sincerely,

JOHN E. MOSS.

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Life Insurance Marketing and Cost Disclosure

SUMMARY

Purpose

The principal purpose of this report is to evaluate the state regulation of life insurance marketing and cost disclosure. The report results from a Subcommittee inquiry commenced during the Spring of 1978 and is based on the record developed during Subcommittee hearings held on August 7, 14, and 15, 1978.

The Subcommittee's interest in the marketing and regulation of life insurance arose for several reasons. First, the late Senator Philip Hart held hearings on the same subject in 1973 and 1974.[1] At those hearings, a number of witnesses asserted that consumers were being injured both because the life insurance market was operating improperly and because the causes of market failure were not being addressed effectively by state regulatory authorities. Among the particular consequences attributed to these failures were that (1) virtually identical life insurance policies were being sold at widely disparate costs, (2) many customers were purchasing inappropriate and inadequate insurance, despite the availability of more suitable alternatives, and (3) many policies, once bought, were soon being dropped by their purchasers at a significant financial loss.

In May, 1976, subsequent to the Hart hearings, the National Association of Insurance Commissioners (NAIC) issued the final version of its model rule on life insurance cost disclosure.[2] That rule, entitled the "Life Insurance Solicitation Model Regulation," appears as Appendix A to this report, and has been adopted in eleven states.[3] It establishes certain cost indexes that can be used by consumers to compare similar policies. Critics, however, have raised numerous objections to the NAIC rule, asserting that it fails to solve the underlying problems. The Subcommittee therefore determined to review the adequacy of the NAIC proposal.

Secondly, in late 1976, the Federal Trade Commission (FTC) authorized its staff to investigate whether satisfactory cost information was being provided to prospective life insurance purchasers. The investigation was—

> "designed to determine: (1) whether and to what extent cost information provided prospective purchasers is now insufficient, (2) what types of compara-

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[1] Hearings on the Life Insurance Industry Before the Subcommittee on Antitrust and Monopoly of the Senate Committee on the Judiciary, 93d Cong., 1st and 2d Sess. (1973–74) [hereinafter cited as *Hart Hearings*].

[2] The NAIC is an organization of state insurance commissioners. Its model regulations have no independent legal effect but constitute recommendations to the individual states.

[3] Hearings on Life Insurance Marketing and Cost Disclosure Before the Subcommittee on Oversight and Investigations of the House Committee on Interstate and Foreign Commerce, 95th Cong., 2d Sess. 338 (1978) [hereinafter cited as H.]. The eleven states are Arizona, Connecticut, Iowa, Montana, Nebraska, New Hampshire, New Jersey, Oregon, South Carolina, Tennessee, and Vermont. Earlier or different versions of the NAIC rule are in effect in eight other states (Arkansas, California, Kansas, New York, Pennsylvania, Texas, West Virginia, and Wisconsin). An additional eight states have held hearings on the 1976 model (Indiana, Nevada, North Carolina, Ohio, Texas, Utah, West Virginia, and Wisconsin). *Id.*

tive cost disclosures would be most accurate and most likely to be useful to consumers, (3) the impact such disclosures would be likely to have upon the industry and upon consumers, and (4) what would be the most appropriate and feasible course of action for the Commission to take in this area." [4]

The staff of the FTC's Bureau of Consumer Protection subsequently concluded that the NAIC rule had significant defects, and undertook to develop an alternative cost disclosure system. The FTC's current draft proposal appears as Appendix B to this report. In February, 1978, the FTC staff wrote to all the state insurance commissioners, advising them of the FTC's misgivings about the NAIC model rule and urging them to delay adoption of the NAIC regulation until the FTC had completed its study.[5] Thus, the Subcommittee's interest in life insurance was also related to its oversight responsibility for the activities of the Federal Trade Commission.

Issues

The Subcommittee's hearings were intended to answer the following questions:

(1) Does the life insurance market operate smoothly to provide consumers the products they need at the lowest possible price, or is there a broad market failure producing consumer loss?

(2) If the market is failing, what are (a) the indicia of this failure, (b) the causes of the failure, and (c) the actual consequences to consumers?

(3) How can the causes of market failure be remedied, and does the NAIC cost disclosure regulation satisfactorily cure market ills?

(4) Does the Federal Trade Commission have an appropriate role in this area, and what is the nature of the FTC's remedial proposals?

(5) What does the experience in the life insurance market and the history of the NAIC cost disclosure rule indicate about the efficacy of state regulation?

Witnesses

The seven witnesses heard on these issues were (in order of appearance):

(1) Albert H. Kramer, Director of the FTC's Bureau of Consumer Protection;

(2) Dr. Joseph M. Belth, Professor of Insurance at Indiana University (Bloomington), a long-time advocate of life insurance cost disclosure;

(3) Herbert W. Anderson, Insurance Commissioner of the State of Iowa, representing the NAIC;

(4) Julius Vogel of the Prudential Insurance Company, representing the American Council of Life Insurance (ACLI), a trade association for life insurance companies;

(5) Joel A. Shapiro, C.L.U., agent for the New York Life Insurance Company, representing the National Association of Life Underwriters (NALU), a trade association for life insurance agents;

(6) Lee Richardson, Office of Consumer Affairs, U.S. Department of Health, Education, and Welfare; and

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[4] FTC December 15, 1976, news release. This news release and its accompanying "Staff Fact Sheet" appear as Hearing Appendixes (H. App.) 1 & 2 respectively. An October 1977 newspaper article describing the FTC project in detail appears as H. App. 3.

[5] The FTC letter is reprinted as Hearing Exhibit F–1 (H. 96).

(7) Ernest J. Moorhead, retired actuary and life insurance cost comparison expert.

Findings and conclusions

The Subcommittee's findings and conclusions are as follows:

(1) The market for ordinary life insurance, by its nature and normal operation does not generate sufficient information for consumers to make intelligent purchasing decisions.

(2) Insurance purchasing patterns, and other indicia of consumer experience in the market, strongly suggest that many consumers do not, or are not able to, purchase life insurance products on the basis of suitability, quality, and cost.

(3) These conditions result in significant consumer loss, and reflect a serious failure in the market mechanism that can be corrected only by deliberate regulatory action.

(4) The solution proposed by the NAIC, while a step in the right direction, is not satisfactory. It contains a number of provisions that unnecessarily blunt its effect and omits altogether certain essential remedies.

(5) The general posture of the states and the NAIC in the area of life insurance cost disclosure appears to be, at best, cautious. In an era of consumerism, the overall record of the states does not reveal an aggressive program to vindicate long-submerged consumer interests.

(6) Recent activities of the Federal Trade Commission in the area of life insurance marketing are justified from a policy standpoint, given the importance of the issues involved and the need for a vigorous, consumer-oriented presence in the regulatory process. The FTC's actions have also been lawful under the McCarran-Ferguson Act, if not always conducted in the most diplomatic fashion.

Recommendations

Based on these findings and conclusions, the Subcommittee urges the NAIC and the states to promptly and forcefully correct the failings in the life insurance market by establishing a mandatory information disclosure system. Specifically, the system should consist of an individualized Policy Summary and a standard Buyer's Guide, both of which should be presented to prospective life insurance purchasers before they make their product selection.

Policy Summary

The Policy Summary should reveal the following five types of information about the particular policy a consumer is considering for purchase. *First*, to assist the purchaser in choosing between term and whole life products (or in selecting some combination thereof), information should be provided for whole life policies showing how the cash value increase compares to a "term plus side investment" plan. The "side investment" would be funded by the dollar difference between the term premium and the higher whole life premium.

We think the comparison could best be accomplished by showing the actual side fund dollar totals and the whole life cash values for selected years. However, disclosure of "Linton Yield" (a percentage figure showing the average annual rate of return imputed to the savings portion of a whole life policy) would also be acceptable.

Second, to assist consumers in comparing costs of similar policies, cost index numbers should be displayed. We recommend the use of either (a) company retention, or (b) net payment and surrender cost index figures. Whichever indexes are used, they should be calculated for a single period of time only. Disclosure of the "level annual dividend" should not be required, and the use of traditional net costs for policy comparisons should be banned entirely.

Third, to help consumers perceive the structure of alternative policies, a "ledger statement" should be required for each policy. The ledger statement (consisting of numbers arrayed in parallel, vertical columns), should cover the first 20 years and also attained age 65, and should disclose premiums, illustrated dividends, surrender values, and death benefits for each year listed. Also, to deter early lapsation, the policy year number and the cash value figure should be printed in red for those years when surrender would result in a loss to the policyholder from a Linton Yield standpoint. An appropriate notice explaining the significance of the red numbers should appear immediately contiguous to the cash value display.

Fourth, the Policy Summary should reveal both the interest rate charged to policyholders who pay premiums other than annually, and the policy loan interest rate.

The Policy Summary should be (a) a document separate from the Buyer's Guide, (b) prepared by the sales prospect's agent according to a format mandated by regulation, and (c) provided by insurers to any person on request. Affirmative disclosure that policy summaries are available should be required in life insurance advertisements.

Buyer's Guide

The Buyer's Guide should be a standard pamphlet designed to attract and hold consumers' attention by emphasizing the practical importance of purchasing an appropriate policy and describing the adverse consequences of an incorrect choice. The guide should discuss:

(a) insurance needs;

(b) the choice between term and whole life, including a description of how to use comparative cash accumulations or Linton Yields, and a discussion of other relevant factors that consumers should consider;

(c) other available types of individual and group insurance products;

(d) the difference between participating (dividend paying) and non-participating policies;

(e) agents and agent services;

(f) how the cost indexes and other information on the Policy Summary can be used to compare the prices and benefit structures of similar policies, including a display of comparative "yardstick data" and an explanation of how such data relates to the indexes for individual policies; and

(g) the problems of underinsurance and early lapse, and how to avoid them.

The Buyer's Guide should be stocked by state insurance offices and insurance companies, and be mailed free to interested persons.

Timing of disclosure

As to when these materials must be disclosed to prospective policy purchasers who are solicited by agents, we recommend that the Buyer's Guide always be presented at the first sales visit. We further recommend that no customer be required to post a premium deposit earlier than 20 days after receiving the Policy Summary, and that no customer be solicited to sign a policy application until at least the appropriate cost indexes have been disclosed. These requirements should be tailored to the sales technique used, so that agents will not be forced to make more sales visits than they already do.

Other disclosure

Besides the mandatory information disclosure system described above, we also recommend that insurers be required to prepare, and provide to interested persons on request, comprehensive data displays about the policies they offer. These data displays should be prepared for several representative issue ages and should provide (a) year-by-year figures for amount of protection (face amount less cash value), price of protection, and rate of return, and (b) summary information showing allocation of premium dollars to savings, protection, dividends, and company expenses. The year-by-year data should be displayed for each year from issue date to at least attained year 75. The summary information should be shown for several durations, such as for policy year 20 and attained age 65.

The display sheets showing these data should be provided by insurers to state regulators at the time policy approval is sought, as an aid to the states in controlling manipulation. Insurers should also provide the display sheets to their agents, who can use them both to achieve a better understanding of the policies being sold to customers, and to meet the information demands of more sophisticated clients.

Other recommendations

Finally, we recommend that the NAIC, the FTC, or both, study how to encourage (a) the development of professional insurance consultants who would provide advice to consumers for a set fee, and (b) the marketing of low price insurance products. The studies should focus particularly on any existing market conditions or regulations that tend to restrain the availability of those services and products.

We do not recommend any exercise of federal power in the life insurance field at this time because we believe that the states should be given an opportunity to address our proposals.

INTRODUCTION

This report deals with "ordinary" life insurance, that is, life insurance sold to individuals in face amounts exceeding $1,000.[6] In 1976, Americans held nearly $1.2 trillion in ordinary life insurance coverage. The total number of policies outstanding was 137 million. Insurance companies collected $22.5 billion in premiums for that coverage, and those payments represented 1.9 percent of all disposable income.[7]

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[6] The other major forms of life insurance are group, industrial, and credit. Group plans normally involve term insurance offered by employers or associations to their employees and members, respectively. Industrial policies are whole life plans offered in face amounts less than $1,000. The premiums are collected by agents on a weekly or monthly basis. Credit insurance is term coverage issued through a lender to insure the life of a debtor. It is designed to satisfy the debt should the debtor die.

At the end of 1976, ordinary life represented 50 percent of all life insurance in force in the United States. American Council of Life Insurance, *Life Insurance Fact Book '77* 21 [hereinafter cited as *Fact Book*]. About two-thirds of new life insurance protection purchased during 1976 was ordinarily life. *Id.* at 11.

[7] *Id.* at 18, 55, 56.

The two basic types of ordinary life coverage are term and whole life.[8] Term is pure protection, much like auto insurance. The customer pays an annual premium in return for being protected during the course of the year from a particular risk, in this case premature death. Also like auto insurance, if the risk being insured against does not occur, the entire premium is "lost" from the customer's standpoint.

The premiums for term insurance constantly increase to recognize the fact that the risk of death increases with age. Thus, in later years, annual premiums for term insurance become quite high. Term is sold to provide coverage for a limited period of time (e.g., one year or five years), but can usually be renewed for additional periods.

Whole life is designed to remain in effect for the entire life of the insured, regardless of how long he or she survives. Its principal feature is that premiums do not increase in amount to reflect the rising mortality risk, but remain level through the duration of the policy. This is accomplished by having the customer pay annual premiums in the early years of the policy that are substantially higher than would be required to purchase term insurance for those years. Part of the excess is used by the insurance company to accumulate a "cash value" for the policy.

The cash value is important for several reasons. First, if the insured decides to surrender his policy before he dies, he gets the cash value back. Second, the insured can normally borrow money from the insurance company, without surendering his policy, by using the cash value as loan collateral. Third, if the insured continues his life insurance into his later years, the growth of the cash value means that the insurance company is at risk for successively lower amounts (i.e., the difference between the cash value and the face amount of the policy). Thus, the premium can be held constant because the consequences of the increasing mortality risk are attenuated from the company's standpoint. Indeed, if the insured lives long enough (usually to age 100), the cash value will increase to the face amount of the policy itself. At that point, the company will be at no risk whatsoever, and will pay the face amount to the insured without the occurrence of death.

Another variable among types of life insurance protection is the distinction between participating ("par") and nonparticipating ("non-par") policies. Non-participating policies are offered only by insurance companies owned by stockholders. The term "non-participating" simply means that the policyholders do not share in company surplus, since the surplus is distributed to the stockholders. Participating policies on the other hand, are sold by both stock companies and "mutual" companies. Mutual companies have no stockholders, and are, in a sense, owned by the policyholders. The holders of participating policies share in company surplus by way of annual dividend payments.[9]

The premiums for non-participating insurance policies are expected to be lower than those for participating policies. However, the pre-

[8] This explanation of life insurance products is simplified. For detailed treatment, see R. Mehr, *Life Insurance: Theory and Practice* (rev. ed. 1977) [hereinafter cited as *Mehr*], or S. S. Huebner & K. Black, *Life Insurance* (9th ed. 1976). A less technical discussion appears in M. Dorfman, *Introduction to Insurance* (1978).

[9] Dividends are never guaranteed. Sales presentations for participating policies involve the display of "illustrated dividends," which are the company's calculations, based on its current experience, of how much in dividends it expects to pay during future years.

mium for participating policies may, in effect, be reduced below non-par premiums depending upon the experience of the company and the amount of dividends paid to the policyholders. Dividend payments to participating policyholders are treated for tax purposes not as income, but as refunds for excess premium payments. In effect, dividends can be regarded as a reduction in premium rates. Both stock and mutual companies may sell term and whole life policies.[10]

Given the nature of the insurance products available, a life insurance customer has to make certain crucial choices once he has decided to purchase a certain amount of life insurance protection. First, he must decide whether he prefers term insurance or whole life insurance, or some combination thereof. Then, he must select from among the many similar policies in his category of choice.

How consumers go about making these choices, is, of course, of great import not only to customers but also to the competing insurance companies. Because these choices must be made, because insurance is a complex product, and because many people are reluctant to consider a product that demands contemplation of death, insurance must be "sold" aggressively. The industry cannot wait for potential customers to appear spontaneously, and an agency system has therefore been established to ensure successful marketing of insurance products.

The issues explored in this report relate mainly to the way in which consumers, in conjunction with their agents, go about making purchase decisions. The specific question for review is whether consumers are getting the kind of information and guidance they need to make intelligent choices from among insurance product alternatives.

Chapter I of the report examines the choice between term and whole life, and considers what information consumers need and how it should be provided. Chapter II addresses how consumers can select one policy from among similar alternatives, and discusses what information is needed to compare policy costs and policy benefit structures. Chapter III deals with the likely impact of our various recommendations on the operation of the life insurance market, and evaluates the recent efforts of the NAIC and the FTC with respect to life insurance cost disclosure.

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[10] In 1976, mutual companies owned about two-thirds of U.S. life insurance company assets, and accounted for slightly more than half of all life insurance in force. *Fact Book,* supra note 6, at 89.

Chapter I—The Term/Whole Life Choice

THE CHOICE PRESENTED

The threshold question an insurance purchaser must address is whether to favor term or whole life as a way of satisfying his insurance needs. On this issue, the industry and its commentators are divided into two camps.[11]

The arguments

On one side, term advocates[12] insist that any rational consumer who understands the mechanics of life insurance products will prefer a term policy. They argue that term insurance provides the maximum face amount of protection for the smallest dollar outlay. Further, they assert that if a purchaser wants to accumulate an investment fund that will be available, for example, upon retirement, his best course is to "buy term and invest the difference" between the low term premium and the higher whole life premium, rather than using all his available premium dollars to buy whole life. Inherent in the term advocates' approach is the assumption that the after-tax return on the term purchaser's side investment fund will exceed the return implicit in the cash value accumulation of the alternative whole life policy. Term proponents claim that obtaining such a return is a relatively easy accomplishment.

Whole life advocates, on the other hand, stress that term insurance is only "temporary." They point out that, at later ages, term insurance becomes prohibitively expensive and difficult to purchase. Thus, they say, continuing to purchase term insurance in later life is not a sensible course of action. Term proponents respond that the wise consumer, who has purchased term over the years and built up an investment fund, has no need for any life insurance *at all* in later life.

Whole life proponents counter, arguing that the "buy term and invest the difference" philosophy fails to recognize the inability of many people to maintain any side investment fund, much less obtain a yield exceeding that available from whole life policies.

Our view of the arguments

The Subcommittee makes the following observations about this controversy.

First, it is certainly true that a person preparing to make a life insurance purchase will find that, at the outset, the price per thousand dollars of face amount coverage is less for term insurance than for whole life. This is so because the whole life policy must overcharge for

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[11] The warring philosophies at work can be seen by comparing the National Association of Life Underwriters brochure (H. App. 24) and the pamphlet by Norman F. Dacey (H. App. 15A). Dacey's argument in full flower can be found in his book, *What's Wrong with Your Life Insurance* (1963).

[12] In the jargon of the life insurance trade, whole life advocates refer derisively to term proponents as "termites." H. 460–61.

protection in the early years of the policy in order to maintain level premiums during later years.

Second, it is also true that term rates must inexorably increase, and thus there comes a point when the term protection premium "crosses over" and exceeds the comparable whole life premium. The term rates continue to increase beyond that point, and become extremely high at later ages compared to the whole life premium, which remains level.[13]

Third, these first two propositions do not themselves lead to any conclusion about whether term or whole life should be favored by a given insurance purchaser. This is because the purchase decision rests not only on the cost relationships between term and whole life over time, but also upon the nature of the consumer's life insurance needs and his personal opinions about how best to assure the future availability of funds.

ANALYSIS OF THE CHOICE

Insurance is designed to spread risk. In the case of life insurance, the risk is that of *premature* death. The concept of prematurity is important. Auto insurance spreads the risk of accidents that might or might not occur. Death surely will occur, the only question is when.

Life insurance exists because people who generate income fear that death will occur before they will accumulate a fund sufficient to satisfy a prospective financial need. People who have no significant, prospective financial needs or who have accumulated wealth sufficient to satisfy any possible needs, do not require any life insurance at all.

The nature and duration of prospective financial needs for which consumers purchase life insurance vary, of course, from person to person. A typical example of a prospective need is a home mortgage. The homeowner who wants to assure that his family can keep the house if he dies realizes that there will be no funds in his estate sufficient to pay off the mortgage balance. The amount of protection needed is known exactly from the mortgage instrument, and this need will decrease over the life of the mortgage as the principal is reduced by mortgage payments. The date on which the need ends can also be determined, because at some point the homeowner, if he lives, can pay off the mortgage and own the house unencumbered. Since the insurance need will last for only a limited time, mortgages are usually covered by a term policy with a gradually decreasing face amount designed to reflect the decline in mortgage principal over the years.

Other financial needs for which life insurance is needed are more complex. A young breadwinner may wish to assure living expenses and educational funds for his growing family. Here, the need also tends to decline as the years pass and children cease to be dependents. However, the dollar amount needed may not decline, because inflation will reduce the purchasing power of a dollar.

It is evident that if a consumer has a substantial insurance need that will extend into his later years, purchasing term may well be

[13] We note at this point our disagreement with the argument that term insurance at later ages is not available for sale. This is simply untrue. Hearing Exhibit A-2 (H. 379) is a collection of current rate cards showing the availability of annual renewal term coverage to age 100. However, the sale of term insurance may be restricted by law in some states. For example, New York will not permit renewal of term insurance beyond age 70. See H. 394.

an unwise choice because the cost of term will eventually "cross over" the whole life cost, and, in the long run, require a greater expenditure to maintain than if level premium whole life had been purchased. Term insurance appears to be the more attractive alternative where either (1) the need for insurance will itself cease before the consumer gets very old, or (2) the amount of the need decreases substantially in later years. In the first instance, the consumer can evade the effect of the increasing term rates altogether by simply ceasing to buy insurance. In the second instance, a decrease in need will enable him to reduce continually the face amount of term insurance, so that his premium dollar outlay in later years will not be drastically larger than the whole life premium.[14]

INFORMATION NEEDED

These features of insurance lead us to conclude that any person considering life insurance should compare (1) the funds that will be assured under a whole life policy with (2) the funds that will be assured by allocating available premium dollars between term insurance and a side investment fund. We reach this conclusion, because, if the difference between term rates and whole life premiums is large enough, and that difference can be invested at an attractive interest rate, the side fund investment may eventually accumulate to cover all of the policyholder's insurance needs. The term plus side fund alternative might then be a wiser choice than continuing to pay whole life premiums forever.

To perform the necessary analysis, the whole life policy face amount can be left level or altered to reflect changing insurance needs, provided that the term face amount is adjusted yearly so that when added to the side investment fund, the sum is always equal to the whole life coverage. The yearly reduction in term insurance would simply recognize the fact that a whole life purchaser cannot obtain both the face amount and the cash value of the policy, whereas the term purchaser has both insurance protection and a separate investment fund.

Since the dollars being paid in by the customer under both alternatives are equal, and the sum of the term face amount and the side investment fund is always kept equal to the whole life face amount, the consumer will always receive the same dollar amount under either program should he die. The only difference between the programs will arise in the different buildup of the whole life cash value and the side investment fund.[15]

The consumer can extend the comparison to a given point in the future,[16] and then compare the final cash accumulation totals. The result will be crucial information about the merits of the alternative

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[14] The insurance program that is finally selected may, of course, involve some *combination* of term and whole life policies. Depending on the purchaser's precise needs, he may also want to consider other insurance products, such as endowment policies. We do not believe that these considerations detract from the thrust of our argument or conclusions.

[15] This method of comparing term and whole life is described in *Mehr,* supra note 8, at 129–134. See also M. Murray, "Analyzing the Investment Value of Cash Value Life Insurance," 43 J. Risk & Ins. 121 (1976).

[16] We emphasize that a purchaser must always be sensitive to the prospective duration of his need for an insurance fund. If his wife is deceased and his children are financially independent when he reaches age sixty, he can simply drop his life insurance, since there will be no need for funds if he dies. Similarly, if he reaches sixty and has accumulated a large savings account or other investments, he may be able to drop his insurance even if his wife is living and his children are still dependent, simply because the investments are sufficient to provide for his dependents should he die.

ways to protect against premature death. This comparison, of course, will not in itself answer the question about which type of policy to favor. Later in this discussion, certain advantages unique to whole life policies and certain other factors will be discussed that, in our view, could well support a decision to purchase a whole life policy even if a higher fund accumulation could be achieved by purchasing term insurance.[17]

We are firmly convinced, however, that life insurance purchasers must confront and address the relative merits of whole life and term if they are to make reasoned purchase decisions. We expressly conclude that whole life, on the one hand, and term insurance with a side investment fund, on the other, are legitimately alternative ways of protecting against premature death.

INADEQUATE MARKET INFORMATION

The problem we find in the market is that the methods used to sell life insurance do not ensure adequate and accurate understanding by consumers of the available product alternatives. This conclusion results mainly from our conviction that many life insurance agents have both strong financial incentives and abiding philosophical convictions that favor one insurance alternative over the other. The Hart Hearings showed, for example, that agent sales commissions were often skewed to favor whole life, with a larger percentage of first year premiums paid to agents for sales of whole life than for sales of term.[18] The NALU witness at our hearings agreed that such skewed commission structures were still prevalent and also agreed that many agents were personally convinced that whole life was clearly the preferable product choice.[19] There are, of course, other agents who benefit financially by maximizing sales of term, and who are just as firmly convinced that term is invariably the best product choice.

We regard this situation as a formula for market failure. Insurance is a complex product, and many customers are no doubt content to follow whatever advice their agent offers.[20] In any event, an agent always has strong incentives to avoid spending any more time with a prospect than is necessary to make the sale. The agent is not paid extra for clearly delineating the product alternatives or helping his client articulate and review all the relevant personal considerations. Sales presentations by whole life proponents, for example, usually do not compare the whole life cash accumulation with that available from a term insurance alternative. It is simply evident to us that agents who have philosophical and financial biases favoring one product alternative will inevitably tend to steer their sales prospects in the favored direction.[21]

We want to make clear that we are not ascribing any improper acts or unethical conduct to agents in promoting their views to their

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[17] See p. 21, infra.
[18] *Hart Hearings*, supra note 1, vol. 4 at 2858–59. *See also* the *First Report* of the Industry Advisory Committee to the Agents' Compensation Systems Task Force of the NAIC C–3 Life Insurance Subcommittee 13–14 (1976) [hereinafter cited as *Agents' Compensation Report*].
[19] H. 462.
[20] *See* H. 254.
[21] See *Agents' Compensation Report*, supra note 18, at 41–42; cf. generally A. Rappaport, "Consumerism and the Compensation of the Life Insurance Agent," XXVI Trans. of the Soc. of Actuaries 529 (1974).

customers. We are simply determining that the natural operation of the ordinary life insurance marketing system is not very likely to foster the informed consumer choices necessary to produce the benefits of competition and maximize consumer welfare. It is clearly undesirable for a consumer's purchase decision to be determined by the views of whichever agent gets to him first.

