

3. Trends which improve the illustrated values may not be assumed to continue beyond two years. Thus, for example, an illustration could not assume continually improving mortality.

4. The qualified actuary approving the calculations involved in the illustrations is prepared to state that all standards of practice of the American Academy of Actuaries dealing with illustrations are met.

Current experience means:

1. The rate of return on the assets backing the product. If the product or product line has not yet been launched, it is the expected rate of return on the assets that will be purchased to support the product line.

2. The spread on the rate of return on assets the company is currently using to cover profit, expenses, mortality or other factors.

3. For percent of premium expenses, the actual percent being incurred, e.g., commissions and premium taxes.

4. For mortality, other expenses including other taxes, lapse and other decrements, the company's most recent experience studies; if these are not available or credible, the experience of comparably situated other companies or of industry studies with any appropriate modifications by the actuary to reflect the expected experience of the company illustrating.

ATTACHMENT SIX-A2

To: Governors of States
Insurance Department Leadership
From: Executive Committee of The National Conference of Insurance Legislators (NCOIL)
Date: July 24, 1992
Re: Full Disclosure/No Misleading Advertising in the Sale of Life Insurance

To encourage full disclosure and combat misleading advertising in the sale of life insurance, the Executive Committee of NCOIL urges that state insurance departments

(1) Require full disclosure of withdrawal charges and actual pure net interest when interest rates are used to advertise and sell life company products;

(2) Stay alert and keep ongoing records to review insurance companies and agents who have complaints filed against them regarding life insurance replacement; and

(3) Review their existing statutes and regulations and to the extent possible, make companies and agents aware of those existing statutes and regulations with regard to false or misleading advertising in the sale of life insurance policies.

ATTACHMENT SIX-A3

Position Paper
Life Insurance Illustrations
By the Life Insurance Disclosure Working Group
of the Life Insurance (A) Committee
August 1993
Draft: 9/7/93

I. Charge to the Working Group

The working group has been charged to evaluate policy illustrations and to consider establishing requirements for the illustrations or ledger information disclosed or made available to consumers of life insurance.

II. Activities to Date

The working group was formed in September 1992 to consider issues raised by Senator Howard M. Metzenbaum (D-Ohio) as to the adequacy of information provided to purchasers of life insurance. Of particular concern were policies sold with the aid of illustrations, some of which demonstrate the possibility that the policy would "pay for itself" at some point in the future. The working group was asked to fully review the concerns expressed in Senator Metzenbaum's letter and to recommend an appropriate regulatory response. The working group members first gathered background material to equip themselves to gauge the extent of the problem and to begin to identify the means of addressing the problems identified.

The first meeting of the working group was in Boston on Nov. 8, 1992. This meeting served as an open forum for discussion of the problems which have occurred in the use of illustrations. The group recognized that it needed more information in order to

fully understand the nature and extent of the problems that exist with respect to policy illustrations. Each member of the working group was provided a copy of Senator Metzenbaum's June 23, 1992, subcommittee meeting transcript.

The second meeting of the working group was held in Atlanta on December 6, 1992. At this time the working group reviewed a draft which California was considering to regulate ledger illustrations used in the sale of life insurance and annuities. Judy Faucett (Coopers and Lybrand) reported on the efforts being undertaken by the Society of Actuaries and James Hunt (National Insurance Consumer Organization) gave a consumer advocacy perspective. William Albus explained the activity of the National Association of Life Underwriters.

At the March 1993 NAIC meeting, the working group again met and heard testimony from Robert Nelson (National Association of Life Underwriters) on the conclusions reached by the NALU regarding supportability and illustrations. William Miller (Prudential) presented a statement on behalf of the American Academy of Actuaries and George Coleman (Prudential) gave a report on behalf of a group of companies and trade associations that had studied the matter of policy illustrations.

The working group met next on June 21, 1993, in Chicago. Commissioner David Lyons (Iowa) reported on his testimony before Senator Metzenbaum and asked the working group to prepare a written report by the September 1993 NAIC National Meeting detailing the proposals and progress of the NAIC.

After the meeting, Mr. Coleman distributed a document with resource group suggestions for a cover page to accompany an illustration, to present critical information in an understandable way.

The working group met by conference call on July 22, 1993, and assigned different members of the working group to study some of the information currently available and to be ready to provide input to the working group on that report when the working group convened in August to write a "white paper" summarizing its efforts.

