

ATTACHMENT TWO-A

State of California
Department of Insurance
Actuarial Division
3450 Wilshire Blvd.
Los Angeles, CA 90010

September 30, 1992

To: John O. Montgomery
From: W. Harold Phillips, Senior Life Actuary
Subject: Additional Data for Proposed Ledger Illustration Law

This memo provides the information requested by Mark Rakich in his memo of 9/18/92 for legislation proposed by the department.

1. Regulation of the preparation and use of sales ledger illustrations employed in the sale of permanent life insurance and deferred annuities.
2. The problem: misleading sales illustrations structured as inducements to buy rather than helpful tools in understanding the workings of the product or as a comparison between products of competing companies. In addition many purchasers as well as agents do not understand what an illustration is and what it is not.

Most agents, companies and actuaries agree that there is a problem and that something needs to be done. The industry appears to be in gridlock on this matter. The proposed legislation will break the gridlock and force solutions. Regulations seem to take too long and can get bogged down (e.g. OAL). Legislation is preferable. It will permit purchasers to make better purchase decisions in the purchase of life insurance and deferred annuities. It will force companies to avoid gimmicks and concentrate on competing on the basics: better value for your insurance dollar.

Current regulation of illustrations is very weak. Companies and agents can do pretty much as they please.

3. Sales illustrations will have to conform to the principles and rules of the legislation and any regulations flowing therefrom. The new law will impact all life insurance companies and their agents that market permanent life insurance and deferred annuities.
4. To our knowledge, only the actuarial division has been involved in the problem and has given consideration to possible solutions. The contact person is Harold Phillips 213-677-7582 in Los Angeles, or other life actuaries.
5. The draft legislation is attached.
6. Consumer groups and consumerists will applaud the legislation. This is somewhat complex area and we are not aware of other ideas arising from consumer groups to solve the problems. Most consumers are not aware of the problem, until the company pays less than they were expecting. The lack of understanding of what an illustration is and is not comes to the fore.

7. The opposition will be on two grounds:

- (a) The cost of retooling and re-education of agents. Virtually all companies will have to change their illustrations.
- (b) Those companies and agent's whose products will look less competitive will scream the loudest.

The proposal was aired about two years ago. It was met with a deadening silence—no reaction at all. Perhaps there was great fear that it would be seriously be proposed at some time, as it is now.

8. To a large extent the law will be self-regulating. Once companies adjust they likely will continue on the right path. Current staff can handle the minor additional work load. The filing of the illustration with the policy form may indeed help the understanding of the workings of the product and thus facilitate review.

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Article 9. Requirements For Ledger Illustrations Used In
The Sale Of Life Insurance And Annuity Policies

Section 10509.10 Purpose

The purpose of this article is the following:

- (a) To regulate the preparation and use of ledger illustrations in sale of permanent life insurance and deferred annuities.
- (b) To establish standards to be used in preparation of ledger illustrations used in the sale of permanent life insurance and deferred annuities.
- (c) To help educate the purchaser as to the understanding of and proper use of a ledger illustration.

Section 10509.11 Application of Article

This article is applicable to all life insurance and annuity sales where a ledger illustration is used in the solicitation.

Section 10509.12 Definitions

- (a) "Ledger illustration" means a year by year extension into the future of values and benefits on a guaranteed (G) and nonguaranteed or illustrated basis (NG), the latter (NG) on the assumption that current experience factors such as interest mortality and expense, will continue unchanged into the future. (Note the statute imposes a maximum interest rate after 10 years.)
- (b) "Current scale" means the current dividend scale for participating insurance or the current set of interest, mortality and expense factors used in the illustration of nonguaranteed charges or benefits.

Section 10509.13 Insurance and Annuities Excluded From This Article

Unless otherwise specifically included, this article does not apply to the following:

- (a) Credit life insurance.
- (b) Term insurance.
- (c) Noncontributory group life insurance where a ledger illustration is not used in the solicitation of the business.
- (d) Reinsurance.
- (e) A solicitation where a ledger illustration is not used.

Section 10509.14 Requirements for the Preparation of Ledger Illustrations.

Every ledger illustration prepared for delivery in this state shall meet the following requirements:

- (a) The ledger illustration must be based on factors not more favorable than what the company is currently paying under the insurer's current scale.
- (b) Each ledger illustration must state that it is neither a guarantee nor an estimate of future results, that it is based on current pricing factors which can change and that as these factors change the scale will change and that it is a virtual certainty that actual results will differ from what was illustrated.
- (c) Current dividends shall be illustrated with the use of experience factors consistent with current experience. Nonguaranteed charges and benefit factors shall be illustrated with the use of experience factors consistent with currently anticipated experience.

- (d) Within 120 days from the date it is determined that the currently illustrated scale cannot be supported by current experience or currently anticipated experience, the illustrated scale shall be reduced to that which can be supported.
- (e) The development of current scales and ledger illustrations shall be consistent with the principles and standards of performance as promulgated by the Actuarial Standards Board of the American Academy of Actuaries.
- (f) Ledger illustrations may not assume ongoing changes that would increase the scale (e.g., improving mortality). Ongoing changes that would reduce the scale are permitted (e.g., increasing unit expenses or decreasing interest rates).
- (g) Projection of experience trends is not permitted beyond one year. Consistency between current scales and ledger illustrations is required. Ledger illustrations shall be related to scales actually being paid on in-force plans in an equitable and justifiable manner.
- (h) Ledger illustrations shall appropriately reflect the current financial results of the company.
- (i) Each company shall have a written current policy on file at its home office (available to the commissioner on request) for determination and redetermination of dividends and nonguaranteed charges and benefits currently being paid and illustrated.
- (j) In the redetermination of nonguaranteed charges and benefits for current payment or illustration past losses are not permitted to be used. Past gains may be used for the determination of current payout but not for illustrations.