This consideration alone would, in our view, support recommendations designed to improve the information available to purchasers. Our convictions are reinforced by the intrinsic importance of the choice consumers are making, reflected by the fact that Americans have devoted immense amounts of money to whole life policies having a less favorable cash value accumulation pattern than that available from "term plus side investment" alternatives.

Statistics show that at the end of 1974, whole life represented 63 percent of all ordinary life insurance in force. Endowment insurance, a variant of whole life, accounted for another six percent. Term accounted for the remaining 31 percent.[22] While the available data do not reveal the total cash values presently held by life insurance companies for their whole life policyholders, best estimates suggest that the amount was over $100 billion in 1977.[23] Other data indicate that life insurance policies represent about one-fifth of all personal savings.[24]

Heretofore, there have been no direct data in dollar terms revealing how well whole life policies do, compared to other investment vehicles, as a way to accumulate cash values. Very recently, the FTC provided us with an analysis of 306 different $25,000 whole life insurance policies issued in 1973 to males aged 35. They compared those policies to an alternative program of term insurance plus a side fund accumulating at an after tax interest rate of five percent. They found that the mean attained age at which the side fund would "cross over" the whole life *face amount* was 67.[25] This means that even a whole life purchaser who intends to keep his policy until he dies (and who is therefore not interested in whole life cash values) could buy term instead and have his target fund saved by age 67.

The FTC, using the same sample of policies, also calculated that, at the "cross over" age the number of dollars in the side fund exceeded the whole life *surrender value* by an average amount of $11,088.[26] This statistic is highly relevant to those who intend to surrender their whole life policies on retirement to obtain the cash value.

There is also a considerable amount of data available from studies that used an alternate method to compare whole life cash accumulations with a "term plus side fund" plan. The alternate method is known as the "Linton Yield."

Unlike the direct cash accumulation calculation method, which requires assumptions both about the term premiums the purchaser will pay and the interest rate he can obtain on his side investment fund, Linton Yield requires only an assumption about term insurance rates. The difference between the term premium and the higher whole life

[22] *Fact Book,* supra note 6, at 21.
[23] H. 398.
[24] H. 72.
[25] H. App. 30B.
[26] *Id.*

premium is put in a hypothetical accumulating side fund. The term coverage is reduced each year so that the sum of it and the side fund always equals the whole life face amount. The interest rate being paid on the side fund is calculated so that, at the end of the analysis period, the side fund and the whole life cash value will be equal.

The interest rate so ascertained is known as the "Linton Yield." In essence, it is a percentage figure that shows the average annual rate of return imputed to the savings portion of the whole life policy. If the yield figure is greater than zero, it means that additions had to be made to the side fund to make it equal to the cash value, and therefore that the whole life policy earned a positive rate of return.

If the yield figure is less than zero, it means that deductions actually had to be taken from the side fund to achieve equality with the cash value, and that therefore the policyholder took a loss on the investment represented by his cash value insurance.[27]

The most recent analysis of Linton Yields for individual whole life insurance policies appears in a 1974 Report by the Society of Actuaries. Two tables from that report, the first showing mean yields and the second showing maximum yields, appear below: [28]

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[27] The Linton Yield method is explained in *Mehr,* supra note 8, at 134–37, and in the Society of Actuaries *Analysis of Life Insurance Cost Comparison Index Methods* 28–30 (1974) [hereinafter cited as *Actuaries Report*].

[28] Both of these tables show Linton Yield calculated at "low" assumed term insurance rates. Term rate calculations are shown in the *Actuaries Report,* supra note 27, at 138–39. We agree with the Report's determination to use "low" term rates for calculating Linton Yields. See n. 49, *infra.*

TABLE 1.—MEAN LINTON YIELDS

[In percent]

Plan: Age: Size	Participating: 20	Participating: Attained age 65	Participating: Attained age 75	Guaranteed cost: 20	Guaranteed cost: Attained age 65	Guaranteed cost: Attained age 75
Whole life:						
Age 25:						
$5,000	4.97	4.73	4.65	3.85	3.25	3.13
$10,000	4.01	4.27	4.26	2.70	2.75	2.73
$25,000	3.54	4.04	4.07	2.44	2.67	2.68
$100,000	3.30	3.93	3.97	2.32	2.64	2.66
Age 35:						
$5,000	4.16	4.24	4.20	2.98	2.86	2.76
$10,000	3.61	3.89	3.95	2.31	2.45	2.46
$25,000	3.36	3.73	3.82	2.25	2.44	2.47
$100,000	3.20	3.64	3.75	2.21	2.43	2.48
Age 45:						
$5,000		3.71	3.80		2.37	2.33
$10,000		3.35	3.58		1.95	2.16
$25,000		3.23	3.52		2.01	2.14
$100,000		3.13	3.45		2.02	2.07
Age 55:						
$5,000			3.07			1.63
$10,000			2.86			1.38
$25,000			2.86			1.50
$100,000			2.80			1.55
Life paid up at 65:						
Age 25:						
$10,000	3.89	4.14	4.16	2.42	2.59	2.65
$25,000	3.40	3.91	3.96	1.92	2.40	2.49
Age 35:						
$10,000	3.48	3.76	3.86	1.99	2.25	2.43
$25,000	3.22	3.61	3.74	1.74	2.12	2.32
Age 45:						
$10,000		3.13	3.48		1.72	2.17
$25,000		3.05	3.41		1.62	2.10
Age 55:						
$10,000			3.01			1.74
$25,000			3.09			1.68
20 pay life:						
Age 25:						
$10,000	2.03	3.27	3.38	1.81	2.60	2.65
$25,000	1.84	3.23	3.35	1.56	2.43	2.51
Age 35:						
$10,000	1.99	2.88	3.12	1.64	2.24	2.40
$25,000	1.85	2.84	3.12	1.47	2.11	2.29
Age 45:						
$10,000		2.06	2.78		1.47	2.03
$25,000		1.99	2.77		1.36	1.94
Age 55:						
$10,000			2.29			1.07
$25,000			2.48			.98

Source: "Actuaries Report 142" (table 44).

TABLE 2.—MAXIMUM LINTON YIELDS

[In percent]

Plan: Age: Size	Participating: 20	Participating: Attained age 65	Participating: Attained age 75	Guaranteed cost: 20	Guaranteed cost: Attained age 65	Guaranteed cost: Attained age 75
Whole life:						
Age 25:						
$5,000	7.95	6.59	6.42	8.17	5.76	5.40
$10,000	5.81	5.41	5.41	5.24	4.00	3.81
$25,000	5.02	5.15	5.18	4.65	4.02	3.91
$100,000	5.23	5.12	5.08	4.43	3.94	3.85
Age 35:						
$5,000	6.20	5.83	5.79	5.56	4.85	4.51
$10,000	4.98	5.05	5.13	4.16	3.70	3.48
$25,000	4.68	4.81	4.93	4.63	4.23	4.04
$100,000	4.66	4.71	4.85	4.51	4.16	4.00
Age 45:						
$5,000		5.89	5.91		4.25	3.72
$10,000		5.07	5.29		3.70	3.35
$25,000		4.66	4.84		4.18	3.88
$100,000		4.49	4.63		4.11	3.84
Age 55:						
$5,000			6.17			3.48
$10,000			5.49			3.34
$25,000			4.98			4.13
$100,000			4.79			4.08
Life paid up at 65:						
Age 25:						
$10,000	5.51	5.22	5.17	3.73	3.15	3.21
$25,000	4.76	4.89	4.89	3.57	2.85	2.96
Age 35:						
$10,000	4.68	4.77	4.86	2.93	2.82	2.95
$25,000	4.26	4.48	4.54	3.14	2.76	2.80
Age 45:						
$10,000		4.42	4.66		2.49	2.68
$25,000		4.15	4.43		2.59	2.72
Age 55:						
$10,000			4.41			2.78
$25,000			4.27			2.76
20 pay life:						
Age 25:						
$10,000	4.29	4.76	4.80	2.76	3.04	3.10
$25,000	3.78	4.47	4.53	2.13	2.91	2.99
Age 35:						
$10,000	4.17	4.56	4.66	2.53	2.75	2.86
$25,000	3.79	4.29	4.43	2.07	2.62	2.79
Age 45:						
$10,000		4.42	4.66		2.29	2.51
$25,000		4.10	4.43		1.96	2.47
Age 55:						
$10,000			4.83			2.55
$25,000			4.51			2.55

Source: "Actuaries Report 143" (Table 45).

These tables show, for example, that for 144 best-selling $25,000 whole life, participating policies issued to men aged 25, Linton Yields after 20 years averaged about three and one half percent. The maximum rate was 5.02 percent. Rates of return on similar non-participating (guaranteed cost) policies after the same 20 year period were even lower, averaging 2.44 percent and peaking at 4.65 percent.[29] Among the other findings of the Report is that for the group of participating policies described above, 38 percent had negative yields for the first 10 years of the policy.[30] The FTC's tentative conclusions based on the Society of Actuaries data show that the 20 year average

[29] The Actuaries found that for all policy categories analyzed, guaranteed cost policies had uniformly lower mean yields than the participating policies. *Actuaries Report*, supra note 27, at 141.
[30] *Id.* at 145.

rate of return on the $100 billion or more in cash values held by life insurance companies is three percent or less.[31]

It is important to note that the increases in cash value realized by the whole life policyholder are not subject to income tax on an annual basis. Cash value is permitted to accrue untaxed until the policyholder either dies or surrenders his policy. On death, no income tax is assessed on either the policyholder or the beneficiary. On surrender, the policyholder is taxed only on the difference between what he receives in proceeds and what he has paid in net premiums.[32] Thus, when comparing other investment devices against whole life insurance yields, net yield after taxes should be employed.

We are persuaded that, even after taking income tax into account, many consumers could consistently achieve returns on safe, alternative investments that would be higher than those received from many whole life policies. The significance in dollar terms to consumers is quite substantial. A 30 year old insurance purchaser who buys term and invests in a side fund yielding a five percent rate of return after taxes will have 50 percent more accumulated when he retires at age 65 than if he buys a whole life policy with a three percent yield.[33]

As we said before, and re-emphasize now, a consumer who accepts low cash accumulation by purchasing a whole life policy is not necessarily making a bad choice. But we think there is a clear case for concluding that purchasers should consider carefully whether the advantages of whole life outweigh a low return. We think that consumers should be given the tools necessary for making that analysis.

Other suspect market conditions

As a supplement to this discussion, we cite two market conditions suggesting that many consumers have not in fact been making well-informed, reasoned choices between term and whole life alternatives. These conditions do not *prove* that consumers are making purchases that they would reject if more information were available, but they do cast some light on that question and are significant enough to warrant discussion. They also reveal further serious consequences for consumers that can result from incorrect life insurance purchase decisions.

The *first* condition indicating that purchasers are making uninformed choices is policy lapse. It appears that consumers often buy policies that they cannot or do not wish to continue in the future. Thus, many policies are "lapsed" shortly after they are purchased because the consumer does not pay the second year premium. This results in a significant loss to a whole life policy purchaser, since, in the usual case, the first year premium is used to pay the agent's commission and other administrative expenses, and none is used to establish a cash value. Therefore, a customer who does not renew his policy after the first year and receives no cash value back, has, in essence, purchased one year

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[31] H. 73.

[32] *Mehr*, supra note 8, at 502–04. *See also* R. Clark, The Federal Income Taxation of Finanical Intermediaries, 84 Yale L.J. 1603, 1645–46 (1975), wherein the author points out the obvious fact that the tax treatment of cash value accumulation is inconsistent with the general principles of the tax code. This feature of life insurance taxation means that otherwise desirable alternative insurance plans, such as those that combine term insurance and an annuity, are put at an unjustified competitive disadvantage. These plans, known as "split life" policies, are described in *Mehr*, supra note 8, at 115.

[33] See Hearing Exhibit A–1 (H. 374). The accumulation factor after 35 years at five percent is 94.3; for three percent it is 62.3.

of extremely expensive term insurance. In 1976, the average lapse rate for policies in force for two years or less was 19.7 percent.[34]

The lapse rates for some individual companies range far higher. The Hart Subcommittee collected a wealth of data on lapse,[35] a review of which led Senator Hart to conclude that:

"* * * average industry figures for all policies sold do not sufficiently indicate just how high early lapse rates are. A better indicator is the 13-month lapse rate of the biggest selling cash value policy of each company. For instance, of 148 companies surveyed by the subcommittee, one out of four policyholders of 64 companies dropped the best selling policy within 13 months after buying it in 1971. Fifteen of these companies had unbelievable high early lapse rates ranging from 40 to 50 percent.' [36]

The FTC, based on the Hart Subcommittee statistics, estimates that consumer loss due to first year lapsation is over $200 million a year.[37]

The *second* condition that troubles us is underinsurance. In an insured's early years,[38] when the gap between available assets and financial responsibilities is widest, and thus the need for life insurance greatest, term insurance coverage will cost considerably less in premium dollars than whole life. Thus, for persons who do not have enough premium dollars to purchase adequate whole life coverage, term insurance is likely to be the best choice. Allocating all premium dollars to purchase whole life will, in such a situation, lead to underinsurance.

The FTC witness cited the "Widows Study" as partial support for the proposition that a lack of consumer understanding in the market facilities inappropriate whole life sales and consequent underinsurance.[39]

The Widows Study, conducted in 1968–69 of widows whose husbands had died in 1966 before the age of 65, found that the widows, on average, had received only $11,900 in lump sum payments from *all* sources, even though 92 percent of the husbands had been covered by some form of life insurance. Of the lump sum funds received, an average of 69 percent ($8,210) represented life insurance payments. Less than a tenth of the widows (mostly from upper-income families) received more than $25,000 in proceeds, while 70 percent received less than $10,000, and 52 percent received less than $5,000. The study concluded that "[j]udged by any standard, the amounts of life insurance received by the widows were low," [40] but did not address the question of whether whole life sales were responsible.

While no similar study has been done recently to ascertain the level of life insurance and other proceeds paid to widows, available data

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[34] *Fact Book,* supra note 6, at 53.

[35] *See* Hart Hearings, supra note 1, vol. 4 at 2532–39, 2886–91. This Subcommittee requested actuary E. J. Moorhead to develop data designed to compare the lapse and surrender rates of term and whole life policies. The results appear as Hearing Exhibit N–1 (H. 296). The construction of that exhibit is discussed in H. Apps. 27A through C. Additional, related data appear in H. App. 27D. Commentary on the significance of the data appears in the record at H. 299–300 (NAIC), 399–402 and 404 (ACLI), and 518 (Moorhead), and in H. Apps. 27E and F.

[36] 121 Cong. Rec. 21475, 21476 (1975) (H. 681) (remarks by Senator Hart on the occasion of his introduction of the Consumer Insurance Information and Fairness Act) [hereinafter cited as *Hart Remarks*]. A full version of the Senator's statement appears as H. App. 19.

[37] H. 17.

[38] In 1976, three-fifths of all new ordinary life insurance was purchased for people between the ages of 15 and 34. *Fact Book,* supra note 6, at 15.

[39] H. 14.

[40] Life Underwriter Training Council and Life Insurance Agency Management Association, *The Widows Study,* vol. 1 (1970) at 5–6, 8, 48–49 [hereinafter cited as *Widows Study*], reprinted in *Hart Hearings*, supra note 1, vol. 1 at 313 et seq.

show that average life insurance protection per American family was slightly over $30,000 in 1976, an amount that would cover the average family's needs for only two years or so.[41] Further, the average death benefit actually paid per life insurance policy in 1976 was $4,203, up only $829 from $3,374 in 1966.[42]

The NAIC witness stated his view that the American people are still seriously underinsured today, but was not willing to concede that inappropriate whole life sales were the cause. He noted that persons who purchase term policies rarely carry them until death, a factor that could depress average coverage figures.[43]

We find that it is impossible to make definitive findings about "underinsurance" without data revealing the other resources available to the beneficiaries of a deceased. After all, a widow who receives no insurance proceeds is not underinsured if her husband's estate includes other substantial assets. The real issue is whether the dependents of the deceased are provided enough funds, from whatever source, to maintain an adequate living standard. Thus, we think it important to note that the Widow's Study, besides detailing the sources and amounts of funds available to the survivors, also revealed that 58 percent of the widows studied had suffered some actual decline in living standards, and that 35 percent had suffered a serious decline.[44] This suggests actual underinsurance.

The Widow's Study data are, of course, rather old. It is difficult to know either how prevalent underinsurance is at present, or what its causes are to the extent it does exist. However, we think it worthwhile to say that any agent who sells $10,000 of whole life rather than $40,000 of term to a young, asset-poor family head is probably doing his client a gross disservice.[45] The NALU witness admitted that such sales do occur and agreed that they were deplorable.[46] It is evident to us that many purchasers in such situations have acted solely on the agent's advice and without any real understanding of what they were doing.

SOLUTIONS

We have concluded that the present system for selling life insurance does not provide adequate information and guidance to ensure informed consumer choice, and have discussed the serious potential consequences for consumers that flow from this failure. We now turn to our four recommendations for solving the problem by increasing the amount of unbiased information available in the marketplace.

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[41] *Fact Book*, supra note 6, at 17.
[42] *Id.* at 46.
[43] H. 326–27. On the other hand, to the extent that term purchasers carry relatively larger face amounts of coverage, their presence in a statistical sample would tend to inflate average coverage figures while their policies were in force.
[44] *Widows Study*, supra note 40, vol. 2 (1971) at 18.
[45] It is no answer to say, as the NAIC witness appeared to, that term is inadvisable for such a person simply because high rates in later years may lead to lapse. H. 327. The most urgent need of our hypothetical client is for maximum protection while his children grow up. True, the fact that the client has no whole life insurance means that he will have no cash value nest egg for retirement (or, at least, he will have a smaller nest egg if he has converted from term to whole life at some point). However, this simply reflects the fact that some people are poor and *can't have both* adequate protection and a nest egg at the same time. We do not think that the solution is to sell such people whole life and leave them exposed to catastrophic consequences should the wage earner die. In any event, the product choice should be made by the purchaser after considering the relevant risks, not by the agent.
[46] H. 462.

Recommendation 1

First, we recommend direct disclosure of information that will encourage and enable a prospective life insurance purchaser to compare whole life with a "buy term and invest the difference" alternative. As discussed previously, we think the simplest and most informative way of performing the analysis is to compare a whole life policy's dollar surrender value at a given age with the dollar amount the purchaser would have in his side investment fund had he selected the term insurance alternative.

The surrender value of a whole life policy at any given year is, of course, easily ascertained. The cash accumulation amount for the term alternative, however, requires assumptions both about term insurance premiums and about the rate of return the side fund will earn. To be completely informative, assumptions about the purchaser's present and prospective tax bracket would also have to be made, although this step could be omitted if the significance of the tax impact is explained to the purchaser.

An alternative way to disclose the information necessary for making the whole life-term choice is to show the Linton Yield for the whole life policy being considered. In one respect, the Linton Yield approach is more definitive than the cash accumulation method, since the only assumption necessary to calculate yields is a schedule of term insurance rates. The resulting figure is the percentage yield imputed to the savings portion of the whole life premium, and simply shows the after-tax yield a purchaser would have to achieve on his term insurance side fund in order to "beat" the whole life plan. No assumed return on investment or income tax effect is included in the Linton Yield computations.

On the other hand, the cash accumulation method shows when the side fund exceeds the whole life *face amount*. This is important for purchasers who never intend to surrender their whole life policies. They are not especially interested in how the whole life cash value increases, and do not find a Linton Yield figure very useful because it merely reveals the side fund earnings rate that would be needed to exceed the *cash value*.[47] This consideration convinces us, on balance, to prefer the cash accumulation method over the Linton Yield as a comparative method. However, we do not affirmatively oppose the Linton Yield, and regard both approaches as acceptable.[48]

We do emphasize our conviction that one or the other should be mandated.[49] The very presence of such a disclosure will tend to excite

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[47] *Cf.* H. 341.

[48] In subsequent portions of this Report, we will frequently use the phrase "rate of return disclosure" as a generic reference both to Linton Yield and to cash accumulation figures.

[49] As to technical details, the interest rate used for the cash accumulation method should be the rate of return readily available to small investors on savings accounts, debt instruments of the United States Treasury, and similar safe investments. Cf. H. 192 (Belth): H. 262 (NAIC). For term insurance rates, we are inclined to recommend the "low range" rates derived under the Society of Actuaries formula:

$$\text{Premium} = (1{,}000\, q_x)\ (0.95) + .90 + \$25/s,$$

where

q_x=mortality rate for age x from an ultimate basic mortality table, and

s=policy size in thousands.

See *Actuaries Report*, supra note 27, at 138–39. As the *Actuaries Report* observes, *id.* at 141, the low scale should be used because "it would typically be assumed that one who seriously considers the two alternative programs upon which the method is based would attempt to obtain a low-priced YRT policy."

Other plausible term rates include those developed by E. J. Moorhead for the Hart Subcommittee, and those contained in IRS revenue ruling 55–7!7. The former are attached as an appendix to the FTC's Technical Notes (See H. 122). The latter, printed as H. App. 22, are used by Professor Belth for his rate of return calculations (see H. 192). In any event, of course, the rates used should be equivalent to those actually available in the market from low cost companies.

the interest of a purchaser and lead him to make the essential analysis of term and whole life. The purchaser's questions to his agent about the computation and significance of the disclosure figures will oblige the agent to describe the available product alternatives. This will enable the purchaser to select the product that best suits his needs and preferences, and inhibit product choices based solely on the proclivities of the agent.[50]

Counterarguments

Before turning to our second recommendation, we want to address certain objections that are raised against the disclosure of rate of return information designed to enable and encourage life insurance purchasers to compare whole life with a "term plus side investment" program.[51]

First, it is asserted that the features of a whole life policy from the policy holders standpoint are unique, and cannot be duplicated by any term/side investment package. The testimony of the ACLI witness typifies this argument:

> "[U]nlike a bank savings account, the cash value of a whole life policy may be used in many ways such as to purchase extended or paid-up insurance benefits, or to provide a life income to the insured or beneficiary, or as collateral for a relatively low cost policy loan. Moreover, since whole life insurance policies are not, in fact, bank accounts plus term insurance, income taxes are not payable on any interest that might be imputed to the policyholder. Further, at death, life insurance proceeds can be obtained quickly without passing through the estate of the insured and without having to be probated. Savings accounts do not provide any of these features, nor can banks provide the very long term investment guarantees which are inherent in whole life policies. Also, banks cannot enhance the insured's ability to continue his program of family protection by providing such benefits as the waiver of premiums in the event of disability. These advantages of permanent life insurance are ignored in the "buy term and invest the difference" comparison * * *." [52]

Other unique advantages of whole life policies that have been noted include the semi-compulsory nature of the whole life savings program, the freedom from the duties of investment portfolio management, and the fact that under some state laws insurance proceeds are protected from creditors' claims.[53]

The answer to these arguments is very simple. We do not doubt that whole life policies have unique characteristics that many would regard as advantageous. The existence of these characteristics is, however, completely irrelevant to the issue of whether the rate of return differential between whole life and a term side fund should be disclosed. The advantages of whole life are factors that can persuade a purchaser to accept a lower rate of return than could be obtained under a term program.

The "whole life is unique" argument is reminiscent of the aphorism that you "can't add apples and oranges." However, an insurance purchaser, like a fruit purchaser, is *comparing* whole life with term (or apples with oranges), not adding them. Surely he is entitled to know what the differences in the products are. An insurance seller should no more seek to obscure rate of return differences than a fruit seller should seek to obscure the fact that oranges are citric and apples are not.

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[50] Concerning the question of what durations should be used for calculating the comparison, see pp. 46–47, infra.
[51] The NAIC, ACLI, and NALU all object to rate of return disclosure.
[52] H. 340. *See also* H. App. 10 for a similar statement.
[53] *Mehr,* supra note 8, at 137–41.

Second, rate of return disclosure for whole life is attacked as improper and misleading because it implies that the whole life contract is a combination of death protection and a savings account, and necessitates artificially splitting the whole life premium into an insurance element and an investment element. The ACLI witness described the putative fallacy in this approach:

"[C]ash values provided under a life insurance policy are a by-product of level annual premiums. These benefits can be made available by insurance companies because, for terminating policyholders, no death benefit will be payable. Therefore, funds held in anticipation of paying a future death benefit are no longer needed by the company. Since the insurance company requires less funds on hand than if the policyholder had continued his policy in force, the company can release to the terminating policyholder the funds it no longer requires. It seems farfetched to call these benefits a savings account." [54]

It is true that calculation of a Linton Yield artificially divides a premium into savings and protection element and accumulates the savings portions in a fund used to ascertain the policy's rate of return. It is also true that company actuaries do not determine whole life premiums by calculating savings and protection elements, and that whole life policies do not provide policyholders with face amount protection plus a separate and independent savings account.

These statements, while accurate, nevertheless do not present significant impediments, philosophical, practical, or otherwise, to the computation and disclosure of information that will assist a purchaser in selecting between whole life and a term plus investment program. For one thing, the total cash accumulation method of comparison does not entail any direct disaggregation of the whole life policy's elements. The Linton Yield method does require a separation, but for relevant and useful purposes. The Linton Yield method compares rates of return, and must therefore keep total cash accumulations equal. A conceptual separation of elements is necessary because the products involved have different contractual characteristics and must be viewed in segments to ensure that the product programs being compared offer equivalent protection and cash value benefits to the purchaser.[55]

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[54] H. 341. *Cf.* H. 305 (NAIC). Various other statements of this argument can be found in *The Nature of the Whole Life Contract: Research Project 10* (NAIC 1974), prepared for the NAIC's Life Insurance Cost Comparison Task Force by the Institute of Life Insurance (now ACLI).