The working group received and reviewed information from the following sources:

- A. American Academy of Actuaries Task Force on Life Illustrations;
- B. Testimony of witnesses before the Antitrust, Monopolies and Business Rights Subcommittee, Committee of the Judiciary, U.S. Senate, June 23, 1992;
- C. National Association of Life Underwriters Sales Illustrations Task Force;
- D. *Consumer Reports* July-September 1993 report on life insurance, especially the sections on sales illustrations, by Trudy Lieberman;
- E. "Illustrations, Ethics and You," a seminar by the Society of CLU and ChFC;
- F. "Fungible Present Value Analysis" by Brian Fetchell;
- G. California proposed legislation on ledger illustrations and the comments received on the proposal;
- H. Submission of resource group.

Judging from the amount of activity being undertaken regarding policy illustrations by other organizations, such as the Society of Actuaries and the Society of CLU and ChFC, along with the media attention that policy illustrations have received, it is clear that there are problems in this area that require regulatory response.

III. Problems Identified in Regard to Current Practices

A. Inappropriate use of illustrations to estimate future performance and to compare performance of different policies.

The theme found in several of the reports reviewed by the working group indicated the danger in attempting to use illustrations to compare different policies. Illustrations are not and cannot be predictions or estimates of future performance. If the assumptions used are altered, the results will be dramatically different, thereby making the company with the most aggressive assumptions look like it performs best if comparisons are made between policy illustrations. The format of the illustrations, with precise numbers, gives the impression that it is an accurate projection of future performance. Even if the assumptions used are exactly the same as current experience, it won't be accurate because future experience won't be identical to current performance. The only valid use of the sales illustration should be to demonstrate how the policy works.

There is often a lack of supportability of the assumptions used in the illustration. The illustration may assume a lower mortality rate than currently being experienced or a higher lapse rate, for example.

B. Lack of accountability of any of the parties to the sale: applicant, agent and company.

In the current marketplace involving life insurance sales, there is virtually no accountability for any participants in the sale. Some insurance companies indicate that they are aware that the illustrations they provide are manipulated by agents, but that they have no way to control these practices. Many agents do not appear to understand the illustrations or the assumptions underlying the illustrations provided by the insurance company. In some cases, it has been reported that portions

of illustrations have not been explained, or even presented, to the applicant. Many applicants do not understand the nature of the information in the illustration or how to make use of this information. When actual performance under the policy is less than that illustrated, they believe they have been misled.

C. Lack of a standardized format for life insurance illustrations.

Illustrations currently in use appear to be far too complex for the applicant and in many cases, the selling agent to understand. Attempts to disclose assumptions used to prepare the illustration usually lead to further complexity and misunderstanding. The consumer may not understand what is guaranteed in the policy, that the other numbers are not an indicator of future performance, and that they are at best only a projection of current performance. In some cases, the consumer doesn't even realize that a life insurance policy has been purchased and that future premium payments are required.

D. Lack of standard and consistent definitions, language, assumptions and methodology.

In some countries the assumptions are set by laws based on average experience, or projections into the future are not allowed. In our country securities such as mutual funds may only disclose past performance and may not imply this will continue into the future. Companies use different terms to describe the components of their illustration so the consumer doesn't know what is being shown. The illustration implies the applicant is purchasing an investment vehicle rather than life insurance. The lack of standard terminology tends to create confusion in the minds of consumers and agents.

E. There is an inadequate description of the policy.

Many companies show only their marketing name on the policy illustration. The consumer has no idea whether he is buying whole life, term life, or a hybrid of the two. Consumers often believe they have bought an investment and do not realize that they have purchased insurance.

F. Consumers are not notified of changes in current assumptions.

The consumer relies on the original illustration as a projection of premium assumptions. However, because the illustration was based on non-guaranteed assumptions, reality will always be different. Annual statements do not update the illustration to reflect actual performance and current assumptions.

G. Insufficient penalty provisions exist.

Without more specific definitions, it is not always possible to say that the illustration is an abuse or an unfair trade practice. There are no specific penalties for life insurance disclosure violations included in the laws.

H. Current regulatory approaches are out of date considering the designs of policies being sold today.

Most state laws contain life insurance disclosure laws which were adopted when the products were much simpler. They do not address many of the abuses possible with the types of complex products now being marketed.

IV. Alternative Solutions to be Considered to Address the Problems Identified

A. The working group recommends consideration of four alternatives to address the problem of inappropriate use of illustrations:

- (1) Use standardized assumptions, similar to the practice in Great Britain where the government sets out the standards to be used in illustrations.
- (2) Don't permit projections into the future, similar to the rules for mutual funds where you can only show past performance.
- (3) Require a uniform illustration or format design and uniform definitions. This would eliminate much of the confusion faced by the consumer, who doesn't understand the variety of products on the market.
- (4) Develop a set of rules that provide clear disclosure of the use of illustrations and the assumptions underlying the illustration.