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Guide To Understanding Of Ledger Illustrations

- (k) The projected interest rate of return for nonguaranteed benefits for durations beyond 10 years shall not exceed the rate of return on 30-year treasury bills rounded to the lower .25%, or the guaranteed rate, if higher. For the current calendar year the rate on Oct. 1 of the previous calendar year shall be used. Where an interest margin is used to cover expenses, such 30-year treasury rate shall be reduced by such margin.
- (l) Where an interest margin is used to amortize initial expenses, the interest rate credited may increase after the expenses are fully amortized. However, such increase may not be illustrated.
- (m) A ledger illustration based on the current scale shall accompany each form filing.
- (n) The ledger illustration shall show with equal or greater prominence the guaranteed values and benefits along with those not guaranteed. Each column must be designated G-guaranteed, or NG-not guaranteed.

Section 10509.15 Regulations

The commission may issue regulations to support this article. Such regulations shall cover items such as smoothness tests, forward pricing, lapse supported ledger illustrations, supportability, enhancements and other related topics.

Section 10509.16 Additional Requirements

- (a) A ledger illustration shall be provided that is consistent with the policy actually issued (the amount of coverage, premium, mortality class, etc.).
- (b) The applicant shall sign a statement that he or she has reviewed the ledger illustration and that he or she understands its limitations. This acknowledgment along with a copy of the illustration shall be retained with the original application by the insurer.
- (c) The insurer shall notify the policy owner each time there is a decrease in scale below what was originally illustrated. Upon request the insurer shall provide new illustrated values based on the current scale.
- (d) The following Guide to Understanding of Ledger Illustrations shall be presented with each ledger illustration.

This guide is being provided to you so that you can better understand what a ledger illustration is and is not. This is required by law.

What is a ledger illustration?

It is an extension into the indefinite future of current experience factors affecting interest, mortality and expense. These factors reflect current experience. As experience with the factors that affect the performance of a product change, the numbers and results that are nonguaranteed will also change. The ledger illustration also shows with equal prominence values that are guaranteed. The company cannot pay less than these. (Note: the statute imposes a maximum interest rate after 10 years.)

What are the chances that a company will pay exactly what is illustrated?

Nil or zero. If nothing changes in all the experience factors the company will be able to pay exactly what is illustrated. However, we know that these factors will change as experience changes. Interest rates go up and down. Mortality experience changes: it is helped by medical breakthroughs and hurt by things similar to AIDS. Unit expenses change: helped by increased productivity and hurt by inflation.

What are the chances that the company will be able to pay more than illustrated?

It depends on how likely experience factors will be better in the future. For example, as interest rates increase and are greater than those in effect at the time of purchase, chances are very good that the company will pay more.

What are the chances that the company will have to pay less than illustrated?

It depends on how likely experience factors will be poorer in the future. For example, if interest rates decrease and are lower than those in effect at the time of purchase, it is very likely the company will pay less.

Should I rely on the numbers in the illustration?

"Yes" for the guaranteed numbers. For the nonguaranteed numbers—"not at all": these are to show you how the plan would work and help you understand the plan based on an extension into the future of current experience factors which will change as experience unfolds.

What is a ledger illustration not?

The nonguaranteed portion of a ledger illustration is:

- (a) Not a guarantee to pay what is illustrated.
- (b) Not a promise to pay what is illustrated.
- (c) Not a most likely scenario of what will be paid. It might be the least likely.

Remember: The purpose of a ledger illustration is to help you understand how the product works. The better you understand the product the better you'll be able to compare similar products of other companies.

Section 10509.16 Administrative penalties

Same as Section 10509.9

Section 10509.17 Effective date

This article shall become effective Jan. 1, 1994.

ATTACHMENT TWO-B

Preliminary Report American Academy of Actuaries Task Force on Life Illustrations

The AAA Task Force on Life Insurance Illustrations has reviewed the recommendations from the research paper on illustration practices prepared by the SOA. Our primary goal is to focus on changes that will benefit consumers and third-party users of illustrations. A secondary goal is to improve illustration methodology for those involved in developing illustrations and setting the underlying assumptions: actuaries, agents and company management.

Changes to illustrations can be considered in three categories:

- (1) Those that should occur immediately due to perceived problems at the consumer level. Action by the NAIC will be required for these changes to have a widespread and immediate impact.
- (2) Those that require broader exposure within, and input from, the industry. It is expected that these changes can be implemented over the next few years, although work within the industry would begin immediately. Regulatory action may be needed to allow for changes in practice.
- (3) Educational efforts that require broad-based support within the industry. While some of these efforts can be implemented in the short-term, changes in consumer and industry perceptions of illustrations will evolve over time.

The Task Force recognizes that as education efforts have an impact on the use of illustrations, some of the short-term changes may no longer be required. However, such changes are necessary on an interim basis to assist the consumer.

o Immediate Changes

These changes are very specific and deal with product structures and premium financing.

Life Insurance Committee