[55] We note our agreement with the following statement:

"The inseparable contract can be separated conceptually as easily as one can separate into two parts the purchase of a car with extra equipment for a single price. That the conceptual separation is not only possible, but an appropriate way to look at cash value life insurance, is shown not only by the fact that it is found in standard textbooks including those of the insurance saint, S. S. Huebner, but even more persuasively by the industry's own readiness to be recognized as a major savings institution when questions other than price disclosure are under discussion. Thus, the Life Insurance Association of America, in a scholarly monograph for the Commission on Money and Credit, published in 1962, had no qualms about a chapter entitled 'Policyholders' Saving Through Life Insurance.' The study talks of industry efforts to push whole-life and endowment as opposed to term, in the hope of 'an augmented flow of savings into life insurance.' They further expressed hope that the 'declining trend in life insurance savings' would be transitory.

The readiness of the industry to make the conceptual separation whenever it suits industry purposes makes it impossible for us to take the actuaries' objections to the savings notion seriously enough to argue about it further" (footnotes omitted). S. Kimball & M. Rappaport, *What Price "Price Disclosure?" The Trend to Consumer Protection in Life Insurance*, 1972 Wisc. L. Rev. 1025, 1028–29 [hereinafter cited as *Kimball*]. *Cf.* H. 28.

We have included in the record several recent industry publications that make typical reference to the "savings account" characteristics of whole life insurance. See:

(1) the NALU brochure (H. App. 24) claiming that: "Permanent forms of life insurance provide guaranteed protection you can't outlive. So your policy benefits are there if you should die, or, far more often, are there to supplement other income and resources in your retirement years."

(2) the Government Employees Life Insurance Company (GEICO) brochure (H. App. 25), stating that: "A whole life or endowment policy will guarantee to pay your family a regular monthly income or a cash sum, or both, if you die. And if you live, the cash values

(Continued)

We think the "improper separation" argument is just another variant of the claim that whole life and term plus investment programs should not be viewed as legitimate alternatives in the first place. Our arguments rejecting that philosophy have been carefully articulated,[56] and we need not repeat them now.[57]

We do want to note one legitimate reason why characterization of whole life as "protection plus a savings account" could be deleterious. Whole life policyholders can misinterpret the characterization and believe that they are able to withdraw cash from their "savings account" without affecting their life insurance protection.

A policyholder, of course, cannot obtain his cash value outright without surrendering his policy, and with it his death protection. He can borrow against his cash value, but must then pay the interest rate established by the policy's provisions and must also realize that his death protection is reduced by an amount equal to the unpaid loan balance.

The agent should carefully explain these features of the whole life policy to the purchaser. The fact that policyholders are not entitled to both the face amount protection and the cash value is perfectly legitimate and inheres in the nature of the whole life contact.[58] If the agent does his job properly, information disclosure designed to assist comparisons between term and whole life will not mislead consumers about the characteristics of the whole life policy.

(Continued)
will provide a nice 'nest egg' you can use as a family emergency fund, for your children's college tuition cost, or for additional retirement income."

(3) the ACLI advertisement (H. App. 26) which has recently appeared in several nationally distributed magazines (e.g. Time, Sept. 11, 1978 at 70–71) and which describes life insurance, Social Security, private pensions, and personal savings as "elements of a comfortable retirement."

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

[56] We also note the following colloquy between Subcommittee counsel and the NAIC witness (H. 294):

Mr. SHAFFER (Counsel). [W]e are talking about a purchaser who wants to protect against premature death. He wants to assure himself a fund. The problem is that there are different ways to assure a fund. I pick the amount of protection I want and just always make sure I have insurance plus other liquid investments that add up to that amount.

Isn't that a feasible way of assuring the fund?

Mr. ANDERSON (NAIC). That most certainly is. That doesn't mean that is the most feasible way.

Mr. SHAFFER. That is right. I may well be a person who insists, for whatever reason, that insurance be the only source that provides the fund. OK. But there is a potential choice. The fact that whole life isn't itself term insurance and a savings account shouldn't prevent me from comparing whole life, as one alternative, to term plus an investment as another alternative, should it?

Mr. ANDERSON. It should not.

[57] The NAIC appears willing to agree that whole life should be compared to term plus investment programs (see n. 56, supra), but argues that "[t]he relative advantages of 'saving' through life insurance versus a bank savings plan or a mutual fund can better be determined by the purchaser without reference to some artificially constructed 'rate of return' * * * disclosure, the technical origins of which are well beyond the comprehension of the average consumer." H. 264.

We are at a loss to know how the relative advantages "can better be determined" other than by the methods (total cash accumulation or Linton Yield) that we have previously discussed. We note that the insurance departments of two states have expressed support for Linton Yield disclosure precisely because it enables consumers to compare "dissimilar policies," i.e. term and whole life. See H. App. 18 (Massachusetts) and H. App. 12A (Wisconsin).

[58] We think it regrettable that some advocates of term insurance have muddled the term-whole life comparison process by suggesting that insurance companies "seize" the cash values when their policyholders die. See H. App. 15A. This argument is disingenuous and misleading. It ignores the fact that the whole life policy can maintain a level premium only by providing successively lower amounts of death protection. The cash value enables the company to provide level death payments without increasing premiums. An insurance policy that paid both the face amount and the cash value could presumably be written, but its premiums will be drastically higher. Term advocates have as much responsibility as whole life advocates for presenting a clear analysis of the controversy. See J. Belth, *Deceptive Sales Practices in the Life Insurance Business,* 41 J. of Risk & Ins. 305 (1974) for a discussion of the different deceptive techniques used by some whole life and term advocates when comparing term and whole life programs.

The first two arguments against rate of return disclosure, just discussed, raised questions about whether such disclosure can be made in a non-misleading, philosophically proper manner.[59] The third and final argument asserts that rates of return, or similar information, should not be disclosed because many purchasers will be motivated to select term rather than whole life, and socially undesirable conditions will result.[60] The undesirable consequences predicted are many, but tend to settle into four main categories. They are:

(1) that since the only worthwhile insurance is insurance in force at death, and since most term policies will lapse before death, increased term sales will ultimately produce numerous destitute widows; [61]

(2) that people who buy term expecting to "invest the difference" will instead spend the difference, to their ultimate regret;

(3) that the nation's economy will suffer from lack of adequate capital investment if life insurance companies no longer make enough whole life sales to produce surplus funds; and

(4) that life insurance agents will find it harder to make a living at their trade and will cease performing the useful services they now provide.

Our reaction to these four arguments is as follows. First, we find patently preposterous the claim that insurance is worthless unless in force at death and that the increased purchase of term insurance will eventually produce destitude dependents.[62] As we detailed earlier, life insurance protects against premature death. It assures the availability of funds to provide for the needs of dependents until such time as an adequate fund to meet these needs can be separately accumulated. Once either the need for insurance dissipates, or separate funds sufficient to meet remaining needs are available, no further insurance coverage need be maintained. The death of an uninsured breadwinner in such circumstances will *not* leave a destitute widow. Her funds will simply come from other sources. Further, the premiums paid for the insurance before it was lapsed are not "wasted," even if the insurance was term and no cash values are returned, because the insurance did precisely the job it was supposed to do: protect against the adverse consequences of premature death. Put another way, a death that occurs after an adequate fund has been accumulated is not "premature," and need not be protected against with life insurance.[63]

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[59] One technical objection to Linton Yield calculations is that yield results vary substantially depending on the term rates assumed. It is true, for example, that using "high" rather than "low" term rates can add a full percentage point to whole life policy yields. *See Actuaries Report*, supra note 27, at 145 (Table 46), reproduced as Hearing Exhibit A–4 (H. 395). The *Actuaries Report* concluded, and we agree, that yields "vary noticeably" when different YRT rates are used. *Actuaries Report*, supra, at 161. *See also id.* at 146, *but cf. id.* at 141. However, this is simply not important. As discussed earlier (note 49, supra), we think "low" term rates should clearly be used, our only concern being that they accurately reflect the rates actually offered in the market by low cost firms.

[60] The letter reproduced as H. App. 9 is a typical statement of these social policy arguments. See also H. App. 10. The beliefs there articulated are obviously sincere and fervent, and our treatment of them in the text is not meant to cast any aspersions on the personal integrity of their advocates.

[61] The ominous implications of such a development are sometimes emphasized by predicting that political forces would arise to promote an expansion of the Social Security system. *Cf.* note 64, infra.

[62] The author of the letter reproduced as H. App. 9 is a general agent and a certified life underwriter. He makes the flat statement that "[t]he only insurance that does any good is that which is in force when the insured dies, or needs it for retirement income, right?" Wrong, and the fact that an agent with such credentials can believe such a statement is appalling.

[63] As to people who cannot afford both adequate term coverage and a side investment fund, see note 45, supra.

Of more intrinsic import is the second social policy argument, predicting that term purchasers will "spend the difference" rather than investing it. We note that this possibility is only relevant for those who can spend premium dollars in excess of the term insurance costs. If they do spend the extra money, they will find themselves at retirement with no nest egg, whereas had they bought whole life, they could surrender the policy for its cash value. Naturally, spendthrifts will regret not having a whole life policy to cash in.

We do not know how many whole life prospects will switch to term if rate of return disclosure is instituted, nor how many of the latter will dissipate their side fund. For one thing, we would expect that an agent whose client has purchased term will check back periodically to see if the difference really is being saved. If it isn't, the agent will have a strong argument favoring conversion to whole life.

Even assuming that many people will "spend the difference" without remorse, it does not follow that the solution is to promote whole life sales by obscuring rate of return differentials. We simply reject the notion, implicit in this argument, that insurance companies should be allowed to fool people into saving for the future. If, from a social policy standponit, we want people to save, and are afraid they will not do so voluntarily, the response has to be crafted on the floors of Congress, not in insurance company boardrooms.[64]

The third social policy argument is that increased term sales will reduce the amount of funds available to life insurance companies for investment, and that therefore the national economy will suffer from inadequate capital investment. It is probably true that increased term sales will decrease insurance company investment, but term insurance purchasers who invest the difference will be depositing their money with some other financial intermediary that serves a capital formation function.[65] If the money is not invested at all, but is spent, the result is the same "insufficient savings" issue analyzed in connection with the previous argument, and the conclusion is the same. Forcing people to save money they otherwise would not, in order to promote social objectives, must be undertaken by the political institutions responsible for mandating such programs.

The final claim is that rate of return disclosure will make sales harder for agents and reduce their ability to provide the useful services they now perform. This argument puzzles us.

To the extent that an agent simply seeks the quickest sale for the largest commission, any kind of mandatory disclosure will naturally inhibit productivity. However, the NALU objects to rate of return disclosure, and that organization surely represents many agents who genuinely seek to serve their clients' interests. We do not understand how an agent can ascertain which insurance product is appropriate without first analyzing rate of return differentials with his client and discussing in considerable detail the relative advantages and disad-

[64] A Congressional solution presumably could entail the expansion of involuntary savings mechanisms such as Social Security. While this is not a report on the benefits and ills of Social Security, we do note arguments suggesting that any expansion of the Social Security system would be undesirable since the citizenry could obtain far better benefits from their Social Security dollars by using them to purchase insurance from private companies. In our view, the validity of that assertion has simply not been proven. See H. App. 23A&B.

[65] We do not think it could be argued that life insurance companies are better financial intermediaries than other institutions that accumulate and invest savings. The point is that the interest rates being paid by competing intermediaries should be known to people who are about to commit their future savings to one of them.

vantages of whole life versus a term plus investment program. A prospective purchaser is clearly entitled to such an explication, regardless of the agent's personal views about which alternative is best. Thus, we think rate of return disclosure will, if anything, facilitate the educational function that conscientious agents should seek to fulfill.

The real fear may be that, if rate of return disclosure actually leads to reduced whole life sales, agent income will drop across the board because term sales pay a lower commission rate. If this happens, the solution will have to be framed by the agents and the insurance companies. Certainly, preserving consumer ignorance cannot be justified as a way of financing the agency system.[66]

In sum, we do not think that any of the arguments commonly advanced against rate of return disclosure are valid. Yield differentials are relevant and highly material to a purchaser considering alternative insurance products. We especially reject the suggestion that consumers should be sheltered from factual information simply because such disclosure could lead consumers to make purchase decisions they might later regret.

In late 1976, the house periodical of the NALU published a commentary concerning the promulgation by the Texas State Insurance Board of a life insurance replacement regulation.[67] The regulation was designed to ensure that an insurance policyholder would be provided with certain information before he dropped one insurance policy and replaced it with another. The NALU commentary recognized that more information disclosure could not *prevent* a policyholder from undertaking an unwise replacement, but concluded as follows:

> "The State Board of Insurance cannot guarantee quality and bargain, but through the regulation in question, it attempts to secure truth in the insurance industry through full and complete disclosure. Although some may argue that such truth would only free the unsophisticated from their money, the Board did not attempt to take away from the citizen his inalienable right to make a fool of himself; it simply attempted to prevent others from making a fool of him. Such an attempt cannot be said to be arbitrary or capricious. It is certainly the function of the Board to set forth a minimum disclosure requirement to assist the consumer."[68]

We wholeheartedly agree, and believe that the same logic is equally applicable to rate of return disclosure. We do not understand the persistence of the NALU, or for that matter the ACLI, in opposing disclosure so plainly needed.

This is an era of aggressive consumerism. American purchasers want to make their own decisions and should be provided the facts

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[66] A more elaborate analysis of the possible impact of information disclosure on the agency system is undertaken at p. 58, *infra*.

[67] R. Panneton, *Replacement Regulation Upheld*, in NALU Life Association News (Dec. 1976), reprinted in NALU *On the Legal Side* 171 (undated).

[68] *Id.* (*On the Legal Side*) at 172. In passing, we contrast the NALU's laudable approach to replacement with that of the Million Dollar Round Table (MDRT), an association of successful agents who have sold large volumes of life insurance. In June 1977, MDRT's president observed that the MDRT code of ethics prohibited "replacement practices detrimental to the client." and threatened to expel MDTR members who transgressed. *Controlling Replacements: Who Should Lead?* in National Underwriter (Life & Health Ins. ed., May 20, 1978) 22. Further, he said, "Even though the 'numbers' might suggest a benefit derived by replacing a policy, this benefit must show a very substantial gain before it will be viewed by our ethics committee as beneficial." *Id.*

This strikes us as nakedly anti-competitive, especially since a recent study has shown that, due to inflation, many older life insurance policies should be replaced. See W. Scheel & J. Van Derhei, *Replacement of Life Insurance: Its Regulation and Current Activity*, 45 J. of Rick & Ins. 189 (1978), *discussed in* J .Coyle, How To Save $7,000 on Your Life Insurance, MONEY 75 (July 1978).

they need to do so correctly. The availability of relevant product information promotes effective competition.

We call for disclosure now.

Recommendation 2

Our *second* suggestion for correcting the market's failure to provide adequate information relevant to the term versus whole life choice is designed to deter early lapse of whole life policies. We recommend that any cash value table displayed for a whole life policy reveal clearly and conspicuously those policy years for which the cumulative Linton Yield is less than zero.[69] More specifically, the policy year number and the cash value figure should be printed in red for those years when surrender would result in a loss to the policyholder from a Linton Yield standpoint.[70] The cash value display should be accompanied by the following notice:

WARNING

> Termination of this policy during the years printed in red will result in a loss to you. Do not purchase this policy unless you intend to keep it at least long enough to avoid a loss. Ask your agent for further details.[71]

We think this is more likely to catch the attention of the policyholder and drive home the point than would, for example, the disclosure of actual Linton Yield figures for durations 5 and 10.[72] We also think it will be more practicable than other proposals for dealing with lapse, such as substantially increasing early cash values by amending state non-forfeiture laws,[73] or adjusting agent commission schedules to reward persistency.[74]

The difficulty with both increased non-forfeiture values and agent persistency bonuses are that they cost money. Costs of this sort are likely to be spread out over all policyholders by increasing premiums and decreasing dividend payments. This means that *all* policyholders will be contributing funds to solve a lapse problem relating to only a portion of policyholders. We prefer to focus first on solutions designed

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[69] Under this proposal, Linton Yields would not be computed by treating each policy year as a separate entity, but would be calculated to the end of each policy year for durations reflecting the life of the policy to that point.

[70] In his testimony, the NAIC witness suggested that it was not important to call consumers' attention to negative yields in early years because: "the relationship of benefits and premiums is illustrated in the policy summary required under the [NAIC] model regulation. If the available cash value is less than the aggregate paid-in premiums, the policyholder can clearly see that there is no policyholder 'profit' on premiums paid." H. 259n.

We do not believe that policyholders "clearly see" that point at all. We doubt that purchasers pay much attention to early year cash values during the sales presentation or that they realize the relevance of the cash value/premium relationship to the issue of lapse. Certainly, the agent is unlikely to emphasize the fact that the poicy he is selling pays no cash values in the first year or years. In any event, we need only cite current two year lapse statistics, see pp. 17–18, supra, to support the view that many consumers are not sensitive to the consequences of lapse.

[71] This notice should also be printed in red, enclosed in a box, and located immediately contiguous to the cash value display. The idea of a warning designed to deter lapse is not new. It dates from at least May, 1975. See *Hart Remarks,* supra note 36, at 21484 (4.689).

[72] The FTC proposes Linton Yield disclosure at policy durations 5, 10, and 20. Disclosure at duration 20 is useful for comparing whole life and term alternatives and we support it. Disclosure at earlier years is plainly directed at lapse deterrence rather than policy alternative comparisons, and we simply doubt that persons who are likely to lapse will grasp the special significance of the negative Linton Yields that are typical of whole life policies at early durations.

[73] State non-forfeiture laws require that certain minimum cash values be paid to persons who surrender their whole life policies. One suggestion, detailed in H. App. 16, is that the statutory minimum non-forfeiture value for year 1 of a whole life policy be 25 percent of the first year premium.

[74] *Cf.* Agents' Compensation Report, supra note 18, at 60–61.

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to prevent lapsation without increasing costs, and therefore recommend a simple information disclosure approach at this time. We especially note that our proposal does not entail disclosure of any new numbers or indexes.

Other disclosure proposals

We wish to address at this point certain other suggestions for policy data disclosure designed to deal with the choice between whole life and term, and with the associated problem of agent bias. For example, it has been argued that data should be disclosed for every whole life policy showing the precise allocation of total premium dollars between the savings element and the protection element and, further, that Linton Yield, amount of protection, and "cost of protection" figures should be calculated and disclosed for each individual policy year.[75] This sort of disclosure is intended to reveal (1) that a whole life policy can be regarded as a combination of protection and savings, (2) that the actual cost to the policyholder of the protection element increases with policy duration even though premiums remain level, and (3) that the cost of protection and the yield of a given policy can vary substantially from year to year depending on the way in which the policy's benefit pattern has been structured.

We think that this kind of information would be very interesting and useful to state insurance offices, agents, and sophisticated consumers, but do not believe that now is the time to mandate disclosure of such data for all policy purchasers.[76] We arrive at this conclusion with considerable regret, and only because we do not think human nature permits an efficient transition from gross ignorance to perfect knowledge overnight.

As we discuss in our next recommendation, we support preparation of a Buyer's Guide for distribution to life insurance consumers. This Guide would explain, in generic terms, basic points about the nature of term and whole life policies, including the fact that whole life policies may be regarded as a combination of protection and savings and that the actual cost of protection rises over the years.[77] Our further proposals for disclosing policy benefit patterns are treated in the next chapter.[78] This, we think, will have to suffice for the present, otherwise an excess of data will discourage most people from attempting any analysis at all.[79]

Another possibility, designed to deal with agent bias resulting from skewed commission structures, is to disclose the percentage commission rates paid to an agent on term and whole life, together with the dollar figure the agent stands to earn from the particular sale he is proposing. There are, we note, certain technical problems that arise in

[75] Professor Joseph Belth has developed the most elaborate proposal of this kind. His system is described in detail at H. 188–99. The FTC's tentative proposal incorporates certain elements of the Belth approach. See Report Appendix B.

[76] See p. 53, infra, for our views on making more elaborate data available to state regulatory officers and other interested persons.

[77] The FTC appears willing to rely on a general statement about the division of whole life premiums between savings and protection elements, and does not insist on a disclosure of exact premium dollar allocation. H. 86.

[78] See pp. 48–49, infra.

[79] Because the Belth system views each policy year as a single entity for purposes of calculating yearly cost of protection and rate of return figures, we think it is more useful for comparing one whole life policy with another than for comparing term with whole life. Indeed, the Belth rate of return schedule tends to give an unduly favorable impression of overall whole life return rates. Cumulative rates of return are lower than year-by-year rates due to the effect of negative yields in early policy years.

attempting such disclosure without misleading consumers both about the total amount of compensation an agent receives for his services over the life of the policy, and about the relation of the agent's compensation to aggregate premiums.[80] In any event, we conclude that a general statement in the Buyer's Guide about commission differentials and possible agent bias is an adequate remedy.[81]

Recommendation 3

As our previous comments have foretold, our *third* recommendation for increasing information relevant to the term/whole life choice is to provide consumers with a Buyer's Guide. The text of the Guide should be mandated by regulation, and pre-printed copies of it, in pamphlet form, should be presented to the sales prospect by the agent at first contact.[82] Indeed, if the agent canvasses to identify prospects and uses his initial contact to schedule a subsequent sales presentation, the Guide could be mailed to the prospect so that he could review it *prior* to the agent's visit. The Guide should also be stocked by state insurance offices and insurance companies, and mailed free to interested persons.

The Guide must be kept as short and simple as possible. It should also be designed to attract and hold the consumer's attention by emphasizing the practical importance of purchasing the appropriate policy and describing the adverse consequences of an incorrect choice. In particular, the Guide should discuss:

(1) insurance needs and how much insurance to purchase;

(2) the choice between term and whole life, including—

(a) a description of the two policy types, noting (i) that whole life can be viewed as a combination of savings and protection, with the size of the protection element decreasing over time as cash values increase, (ii) that the actual cost of protection under a whole life policy rises even though premiums remain level, and (iii) that a purchaser cannot directly obtain the cash value without surrendering his policy;

(b) a discussion of the dollar premium differences between term and whole life, and the relevance of that difference to the danger of underinsurance;

(c) a note dealing with the inadvisability of purchasing whole life for short durations, the problem of lapse, and the significance of the policy cash value display;

(d) a remainder to consider the extent to which insurance needs may change in the future;

(e) an analysis of the advantages and disadvantages of whole life compared to a "buy term and invest the difference" alternative, including a description of rate of return,[83] and the unique characteristics of whole life that may make a relatively low yield acceptable; and

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[80] *See* H. 461; *cf. Agents Compensation Report*, supra note 18, at 30–32.

[81] *Cf.* H. 138–39. A related question is whether, from a policy standpoint, agent commission rates should be fixed by law to neutralize any agent bias favoring certain types of insurance. There are serious technical problems with this idea, *see H.* 139–40 (FTC); H. 225 (Belth); *cf. Agents' Compensation Report*, supra note 18, at 41–42.

[82] Our recommendations concerning preparation and delivery of the policy summary sheet, which would disclose rate of returns, cash values, and other data unique to each individual policy, are discussed at pp. 49–51 infra.

[83] For purposes of the Buyer's Guide, the Linton Yield should probably be called something else, such as "average annual rate of return." *Cf.* FTC Buyer's Guide, Report Appendix B.

(f) a reference to the possibility of purchasing convertible term or a combination of whole life and term as a way of satisfying insurance needs;

(3) other types of individual insurance, such as endowment and paid-up at 65;

(4) group insurance;

(5) the difference between participating and non-participating policies, including an explanation of the significance of "illustrated dividends" and a statement that such dividends are not guaranteed;

(6) agents, noting the value of a good agent, but also explaining the significance of commission differentials and the fact that some agents will only sell the products of one company; and

(7) the availability of additional information, including a brief bibliography.[84]

A few remarks are appropriate at this point about the Buyer's Guides developed by the NAIC and the FTC.[85] The NAIC proposal, we are obliged to say, omits a great many of the points listed above. It does not, on the other hand, include any statements to which we affirmatively object.[86]

The FTC version covers nearly all the points we regard as essential and is therefore considerably more desirable, in our view. However, it has been claimed that the FTC Guide exhibits a bias in favor of term insurance, and our review tends to confirm that charge to some degree.

The clearest example appears in the FTC's discussion of "two ways to save." After explaining how whole life and term plus a side investment are alternative ways of accumulating funds for the future, and describing the significance of Linton Yields, the FTC's Guide concludes:

> "If the whole life policy's rate of return is lower than what you could get elsewhere, you'd probably do better buying a term policy and investing the difference." [87]

As we have noted, this statement is not correct because the purchaser should analyze the advantages of the whole life option to decide if they are worth accepting a relatively lower return on investment. Indeed, the FTC witness at our hearings was quite definite that:

> "[W]hole life insurance used as a savings vehicle does have a legitimate role and it may be a very rational choice for large numbers of consumers to buy versus term insurance. Our concern is that the choice to buy the whole life insurance be an informed one * * *." [88]

Nonetheless, the FTC Guide nowhere refers to the unique characteristics of whole life as a savings vehicle nor to the potential dangers

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[84] The Buyer's Guide should also include a discussion of how to find a low cost policy by using policy cost index numbers. Our recommendations with respect to cost indexes are detailed at pp. 39–46, infra.

[85] A comparison prepared by the Michigan insurance department of the NAIC and FTC Buyer's Guides appears in H. App. 11.

[86] This is not to say that all the points discussed in the NAIC Guide are treated adequately. For example, the NAIC Guide includes an explanation of the difference between term and whole life insurance. However, a survey conducted in 1976 for the Prudential Life Insurance Company found that only 45 percent of those who had read all or most of the Guide could successfully explain the difference between the two types. CORP, *Impact Among Policyowners of the New Business Booklet* 21 (Prudential 1976).

[87] FTC Buyer's Guide, Report Appendix B at 6.

[88] H. 95.

of an "invest the difference" plan.[89] This is an omission that should be corrected.[90]

Recommendation 4

Our *fourth* recommendation is that the NAIC, the FTC, or both, should study how to encourage the development of professional insurance consultants who would provide counsel and advice to consumers for a set fee.[91] Whenever consumers purchase products and services on the advice of salesmen whose compensation level depends on the amount expended by the consumer, some abuse is likely. Salesmen will naturally tend to emphasize the more expensive alternatives, and consumers unable to ascertain and evaluate the alternatives will naturally tend to follow the salesman's recommendation.

If consumers can purchase unbiased, expert advice for a reasonable fee, they will be able to make more suitable product choices. Competitive forces will also be able to operate more effectively.