One of these alternatives, or a combination of two or more, or other options should provide the solution to this problem.

B. Accountability

To address the problem of accountability, all the parties to a sale should be made accountable for their actions. The agent and applicant should sign the illustration used at point of sale to indicate the projected performance of the policy based on non-guaranteed factors was disclosed and explained to the consumer. The insurer should be required to examine the illustration used and to verify that the illustration correctly shows the product sold. If the illustration contains errors, the insurer should prepare a new one with corrected information as part of the policy delivery. An officer of the company should sign the illustration delivered with the policy to verify that it correctly illustrates the policy issued. If the illustration is changed from that used at the point of sale, the agent is responsible for explaining any differences and the agent and applicant must sign the

corrected illustration. The company must maintain the correct and signed illustration until the policy is out of force three years, with a copy to the policyholder.

C. Understandable Illustrations

To assist the consumer in understanding an illustration, the illustration should set forth policy value, cash surrender value, and death benefit, using both current assumptions and guaranteed assumptions. If policy values become exhausted in any duration, that must be clearly reflected and explained in bold print (as a means to better emphasize the consequences of exhaustion) in the illustration. The working group needs to develop one or more standardized formats for illustrations to follow. It may not be appropriate to include an interest rate either guaranteed or credited on the illustration because the consumer tends to equate this with the rate paid on a savings account without considering that expenses are taken out of the premium first and a much smaller net amount is left to draw interest. Because of the ability of the company to change the interplay of interest, mortality and expenses, the number may have no place on an illustration. A requirement to illustrate only the guarantees would also make illustrations easier to understand.

D. Standardized Definitions

It will be necessary to develop standard definitions with significant guidance from the Life and Health Actuarial Task Force. These definitions should be prepared and forwarded to the working group by no later than (date). This should build on the work begun by the Society of Actuaries. Some of the standard terms that will be developed are supportability, current experience, mortality assumptions, interest or crediting rates, expense charges, and persistency. Others will no doubt be identified. The working group recognizes that the development of standard definitions extends the project beyond the regulation of illustrations but intends to minimize the impact as far as possible.

E. Description of the Policy

Illustrations need to clearly identify the type of insurance being illustrated by generic name. In addition to any marketing title, the policy illustration must clearly label the policy as term, whole life, etc. (a list of generic names to be determined). The illustration must also indicate the minimum premium necessary to carry the policy to age 100 on a level premium basis using guaranteed factors if it is a universal or indeterminate premium type product, and show the effect of vanishing premiums and their resumption.

F. Assumptions

When underlying assumptions change, the policyholder should be notified. At least annually, a new illustration should be prepared showing projections using the new current assumptions, if there have been any changes. It is reasonable and appropriate to indicate to the policyholder that the assumptions on which the original illustration were based are no longer true. Interim changes in assumptions do not require a report, but one should be offered to the consumer at a minimal cost.

G. Penalty Provisions

Penalties for failure to generate supportable illustrations or to update them at least annually should be included in any solution to the current problems with illustrations. An appropriate penalty may be to require payments based on the illustration as prepared, if higher than actual experience.

V. Recommendations to Address the Problems

A new NAIC model act and regulation should be drafted or revisions to the life disclosure regulation prepared, to address specifically the problems and abuses herein identified. The alternative solutions identified in this report should be analyzed in detail and incorporated in the new or revised model as appropriate. The goal in developing the new regulatory language is to require that illustrations clearly disclose how the policy being illustrated will work and that it be understandable to all parties involved in the sale of life insurance. The members of the working group believe that an exposure draft of these acts and regulations should be completed by no later than (date). To protect the consumers of their states, insurance departments should give serious consideration to adoption of the revised standards.

ATTACHMENT SIX-B

Life Disclosure Working Group
of the Life Insurance (A) Committee
Conference Call
July 22, 1993

The Life Disclosure Working Group of the Life Insurance (A) Committee met by conference call at 11 a.m. on July 22, 1993. A quorum was present and Bob Wright (Va.) chaired the meeting. The following working group members or their representatives participated in the conference call: Don Koch (Alaska); John Montgomery (Calif.); Roger Strauss (Iowa); Lester Dunlap (La.); Noel Morgan (Ohio); Tony Higgins (N.C.); and Fred Nepple (Wis.). Also participating in the call was Carolyn Johnson (NAIC/SSO).