There tends to be consumer resistance to "fee-for-advice" services because Americans are not accustomed to paying for pure information and because the advice fee, from the consumer's standpoint, amounts to a surcharge on the ultimate product price. Incurring an advice fee can nonetheless result in lower ultimate costs because the consumer can avoid making unnecessarily expensive purchases. Also, the presence of better informed customers can put strong downward pressure on product prices across the board.

The time appears ripe to encourage providers of fee-for-advice services. Consumer realization of the value and importance of unbiased information is on the increase, and professional advisors are operating in a number of fields.[92] We suspect that some state laws and regulations unnecessarily inhibit the activities of insurance advisors.[93] We also think that laws designed to prohibit commission rebates from

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[89] Other portions of the FTC Guide could be construed as pro-term mainly because of language tone. For example, the Guide at page 2, says that "Beyond age 65, term premiums become very expensive. But by then you may want to drop your policy anyway. The point to remember is that a renewable term policy, and not just a whole life policy, can meet your long-term insurance needs, at least through age 65."

While true, the second sentence might be revised to say that "However, by that time, your need for insurance may no longer exist," and the third sentence could be dropped altogether.

Similarly, at page 3 of the Guide, the FTC notes that term premiums are lower than whole life premiums in early years, and then concludes that: "Therefore, if you're interested in getting the most death protection for your money, you should buy term insurance." Further, on page 4, the Guide discusses the uses of cash values as follows: "You can get the full amount of the cash value by canceling the policy. But if you do, you'll lose your death protection. You can also borrow up to the full amount of the cash value in the form of a policy loan. But if you do that, you'll have to pay interest to the insurance company at the rate fixed in the policy."

Again, both these remarks are true, but couched in unnecessarily pejorative language.

[90] Other Buyer's Guides we have reviewed include those developed by the state insurance offices in Wisconsin and New York. The Wisconsin Guide is reprinted in the Hearing Appendix in two versions. The first, in H. App. 12A, was issued in draft form to accompany Wisconsin's May 1978 proposed life insurance solicitation rule. The second, in H. App. 12B, was issued in October 1978 as part of Wisconsin's final rule. The New York Guide, entitled "Consumers Shopping Guide for Life Insurance (1977)," is retained in the Subcommittee's files and is available from the New York Superintendent of Insurance.

While this report cannot undertake a detailed analysis of these Guides, we are especially impressed by the Wisconsin draft proposal, which closely follows the FTC version while avoiding many of its faults. We have not had sufficient time to analyze the final Wisconsin version. The New York Guide is quite comprehensive, and also quite long (31 large pages of text, 58 pages of cost comparison charts). Its length may tend to intimidate unsophisticated purchasers. One solution might be to develop a "short form" version for distribution to all purchasers, retaining the longer version for issuance on request.

[91] *See* H. App. 12A.

[92] For example, auto disgnostic centers offer advice for a fee to consumers who are preparing to order auto repair services. Home purchasers can pay to have their prospective new home inspected for defects by an independent agent before committing themselves to the purchase. Some financial consultants offer assistance on a fee (non-commission) basis to those seeking investment advice.

[93] See H. App. 13.

being paid by agents to consumers should probably be modified to require that advisors return to their clients all commissions earned.[94] Thus, a consumer who pays an advice fee, and later decides to purchase insurance through his advisor, should receive a rebate of any commissions otherwise payable by the insurer to the advisor.

A rebate to the consumer of all commissions must be *required* by law, otherwise, advisors will still have an incentive to recommend expensive products.[95]

We think that these concerns, and others, could profitably be addressed in a study, because the delivery of reasonably priced, unbiased insurance advice to consumers would go a long way toward promoting wiser product purchases.

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[94] There was some discussion at the hearings of a proposal to allow offset of the advice fee against any earned commissions. Put another way, the advice fee would be subtracted from the commission and rebated to the consumer. If the fee exceeded the commission, the entire commission amount would be rebated. If the commission exceeded the fee, only enough of the commission to cover the fee would be rebated. See, e.g., H. 141 (FTC), H. 330 (NAIC), H. 521–22 (Moorhead). The NALU witness pointed out that New York already has a law to that effect. N.Y. Ins. Law § 112-a(8)(a). H. 461–62. The law provides that "[n]othing in this chapter shall prohibit the offset, in whole or in part, of compensation payable [for advice] * * * by compensation otherwise payable * * * as a result of [the] sale of insurance or annuities * * *."

This law does not eliminate bias because the advisor, in effect, keeps the portion of the commission that exceeds the advice fee. Thus, he will be still inclined to recommend insurance that maximizes the commission.

[95] In passing, we note and applaud the development of "no load" policies by some insurance companies. These policies are sold either directly to purchasers or through a fee-paid advisor without payment of a sales commission. See H. App. 13.

Chapter II—Selecting an Insurer

THE CHOICE PRESENTED

Once the insurance consumer has determined what *type* of life insurance he wants, he must decide which insurance company to patronize. There are, of course, several considerations affecting such a decision, including the present and prospective solvency of the company, and the quality and promptness of the service provided by the company's agents. A major factor, however, is (or at least should be) the cost to the purchaser of the policy as compared to the costs of similar policies offered by other insurers.

INADEQUATE MARKET INFORMATION

We find that the natural operation of the life insurance market has not produced information that enables purchasers to compare policy costs in a meaningful way. This condition occurs principally because the *cost* to the purchaser of a life insurance policy is *not* the same as the total dollars paid for it.

The explanation for this phenomenon best begins with a description of the technique historically used to explain life insurance costs. Typically, agents would illustrate the cost of an insurance policy by first adding up the premiums that the consumer would pay for the policy over a twenty year period. The total of annual dividends would then be subtracted, as would the cash value that the customer stood to receive if he surrendered his policy at the twentieth year.

The outcome would ostensibly reveal the "cost" of the policy by deducting what the customer *paid* to the insurance company (i.e., the premiums) from what he *received* (i.e., the dividends and the cash value). The resulting figure would be described to the purchaser as the actual cost of the insurance protection that he would have over the twenty year period, and this "cost" would be compared to the "cost" of other policies.[96]

This traditional "net cost" method is misleading because it totally ignores the time value of money. When calculating relative costs for products that are purchased by payments spread out over many years, it is essential to recognize that a dollar paid today is more expensive than a dollar paid years from now. Similarly, a dividend dollar received today or next year is more valuable than a dividend dollar received far in the future. Thus, differing premium or dividend payment streams must be adjusted for interest to make them comparable.

Because of the impact of interest, two policies of the same type and face amount (e.g., $25,000 whole life) may have quite different interest-adjusted costs, even though their premiums and cash values are identical and their dividends add up to equal amounts over a 20-year period. Typically, this happens because of variations in the way dividends

[96] A discussion of the traditional net cost method appears in the *Report* of the Joint Special Committee on Life Insurance Costs 5–7 (Institute of Life Insurance [now ACLI] 1970) [hereinafter cited as *Costs Report*]. See also H. 86–87.

are paid. One policy that bunches high dividends in late policy years "costs" more from an interest-adjusted standpoint than another policy that smoothly increases dividends over time. Nonetheless, the traditional net costs of the two policies can be the same.

The Society of Actuaries analyzed a sample of policies by first ranking them on a traditional net cost basis and then on an interest adjusted basis. It found the differences in rank order between the two methods to be "very significant." [97] Similarly, the Society found that comparison of policy premiums did not accurately reveal differences in interest-adjusted policy costs.[98]

Price Dispersion

Perhaps the inability of consumers to ascertain which policies are low cost would not be especially troublesome if the cost variation among similar policies were slight. However, there is no doubt that interest-adjusted policy costs vary over a wide range. This has been shown conclusively in studies conducted by the Society of Actuaries,[99] the Hart Subcommittee,[100] Professor Belth,[101] and others.[102]

Our hearings did generate some dispute over precisely how the size of existing price differences should be described. The FTC witness, for example, stated that "cost variations of over 100 percent for essentially identical coverage are not uncommon." [103] The ACLI witness retorted by submitting an analysis, in graphical form,[104] of price variations appearing in the New York *Shopping Guide for Life Insurance*. The *Shopping Guide* was published by the New York insurance department in 1977, and shows interest adjusted costs for all the life insurance policies sold in that state.

The ACLI study covered 116 different $25,000 whole life policies available for sale to males aged 35. The analysis showed that of 63 participating policies, 54 had interest adjusted costs ranging from $1.50 above to $1.50 below the average cost (per thousand dollars of coverage) for the policies in that sample. Of 53 non-participating policies, 46 had costs within $1.50 of the average for that sample.[105] The ACLI concluded that these dispersions were "small enough to suggest that it is difficult to sell life insurance where * * * cost indexes for similar competing products differ drastically from the average." [106]

In a technical sense, the FTC is correct in asserting that some high priced policies have a cost index twice as high as some low cost policies. For example, citing data from the same New York *Shopping Guide* used by the ACLI, the FTC observed that for $25,000 participating

[97] *Actuaries Report*, supra note 27, at 83. *See also* E. J. Moorhead, *The "Manipulation" Issue: Research Project 12* at 7–8 (NAIC 1975) [hereinafter cited as *NAIC Report 12*]; *Costs Report*, supra note 96, at 26–31.

[98] *Actuaries Report*, supra note 27, at 119. For example, see Table 32, *id.* at 116. The table shows that of 36 policies with low premiums, 7 (or 19.4 percent) were actually the most expensive policies available when ranked on an interest-adjusted basis.

[99] *Id.* Ch. 6.

[100] *Hart Hearings*, supra note 1, vol. 4, discussed in J. Belth, Information Disclosure in Life Insurance, 24 Drake L. Rev. 727, 728–730 (1975).

[101] The Belth studies are summarized in *Kimball*, supra note 55, at 1026–27 and *Mehr*, supra note 8, at 147–48.

[102] See, e.g., the studies cited in Kimball, supra note 55, at 1026 n. 8. See also H. 510.

[103] H. 13.

[104] H. 342.

[105] H. 336.

[106] H. 337.

whole life policies sold to men aged 35, the lowest cost index per thousand dollars of coverage is $1.11 and the highest is $13.55, a difference of over 1000 percent.[107] Further, 98 percent of the policies in the sample had cost indexes at least twice as high as the lowest cost policy.[108]

However, it should be noted that the lowest cost policy in the sample is issued by the Teachers Insurance and Annuity Company, which has no agents and sells only to employees of educational institutions.[109] If the six companies that have no agents are extracted from the FTC sample, the lowest cost available jumps from $1.11 to $4.58, and the proportion of policies in the sample with costs at least twice as high as the lowest policy drops from 98 percent to three percent.[110] Assuming, as we do, that the services of an agent are worth something, comparing policy costs of companies that have agents with those that don't tends to confuse matters.

Further, since the cost numbers being employed are *indexes*, expressing one cost as a percentage of another can cause misunderstanding. For example, consider two policies that are exactly identical except that the premiums are $19 per thousand for the first policy and $20 per thousand for the second. The cost indexes for the two policies might be $1 per thousand and $2 per thousand, respectively. However, saying that the second policy costs "twice as much" as the first obscures more than it reveals.[111]

The important issue is whether price variations among the policies available to typical purchasers are substantial enough to warrant the attention of those purchasers. Accepting *arguendo* the ACLI's view of the *Shopping Guide* data, it appears that the costs of most policies in the sample fall within $1.50 of the average.

This would mean a $3 per thousand difference between high cost and low cost policies. For a $25,000 policy, the cost difference would thus be $75 per year. If the purchaser is 35, and surrenders the policy on retirement after holding it for 30 years, the cost difference in dollars is $5,232, assuming five percent interest.[112] Even a $1 difference in index costs would mean $1,744 to the purchaser of a $25,000 policy held for 30 years.[113] These are plainly cost differentials that any sensible purchaser would want to consider.[114]

Price competition

Another facet of the controversy relating to insurance price variations is the question of whether effective price competition exists among life insurance companies. The FTC staff believes that the kind of price divergence found in the life insurance market is indicative of weak competition,[115] and that companies contend primarily for agents rather than for customers.[116] Mr. Moorhead agrees with those views.

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[107] H. 353.
[108] *Id.*
[109] H. 366.
[110] *Id. See also* H. 359–60.
[111] *See* H. 367. *See also* American Life Insurance Association (now ACLI) *Research Project* 8 at 7 (NAIC 1974) *Actuaries Report,* supra note 27, at 13.
[112] See Hearing Exhibit A–1 (H. 374). The appropriate accumulation factor is 69.8.
[113] *See* H. 375.
[114] The NALU witness agreed that a $1 difference in interest-adjusted costs per thousand was substantial H. 458. Mr. Moorhead testified that he regarded a 50 cent difference as material. H. 513. The ACLI witness agreed that a person could save a significant amount of money by purchasing a low cost policy. H. 375.
[115] The FTC argues, for example, that the price dispersion range found among life insurance products is broader than that found among prices for other consumer products. See H. App. 30B.
[116] H. 18, 150–51.

He suggests further that, although downward pressure on prices exists to some extent because agents want to sell products that are better buys than those sold by competing agents, agent agitation for lower prices is not especially forceful because many agents do not themselves recognize the wide variation in policy costs.[117]

The FTC and Moorhead also assert that low cost life insurance companies don't have a large market share,[118] a condition contrary to expectations since effective competition should force high cost companies to cut prices or lose their market share.[119]

The industry argues that there is in fact vigorous competition among companies, citing:

(1) the increase in the number of companies from 650 in 1950 to 1,750 now;[120]

(2) the drop in market concentration reflected by the fact that the twenty largest companies in 1950 had 74 percent of life insurance in force, whereas the twenty largest in 1975 had only 54 percent of insurance in force;[121]

(3) the general reduction over the past several decades in the cost of life insurance to consumers;[122] and

(4) the constant sensitivity of company managers to cost competitive policies offered by other companies.[123]

The ACLI argues further that existing price variations are explained, not by lack of competition, but by legitimate differences among company operations:

> The cost of life insurance policies is affected by a number of factors. These factors include not only mortality rates experienced by policyholders, investment returns earned by companies and expenses incurred by companies, but also factors such as the rates at which policies lapse due to nonpayment of premiums, the average size of policies sold by companies, the profit goals of company management or decisions by management as to how much surplus may safely be distributed among participating policies.
>
> Companies sell in many different markets and experience, therefore, different results in mortality, lapse and average policy size. The other factors mentioned previously also differ from company to company—in some cases because of management, in some cases for reasons beyond the control of management.[124]

The FTC retorts that such differences among companies will explain some price spread, but not the wide divergence found in the life insurance market.[125]

We do not make a finding on this issue, partly because the evidence on the record is so mixed, but mainly because we do not believe a finding here is necessary. It may well be that life insurance companies are highly sensitive to competitive pressures, and that the existing

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[117] H. 510. Regarding agent perception of, and reaction to, life insurance cost differentials, see pp. 37–38, infra.

[118] H. 18 (FTC), H. 509 (Moorhead). *See also Hart Remarks,* supra note 36, at 21477 (H. 682). The FTC also notes that Linton Yields for high-risk insurance companies are not higher than yields for low-risk companies, contrary to what would be expected if competitive forces were operating properly. H. 355–56.

[119] One interesting question is why a company would want to be low cost if aggressive pricing is not rewarded with increased market share. That issue is discussed by the FTC (H. 137–38) and the Northwestern Mutual Life Insurance Company (a well regarded low-cost company) (H. App. 14).

[120] H. 335 (ACLI), H. 427 (NALU).

[121] H. 337.

[122] H. 335, 364 (ACLI), H. 415 (NALU).

[123] H. 344–45.

[124] H. 335, 363. *See also* H. 368–69; American Life Insurance Association (now ACLI), *Research Project 5* (NAIC 1975).

[125] H. 130–34. *See also* H. 138.

price ranges can be explained in some manner. The point nonetheless remains that consumers ought to be apprised of price differences, so that they can decide for themselves what influence price considerations should have on their purchase decisions. A company that sells expensive policies because it has had an unfortunate investment history, or experiences heavy selling costs, should not be permitted to obscure the fact that its policies *are* high priced. It may, of course, seek sales by stressing that it has revised its investment policies, or that it offers superior service worth the extra price, but it cannot argue that its prices should be shrouded in secrecy merely because potential customers should take factors other than price into account.

Information needed

We think it evident, from a policy standpoint, that while life insurance consumers ought not to make choices *solely* on the basis of policy cost, purchasers should be able to compare policy costs readily. Otherwise, product selections will be made without reference to a relevant product element, and the full benefits of price competition will not be realized. To the extent that traditional net costs and annual premium figures are the only data available for price comparison purposes, consumers who attempt to shop for a low price policy will be frustrated.[126] Consumers will pay unnecessarily high costs across the board because of their lack of knowledge and their inability to identify and purchase the most satisfactory product.

Life insurance consumers today plainly need considerable assistance if they are to play the role of effective shoppers. While consumer understanding that life insurance policies vary in price appears to have increased over the past decade,[127] this development is attenuated by the continuing high number of consumers who equate price with premium.[128] Further, recent data show that less than half of insurance purchasers have *ever* actually attemped to compare costs.[129]

These conditions are surely aggravated by the stunning fact, revealed in a 1976 survey, that 37 percent of full time life insurance agents, and 45 percent of their supervisors, believe that "(t)here is little difference in net cost for similar policies." [130] A further 11 percent of both agents and supervisors had no opinion on the question.[131] This presumably means that nearly half of all agents in the field would not think it important to advise their clients about the savings possible from purchasing low cost insurance.

Further, even if agents were aware of cost differentials, they are not always able to provide the advantages of low cost to their clients. New

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[126] See the National Consumers League's statement (H. App. 6) for a description of problems that consumers have in attempting to shop for life insurance.

[127] In 1966, only 44 percent of consumers thought that life insurance costs differed substantially. See H. 73 (FTC), citing U.S. News and World Report, *The Buyers of Ordinary Life Insurance* (1966). By 1975, that percentage had increased to 65 percent. Institute of Life Insurance (now ACLI). *Monitoring Attitudes of the Public, 1975 Survey* 55 (1975) [hereinafter cited as *1975 MAP*] *See also* Institute of Life Insurance and Life Insurance Marketing and Research Association. *Life Insurance Consumers* 11 (1975) [hereinafter cited as *Insurance Consumers*] (reprinted in *Disclosure of Insurance Policy Information to Consumers:* Hearings on S. 718 before the Subcommittee on Housing, Insurance and Cemeteries of the Senate Committee on Veterans Affairs, 95th Cong., 1st Sess. 222 et seq. (1977)).

[128] In 1974, 54 percent still thought that premiums represented the cost of insurance. *Insurance Consumers*, supra note 127, at 11.

[129] In 1975, only 42 percent claimed ever to have shopped around for a low price policy. *1975 MAP*, supra note 127, at 55. *See also Insurance Consumers*, supra note 127, at 16.

[130] National Association of Life Underwriters and Life Insurance Marketing Research Association, *Survey of Agency Opinion* 33 (1976) (Question 6).

[131] Id.

insurance agents rarely earn enough in commissions to sustain themselves, and their employing companies therefore frequently subsidize them in early years with salary payments.[132] In order to ensure that the agents who survive and become good producers will benefit the company in later years, "renewal" commissions are paid on policies sold by the agent in earlier years. However, these commissions are not "vested," but are paid only if the agent actually remains with the company.[133] Further, some companies simply require by contract that their agents submit all new insurance applications to the home office.[134] These conditions generate significant pressure on agents to continue dealing with their original company even if that company's policies are high priced.[135]

SOLUTIONS

Our recommendations for promoting and improving consumer cost consciousness and the ability of consumers to locate low cost policies are as follows.

Recommendation 1

First, the traditional net cost method should be banned as a technique for comparing the costs of one life insurance policy with another. The failure of that method to take account of the time value of money renders it inherently deceptive.

Recommendation 2

Second, consumers should be presented with certain information about the policies they are considering for purchase. The information provided should be of two types: (a) a cost index number or numbers, and associated "yardstick" data, designed to show how the policy compares on an interest-adjusted basis to other similar policies; and (b) a display revealing the pattern in which funds and benefits flow between the policyholder and the insurance company during the life of the policy. Our recommendation is two-fold because, as discussed further below, we recognize that no cost index number (nor indeed, even a collection of cost index numbers) can alone solve a purchaser's information needs.

The general precepts we have employed in addressing information disclosure issues are that:

(1) the information must be relevant to the decision purchasers are trying to make;

(2) the information must be valid; and

(3) the information must be *conducive* to use.

We consider the last element above particularly important, because even the most carefully devised and worthwhile disclosure system will

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[132] *Costs Report,* supra note 96, at 14–15.

[133] *Id.* at 13–14. After an agent has been employed by a company for a certain number of years, commissions do "vest" and the agent may terminate his employment without losing future commissions. However, some companies require 15 or more years of service before full vesting occurs. *Id.* This is only one manifestation of the problems that companies have in managing the agency system. Another is the staggering turnover of agents who never do earn enough commissions and eventually leave their jobs. A study of thirty major insurance firms by the Hart Subcommittee showed that of all new agents hired in 1967, 87.9 percent had left by the end of 1972. Only 3,029 of the original 25,091 agents remained after five years. *Hart Hearings,* supra note 1, vol. 4 at 2595–96.

[134] *Costs Report,* supra note 96, at 9–10. The *Report* states, however, that "a substantial number of companies has given up the right to 'first refusal' to their agent's business after the completion of financing, and more will probably do so in the future." *Id.* at 10.

[135] *Cf. Hart Remarks,* supra note 36, at 21477 (H. 682).

go to waste if consumers do not recognize its value and employ it. We think it crucial that the materials presented to consumers be arranged to emphasize the importance of cost comparison and to facilitate correct use of the cost comparison data. Policy information displays should not be so complex and comprehensive that the typical customer will be intimidated.

We are not, however, especially concerned about whether consumers (or even agents) comprehend how the cost index numbers are computed, provided that the significance and use of the numbers is understood. In this regard, it has been pointed out elsewhere that consumers respond to a variety of index numbers (such as the Dow-Jones Industrial Average) that are calculated by methods that most people could not explain.[136] In our view, that sort of "understanding" is sufficient for cost indexes as well.

Cost indexes

We have considered the question of which cost index method or methods should be required.

Our analysis focussed on the "surrender cost," "net payment cost" and "company retention" indexes because, although the number of other possible cost indexes is large,[137] the cost disclosure proposals currently in vogue use one or more of those three methods.[138]

The "surrender cost" index is calculated on the assumption that the policyholder keeps his insurance in force for a specified number of years (20, for example) and then surrenders it. First, the premium payments are accumulated at interest over the period.[139] Then, the resulting total is reduced by the sum of the dividend payments (also accumulated at interest), and reduced further by the surrender value in the final year. The outcome of these calculations is a total cost figure that is then converted to a "present value" expressed on a level annual basis. (That is, the total cost is stated as a single amount that would have to be paid *every year*, and accumulated at interest, to yield the total cost amount at the end of the period.) [140]

The "net payment cost" index is computed in the same way as the surrender cost index, except that the surrender value in the final year is ignored. Thus, this index assumes that the policyholder will not surrender his policy at all during the period.

The calculation is accomplished by accumulating the dividends at interest, subtracting the resulting dividend total from the sum of the premiums (also accumulated at interest), and converting the differ-

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[136] *Actuaries Report,* supra note 27, at 39–40. *But see* American Life Insurance Association (now ACLI), *Research Project* 8, App. A at 6 (NAIC 1974).

[137] A number of cost indexes are described in the *Costs report,* supra note 96, at 9–19. See also *Mehr,* supra note 8, at 149–55; W. Scheel, *Yearly Prices of Protection and Rates of Return in a System of Life Insurance Cost Disclosure,* 44 J. of Risk and Insurance 37, 44 (1977). Mathematical formulas for computing the various cost index numbers are presented in the *Actuaries Report,* supra note 27, at 25–32.

[138] The NAIC model rule employs both the surrender cost and the net payment cost indexes. The FTC proposal and the Belth system use the company retention index.

[139] The method thus demands that some interest rate be assumed to measure the time value of money. This is the "interest-adjusted" feature.

[140] A "present value" is simply an amount that will accumulate at interest to a given future value in a specified number of years. Assuming a five percent annual interest rate, $110.25 paid two years from now has a present value of $100, since $100 invested now at five percent will yield $110.25 in two years. Put mathematically, if $\$100=x$, x invested for two years at 5 percent will yeild $x+0.05x+(x+0.05x)(0.05)=1.1025x$. Substituting $100 for x, $(1.1025)(\$100)=\$110.25$. Expressing a present value on a level annual basis is somewhat more complex. Again assuming a five percent interest rate, $110.25 paid two years from now has a present value in level annual terms of $51.22. Mathematically, if $\$51.22=x$, x invested *every year* for two years at 5 percent will yield $x+0.05x+x+(2x+0.05x)(0.05)=2.1525x$. Substituting $51.22 for x, $(2.1525)(\$51.22)=$ $110.25.

ence to a "present value" payment expressed on a level annual basis.

The "company retention" index, unlike the previous two indexes, does not assume that the policyholder will surrender his policy in one particular year. It is a considerably more complex method that takes account of the statistical possibility that a policyholder may die or surrender his policy during any year in the period. These probabilities are used to calculate "expected" values for the various cash flow elements of the policy.

The company retention figure itself is obtained by accumulating at interest the "expected" premiums, substracting the sum of the "expected" death benefits, cash values, and dividends (also accumulated at interest), and converting the result to a present expected value expressed on a level annual basis.[141] The final figure is called the "company retention" index because, from the policyholder's standpoint,[142] it is the expected amount (in present value terms) that the *insurer* will retain for its expenses and profits out of the present expected value of the policyholder's premiums.[143]

It will be noted that both the surrender cost and the net payment cost methods generate figures that can be regarded as the "true cost" for the policyholder if his situation matches exactly the circumstances assumed by the calculation. Thus, if a person who surrenders his policy in year 20 has received dividends precisely as shown in the original dividend illustration, he will have a surrender cost equal to the policy's 20 year surrender index. This is, of course, an unlikely eventuality, and in any event, *cannot be ascertained at the time the policy is sold.* The company retention figure, on the other hand, can never be a "true cost," even in retrospect, because it doesn't purport to measure the price of protection in the first place,[144] and because its computation is based on average mortality and lapse assumptions.

The technique for calculating the company retention index is sometimes described as being a "group average" approach, whereas the technique for the surrender cost and net payment indexes is known as the "event specific" or "snapshot" approach.[145] The practical significance of the distinction is that group average indexes, while intrinsically more complex than event-specific indexes, reveal more information about the structure of a given life insurance policy.[146] Thus, in determining whether to select an event-specific method (like the surrender cost index), or a group average method (like company retention), we are confronted with what appears to be a trade-off between information value and simplicity.

However, the problem is really more subtle than that, for at least three reasons. First, the mere fact that calculating a company reten-

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141 The "company retention" method is detailed in J. Belth. *Life Insurance: A Consumer's Handbook* 246–37 (1973). *See also* H. 112–14. It should be noted that Dr. Belth, unlike the FTC, does not express the retention figure on a level annual basis, but simply displays the *total* expected present value.

142 The retention figure is not the insurer's *profit*. For one thing, retention covers insurer expenses as well as profit. More importantly, however, the retention figure is calculated using industry-average mortality and lapse rates that may have very little relation to the insurer's particular experience.

143 The company retention figure does not measure the portion of premiums that goes to buy death protection because it does not include the insurer's mortality costs. The price of death protection would be equal to the present expected value of premiums less the sum of the present expected values of the cash value and dividend payments. *Mehr,* supra note 8, at 154 n. 42. *See* J. Belth, *Life Insurance: A Consumer's Handbook* 49 (1973).

144 See note 143, *supra.*

145 E. J. Moorhead, *"Snapshot" and "Average" Approaches to Policy Cost Comparison: Research Project 3* (NAIC 1975) [hereinafter cited as NAIC Project 3]. *See also Mehr,* supra note 8, at 149.

146 *Mehr,* supra note 8, at 154–55.

tion index is "complicated" does not necessarily mean that consumers will be less likely or less able to employ it effectively. As we noted previously, people already respond to various kinds of indexes without fully understanding their computation. We think time should be allowed for experimentation with different indexes to ascertain their actual efficacy in the field.[147] It may well be that, in practice, consumers can perceive the correct use of the company retention index just as readily as they can the use of the surrender cost index.

Second, some claim that the company retention index should not be employed in any event because the "greater information" it conveys is not useful to consumers. The principal (but not sole) argument here is that cost indexes calculated to reflect group lapsation rates are actually misleading, both because lapse is controlled by the individual purchaser and because actual lapse rates vary widely from company to company.[148] We think there is some validity to this objection and do not believe the issue it presents has yet been satisfactorily resolved.

Third, the "event specific" indexes, besides being criticized by company retention advocates for conveying too little information,[149] are also charged with being vulnerable to "manipulation." The FTC witness asserted, and we agree, that manipulation is the most serious problems with the surrender cost index.[150]

A policy is "manipulated" if it is structured so that its cost index rank makes it appear to be a better buy compared to other policies than it really is.[151] It will be recalled that the traditional net cost method can be manpiulated by bunching dividends in late policy years. A policy so structured can have a lower traditional net cost than another policy with smoothly increasing dividends. Nonetheless, the manipulated policy would be a poor choice because dividends paid later are worth less, and because a purchaser who lapses prior to the high dividend years will not receive the dividends at all.

The surrender cost index can also be exploited, but in a different fashion. It is manipulated by boosting the cash surrender value for (or awarding a large terminal surrender dividend in)[152] the last year for which the index is calculated.[153] The index will not reveal cash value or terminal dividend differences among policies for years prior to the assumed surrender, because it recognizes only surrender values payable in the last year of the calculation period. Consequently, two policies with equal surrender values in the 20th year can have equal 20 year surrender cost indexes even though the policies have drastically unequal surrender values *prior* to year 20. The policy with lower surrender values in early years will, of course, be a less desirable purchase for any policyholder who terminates before year 20.

Early surrender value differences among policies will, however, be detected by the company retention index, because it does not assume

[147] The FTC is conducting experiments that may shed some light on this issue. H. 123. See also H. 307 (NAIC field testing).

[148] *See Costs Report,* supra note 96, at 20. *But see Kimball,* supra note 55, at 1042 n. 69 suggesting that using group averages for company retention should be no more objectionable than using an interest assumption for surrender cost calculation. In our view, that argument is flawed because any individual's lapse rate is likely to vary considerably from the group average, whereas the time value of money varies from individual to individual over a relatively narrower range.

[149] *See,* e.g., Kimball, supra note 55, at 1040.

[150] H. 24.

[151] *Cf. NAIC Report* 12, supra note 97, at 2.

[152] Terminal surrender dividends are special, additional payments made to the policyholder if he surrenders after holding the policy for a certain minimum number of years.

[153] H. 24. *See also* atuhorities cited in *Mehr,* supra note 8, at 153 n. 33.

surrender in any one particular year. Rather, it recognizes each year's cash value and takes account of the average statistical likelihood that a policyholder will terminate in a given year.[154] There are, in fact, policies on the market that rank significantly less well against other policies on a company retention basis than they do on an interest adjusted basis precisely because they have high terminal surrender dividends and 20 year cash values.[155]

The NAIC nonetheless takes the view that the surrender cost index should be preferred to the company retention index because the former index is easier to understand. The NAIC answers the manipulation argument by asserting that state insurance departments should control policy structures as part of the policy approval process.[156] The FTC staff and others question the NAIC's approach to manipulation on two fronts. First, they argue on philosophical grounds against substituting the judgment of government regulators for that of consumers making purchase decisions in the marketplace.[157] Second, they doubt that the commitment of resources and will necessary to provide adequate regulatory protection against manipulation can be sustained by the states or anyone else.[158]

These are not trivial objections, but neither are they conclusive. We share the predisposition against regulatory intervention, but note that the market will generate efficient results only if purchase decisions are based upon *accurate* information. Even assuming that an absolutely manipulation-proof cost index were available, and that consumers used it effectively, some regulatory presence would be necessary to ensure (1) that the cost indexes computed by insurers for their policies were correct, (2) that dividend illustrations were not inflated, and (3) that policies were not manipulated by altering policy structure for years *after* the index calculation period. This third point is especially important because *no* index can reveal anything about policy years that are not included in the index computation. Of course, one obvious way to solve that dilemma is to show index numbers at high durations (i.e., calculated for long policy holding periods), but the FTC's proposal (as well as the NAIC's) entails indexes that reflect no more than the first 20 years of any policy's life.[159] Under such schemes, some regulatory review is absolutely essential.

We note at this point that whenever regulatory control of policy structures is contemplated, one practical issue that arises is how to treat "justifiable" policy discontinuities. An insurer, charged with "manipulating" one of its policies to exploit the cost index system then in use, may be able to show that the structural peculiarities of the policy accurately reflect the company's experience with it. The NAIC witness was of the view that state regulators, after "balancing the interests," could nonetheless properly ban such a policy if its sale

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[154] H. 25. The company retention index is not, however, completely immune from manipulation. H. 88–89. As with any index, company retention reveals nothing about policy structure for years *after* the index calculation period.

Further, the company retention index, as formulated by Professor Belth, has been criticized for being unduly sensitive to large termination values payable in the last year of the period. See W. Scheel, *Company Retention—An Unreliable Indicator of the Cost of Life Insurance to the Policyholder*, 42 J. of Risk and Insurance 81, 88 (1975). Scheel's article also criticizes other aspects of Belth's formula.

[155] *NAIC Project 12* supra note 97, at 8, 10.

[156] H. 311.

[157] H. 88–89 (FTC), H. 203–04, 224 (Belth).

[158] *Id.*

[159] The FTC staff indicated that they might consider displaying index numbers at high durations, rather than for policy year 20 as required by their present proposal. See H. [illegible]–61.

would lead to deception of purchasers.[160] Professor Belth was particularly opposed to that kind of market intervention.[161] He urged that "the problems associated with peculiar price structures * * * be handled by disclosure and the resultant marketplace reaction to such disclosure, rather than by actions of already overburdened regulators."[162]

In our view, if the cost disclosure index to be used does not adequately reveal policy discontinuities (for example, low terminal payments at early durations under the surrender cost index), then regulatory authorities should not ban an offending policy. Rather they should simply impose special disclosure requirements. For example, a policy could be required to exhibit the following notice next to its cash value display:

WARNING

> This policy has unusually low cash values in policy years prior to year 20.

This will alert the prospective purchaser to the problem, and allow him to consider its relevance. For example, a purchaser who intends to keep his policy in force for life would presumably not be too concerned about low cash values in early years if the policy had other desirable characteristics.

Turning now from questions about the philosophical propriety of policy regulation to questions about whether control of manipulation will actually be achieved, we find some validity to the doubts that have been asserted concerning the willingness and ability of state insurance departments to deal with policy discontinuities. For example, in July 1978, this Subcommittee wrote the insurance commissioners of five states that had already adopted some version of the NAIC model rule, inquiring about their efforts to police policy structures.[163] One state did not reply.[164] Two others claimed to review new policies adequately for manipulation.[165] Of the remaining two departments, one said that it reviewed new policies only to assure compliance with the state nonforfeiture law (requiring certain minimum cash values).[166] The other department stated outright that "[i]n practice, we are making only a rather limited check for 'manipulation' at the present time" and that discontinuities in the amounts of projected terminal dividends were not considered objectionable.[167]

The NAIC witness reacted to the statements of the latter two states by agreeing that "[t]here certainly is some cause for concern" about effective state control of manipulation under the NAIC rule.[168]

Similarly, in May 1978, Professor Joseph Belth wrote to the insurance commissioners in 28 states and the District of Columbia, requesting them to review their approval of the President's Preferred Life insurance policy issued by the Gulf Life Insurance Company.[169] That

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[160] H. 312.
[161] H. 224.
[162] H. 203–04.
[163] Our letter of July 19, 1978 to Arizona appears at H. 316. Identical letters were sent to Connecticut, New Hampshire, Texas, and Vermont. See H. 322–23.
[164] H. 323 (Connecticut).
[165] New Hampshire (H. 317) and Vermont (H. 321).
[166] H. 320 (Arizona).
[167] H. 319 (Texas). A subsequent exchange of correspondence between the Subcommittee and the Texas insurance department appears as H. App. 17A and B.
[168] H. 323.
[169] Dr. Belth's May 12, 1978 letter appears at H. 313–15.

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policy has a severe discontinuity in policy year 21, caused by a sudden decrease in the rate of cash value accumulation.[170]

By the time of Professor Belth's testimony before this Subcommittee in August 1978, a few states had withdrawn the policy, a few states had expressly decided not to withdraw it, several others had decisions pending, but over half had not even acknowledged receipt of the inquiry.[171] This situation also does little to bolster our confidence in state control of manipulation.

The NAIC witness was optimistic that state regulators would soon realize the need to present abuse of cost index systems, and would police policy structures:

> Through the combined expertise of the States acting through the committees, subcommittees and task forces of the NAIC, we can bring ourselves to a level of understanding and a level of treatment of a particular problem that sometimes we can't do severally.
>
> You may well find the [States'] attitudes * * * will change in a fairly short period of time because of this combined activity and because of the fact that problems such as this are being brought to our attention.[172]

We hope he is correct.[173]

In sum, our concern about the possibilities (1) that a group average index will be less conducive to effective consumer use than an event specific index, (2) that the existing formulas used to calculate group average indexes may not be properly constructed, and (3) that the states will not be able to achieve effective yet circumspect control of manipulation, leave us unable to recommend one index over another.[174] We think that there are sufficient advantages and doubts associated with both the surrender cost and the company retention index to justify the choice of either.[175]

How many indexes?

A subsidiary question arises, however, as to *how many* different indexes should be displayed. The NAIC rule requires both the surrender cost and the net payment cost index, a feature that the FTC finds objectionable on the grounds that providing more than one index number increases the risk of "confusing consumers and defeating the purpose of cost disclosure." [176]

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[170] See H. 322. A year-by-year policy information disclosure sheet prepared by Professor Belth for the Gulf Line policy appears as H. App. 21.

[171] H. 166.

[172] H. 323. See also H. 300.

[173] We note that at page 10 in *NAIC Report 12,* supra note 97, transmitted to the NAIC on January 28, 1975, Mr. E. J. Moorhead recommended that a central office be established for cooperative review of policies by the states. In his testimony prepared for our hearings, Mr. Moorhead reiterated that recommendation. H. 512. The subsequent NAIC response to his comment appears in H. App. 29B.

[174] Snapshot and group average index methods can be compared and contrasted on a number of other grounds. We are not discussing those differences here because they are of relatively less import. See, for example, *NAIC Report 3,* supra note 145, at 2–4; *Actuaries Report*, supra note 27 at 42–43.

[175] There is, perhaps, some consolation in the fact that policy cost rankings under the surrender cost index correlate highly with rankings under the company retention index. See *Actuaries Report,* supra note 27, at 74–79; *NAIC Report 3,* supra note 145, at 5; *NAIC Report 12*, supra note 97, at 4.

[176] H. 23. The FTC testimony correctly notes that the *Costs Report,* supra note 96, at 20, recommends that only one index be used and that the surrender cost be favored over the net payment cost. H. 24. We can only observe that the FTC proposal itself employs two indexes: company retention and average rate of return (i.e., Linton Yield).

It should be noted that Linton Yields, besides being useful for comparing term and whole life, can also be used for comparing one whole life policy with another. Indeed, in one respect, yield figures are less subject to criticism when used for the latter purpose than when used for the former. It will be recalled that altering the assumed term rates used to calculate yields will noticeably affect the resulting yield rate for any particular policy. See note 59, supra. It has been shown, however, that altering assumed term rates has little effect on policy *rankings* based on yield. *Actuaries Report,* supra note 27, at

We simply do not find that possibility very threatening. We note that the usefullness of event specific indexes is inevitably limited by the relevance of the assumed "event" to the particular purchaser. A surrender cost is simply not revealing to a consumer who is determined to hold his policy until death. We are persuaded by the NALU's argument that providing only the surrender index would make the efforts of a conscientious agent to assist his client harder than if both the surrender and the payment cost indexes were available.[177] Another point worth mentioning in this regard is that term insurance policies will require only one index even if an event specific approach is employed, because, due to the absence of cash values, the surrender cost and the net payment cost are identical.

The NAIC model rule is also criticized for requiring participating policies to disclose a figure termed the "equivalent level annual dividend."[178] This figure is calculated by accumulating dividends at interest and then converting the result to a present value expressed on a level annual basis. The theoretical relevance of the figure is that it can be added directly to either the surrender cost or net payment cost index of a participating policy to show how costs would increase if no dividends at all were paid. The rationale for disclosing this figure is that agents for non-participating (i.e., non-dividend paying) insurers should have a way to explain the significance of the fact that dividends illustrated for participating policies are not guaranteed.[179]

The underlying problem that the level annual dividend is intended to address is a real one. It is quite possible for a low premium, non-par policy to have a surrender cost equal to a high premium-high dividend participating policy, yet the policies will not be equally good alternatives because the participating policy involves more risk. The participating policy will cost more than the non-par policy in the end if actual dividends paid are lower than the illustrated dividends that were used to calculate the index. Of course, the par policy will cost less than its index cost if the dividends paid are higher than those illustrated.

We think, however, that the "level annual dividend" is a profoundly inappropriate way of describing risk differences between par and non-par policies.[180] The figure is well suited only for painting a lurid picture of improbable par company catastrophe, and bears no worthwhile relevance to a reasonable analysis of actual risk. Providing this figure will put a tool highly conducive to misleading use directly into the hands of the agents who have a strong incentive to employ it deceptively.

146–47. Another interesting feature of Linton Yields is that the results of yield calculations are less likely to fluctuate over time compared to interest-adjusted indexes, because term insurance rates are more steady than interest rates. See H. App. 18.

It might be possible to argue that no index other than Linton Yield is needed to compare whole life policies. However, one answer would be that the yield calculation is just as susceptible to policy manipulation as the surrender cost index. This is because Linton Yield is a "snapshot" index and is sensitive to high terminal dividends. *Cf. NAIC Report 3*, supra note 145, at 2.

[177] H. 464.

[178] H. 511.

[179] It has sometimes been claimed that cost indexes should not be used at all to compare par and non-par policies because illustrated dividends are not guaranteed. The Society of Actuaries rejected that argument, noting, for example, that dividends paid would have to fall short of illustrations by 30 percent before surrender cost rankings would be altered, and concluding that "it would seem inappropriate to dismiss as a useless exercise the comparison of cost indices between otherwise comparable participating and guaranteed cost policies for fear that illustrated dividends may not be fully realized." *Actuaries Report,* supra note 27, at 132. We agree.

[180] *See Actuaries Report, id.* at 21–23.

the significance of a $10 savings that can be obtained by purchasing a television set at one store rather than another. The significance of a $10 difference in cost indexes is far less evident.

We therefore think that the Buyer's Guide provided to prospective purchasers should contain at least some yardstick information. For example, index cost ranges at various issue ages for a $25,000 whole life policy could be displayed.[191] We also are impressed with the idea of providing additional price range information for individual purchasers through the medium of a toll-free telephone service.[192] Separate booklets showing index ranges and listing cost index figures for various individual policies available for sale can also be provided.[193]

We do not believe, however, that we should endorse the original FTC yardstick proposal. They recommend that the agent provide cost index ranges for the policy the client is considering. The agent would have to mark the graph to show where the cost index for the proposed policy fell with respect to the index ranges.

We think it acceptable to provide a purchaser with ways to ascertain the relative cost position of a particular policy. It is quite another matter to require the salesman to affirmatively point out how the price of his product compares to that of competitors. In our view, the latter approach represents an extremely intrusive intervention into the sales process, the need for which has not yet been proven. We opt at present for a less antagonistic regulatory posture.

Policy structures

This completes our discussion of cost index disclosure. As we noted at the outset of this analysis, however, it is clear to us that no combination of indexes, even enhanced by yardstick data, can meet the minimal information needs of policy purchasers.[194] We agree with the Society of Actuaries that adequate information entails not only a method for comparing *costs* of competing policies, but also a method for disclosing "the cash flow elements and benefits of a particular life insurance contract as it relates to the individual purchaser. The major purpose of such a method would be to inform the prospective purchaser, once he has been directed in a general way to a particular policy, about the details of the policy as it relates to his *specific* circumstances."[195]

The "cash flow" of a policy is defined by the Society for this purpose as "the actual transfer of funds between the policyholder and the insurance company, in either direction, and includes premiums, dividends, cash values, and death benefits."[196]

We recommend that the four elements of policy cash flow (premiums, illustrated dividends, surrender values, and death benefits) be displayed in ledger fashion for each of the policy's first 20 years and for attained age 65.[197] As discussed previously, the numbers show-

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[191] See the Wisconsin approach in H. App. 12A.
[192] *Id.*
[193] Information booklets ranking companies by cost index, such as the New York *Consumers Shopping Guide*, have their faults, mainly relating to the fact that companies are continually changing policies. Thus, cost rankings can be outdated as soon as they are published. See H. 308, 453. For that reason, we think such guides should always include a listing of cost index *ranges* for each policy type shown, and should emphasize that the ranges are much more reliable over time than the individual rankings.
[194] *See generally*, *Actuaries Report*, supra note 27, Ch. 8.
[195] *Id.* at 6 (footnote & parentheses omitted).
[196] *Id.* (footnote).
[197] A typical "ledger statement" format appears in H. App. 21.

ing surrender values should be printed in red ink for every policy year during which surrender would produce a negative yield.

We think the disclosure should cover each year in the initial 20 year period, rather than, for example, the first five years and representative years thereafter (as is required by the NAIC Rule),[198] because a considerable number of whole life policies have negative yields even after the first 10 years.[199] We would not require more than the first 20 years, however, (other than attained age 65), because of our desire to avoid overwhelming the purchaser.

We also think that the interest rate charged to policyholders on policy loans should be disclosed, as well as the interest rate assessed for paying premiums other than annually. The reasons for requiring disclosure of policy loan interest rates are self-evident. As for payment interest rates, we note that 81 percent of ordinary life insurance policies in force in 1976 were paid for on other than an annual basis.[200] Evidence presented at our hearings revealed not only that the interest rates assessed for periodic premium payments are significant, but that they vary widely from company to company. A survey of 15 companies showed effective annual rates varying among companies by as much as 14 percentage points and ranging up to a high of 29.3 percent on individual policies.[201]

All the required information, including the cost indexes and 20 year cash flow display, should be included on a "policy summary" sheet. The summary should be separate from the Buyer's Guide, and prepared by the prospect's agent according to a format that has been established by regulation.[202] Policy summaries should also be provided by insurers to anyone on request, and affirmative disclosure of the fact that policy summaries are available should be required in life insurance advertisements.[203] The Buyer's Guide should include a description of how the cost indexes and other information on the policy summary can be used to select a suitable, low-cost policy. The Guide should note that minor differences in cost indexes can be ignored for policy comparison purposes.

Timing of disclosure

The question of when during the sales process to disclose cost indexes and other policy information to customers has generated considerable controversy. Obviously, if the purpose of the disclosure is to assist the consumer in making a purchase decision, the information should be provided before the decision is made. A practical problem arises, however, due to the fact that an insurance agent does not know at the outset of the sales presentation what sort of policy the customer will choose. The agent cannot reasonably be expected to prepare elaborate policy data disclosures in advance for all of the alternatives that could be selected.

Analysis of this issue requires a description of the sales process. Most sales procedures involve either two or three steps. The "two-step" approach occurs when the agent sells the prospect a particular policy

[198] See NAIC Rule § 4(G)(5).
[199] *Actuaries Report*, supra note 27, at 145.
[200] *Fact Book*, supra note 6, at 14.
[201] See H. 179. For a discussion of what interest rate is charged by New York Life, see H. 456–57 & H. App. 31.
[202] A discussion of the need for regulatory control of policy summary formats appears at p. 55, *infra*.
[203] *See Kimball*, supra note 55, at 1051.

at the initial sales presentation, has the customer sign a policy application, and obtains a premium deposit. The agent processes the application through the insuring company, and then returns to the customer for the "second step," which is simply delivery of the issued policy.

The "three step" approach occurs when the agent does not attempt to sell a particular policy at the initial meeting with the prospect. Rather, the initial meeting is devoted to analyzing the prospect's insurance needs and discussing his general insurance preferences.

On the second visit, the agent actually presents a policy proposal, obtains a signed policy application, and accepts a premium deposit. The application is thereafter processed through the insurer, and the agent then returns a third time for delivery of the issued policy.[204]

The NAIC model rule, which entails a Buyer's Guide and a policy data summary sheet, requires that both the Guide and the summary be delivered either (1) prior to accepting the purchaser's initial premium or premium deposit, *or* (2) at the time the issued policy is delivered to the purchaser, provided that in this latter instance, the purchaser must be granted at least ten days to change his mind and receive an unconditional refund.[205] Not surprisingly, most companies operating under the NAIC model rule have selected the second option (known as the "10-day free look"), and thus present the disclosure materials when the issued policy is delivered.

Likewise not surprisingly, the FTC is critical of the NAIC approach, arguing that once the consumer has made a purchase decision, signed an application, and made a premium deposit, he becomes "psychologically committed * * * and is, therefore very unlikely to read and use a disclosure package provided for the first time only after a policy has already been paid for." [206] The FTC position is, we think, supported to some degree by an ACLI survey of 22 large insurance companies that allow their customers a "10-day free look." Of the approximately 5 million new policies sold by those companies in 1977, only about 1.4 percent were returned.[207]

We do not find the NAIC approach acceptable, but neither do we think that the answer is simply to drop the 10-day option and require agents to deliver policy data prior to the acceptance of premiums. Providing a consumer with a Buyers' Guide and a policy summary moments before accepting his premium check does not address the fundamental problem any more effectively than presenting him with policy data after he has made his decision and then giving him 10 days to

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[204] The details of the sales process are discussed at H. 406–07.

[205] NAIC Rule § 5 (A).

[206] H. 22–23.

[207] H. 398. Further, it apears that the ACLI has some philosophical doubts itself about the general efficacy of cooling-off periods like the 10-day free look. For example, the NAIC model policy replacement regulation, which is designed to allow the company whose policy is being replaced to make a defensive sales presentation, requires the replacing insurer either (1) to delay issuance of the policy until 20 days after notice of the replacement is transmitted to the current insurer, or (2) to issue the policy immediately, but provide the policy purchaser with a 20-day "free look." Under the "free-look" option, the 20-day period provides the company being replaced with an opportunity to convince the consumer to retract his decision.

In a June 13, 1978 letter to the NAIC (Hearing Exhibit A–3, H. 409), the ACLI *opposed* the 20-day free look option, as follows:

"Once a replacement sale has been consummated and the existing policy, insurer or agent, have been discredited in the eyes of the policyholder, a reversal of that action will be extremely difficult, even if the replacement is shown to be disadvantageous to the policyholder."

During our hearings, the ACLI witness was queried on that argument (H. 410):

Mr. SHAFFER (Subcommittee Counsel): My obvious question is, isn't this inconsistent with your position on timing for the model solicitation rule?"

[illegible]

change his mind. We think that information disclosure will work only if the purchaser has enough time both to absorb the significance of the policy summary and to review some competing life insurance policies.

We recommend that no customer be required to post a premium deposit earlier than 20 days after receiving the policy summary sheet. We also recommend that no customer even be solicited to sign a policy application until he has seen at least the cost indexes for the proposed policy. However, information disclosure requirements should be structured to avoid forcing agents who now use a two-step sales approach to expand to three steps.[208] We believe that the timing of the disclosure requirement must be tailored to the sales technique used.

The specifics of our proposal are as follows. First, for two-step sales, the prospect should be provided with the Buyer's Guide and a completed "Preliminary Policy Summary" during the initial sales presentation. At that time, the agent may request the prospect to sign a policy application but may not solicit or accept a premium deposit. The "Preliminary Policy Summary" will show only the policy's cost indexes, and such premium and death benefit data for representative policy years as can be extracted from the agent's rate book.[209] It is our intention, in this regard, that insurer's be obliged to print policy cost indexes in their agents' rate listings, a practice that some companies already follow.[210]

After the initial sales presentation, the agent will return to his office and prepare a "Final Policy Summary," which will show all the information for which disclosure is required. The Final Summary will then be mailed to the consumer, accompanied by a premium billing notice. The notice should provide the customer a minimum of 20 days to remit,[211] and advise him that he is under no obligation to purchase the policy.

If the customer decides to pay, the application is processed and the agent returns to deliver the issued policy. This system necessitates only two agent visits, and eliminates altogether the need for a 10-day free look after policy issuance.

For agents who use a three step technique, our recommendation is modified to omit the "Preliminary Policy Summary." At the first visit, the agent need only deliver the Buyer's Guide.[212] At the second visit, the agent will be able to deliver the Final Policy Summary, since he will know at that time which particular policy he is selling. Upon presenting the policy summary, the agent may request the prospect to sign a policy application and may present him with a premium bill. The agent may not, however, accept a premium deposit at that time. The premium notice should provide the customer at least 20 days to remit, and should advise him that he is under no obligation to purchase the policy.

If the customer decides to pay, the policy issues and the agent effects delivery. Only three visits are required under this system and, again, the need for a 10-day free look is eliminated.

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[208] See H. 407; *cf.* H. 463.

[209] The concept of a "preliminary policy summary" is borrowed from the final Wisconsin solicitation rule (H. App. 12B), and we would anticipate that the summary format used to implement our proposal would be modeled along the lines of the preliminary summary in the rule.

[210] See H. 407, 463.

[211] The purchaser can remit earlier, if he so chooses.

[212] We are simply not impressed with the NAIC argument the delivering the Buyer's Guide and the policy summary at separate times will "dissipate" the impact of the disclosure system. See H. [illegible]

Other disclosure possibilities

There are a number of other possible information disclosure requirements that have been suggested, but that we have decided not to adopt at this time. For example, it would be possible to expand the year-by-year policy data display to cover more than death benefits, premiums, dividends, and surrender values. One proposal would add figures showing yearly amounts of protection (i.e., the difference between face amount and cash value), rates of return, and the "price of protection." [213] Further, a separate display could be provided to show how *total* premium dollar accumulations are allocated to the protection, savings, dividends, and company expense elements of the policy.[214]

We discussed these ideas in the portion of our report dealing with the term-whole life choice, and concluded that such disclosure should not be mandated because of our apprehension about consumer resistance to complicated data presentations. We think the same considerations apply here with respect to comparisons of one policy with another, and thus arrive at the same conclusion. Again, however, we opt for less complete disclosure reluctantly, and only because we believe that the purity of our disclosure philosophy must be tempered with a practical appreciation of human nature.[215] As our next recommendation explains, we think that more detailed policy information should be readily available to those who seek it. We only conclude at this time that the *mandatory* cost disclosure display provided to every sales prospect should be kept simple.

Counterargument

Before turning to our next recommendation, we wish to address briefly one claim that is occasionally advanced against requiring *any* information disclosures at all.[216] The gravamen of the claim is that consumers don't want more data than they are already getting.

First of all, it's not clear whether the claims about lack of consumer interest are even correct. A 1975 survey, for example, showed that if comparative cost information were available, 67 percent of consumers would use it to shop for insurance, and another 18 percent would at least ask the agent how the cost index for his policy ranked against competitors.[217] Further, a number of consumer groups and advocates have filed comments with this Subcommittee exhibiting great enthusiasm for policy data disclosure.[218]

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[213] H. 191–93. It should be noted that Belth's formulas for computing price of protection and yearly rate of return have been criticized. See W. Scheel, *Yearly Prices of Protection and Rates of Return in a System of Life Insurance Cost Disclosure,* 44 J. of Risk and Insurance 37 (1977).

[214] *See* 193–95. *But see* note 154, *supra.*

[215] Another proposal advanced by Dr. Belth is that yearly rate of return and price of protection information should be given to policyholders periodically (preferrably once a year) during the life of the policy. See H. 196–199. We regard his suggestion as interesting but beyond the scope of this report. *Cf.* H. 90.

[216] We note that this claim is not raised by the industry. They agree, for example, that cost disclosure indexes should be made available. H. 337. Indeed, a number of companies are already using the NAIC rule format nationwide. H. 372. (Prudential); H. 451 (New York Life). The ACLI witness testified that "[a] survey conducted late last year showed that companies selling over 50% of the life insurance business in the United States either now deliver or will soon deliver policy summaries and buyer's guides with all their policies rather than just in those states that have adopted the model regulation. Thus, over the next year or two, five to ten million people will receive the information required by the model regulation." H. 339.

[217] 1975 *MAP,* supra note 127, at 55. *See also Insurance Consumers,* supra note 127, at 19.

[218] See National Consumers League (H. App. 6) Consumer Federation of America (H. App. 7) J. Mintz (H. App. 8). See also H. 485–86.

Even assuming, however, that consumers were uninterested, we would not change our recommendations. Life insurance purchase decisions, measured against any criterion, are unquestionably important to consumers from a financial and practical standpoint. The likelihood that consumers are not yet aware of the stakes, and thus not particularly concerned about the choices they make, is a powerful reason for insisting on effective disclosure. Marketing practices that can cause profound injury without being recognized by consumers as a source of harm are among the most troublesome problems that regulators confront.

One insurance agent, in a letter filed with the Subcommittee, remarked that when he paid off death claims, neither the widows nor the estate executors asked "Was this cheap insurance or the expensive kind?"[219] We believe it. That is precisely one of the features of the life insurance market that concerns us.[220]

Recommendation 3

As intimated above, our *third* recommendation for facilitating informed consumer choice among competing life insurance products is to require that insurers prepare, and provide on request, comprehensive information about the policies they offer. These policy data displays should be prepared for several representative issue ages and should provide year-by-year figures for amount of protection (face amount less cash value), price of protection, and rate of return. They should also include summary information showing allocation of premium dollars to savings, protection, dividends, and company expenses. The year-by-year data should be displayed for each year from issue date to at least attained year 75. The summary information should be shown for several durations, such as for policy year 20 and attained age 65.[221]

Policy display sheets showing these data should be provided by insurers to state regulators at the time policy approval is sought, as an aid to the states in controlling manipulation.[222] Insurers should also provide the sheets to their agents, who can use them both to achieve a better understanding of the policies being sold to customers, and to meet the information demands of more sophisticated clients.[223] ("Advice for fee" insurance consultants will also be able to employ the sheets to develop better purchase recommendations for their clients.) The availability of detailed disclosure forms should, of course, be noted in the Buyer's Guide.

Recommendation 4

Our *fourth*, and final, recommendation is that a study be commenced, by the NAIC, the FTC, or both, to identify and address the propriety of any existing market conditions or regulations that tend to restrain the availability of low price insurance products. While this report focuses principally on "consumer protection" issues, we think that the development of well-informed consumers in the life

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[219] See H. App. 9.

[220] A related question is why the market hasn't generated policy information spontaneously if such data would be truly valuable to consumers. The FTC addresses this issue satisfactorily at H. 135–36.

[221] This sort of information is not readily available to consumers today. *See* H. 201; *Cf.* H. 323–24.

[222] *See* H. 520. This idea was suggested to the NAIC in 1975. *NAIC Project 12,* supra note 97 at 10. The ACLI has no objection to the concept. H. 412–13.

[223] The NALU does not object to this proposal. H. 464.

insurance market will surely be enhanced by the presence of aggressive price competitors.

For example, the restrictions on insurance sales by savings banks appear ripe (to say the least) for re-examination.[224] We recognize that restrictions on insurance sales by banks are sometimes justified by asserting that banks will coerce customers to purchase insurance as a condition for receiving other bank services, such as loans.[225] However, banks in a few states do sell insurance, and we are not aware of any studies that have been conducted to ascertain if such coercion has occurred.

Further, we think that any existing obstacles to the development of "no-load" policies should be reviewed. This concern overlaps with our recommendation in the preceding chapter that "advice for fee" insurance consulting services be promoted. It seems likely that no-load policies are difficult to offer because, due to the absence of commissions, insurance consultants are the only sales representatives willing to handle them. To the extent that the dearth of consultants results from regulatory restrictions, those restrictions should be eliminated.[226]

REVIEW OF NAIC AND FTC PROPOSALS

We previously had occasion to comment on our opinion of the Buyer's Guides developed by the NAIC and the FTC.[227] At this point, we review the policy data disclosure systems supported by those two organizations.

The NAIC model rule [228] is unquestionably a significant advance in the field of cost disclosure. As our preceding recommendations make clear, we are pleased that the rule outlaws traditional net cost as a comparison technique, and mandates disclosure of interest-adjusted cost index numbers and the policy loan interest rate. On the other hand, we think it is deficient in the following areas:

(1) it fails to disclose (a) rate of return, (b) a year-by-year cash value display designed to deter premature lapse during the first 20 years of the policy's life, (c) "yardstick" data, and (d) interest rates charged on non-annual premium payments;

(2) it delays the disclosure of policy information until after the customer has made his purchase decision;

(3) it requires the cost index display to include an unnecessary and misleading "level annual dividend" figure; and

(4) it does not require (a) language in the Buyer's Guide and on the policy summary that would attract attention and emphasize the importance of price comparison, (b) notices in life insurance advertisements to alert consumers that further policy information is available, and (c) development by insurers of additional policy data for presentation to state regulators, agents, and sophisticated consumers.[229]

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[224] *See Hart Hearings*, supra note 1, vol. 2 at 791–908.

[225] *See* V. Evans, *Bank Competition*, NALU Life Association News (Dec. 1974), reprinted in NALU *On the Legal Side* 37 (undated).

[226] The existence of "independent" insurance agents who can place business with any insurance company is helpful, but such agents are still inclined to deal with companies that have attractive commissions rather than with those that offer the lowest prices to policyholders.

[227] See p. 30–31, supra.

[228] The text of the rule appears in Report Appendix A. Its requirements are described in detail by the NALU witness in his prepared statement. H. 435–40.

[229] A number of the witnesses at our hearing had harsh characterizations for the NAIC rule taken as a whole. See Belth, H. 164 ("pseudo disclosure"); Richardson, H. 505 ("very inadequate"); Moorhead, H. 511 ("signally fails").

Two other topics that warrant attention with respect to the NAIC rule are (a) "comprehensibility" and (b) policy summary format specification. The "comprehensibility" issue relates to certain field surveys that have been conducted to assess the impact of the NAIC Buyer's Guide on consumers' ability to understand and use the NAIC disclosure system for cost comparison purposes.

For example, one study conducted for the ACLI [230] in early 1976 (and subsequently presented to the NAIC) showed that, prior to reading the NAIC Buyer's Guide, only 16 percent of the respondents felt quite knowledgeable about life insurance, while 57 percent felt that way after reading the Guide.[231] The problem is that only 31 percent of the respondents were able to identify the index numbers as the method for comparing policy costs, and only 21 percent knew that low index numbers meant low cost.[232]

A second study, done for Prudential Life Insurance in the summer of 1976, found that only 63 percent of the policyholders surveyed even recalled getting a copy of the Buyer's Guide.[233] Of those who remembered reading the Guide, 79 percent claimed it was helpful, but only 5 percent could explain that the surrender cost index was a method of cost comparison.[234]

Naturally, these statistical results do not inspire much confidence in the rule. The NAIC witness responded to the survey findings by stating that the NAIC was itself planning to undertake field testing, and would be "perfectly ready and willing to make whatever kinds of changes are required in the system that exists in order to make it more useful." [235]

As to format specification, Dr. Belth raised the following point:

> The NAIC approach does not prescribe a precise format for disclosure. Thus it is likely that each company will put together its own version of how to comply with the disclosure requirements. The result is that buyers will not be able to make comparisons readily among similar policies issued by different companies. I discussed this problem in a letter to Commissioner Wilde of Wisconsin in late August. Attached to the letter were examples of [policy summaries] promulgated by Equitable of New York, Prudential, and State Farm Life. This letter and the attachments are contained in [my] Exhibit G. I believe it is essential that a disclosure regulation be specific about the disclosure format, and that a company's interpretation of the regulation for each of its policies be subject to approval by the insurance department as a part of the policy approval process.[236]

Dr. Belth's Exhibit G reveals that substantial divergence exists among policy summary formats complying with the NAIC rule requirements. We agree that format is important enough to warrant regulatory control.

The FTC disclosure proposal is more closely congruent with our recommendations than is the NAIC rule. The FTC approach, however, does have the following defects:

(1) it fails to disclose (a) a year-by-year cash value display designed to deter premature lapse during the first 20 years of the policy's life, (b) interest rates charged on non-annual premium payments, and (c) the policy loan interest rate; and

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230 See H. 308.
231 Actionfacts: *A Report on a Study of Consumer Reaction to and Comprehension of a Life Insurance Buyer's Guide* Ex. 4 (1976) (H. 57).
232 *Id.* Ex. 9 & 10 (H. 60).
233 CORP, *Impact Among Policyowners of the New Business Booklet* 3 (Prudential, 1976).
234 *Id.* at 15, 23.
235 H. 307.
236 H. 168–69. Belth's Exhibit G appears at H. 180 et seq.

(2) it does not require (a) notices in life insurance advertisements that further policy information is available, and (b) development by insurers of additional policy data for presentation to state regulators, agents, and sophisticated consumers.

As to the "comprehensibility" of the FTC method, the FTC staff has commissioned experiments designed to test consumer reaction to the disclosure systems devised by it and others.[237] We, of course, look forward to the results of that project.

Finally, the format specification aspect of the FTC proposal was also treated by Dr. Belth in his testimony:

> The FTC approach, unlike the NAIC approach, apparently prescribes a precise format for disclosure. In doing so, however, it introduces a new dimension of the format problem. The FTC approach uses one form for "whole life" policies and a different form for "term" policies. I believe it will be difficult to categorize many policies—especially policies with term riders. And it is not clear what the FTC intends to do about disclosure in the burgeoning area of annuities. In my opinion, it is important to develop a single format that will be applicable to any life insurance policy or annuity. Then it would not be necessary to figure out what kind of disclosure form should be used for any particular policy. The system I have recommended was designed with this objective in mind.[238]

These points are correct, and provide one more reason why we think that a policy data display along the lines suggested by Dr. Belth should be implemented as soon as consumers are capable enough to handle it.[239] The point raised by Dr. Belth about different disclosure formats for whole life and term policies applies to the system we have recommended in this report as well as to the FTC system, and we see no easy way out. Presumably, a separate display will have to be required for both the whole life and term portions of a combined policy.[240]

As to Belth's point about annuities, neither we nor the FTC purport to cover those products in our proposals.[241]

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[237] H. 123.
[238] H. 169–70.
[239] We look forward to the day when Belth-type displays will appear on home computer screens with the flip of a switch.
[240] *Cf.* H. 91.
[241] *See* H. 91–92.

Chapter III—The Market, the NAIC, and the FTC

In this chapter, we assess (1) the potential impact of our recommendations on the life insurance market, (2) the adequacy of the NAIC's regulatory efforts in that market, and (3) the propriety of the FTC's recent involvement in the same area.

THE MARKET

We think it appropriate, in this era of deregulatory fervor, to consider the likely costs and possible adverse consequences in the market of the various recommendations that we have made.

We do not think that the monetary costs of implementing our recommendations present any significant impediment to their acceptance. Buyer's Guides and policy data summaries are already in use by many companies,[242] and it is evident that the costs of printing and distributing the materials, when spread across the millions of new policies sold every year, result in only a minuscule additional expense to any given customer.[243]

Our recommendations basically focus on including different information in the policy summary than appears now, and on ensuring the availability of certain additional data. The expenditures necessary to make the required calculations do not appear especially troublesome to the industry.[244] We have carefully avoided proposing the inclusion of information that would be intrinsically expensive to produce.[245] We have also deliberately framed our recommendations regarding the timing of policy information disclosure to avoid increasing the number of trips made by the agent to his prospect.

A second possible consequence we considered was the development of residual markets. If consumers generally become more cost conscious, companies may be inclined to stop serving certain markets that are relatively more expensive to underwrite. As a result, certain segments of the population might find it difficult or impossible to purchase life insurance.

We are doubtful that persons desiring insurance will be refused coverage. More likely, policy rates will become more closely tied to the actual expenses of insuring particular classes. That, of course, is the way markets should operate.[246]

To be sure, rate classifications can clash with social policy objectives, but the solution is then a reasoned response developed through the appropriate public policy mechanisms. Residual markets are not properly avoided by keeping consumers ignorant of available low-cost product alternatives.[247]

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[242] See note 216, supra.
[243] *See Kimball,* supra note 55, at 1032–33.
[244] H. 413–14. The ACLI does suggest that it would be costly to *change* systems. *Id.* This would, of course, be a one-time-only expenditure.
[245] *Cf.* H. 414.
[246] H. 141–42.
[247] Kimball, supra note 55, at 1049.

The impact of our recommendations on the agency system was the third topic we analyzed. In one respect, an effective cost disclosure policy affects agents because it educates *them* about the relative cost and features of the products they are selling. As discussed earlier, there are more than a few agents who themselves have a great deal to learn about policy costs.

It may be that many of the benefits of cost disclosure will accrue simply because agents will demand better products to sell.[248] This consequence could arise even if consumers pay little attention to the cost disclosure materials. In this regard, we point out that our recommendations would require insurers to disseminate comprehensive Belth-type policy data displays to their agents. If sensitizing agents to product differences is beneficial, detailed disclosure to agents obviously shouldn't be delayed merely because consumers are not yet ready for it.

On the other hand, if consumers do become aggressive life insurance shoppers, a "free rider" problem could develop. An agent who laboriously educates consumers, only to have them use their newly acquired understanding to purchase policies with lower costs than he can offer, will presumably not long remain an agent.

One answer is that agents should charge a fee for their counsel, thus receiving compensation for their efforts whether or not a policy is sold. This approach, of course, is reflected in our "fee-for-advice" recommendation. Practically speaking, however, insurance advisors will be able to serve only those consumers who are out to "buy" insurance.

Consumers who must be "sold" insurance, that is, who buy only after being contacted and affirmatively encouraged by an agent, probably cannot be effectively served except by a commission-funded sales force.[249] We observe that such consumers will likely value an agent's service, and are likely to place their business with a company that their agent serves,[250] rather than with a company that has lower costs but no agents at all.[251] In our view, the demise of the agency system is simply not a likely consequence of cost disclosure.

THE NAIC

One of the questions our hearings sought to address was whether state regulation of the life insurance market has been adequate. We want to be explicit that our analysis here of state efficacy focuses strictly on the problem of providing information to potential purchasers of ordinary life insurance. As the NAIC properly points out, even in the limited area of life insurance, "cost disclosure" regulation is but one element of the state program for assuring a life insurance market that operates to the public's benefit.[252] Thus, the conclusions drawn from our review cannot be haphazardly generalized to the whole gamut of state insurance activities. Our findings will, how-

[248] See H. 234–35, 520. *See also Kimball,* supra note 55, at 1034–35.

[249] H. 140–41, 226.

[250] We naturally believe that agents should not be restricted to placing their sales with only one insurer.

[251] The FTC also notes that, at present, there is no positive correlation between the companies that have well-paid agents and the companies that offer high price policies. H. 140.

[252] H. 270–72.

ever, represent a part of the larger record that can ultimately be assessed to judge state regulation overall.

We begin our analysis by citing the NAIC's description of what their rule purports to accomplish. The NAIC witness stated the objectives as follows:

There are three basic types of information that a life insurance prospect should have in evaluating a life insurance purchase decision: (1) what types of coverage and options are available; (2) what coverage is most suitable to the purchaser's needs; and (3) how to obtain suitable coverage at low cost. Each of these objectives is addressed in the NAIC Model Life Insurance Solicitation regulation.[253]

The NAIC disclosure rule achieves the first objective above reasonably well. The Buyer's Guide does describe the types of coverage available. As to helping the consumer decide whether term or whole life coverage is "most suitable," the NAIC witness admitted that none of the cost indexes required by the rule were relevant to that issue, but asserted that appropriate information was "provided by way of narrative explanation in the buyer's guide." [254]

The "narrative explanation" referred to is a short, general description of the differences between term and whole life. It fails altogether to explain the significance of even the most fundamental aspects of the term-whole life choice. The NAIC rule neither provides rate of return data nor even mentions the concept. Instead, the NAIC adopts the position of non-disclosure that has been advanced by insurers for years to avoid revealing the information that would enable consumers to make a meaningful decision. The NAIC thus finds itself endorsing irrevelant and unpersuasive arguments devised by insurers to protect their economic position as financial intermediaries.

We would have expected to find the NAIC employing its influence to dissipate the wholly unnecessary confusion that surrounds the term-whole life controversy. Regrettably, we find the NAIC at the forefront of efforts to perpetuate it.

Another aspect of selecting the "most suitable" coverage is the problem of premature lapse. Clearly, a good many people who let their whole policies lapse shortly after they purchase them, and suffer a financial loss in the process, can be regarded as having made an unsuitable purchase. Yet, although lapse has been a recognized issue for at least a century,[255] the NAIC rule contains no provisions specifically designed to deter early lapse. The following statement at our hearing by the NAIC witness illuminates the NAIC posture toward lapse reduction:

I am not aware of any specific model law or model regulation adopted by the NAIC which is designed to remedy the problem, the acknowledged problem, of early lapse of whole life insurance policies. We continue to recognize that it is a problem.[256]

On the basis of the above considerations, we feel fully justified in concluding that the NAIC rule neglects to deal effectively with lapse and the term-whole life choice, and therefore fails to help consumers select the most suitable type of coverage.[257]

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[253] H. 255–56.
[254] H. 263–64.
[255] See H. App. 20 for NAIC convention transcripts dating from 1915 and 1972 that deal with the problem of lapse. See also H. 327–28.
[256] H. 328.
[257] We also do not think that the NAIC Buyer's Guide emphasizes the danger of underinsurance with nearly enough force. This is another facet of the "suitability" problem.

The third objective asserted by the NAIC for its model rule is to help consumers identify suitable coverage at low cost. Here, the NAIC rule represents a major achievement, because it does mandate interest-adjusted cost indexes and outlaws comparisons using traditional net costs. However, as we discussed previously in detail, the rule requires too many index numbers to be displayed (including the useless "level annual dividend"), omits yardstick data entirely, and provides for disclosing the cost comparison data only after the purchase decision has been made. Further, we have doubts about effective control of policy manipulation and, given the results of field surveys already conducted, about the comprehensibility of the NAIC disclosure system.

With respect to issues relating to cost indexes, the NAIC earnestly argues that it's too soon to know whether the model rule will work.[258] The NAIC witness indicated that further field testing was in the offing and that a whole series of other initiatives designed to improve consumers' purchasing abilities were under way.[259] We think the NAIC raises a legitimate point here, and we are thus willing to defer judgment. The passage of time should also tell us more about the adequacy of manipulation control and may also allow some of the uncertainties about the calculation of group average indexes to be resolved. A more adequate record would then be available to support findings and recommendations with respect to the cost comparison aspects of the NAIC rule. We note, however, that the passage of time will do nothing to allay the failure of the present rule to address lapse and the term-whole life choice.

One feature of the cost comparison issue that does concern us is the question of when interest-adjusted cost indexes should have been mandated. The NAIC witness asserted that inflation was the main reason why interest adjustments were necessary and that, prior to the high interest rates of the last decade, it was a relatively easy and straightforward matter to compare the costs of competing policies.[260] Mr. Moorhead, on the other hand, took the view that the need for interest-adjusted indexes was related not to inflation but to the industry practice that arose after World War II of paying increased terminal dividends and cash values.[261] Professor Belth testified that he had concluded as early as 1963 that cost disclosure was necessary, a proposition he supported exhaustively in his 1966 study, *The Retail Price Structure in American Life Insurance*.[262]

We agree with Messrs. Moorhead and Belth, mainly because of the remarkable impact of compound interest that occurs even at low interest rates. Assume two $10,000 whole life policies with equal net costs, but whose 20 year surrender costs differ by $2 per thousand or $20 per year. Even at a low 2 percent assumed interest rate, the difference in cost between the two policies is $496 after 20 years.[263] In the 1950's, that amount of money was significant, and it is by no means trivial even today. These facts suggest to us that NAIC efforts since 1970 to

[258] H. 256–57. See also H. 441–42.
[259] H. 265–68, 300–02, 307.
[260] H. 251 and H. App. 29B. However, the NAIC witness did not believe that a future reduction in inflation would justify abandonment of interest adjusted cost comparison. H. 325.
[261] H. 519–20.
[262] H. 163.
[263] See Hearing Exhibit A-1 (H. 374). The appropriate factor is 27.783.

implement a cost disclosure system have been more a reaction to the rising crescendo of criticism from outside the industry than a response to the implications of high inflation.[264]

In sum, we find that the states generally, and the NAIC particularly, have been unnecessarily slow and unduly cautious about vindicating consumer interests in the life insurance cost disclosure field. Acceptance of interest-adjusted cost indexes was a profound step for the NAIC and we do not denigrate it. However, that step could and should have been taken earlier. By now, both agents and consumers should be fully conversant with rate of return and cost of protection concepts. They aren't. The NAIC should have been the first to detect the need for cost disclosure and to press vigorously for a fully effective system. It wasn't. As a consequence, substantial consumer injury continues to occur in the life insurance market to this very day, and is likely to continue occurring even if every state in the Union promptly adopts the NAIC model rule in its present form.

We do not, however, recommend instant invocation of federal power to pre-empt the life insurance cost disclosure field. We instead recommend that the individual states adopt cost disclosure rules along the lines urged by this report. We recognize that no existing federal entity is in an auspicious posture to undertake a permanent federal regulatory role in the life insurance area. Further, we believe that the states ought to have an opportunity to address themselves to the issues with a conscious awareness that they are under Congressional observation. We will then see whether, as the NAIC asserts, such scrutiny "concentrates the mind wonderfully." [265]

THE FTC

The last question for consideration is whether and to what extent the FTC has an appropriate role in the field of life insurance cost disclosure. From a legal standpoint, the principal responsibility for ascertaining whether the life insurance market is operating properly, and for taking remedial action if it is not, rests in the hands of the individual states. This is a consequence of the McCarran-Ferguson Act of 1945, 15 U.S.C. §§ 1011–1015,[266] which provides that regulatory power over insurance is vested with the states unless a federal statute otherwise expressly provides.

The practical effect of the statute is to insulate from attack state regulation that might otherwise constitute an impermissible burden on interstate commerce. Congress did, however, reserve to itself the

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[264] See H. 172, 484. We note in passing that the problem of life insurance cost comparison was recognized as early as 1908. In that year, the Wisconsin insurance commissioner concluded that there was a clear need to exercise state regulatory power in aid of life insurance purchasers. "It would seem," he said "as if there could be no question that the present and prospective policyholder is entitled to have all the facts with regard to his policy in such form that he can understand them and be able to compare the expense and the insurance benefit." Commissioner of Insurance, *Annual Report* 14 (1908). Perhaps not surprisingly, the cost disclosure proposal supported by that Commissioner never saw the light of day: "When the recommendation was suggested in the hearings of the committee, it met with the answer that the prospective policyholder would not take the insurance if he knew what he was paying for expense. * * * [S]o novel was the proposition to give the policyholder a chance to protect himself and so strenuous were the objections to the plan on the part of the companies, even during the hearings by the investigation commitee, that the committee felt that it would be difficult to secure its immediate adoption." *Id.*

[265] H. 277.

[266] The Act passed shortly after the Supreme Court's decision in *United States* v. *South-Eastern Underwriters Association*, 322 U.S. 533 (1944), holding for the first time that the insurance industry operated in interstate commerce and was therefore subject to federal regulation. A copy of the Act appears as H. App. 4.

option to impose federal statutory controls on any aspect of insurance. Congress also provided that the federal trade regulation principles embodied in the Sherman, Clayton, and Federal Trade Commission Acts [267] were to remain applicable to insurance, but only "to the extent that such [insurance] business is not regulated by State law." [268]

In the absence of McCarran-Ferguson, the FTC could clearly exercise its statutory rulemaking powers [269] and promulgate a life insurance cost disclosure regulation that would apply nationally and pre-empt any state-mandated cost disclosure requirements. It seems clear, however, that due to McCarran, states that now have a cost disclosure regulation would not be affected by an FTC rule, because the acts and practices at issue would be "regulated by State law." [270]

The NALU witness observed that a difficult issue is created by the fact that all states have on their books provisions prohibiting deceptive practices in the marketing of insurance policies. It could be argued that the mere presence of these rules ousts the FTC's jurisdiction in all states even if no specific state cost disclosure rules are in force.[271] That question has not been litigated, nor have the related questions that would arise if a state enacted a cost disclosure rule *after* an FTC rule was promulgated, or if a state conducted a cost disclosure rulemaking proceeding and concluded that no affirmative disclosure requirements were necessary.

We see little reason to discuss these questions now, because they will arise only if the FTC actually issues a rule, and the Commission has expressly represented that no such rule will be promulgated any time during fiscal year 1979.[272] The Commission's position is that its staff will seek to work closely with the states in a cooperative spirit during 1979.[273]

However, the Commission states, "[s]hould these efforts prove unsuccessful, * * * it is likely that the Commission would reassess whether the public interest warrants initiation of a [trade regulation rule] proceeding. Of course jurisdictional issues posed by the McCarran-Ferguson Act will require careful analysis." [274]

We find this posture of the FTC to be wholly lawful, proper, and appropriate. Our analysis of the life insurance industry and its regulators has convinced us that the infusion of fresh views by an agency experienced in consumer protection activities is highly desirable. Even if the FTC never invokes its statutory powers, the size of the life

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[267] The Sherman Act, 15 U.S.C. §§ 1–7, prohibits combinations in restraint of trade and monopolization or attempts to monopolize. The Clayton Act, 15 U.S.C. §§ 12–27, prohibits price discrimination, exclusive sales agreements, mergers, and interlocking directorates, where the effect is to lessen competition or tend to create a monopoly. The Federal Trade Commission Act, 15 U.S.C. §§ 41–58, prohibits unfair methods of competition and unfair or deceptive commercial practices.

[268] 15 U.S.C. § 1012(b).

[269] See 15 U.S.C. § 57a.

[270] See H. 157. See also H. 432–33.

[271] H. 431–32.

[272] Hearing Exhibit F–2 (H. 154). See also H. 155.

[273] *Id.* The Commission claims that its staff has met with over 20 commissioners and that "[m]any of these commissioners have expressed a strong interest in working with us in our investigation." H. 154. The Subcommittee has received a letter from the Wisconsin Insurance Commissioner stating that "[o]ur department has received much useful advise from the Federal Trade Commission as we have worked on this proposed regulation. We believe very strongly in the viability of state initiative concerning life insurance cost comparison, but at the same time, we welcome the assistance of the FTC. We view the FTC not as a competitor, but rather, as a supplement to our efforts." See H. App. 12A. *See also* H. 155 and H. App. 30 B (Exhibit 5).

[274] Hearing Exhibit F–2 (H. 154).

insurance industry, its importance to consumers, and its methods of doing business clearly justify the expenditure of some FTC resources to maintain at least an advisory federal presence.[275] Further, the McCarran Act obviously contemplates that the FTC Act can apply in some respects to the business of insurance, and it is basic law that the agency administering a federal statute should substantially influence demarcation of the statute's jurisdictional boundaries. Thus, we think that the FTC is entitled at least to explore how its responsibilities and powers relate to the issues presented by life insurance cost disclosure.

We, of course, expect the FTC to be sensitive to the rights of the states and to respect their position as the principal regulators of insurance. Particular care should be used whenever the Commission staff approaches the states in an attempt to influence state policymaking processes.

For example, in early 1978, the FTC staff wrote the 50 states to advise them that the FTC was developing a cost disclosure system and to voice "misgivings" about the NAIC model rule.[276] The letter continued as follows:

> If your department is considering the adoption of the NAIC Model Regulation in the near future, we urge you to delay your rulemaking hearings until after June 15, 1978. By that time we expect to obtain the results of an important consumer research experiment now being conducted at Purdue University. That experiment is designed to test the relative comprehensibility of both the NAIC and FTC cost disclosure systems. There is certainly little sense in hastening to adopt the NAIC Model Regulation if subsequent research reveals that the NAIC system is incomprehensible to most consumers.[277]

We find the tone of this language too heavyhanded, under the circumstances. The FTC witness testified that, under prevailing Commission practice, letters to states need not be reviewed by the Commissioners themselves. Given the volume of paper that the Commission handles, such a practice is understandable. However, the appropriate Bureau Director should scrutinize closely the language of any staff letter that urges a particular course of action on state regulators. We think the review process failed here.

Beyond the question of tone, however, is the more substantive issue of whether the FTC staff should have been pressing the states to delay adopting the NAIC rule in the first place. The NAIC witness alleged that:

> "certain releases by the commission's staff have had the effect of derailing efforts by the states to implement meaningful disclosure rules and stimulate consumer cost comparisons." [278]

We do not think it is inherently improper for the FTC to voice objections about existing or proposed state regulations. Surely, the FTC could properly oppose a state law that legalized horizontal price fixing or endorsed bait and switch schemes, and could write a letter to the state saying so. We ourselves do not recommend adoption of the NAIC model rule in its present form, and do not see anything intrinsically objectionable about the FTC's opposition to the NAIC rule.

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[275] We also note that, besides its direct regulatory authority under the FTC Act, the Commission is empowered to investigate the conduct of any corporation "excepting banks and common carriers," 15 U.S.C. § 46(a), and to make reports to Congress recommending legislation, 15 U.S.C. § 46(f). We do not think that such non-regulatory activities are affected by the McCarran Act. *Cf.* H. App. 30 B.

[276] Hearing Exhibit F–1 (H. 96).

[277] *Id.*

[278] H. 208.

We are, however, troubled that the FTC was urging delay before its own investigation was complete. The FTC witness justified encouraging the states to wait on the grounds that "[w]e felt it made some sense to avoid [the] needless expenditure of resources" that would occur if a state promulgated the NAIC rule and shortly thereafter decided to amend it in light of the FTC's findings.[279] But that judgment is for the states to make, not the FTC. We think the FTC should simply have (1) advised the states about the impending FTC report, and (2) requested that they consider whether resources could be saved by a short delay.

In conclusion, we believe that the FTC's recent activities in the life insurance field have been proper from both a legal and policy standpoint. We do think that the Commission staff could and should have been more circumspect in its dealings with state regulators.

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[279] H. 157.

DISSENTING VIEWS OF HON. JAMES M. COLLINS, M.C.

I object strenuously to this Report, more strenuously than I have to any report that has been issued by this Subcommittee during the last four years, which has been the length of my tenure as Ranking Republican. Over these years, I have had many and varied disagreements with many reports, but those disagreements are mild by comparison.

The reason for my unusually strong feelings is that I believe that this Report puts this Subcommittee foursquare into the business of telling Americans what type of life insurance that they should buy. This is one of the most unique, private and personal decisions that a person can make, because everyone's insurance needs are different. You simply cannot generalize about this sort of thing, but the Report has totally bought the Federal Trade Commission's wrongheaded "buy term and invest the difference" approach. This is not the business of government.

The country is finally awakening to something that I have been pointing out for all of my years in the Congress, which is that the federal government is officiously intermeddling into the private lives of people, and they do not like it. Now, along comes this Report which really overreaches rather deeply into those private lives. This Report is the height of arrogance.

Quite frankly, I am amazed that any instrumentality of the federal government would believe that it is in a position to give advice on the question of insurance. The federal government is into the insurance business in a very big way through their annuity programs of Social Security, Railroad, Civil Service, and Military retirement programs, all of which are in abysmal shape. Social Security took in $80 billion last year but expended $88 billion; Railroad Retirement four years ago was in catastrophic shape, and the Congress had to bail it out; Civil Service Retirement deficiencies have been estimated to be $150 billion; and in the Military Retirement System there are no reserves. Based on this performance record, the federal government should be asking for advice from the private insurance industry rather than suggesting how it goes about its business.

The bias of this Report to the "buy term and invest the difference" approach runs through the whole Report. There is insistence in the Report on the proposition that people will "invest the difference" when they buy term insurance. Whether people will actually do this is open to grave question but in any event it is misleading to refer to term-with-a-side fund in attempting to denigrate whole life insurance. The Majority and the FTC should in fairness compare term insurance, alone, with whole life insurance. As a consumer product, whole life insurance stands on its own; competing products should do so also, without reference to and reliance on unspecified and problematical "other" investments.

The government has no more business advocating term insurance over whole life insurance than it has in telling people that they should buy low price cars and "invest the difference." This constitutes government meddling of the worst kind.

Another basic fallacy of the Report's reasoning is the erroneous assumption that no system of disclosure will be effective unless it compares the rate of return on policy values in whole life insurance with the rate of return on other investments, such as savings accounts.

The unique nature of cash values must be taken into account in considering whether great emphasis on the rate of return on these values as compared to other "savings" is merited. Historically, the development of cash value life insurance stemmed from the desirability, if not the necessity, of providing a level premium for the duration of the life insurance contract. The vitality of the level premium is well described by the late Dr. Van Lucas at page 41 of the "Life and Health Insurance Handbook" (Dow Jones-Irwin, Inc., Homewood, Illinois, 1973).

> The chief significance of the level premium concept lies in the fact that the redundant premiums in the early years of cash value contracts create a fund which is held by the insurer for the benefit and to the credit of the policyowners. Earnings (principally interest) are produced by investing the fund. The accumulated fund, improved by earnings, is used to pay out the benefit amounts provided for under the contract. Thus, the level premium is the only arrangement under which it is possible to provide insurance protection to the upper-most limits of the human life-span without the premium per unit of face amount increasing as age advances and eventually becoming prohibitive for most individuals.

Much misunderstanding of cash value life insurance has been caused when people have overlooked the true function of cash value in the life insurance policy and have insisted on comparing it to "investments" and "savings", whereas in fact cash values is primarily an incident of the reserve required by law to support the promise to pay at a later time, having its origin in the excess premiums charged in the early years of the contract to keep the premium level over the life of the policy.

Historically, policies contained no provision for the payment of amounts representing an insured's equity on termination prior to the maturity of the policy, until the first nonforfeiture law was enacted in Massachusetts in 1861, and this law only required companies to provide extended term insurance with a part of the policy reserve. The law did not require a cash value, nor did such laws subsequently enacted in other states call for a cash value until after the turn of the century. Cash values, then, rather than being "savings" or "investment" in concept, grew out of public policy against full forfeiture upon lapse and the desire to establish a basis whereby the purchaser could recover some of the payments already made. The public purpose to be served by cash values, is, therefore, unlike that of typical savings and investment media, and thus it is erroneous to compare the two as the Majority (and the FTC) would do.

CAPITAL INVESTMENT

The compelling argument that the economy will suffer from depressed investment capital if people are discouraged from buying whole life insurance as they have in the past is brushed aside in the Report by saying that term insurance purchasers will invest the difference in other financial institutions and there will be no loss of investment. Aside from the use of a fallacious argument (that people who buy term insurance do in fact invest the difference), this overlooks the longer term capital investments of life insurance companies (e.g., mortgages) as compared to those of many other financial institutions. Sharp reductions in whole life premium income would have an adverse effect on long-term life insurance company investments (neither the FTC nor the Majority seem to recognize that they are flirting with this adverse economic consequence).

The steady payment of premiums by life insurance policyholders to the life insurance companies in America accounts in large measure for the investment capital—particularly long-term investment capital—the life insurance business can thus make available for the economy.

The life insurance business is now the fifth leading source of investment capital for the country, with investment holdings approximating $300 billion. There are 200 million or so individual cash value life insurance policies in force. To the extent that undue federal government interference would change the purchasing patterns of cash value life insurance, this would tend to discourage individuals from acquiring and holding life insurance, and this major—if not vital—source of America's investment capital could be seriously impaired. This could in turn have a deleterious effect on all facets of the economy, including employment.

The purchase and retention of permanent life insurance has been a major means, not only of achieving needed capital formation, but also of private individual retirement and family security.

PROFESSIONAL INSURANCE CONSULTANTS

There is a recommendation in this Report that a system of professional insurance consultants who would work for a fee be developed, apears at first blush to be attractive. However, on closer examination, this suggestion might create more problems than it would solve. For example, as in the case of higher and lower priced automobiles, it is easier to sell lesser amounts of life insurance than greater amounts; if the agent is going to receive the same amount of money no matter what the face amount of the policy, this could result in under-insurance for many (maybe most) buyers. Similarly, if the agent will receive the same amount of money regardless of the kind of insurance he sells, obviously more term insurance will be sold, because people will be attracted to higher face amounts for the same cash outlay. But to the extent that whole life insurance might be admitted (even by the FTC and the Majority) to be a superior product, the purchase of this product would be discouraged. That, of course, seems to be the clear object of the FTC and the Majority, but it is at least debatable whether this would be generally desirable.

Since the marketing of life insurance is one of the strongest and most competitive businesses in America today, generating over $22 billion in sales in 1976—the federal government, specifically the Federal Trade Commission, has become concerned with regulating this competition.

Life insurance in force in the United States more than doubled in the decade ending in 1976 (to $2.34 trillion), as did the amount of life insurance per American family (to $30,000). Americans were purchasing $320 billion of life insurance annually by the end of that decade, and benefits payments were, by then, very nearly $25 billion a year. There were over 1,700 companies competing in the market place, and in 1976 new life insurance company investments in the economy had reached a record high of $175 billion. At the same time, the life insurance industry incurred taxes and fees of $4 billion on its 1976 operations. These are hardly the earmarks of an industry operating in a "failing market", as is indicated in the Report.

The life insurance industry has never been subjected to or needed Federal intervention. The state commissions have done an outstanding job of taking care of the industry problems in each respective state as well as on a coordinated national level and will continue to do so if permitted to operate in a fashion unfettered by Federal Government meddling. In fact, the Federal Government has in effect been explicitly precluded from setting standards for insurance matters by the McCarran-Ferguson Act of 1945 (15 U.S.C. 1011–1015), which decreed that the responsibility for insurance regulation should remain with the states. Recently, the House Appropriations Committee, in reporting its action on the Federal Trade Commission's fiscal year 1979 budget request, recommended strongly that "the Commission not take any final action during fiscal year 1979 which might be inconsistent with the model regulation of the National Association of Insurance Commissioners." In furtherance of the House Appropriations Committee view regarding the Federal Trade Commission's efforts to implement insurance cost disclosure guidelines for consumers, the Senate Appropriations Committee Report includes a directive from Chairman Warren Magnuson that "in no event should the Commission nor its staff attempt to impede or thwart the adoption by the states of the Model Life Insurance Cost Solicitation Regulation supported by the National Association of Insurance Commissioners." These statements by Committees of both bodies of the Congress indicate to me that the NAIC Model Legislation is viewed considerably different than the conclusions of the Subcommittee Report. If it were as fraught with problems as the Report suggests, I doubt that these two Committees would permit its further adoption by states especially, since almost everyone concedes that if this is done, the FTC would be preempted if it promulgates its own Trade Regulation Rule at some later point in time.

This NAIC model regulation embodies a life insurance cost disclosure method adopted by the National Association of Insurance Commissioners in final form in 1976 and adopted by a growing number of states. However, the Federal Trade Commission has come up with its own plan for cost disclosure. The agency would like to see the states who are not yet using the NAIC insurance cost disclosure method hold off on their rulemaking until the FTC is officially allowed to distribute its own recommendations for the best insurance buys. The FTC guidelines would clearly open the door for further federal intervention.

In the Subcommittee hearings, I learned a lot about the FTC's point of view on life insurance from Mr. Albert H. Kramer, Director of the FTC Bureau of Consumer Protection, and the Report seems to have adopted his basic reasoning that the rate of return on the savings element of a life insurance policy is a most vital element of any cost disclosure method. It has been my experience that most people look at life insurance as a means of protection for their families. Yet in the draft of the FTC Life Insurance Buyer's Guide and in the Subcommittee Report, term insurance was repeatedly emphasized as a more sound investment over a whole life policy. The agency and the Report recommend that a young person buy term insurance and invest the difference.

I asked Mr. Kramer at our hearings on Life Insurance if he had ever sought advice from the Treasury Department in buying U.S. Savings Bonds. It is a well-known fact that the percentage of interest on U.S. Savings Bonds is not as great as those of other savings institutions, like banks or credit unions. He acknowledged that no one had volunteered information from the Treasury Department on savings bonds, but that he could collect a mixed bag of information on an investment in savings bonds versus more speculative areas like the stock market. My concern is that if the government does not volunteer information on the interest rates of its own plans, why should the bureaucrats be in the business of what they should disclose.

I believe that if, as they seem to intend, the FTC backed by the Subcommittee Report is successful in making cost the chief criterion in the purchase of a life insurance policy, one adverse effect of this will surely be to force many life insurance companies that invest conservatively in such relatively lower return investments as long-term home mortgages to seek other, higher yield investments so that they can in turn lower their premiums to satisfy the FTC and the Subcommittee and be "competitive". In placing undue emphasis on cost alone, the FTC and this Subcommittee are perhaps unwittingly flirting with much larger domestic economic questions. I believe this because, as I have indicated, life insurance company investments are approaching $200 billion, and thus the consequences that may flow from any action such as the FTC and the Subcommittee would apparently favor must be carefully assessed before this Subcommittee or any agency of the federal government is allowed to precipitate these adverse consequences under the guise of "protecting the consumer."

As I have emphasized, the life insurance industry serves millions of people with individual experiences and needs. A blanket government recommendation to buy term rather than whole life insurance, which the FTC and the Report seem bent on recommending, is not beneficial to all consumers and would indeed be harmful to some. The government cannot recommend one way of investment for all.

As I pointed out in the Subcommittee hearings and in these views, it is not possible for a government guide to encompass all of the individual life insurance needs and adjustments. And who is to say the public will be able to understand yet another government form?

CONCLUSION

In conclusion, I would say that the matter of regulating the life insurance industry is best left to the several states and the FTC should stay completely out. The FTC's meddling will not solve problems; it will only compound them. The states have effectively regulated the industry for years without the assistance of the federal government. There is great competition in this marketplace, and I have yet to see anyone allege that the life insurance industry is engaging in fraudulent or deceptive trade practices.

As for the Subcommittee Report, it should be totally dismissed, because it adopts the mistaken notion that insurance is something very much akin to decisions made about investing in gold, gems, municipal bonds, or common stock. Such is not the case.

James M. Collins.

Appendix A

NAIC MODEL LIFE INSURANCE SOLICITATION REGULATION

May 4, 1976

Section 1. Authority.

This rule is adopted and promulgated by (title of supervisory authority) pursuant to sections [4(1) (a) of the Unfair and Deceptive Acts and Practices in the Business of Insurance Act] of the insurance code.

Section 2. Purpose.

(A) The purpose of this regulation is to require insurers to deliver to purchasers of life insurance, information which will improve the buyer's ability to select the most appropriate plan of life insurance for his needs, improve the buyer's understanding of the basic features of the policy which has been purchased or which is under consideration and improve the ability of the buyer to evaluate the relative costs of similar plans of life insurance.

(B) This regulation does not prohibit the use of additional material which is not in violation of this regulation or any other (state) statute or regulation.

Section 3. Scope.

(A) Except as hereafter exempted, this regulation shall apply to any solicitation, negotiation or procurement of life insurance occurring within this state. This regulation shall apply to any issuer of life insurance contracts including fraternal benefit societies.

(B) Unless otherwise specifically included, this regulation shall not apply to:

1. Annuities.

2. Credit life insurance.

3. Group life insurance.

4. Life insurance policies issued in connection with pension and welfare plans as defined by and which are subject to the federal Employee Retirement Income Security Act of 1974 (ERISA).

5. Variable life insurance under which the death benefits and cash values vary in accordance with unit values of investments held in a separate account.

Section 4. Definitions.

For the purposes of this regulation, the following definitions shall apply:

(A) Buyer's Guide. A Buyer's Guide is a document which contains, and is limited to, the language contained in the Appendix to this regulation or language approved by (title of supervisory authority).

(B) Cash Dividend. A Cash Dividend is the current illustrated dividend which can be applied toward payment of the gross premium.

(C) Equivalent Level Annual Dividend. The Equivalent Level Annual Dividend is calculated by applying the following steps:

1. Accumulate the annual cash dividends at five percent interest compounded annually to the end of the tenth and twentieth policy years.

2. Divide each accumulation of Step 1. by an interest factor that converts it into one equivalent level annual amount that, if paid at the beginning of each year, would accrue to the values in Step 1. over the respective

periods stipulated in Step 1. If the period is ten years, the factor is 13.207 and if the period is twenty years, the factor is 34.719.

3. Divide the results of Step 2. by the number of thousands of the Equivalent Level Death Benefit to arrive at the Equivalent Level Annual Dividend.

(D) Equivalent Level Death Benefit. The Equivalent Level Death Benefit of a policy or term life insurance rider is an amount calculated as follows:

1. Accumulate the guaranteed amount payable upon death, regardless of the cause of death, at the beginning of each policy year for ten and twenty years at five per cent interest compounded annually to the end of the tenth and twentieth policy years respectively.

2. Divide each accumulation of step 1. by an interest factor that converts it into one equivalent level annual amount that, if paid at the beginning of each year, would accrue to the value in step 1. over the respective periods stipulated in step 1. If the period is ten years, the factor is 13.207 and if the period is twenty years, the factor is 34.719.

(E) Generic Name. Generic Name means a short title which is descriptive of the premium and benefit patterns of a policy or a rider.

(F) Life Insurance Cost Indexes.

1. Life Insurance Surrender Cost Index. The Life Insurance Surrender Cost Index is calculated by applying the following steps:

a. Determine the guaranteed cash surrender value, if any, available at the end of the tenth and twentieth policy years.

b. For participating policies, add the terminal dividend payable upon surrender, if any, to the accumulation of the annual Cash Dividends at five percent interest compounded annually to the end of the period selected and add this sum to the amount determined in step a.

c. Divide the result of step b. (step a. for guaranteed-cost policies) by an interest factor that converts it into an equivalent level annual amount that, if paid at the beginning of each year, would accrue to the value in step b. (step a. for guaranteed cost policies) over the respective periods stipulated in step a. If the period is ten years, the factor is 13.207 and if the period is twenty years, the factor is 34.719.

d. Determine the equivalent level premium by accumulating each annual premium payable for the basic policy or rider at five percent interest compounded annually to the end of the period stipulated in step a. and dividing the result by the respective factors stated in step c. (this amount is the annual premium payable for a level premium plan).

e. Subtract the result of step c. from step d.

f. Divide the result of step e. by the number of thousands of the Equivalent Level Death Benefit to arrive at the Life Insurance Surrender Cost Index.

2. Life Insurance Net Payment Cost Index. The Life Insurance Net Payment Cost Index is calculated in the same manner as the comparable Life Insurance Cost Index except that the cash surrender value and any terminal dividend are set at zero.

(C) Policy Summary. For the purposes of this regulation. Policy Summary means a written statement describing the elements of the policy including but not limited to:

1. A prominently placed title as follows: STATEMENT OF POLICY COST AND BENEFIT INFORMATION.

2. The name and address of the insurance agent, or, if no agent is involved, a statement of the procedure to be followed in order to receive responses to inquiries regarding the Policy Summary.

3. The full name and home office or administrative office address of the company in which the life insurance policy is to be or has been written.

4. The Generic Name of the basic policy and each rider.

5. The following amounts, where applicable, for the first five policy years and representative policy years thereafter sufficient to clearly illustrate the premium and benefit patterns, including, but not necessarily limited to, the years for which Life Insurance Cost Indexes are displayed and at least one age from sixty through sixty-five or maturity whichever is earlier:

   a. The annual premium for the basic policy.

   b. The annual premium for each optional rider.

   c. Guaranteed amount payable upon death, at the beginning of the policy year regardless of the cause of death other than suicide, or other specifically enumerated exclusions, which is provided by the basic policy and each optional rider, with benefits provided under the basic policy and each rider shown separately.

   d. Total guaranteed cash surrender values at the end of the year with values shown separately for the basic policy and each rider.

   e. Cash Dividends payable at the end of the year with values shown separately for the basic policy and each rider. (Dividends need not be displayed beyond the twentieth policy year.)

   f. Guaranteed endowment amounts payable under the policy which are not included under guaranteed cash surrender values above.

6. The effective policy loan annual percentage interest rate, if the policy contains this provision, specifying whether this rate is applied in advance or in arrears. If the policy loan interest rate is variable, the Policy Summary includes the maximum annual percentage rate.

7. Life Insurance Cost Indexes for ten and twenty years but in no case beyond the premium paying period. Separate indexes are displayed for the basic policy and for each optional term life insurance rider. Such indexes need not be included for optional riders which are limited to benefits such as accidental death benefits, disability waiver of premium, preliminary term life insurance coverage of less than 12 months and guaranteed insurability benefits nor for basic policies or optional riders covering more than one life.

8. The Equivalent Level Annual Dividend, in the case of participating policies and participating optional term life insurance riders, under the same circumstances and for the same durations at which Life Insurance Cost Indexes are displayed.

9. A Policy Summary which includes dividends shall also include a statement that dividends are based on the company's current dividend scale and are not guaranteed in addition to a statement in close proximity to the Equivalent Level Annual Dividend as follows: An explanation of the intended use of the Equivalent Level Annual Dividend is included in the Life Insurance Buyer's Guide.

10. A statement in close proximity to the Life Insurance Cost Indexes as follows: An explanation of the intended use of these indexes is provided in the Life Insurance Buyer's Guide.

11. The date on which the Policy Summary is prepared.

The Policy Summary must consist of a separate document. All information required to be disclosed must be set out in such a manner as to not minimize or render any portion thereof obscure. Any amounts which remain level for two or more years of the policy may be represented by a single number if it is clearly indicated what amounts are applicable for each policy year. Amounts in item 5 of this section shall be listed in total, not on a per thousand nor per unit basis. If more than one insured is covered under one policy or rider, guaranteed death benefits shall be displayed separately for each insured or for each class of insureds if death benefits do not differ within the class. Zero amounts shall be displayed as zero and shall not be displayed as a blank space.

Section 5. Disclosure Requirements.

(A) The insurer shall provide, to all prospective purchasers, a Buyer's Guide and a Policy Summary prior to accepting the applicant's initial premium or premium deposit, unless the policy for which application is made contains an unconditional refund provision of at least ten days or unless the Policy Summary contains such an unconditional refund offer, in which event the Buyer's Guide and Policy Summary must be delivered with the policy or prior to delivery of the policy.

(B) The insurer shall provide a Buyer's Guide and a Policy Summary to any prospective purchaser upon request.

(C) In the case of policies whose Equivalent Level Death Benefit does not exceed $5,000, the requirement for providing a Policy Summary will be satisfied by delivery of a written statement containing the information described in Section 4(G), items 2, 3, 4, 5a, 5b, 5c, 6, 7, 10, 11.

Section 6. General Rules.

(A) Each insurer shall maintain at its home office or principal office, a complete file containing one copy of each document authorized by the insurer for use pursuant to this regulation. Such file shall contain one copy of each authorized form for a period of three years following the date of its last authorized use.

(B) An agent shall inform the prospective purchaser, prior to commencing a life insurance sales presentation, that he is acting as a life insurance agent and inform the prospective purchaser of the full name of the insurance company which he is representing to the buyer. In sales situations in which an agent is not involved, the insurer shall identify its full name.

(C) Terms such as financial planner, investment advisor, financial consultant, or financial counseling shall not be used in such a way as to imply that the insurance agent is generally engaged in an advisory business in which compensation is unrelated to sales unless such is actually the case.

(D) Any reference to policy dividends must include a statement that dividends are not guaranteed.

(E) A system or presentation which does not recognize the time value of money through the use of appropriate interest adjustments shall not be used for comparing the cost of two or more life insurance policies. Such a system may be used for the purpose of demonstrating the cash-flow pattern of a policy if such presentation is accompanied by a statement disclosing that the presentation does not recognize that, because of interest, a dollar in the future has less value than a dollar today.

(F) A presentation of benefits shall not display guaranteed and non guaranteed benefits as a single sum unless they are shown separately in close proximity thereto.

(G) A statement regarding the use of the Life Insurance Cost Indexes shall include an explanation to the effect that the indexes are useful only for the comparison of the relative costs of two or more similar policies.

(II) A Life Insurance Cost Index which reflects dividends or an Equivalent Level Annual Dividend shall be accompanied by a statement that it is based on the company's current dividend scale and is not guaranteed.

(I) For the purposes of this regulation, the annual premium for a basic policy or rider, for which the company reserves the right to change the premium, shall be the maximum annual premium.

Section 7. Failure to Comply.

Failure of an insurer to provide or deliver a Buyer's Guide, or a Policy Summary as provided in Section 5 shall constitute an omission which misrepresents the benefits, advantages, conditions or terms of an insurance policy.

Section 8. Effective Date.

This rule shall apply to all solicitations of life insurance which commence on or after (Insert a date at least six months following adoption by the regulatory authority.)

Life Insurance Buyer's Guide

APPENDIX

Life Insurance Buyer's Guide

LIFE INSURANCE BUYER'S GUIDE

This guide can show you how to save money when you shop for life insurance. It tells you how to:

- Decide how much life insurance you should buy,
- Decide what kind of life insurance policy you need, and
- Compare the cost of life insurance policies.

Prepared by the
National Association of Insurance Commissioners

The National Association of Insurance Commissioners is an association of state insurance regulatory officials. This association helps the various Insurance Departments to coordinate insurance laws for the benefit of all consumers. Your State Insurance Department urges you to use this guide in making a life insurance purchase.

HOW TO BUY LIFE INSURANCE

When you buy life insurance, you want a policy which fits your needs without costing too much. Your first step is to decide which kind and how much you need. Then, find out what various companies charge for that kind of policy. You can find important differences in the cost of life insurance by using the life insurance cost indexes which are described in this guide. A good life insurance agent will be able and willing to help you with each of these shopping steps.

If you are going to make a good choice when you buy life insurance, you need to understand which kinds are available. If one kind does not seem to fit your needs, ask about the other kinds which are described in this guide. If you feel that you need more information than is given here, you may want to check with a life insurance agent or books on life insurance in your public library. If you encounter problems, contact your State Insurance Department at the state capital.

HOW TO CHOOSE THE AMOUNT

There is more than one way to decide how much life insurance a person needs. One approach is to figure how much cash and income your dependents would need if you were to die. You should think of life insurance as a source of cash needed for expenses of final illnesses, paying taxes, mortgages or other debts. Life insurance can also provide income for your family's living expenses, educational costs and other future expenses. Your new policy should come as close as you can afford to making up the difference between (1) what your dependents would have if you were to die now, and (2) what they would actually need.

HOW TO CHOOSE THE RIGHT KIND

All life insurance policies agree to pay an amount of money if you die. But all policies are not the same. There are three basic kinds of life insurance:

1. Term insurance
2. Whole life insurance
3. Endowment insurance

Remember, no matter how fancy the policy title or sales presentation might appear, all life insurance policies contain one or more of the three basic kinds. If you are confused about a policy that sounds complicated, ask the agent or company if it combines more than one kind of life insurance.

Term Insurance

Term insurance is death protection for a "term" of one or more years. Death benefits will be paid only if you die within that term of years. Term insurance generally provides the largest immediate death protection for your premium dollar.

Some term insurance policies are "renewable" for one or more additional terms even if your health has changed. Each time you renew the policy for a new term, premiums will be higher. At older ages, those premiums become very large.

Some term insurance policies are also "convertible." This means that before the end of the conversion period, you may trade the term policy for a whole life or endowment insurance policy regardless of your health. Premiums for the new policy will be higher than you have been paying for the term insurance.

Whole Life Insurance

Whole life insurance gives death protection for as long as you live. The most common type is called "straight life" or "ordinary life" insurance, for which you pay the same premiums for as long as you live. These premiums can be several times higher than you would pay initially for the same amount of term insurance. But they are smaller than the premiums you would eventually pay if you were to keep renewing a term insurance policy until your later years.

Some whole life policies let you pay premiums for a shorter period such as 20 years, or until age 65. Premiums for these policies are higher than for straight life insurance since the premium payments are squeezed into a shorter period.

Although you pay higher premiums, to begin with, for whole life insurance than for term insurance, whole life insurance policies develop "cash values" which you may have if you stop paying premiums. You can generally either take the cash, or use it to buy some continuing insurance protection. Technically speaking, these values are called "nonforfeiture benefits." This refers to benefits you do not lose when you stop paying premiums. The amount of these benefits depends on the kind of policy you have, its size, and how long you have owned it.

A policy with cash values may also be used as collateral for a loan. If you borrow from the life insurance company, the rate of interest is stated in your policy. Any money which you owe on a policy loan would be deducted from the benefits if you were to die, or from the cash value if you were to stop paying premiums.

Endowment Insurance

An endowment insurance policy pays a sum to you—the policyholder—if you live to a certain age. If you were to die before then, the death benefit would be paid to your beneficiary. Premiums and cash values for endowment insurance are higher than for the same amount of term or whole life insurance. Thus endowment insurance gives you the least amount of death protection for your premium dollar.

HOW TO FIND A LOW COST POLICY

After you have decided which kind of life insurance fits your needs, you don't want to pay more than you should for a policy. Your chances of finding a good buy are better if you use two types of index numbers that have been developed as a consumer aid in shopping for life insurance. One is called the "Surrender Cost Index" and the other is the "Net Payment Cost Index." It will be worth your time to try to understand how these indexes are used, but in any event LOOK FOR POLICIES WITH LOW COST INDEX NUMBERS.

What Is Cost?

"Cost" is the difference between what you pay and what you get back. If you pay a premium for life insurance and get nothing back, your cost is the premium. If you pay a premium and get something back later on, your cost is actually smaller than the premium.

As you have seen earlier in this guide, some policies have cash values. If you pay premiums and then get a cash value back, the cash value lowers your cost.

The cost of some policies can also be reduced by dividends; these are called "participating" policies. Companies are permitted to tell you what their current dividends are, but these are merely illustrations. The size of dividends in the future is unknown today and cannot be guaranteed. Dividends actually paid are set each year by the company.

Some policies do not pay dividends. These are called "guaranteed cost" or "non-participating" policies. Every feature of a guaranteed cost policy is fixed, so that you know in advance what your future cost will be.

Although the premiums and cash values of a participating policy are guaranteed, the dividends are not. Premiums for participating policies are typically higher than for guaranteed cost policies, but if the premiums prove to be more than the company actually needs, part may be refunded in the form of policy dividends. Thus, no one can say what actual future cost will be in the case of participating policies.

What Are Cost Indexes?

In order to compare the cost of policies, you need to look at:

1. Premiums
2. Cash values
3. Dividends

Cost indexes combine two or more of these factors to give you a convenient way to compare costs.

Since an adjustment must be made to take into account that money is paid and received at different times, it is not enough to just add up the premiums you will pay and to subtract the cash values and dividends you expect to get back. These indexes have been developed to take care of the arithmetic for you. Instead of having to go through a mathematical calculation yourself, you just compare the index numbers which are available from life insurance companies:

1. *Life Insurance Surrender Cost Index*—This index is useful if you consider the level of the cash values to be of primary importance to you. It measures your cost if you were to turn the policy in at some future point in time, such as 10 or 20 years, and take its cash value.

2. *Life Insurance Net Payment Cost Index*—This index is useful if your main concern is the benefits that are to be paid at your death, and if the level of cash values is of secondary importance to you. It measures your cost at some future point in time, such as 10 or 20 years, if you keep your policy and do not take its cash value.

* * *

You may hear about another number which is called the Equivalent Level Annual Dividend. It indicates the part dividends play in the cost of participating policies, by showing you how much the cost indexes have been reduced by dividends. You can add a policy's Equivalent Level Annual Dividend to its cost index to find the "maximum possible cost index" for that policy in the very unlikely event no dividends are paid. You can then compare the maximum costs of similar policies. However, if you compare the maximum cost of a participating policy with the cost of a non-participating policy, remember that the maximum cost index of the participating policy will be reduced by dividends, and the cost index of the non-participating policy will not change.

How Do I Use Cost Indexes?

The most important thing to remember when using cost indexes is that a policy with a small index number is generally a better buy than a comparable policy with a larger index number. The following rules are also important:

Cost comparisons should only be made between similar plans of life insurance. Similar plans are those which provide essentially the same basic benefits and require premium payments for approximately the same period of time.

Compare index numbers only for the same kind of policy, for your age, and for the amount you intend to buy. Since no one company offers the lowest cost for <u>all</u> types of insurance at <u>all</u> ages and for <u>all</u> amounts of life insurance, it is important that you get the indexes for the actual policy, age and amount which you intend to buy. Just because a "shopper's guide" tells you that one company's policy is a good buy for a particular age and amount, it does not necessarily mean that all of that company's policies are equally good buys.

Small differences in index numbers could be offset by other policy features, or differences in the quality of service you may expect from the company or its agent. Therefore, when you find small differences in cost indexes, your choice should be based on something other than cost.

In any event, you will need other information on which to base your purchase decision. Be sure you can afford the premiums and that you understand the policy's cash values, dividends and death benefits. You should also make a judgment on how well the life insurance company or agent will provide service in the future to you as a policyholder. Do not use a life insurance cost index to determine whether you should drop a policy you have already owned for a while, in favor of a new one.

IMPORTANT THINGS TO REMEMBER–A SUMMARY

The first decision you must make when buying a life insurance policy is choosing a policy whose premiums and benefits most closely meet your needs. Next, find a policy which is also a relatively good buy. If you compare Surrender Cost Indexes and Net Payment Cost Indexes of similar competing policies, your chances of finding a relatively good buy will be better than if you do not shop. REMEMBER, LOOK FOR POLICIES WITH LOWER COST INDEX NUMBERS. A good life insurance agent will help you to choose the amount of life insurance and kind of policy you want and to make cost comparisons of similar policies.

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

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

FTC's draft
of
LIFE INSURANCE BUYER'S GUIDE

Appendix B

> IMPORTANT: Most people think all life insurance policies cost about the same. They don't. Reading this Buyer's Guide can save you many hundreds of dollars over a twenty-year period by helping you find a low-cost policy that best fits your needs.

TWO TYPES OF INSURANCE

There are two basic types of life insurance: term and whole life. Both pay money-- the policy's face amount or death benefit -- to your family when you die. They differ in that term insurance provides only death protection, while whole life insurance combines death protection with a savings program. Another important difference is in the premiums. Term premiums are at first quite low, but go up each time you renew your policy. Whole life premiums are at first much higher than those for the same amount of term insurance, but stay level as long as you keep the policy in force.

Whole life insurance is a lifetime contract, while term insurance is sold for a fixed number of years, usually one, five, or ten. Many term policies, however, are guaranteed renewable until you're 65 or older. This means that each time your term policy is about to expire, you can renew it for another term without having to worry about passing a medical exam. With each renewal your premium will go up. It's a slow process, though. If you buy a renewable term policy at age 35, it will take about 20 years until the premium for your renewable term policy will be higher than the level premium you would have paid if you had bought a whole life policy. Beyond age 65, term premiums become very expensive. But by then you may want to drop your policy anyway. The point to remember is that a renewable term policy, and not just a whole life policy, can meet your long-term insurance needs, at least through age 65.

HOW MUCH TO BUY

Before deciding between term and whole life insurance, you should first ask yourself why you need life insurance. The main reason for buying life insurance is to help your family keep up a decent standard of living if your early death deprives them of your earnings. How much insurance should you buy? Enough to cover the difference between the amount of money your family will need if you die and the amount they'll actually have. If you're covered by Social Security, don't forget to include the monthly check your family will get from the government in figuring how much insurance you'll need.

TERM OR WHOLE LIFE

When you're young and your insurance needs are generally greatest, term insurance gives you three to five times more death protection for your premium dollar than whole life. Many people, especially those with young children, can only afford the amount of insurance they need by buying term insurance. Therefore, if you're interested in getting the most death protection for your money, you should buy term insurance.

Most people find that their need for death protection drops as they get older and their children grow up and leave home. Still, many people want some insurance in force during their retirement years. Insurance after 65 serves a different purpose than protection against the loss of your earnings. After 65 insurance is mainly used to pay for funeral expenses, medical bills, and death taxes. It can also provide money for the surviving members of your family. Buying a whole life policy is one way to make sure that money for these purposes will be available during your retirement years.

SAVING THROUGH WHOLE LIFE INSURANCE

There's a simple reason why a whole life policy can make insurance affordable beyond age 65. The premium for a whole life policy stays the same throughout your life. During the early years of your policy you pay much more than the amount needed to buy death protection for a person your age. Most of the difference goes into the policy's savings element, called the cash value, which grows steadily over the years. When you die, the insurance company will use this cash value to help pay the policy's death benefit. For example, if you buy a $10,000 whole life policy at age 35, it will have a cash value of about $5,500 by the time you're 65.

If you die at 65, your family will get $10,000. Of that amount, $5,500 will come from the cash value you've built up. The insurance company will only have to come up with an additional $4,500 to pay the $10,000 death benefit. If you live beyond 65, your cash value will continue to grow. At the same time, the amount the company will have to come up with to pay the death benefit will continue to decrease. Thus, a whole life policy permits you to afford insurance beyond 65 because your level premium buys less and less death protection as time goes on.

Besides making it possible to have life insurance beyond age 65, cash values can be useful to you in other ways. Many people find buying a whole life policy a convenient way to save for retirement or other purposes. Each time you pay your premium, a part of the premium automatically goes to build up the policy's cash value. You can get the full amount of the cash value by canceling the policy. But if you do, you'll lose your death protection. You can also borrow up to the full amount of the cash value in the form of a policy loan. But if you do that, you'll have to pay interest to the insurance company at the rate fixed in the policy. Finally, if you die with your whole life policy in force, your family gets only the policy's death benefits (less any unpaid loans), <u>not</u> the death benefit plus the cash value.

TWO WAYS TO SAVE

If you want death protection for your family while you're young and a source of money for use after you're 65, there are two things you can do. You can buy a whole life policy with its built-in savings program. Or you can buy a term policy and each year invest the difference between the whole life and the term premium in a savings account, U.S. savings bonds, or some other safe investment. If you're the kind of person who can save regularly, you'll build up a sizable sum of money by the time you're 65. You can then use this sum for the same purposes as the cash value of a whole life policy. This may greatly reduce or even end your need for life insurance in your later years.

To find out whether you can save more by buying a particular whole life policy or by buying a term policy and investing the difference, look at the whole life policy's Average Annual Rate of Return. This rate is figured by treating part of your premium as payment for relatively inexpensive death protection and the remainder as a savings "deposit." The rate of return is then the interest rate that would build up these deposits to equal the cash value guaranteed in the policy. You'll find the Annual Rate of Return if you keep the policy for 5, 10 and 20 years on the Consumer Cost Statement an agent must give you with each policy you're shown. You should compare this rate of

COMBINING TERM AND WHOLE LIFE

If you think you'll want some insurance in force after 65 but can't afford enough whole life insurance to give your family adequate protection while you're young, there are several things you can do. One is to buy a renewable term policy that's also convertible. You can trade in such a policy at any time for a whole life policy of the same or lesser face amount without having to pass a medical exam. People with young children often find this type of policy attractive because it lets them buy a large amount of death protection when they're young at a price they can afford. At the same time they preserve their option to buy a whole life policy later if they decide they want some insurance in force after age 65. Another thing you can do is buy a combination of term and whole life insurance. You can do this by buying separate policies. Or you can buy a whole life policy with a term policy attached to it. (This is called a term rider.) In either case you'll get insurance that can remain in force past 65 along with some additional death protection for your younger years when you need it most.

"PAR" OR "NON-PAR" POLICIES

Some term and whole life policies are designed to pay dividends (participating or "par" policies), while others aren't (non-participating or "non-par" policies). Dividend-paying policies generally have higher premiums than non-return with the interest rate you could earn on a savings account or other safe investment. But remember to take taxes into account. Interest earned on the savings element of your whole life policy is usually not taxed, while the return on most other investments is. So be sure to compare the Annual Rate of Return on a whole life policy with the after-tax return on other safe investments. If the whole life policy's rate of return is lower than what you could get elsewhere, you'd probably do better buying a term policy and investing the difference.

A WORD OF CAUTION BEFORE BUYING WHOLE LIFE

Don't buy a whole life policy unless you're sure it's the type of policy you want. It's a costly mistake to buy a whole life policy only to drop it after a year or two. If you do, you'll usually get next to nothing back. It's true that few people plan to drop their whole life policies soon after buying them. Yet about one in five new policyholders actually does just that. Moreover, you shouldn't buy a whole life policy unless you plan to keep it at least ten years. The cash value of a whole life policy builds up very slowly during the policy's early years, making whole life insurance a very uneconomical way to save for short-term needs.

dividend-paying policies, but often cost less in the long run, especially if their dividends are paid year after year. The dividend amounts a company expects to pay each year are known as "illustrated" dividends. These illustrated dividends are <u>not</u> guaranteed. The exact amount a company actually decides to pay in dividends each year depends upon a number of factors, including the company's investment income for that year. These factors simply can't be predicted with complete accuracy several years in advance. In recent years, however, the actual dividends paid on most "par" policies have been higher than those illustrated at the time the policies were sold.

GROUP INSURANCE

Before you buy an <u>individual</u> life insurance policy, check with your employer, labor union, or professional association on your eligibility for <u>group</u> term insurance. Group insurance often costs much less than either individual term or individual whole life, especially if your employer pays part of the premiums. In addition, you can usually buy group insurance without passing a medical exam. Like individual term insurance, however, group insurance is usually renewable only through age 65 or 70. There may also be a limit on the amount of group insurance you'll be able to buy. If you switch employers or drop your union or professional association membership, your group coverage may end. But if that happens, you're guaranteed the right to convert that coverage to an individual whole life policy (at a higher premimum). All things considered, group insurance can provide a solid, relatively inexpensive foundation for your personal insurance program.

HOW TO FIND A LOW-COST POLICY

Once you've decided on the type and size of policy you want, use the Consumer Cost Index to find a low-cost policy. It's on the cost statement that comes with each policy you're shown. Don't just pick a policy with a low premium. Premiums only measure what you pay for a policy. They don't measure a policy's benefits. Those benefits, which may include cash values and dividends as well as death protection, vary by large amounts among policies with similar premiums sold by different companies. The Consumer Cost Index takes premiums, cash values, and dividends into consideration and is a measure of the difference between what you pay for a policy and what you or your family gets back. Remember: the lower the Consumer Cost Index, the lower the policy's cost to you.

IMPORTANT: Most people think all policies cost about the same. They don't. The cost of similar policies varies sharply. To tell at a glance whether a particular policy has a low Consumer Cost Index, look at the chart attached to the policy's consumer cost statement.

In using the Consumer Cost Index, remember three things. First, the index is only approximate. So, rather than searching for <u>the</u> lowest-cost policy on the market, use the index to find a <u>group</u> of relatively low-cost policies from which to make your final choice. Second, the Consumer Cost Index is only useful in comparing the costs of <u>similar</u> policies. <u>Don't</u> use it to compare the cost of a term policy to that of a whole life policy. Instead, base your choice of term versus whole life on factors mentioned earlier in this Buyer's Guide. Third, the Consumer Cost Index for a dividend-paying policy assumes that dividends on the policy will be paid exactly as illustrated at the time the policy was issued. This, however, rarely happens. Since the exact amount of a "par" policy's dividends isn't guaranteed, the policy's actual cost may turn out to be higher or lower than that indicated by the Consumer Cost Index. In recent years, however, the actual dividends paid on most "par" policies have been higher than those illustrated at the time the policies were sold. As long as you recognize this uncertainty, you can use the Consumer Cost Index to compare the costs of dividend-paying and non-dividend-paying policies.

OTHER TYPES OF POLICIES

In addition to whole life policies, there are many other policies on the market with savings elements. The most common of these are "life paid up at 65," "20-pay life," and endowment policies. "Life paid up at 65" and "20-pay life" are policies in which you pay premiums over a limited period instead of over the entire life of the policy. Endowments are policies in which the cash value equals the policy's face amount at the end of a limited period, usually 20 or 30 years. Each of these policies have higher premiums than simple whole life policies. They may be useful for certain special needs. But most people's insurance needs can be met by either term or whole life insurance or a combination of the two.

AGENTS

A final word about agents. You'll probably buy your life insurance through an agent. An honest, well-informed agent can help you find a low-cost policy that fits your needs. But a life insurance agent is also a salesman who's paid on a commission basis. Typically that commission is based on a percentage of your yearly premium. Thus, for the same amount of insurance, an agent will get a higher commission for selling whole life than for selling term because the whole life policy's premium are higher. In addition, many agents get a higher percentage commission for selling whole life than for selling term. Finally, not all agents are well-informed, not all policies are competitively priced, and not all agents are free to offer you choices that are in your best interests because they may represent only one high-cost company. Read this Buyer's Guide carefully, along with the Consumer Cost Statement that comes with each policy you're shown. If you do, you should be able to make better use of a good agent's services. And you'll be more likely to find a low-cost policy that best fits your needs.

REMEMBER: Be sure to shop carefully before buying life insurance. And always look for a policy with a <u>low</u> Consumer Cost Index.

FTC's Draft of Whole Life

Consumer Cost Statement

IMPORTANT: Most people think all life insurance policies cost about the same. They don't. The cost of similar policies varies sharply. You can save many hundreds of dollars by choosing a low-cost policy. To find out whether this policy is low-cost, first read this Cost Statement, then check the attached chart.

Company: P
Type of Policy: Whole Life (Participating)
Name of Policy: Special Preferred
Face Amount: $25,000
Policyholder's Sex and Age at Issue: Male - 35

YEARLY PREMIUM: $546 ($21.84 per $1,000 of face amount)

CONSUMER COST INDEX: $156 ($6.24 per $1,000 of face amount)

AVERAGE ANNUAL RATE OF RETURN:
-12.40% if you keep the policy 5 years
1.73% if you keep the policy 10 years
2.97% if you keep the policy 20 years

How To Use This Consumer Cost Statement

Consumer Cost Index: To find a low-cost policy, look at the policy's Consumer Cost Index, not its premium. Premiums only measure what you pay for a policy. The benefits you receive from policies with similar premiums vary widely. The Consumer Cost Index takes premiums, cash values, and dividends into consideration, and is a measure of the difference between what you pay for a policy and what you or your family gets back. The lower the Consumer Cost Index, the lower the policy's cost to you.

The Consumer Cost Index should only be used to compare the cost of similar policies. Don't use it to compare the cost of a term policy to that of a whole life policy.

Average Annual Rate of Return - Part of each premium you pay buys you death protection and part can be viewed as a deposit which builds up the savings (or cash value) portion of your policy. The Average Annual Rate of Return shows you the interest you'll get on the savings portion of this policy if you keep it for 5, 10 or 20 years. The rate of return is one factor you should consider in deciding whether to buy term or whole life insurance. For a discussion of this and other factors, read your Buyer's Guide.

Where Your Premium Goes - The table below will give you a rough idea of what you're getting when you buy this whole life policy. It shows you how the company, on the average, will use the premiums it receives over the policy's first 20 years. Many people are surprised to discover how much of a whole life policy's yearly premium goes into the savings portion of the policy and how little is used to provide death protection. The figures in the table are based on average, industry-wide data and therefore aren't exact.

Where Your Premium Goes (20-year average)	Yearly Average
Death Protection	$ 52
Savings (Cash Value)	$274
Dividends	$ 64
Company Expenses & Profit	$156
TOTAL PREMIUM	$546

FTC's Draft Yardstick

HOW THIS POLICY'S COST COMPARES WITH THE COST OF OTHER SIMILAR POLICIES