Life Insurance Illustrations

by Mark Peavy, FSA, MAAA

Introduction

The Life Insurance Disclosure Working Group of the NAIC's Life Insurance (A) Committee has been assigned the task of developing new standards for life insurance illustrations. For the purpose of this project, the term "life insurance illustration" pertains to the presentation of premiums, values and benefits, where such presentation is primarily in tabular form and includes both guaranteed and non-guaranteed policy elements. Given the relative lack of familiarity most consumers have with life insurance products, one important goal for the Working Group is to make illustrations more understandable for the average consumer.

The Working Group previously has exposed several versions of a draft model regulation and plans to complete this assignment in time to allow for consideration by the full NAIC during 1995. This goal would be daunting enough even if life insurance had not evolved beyond the fixed premium/fixed benefit stage. While such policies do still exist, we also live in a world where just about any premium pattern or benefit design can be offered. Developing standards that are flexible enough to encompass a virtually infinite array of life insurance products while maintaining sufficient standardization to assure that the illustration will be comprehensible and fairly presented is an almost overwhelming task.

Mark Peavy is the staff Life/Health Actuary at the NAIC where he provides staff support to the NAIC's Life Disclosure Working Group that is developing standards for life disclosure.

Background

The sales process for life insurance products can occur in any number of ways. For all but the simplest package of benefits, it is usually necessary to present to the consumer a description, both narrative and numeric, of what benefits and options exist and what premiums must be paid to obtain those benefits. Twenty years ago the NAIC developed the Life Insurance Disclosure Model Regulation (originally entitled "Life Insurance Solicitation Model Regulation") to provide parameters for the presentation of this information. (This Disclosure Model does not apply to annuities, credit life insurance, certain group life insurance, certain life insurance policies subject to ERISA requirements and variable life insurance.) The Disclosure Model requires that a buyer's guide and a policy summary be delivered to the prospective purchaser prior to the insurer's accepting the initial premium. (This requirement is relaxed for certain types of policies, but delivery of this information can never be deferred beyond the delivery of the policy.) The Disclosure Model contains prescriptive language for the buyer's guide, which is designed to give the consumer a general understanding of how various forms of life insurance function and what general decisions the consumer will need to make to pick the appropriate coverage.

In contrast to the general, narrative nature of the buyer's guide, the policy summary contains information very specific to the underlying policy for certain policy years, including numerical data such as: the annual premium, the amount payable upon death at the beginning of the policy year, the total cash surrender values, the cash dividends payable at the end of the policy year, and any endowment amount not displayed as part of the cash surrender value. If the policy contains non-guaranteed factors, the maximum premium, minimum amount payable upon death, minimum cash value, and minimum endowment amounts also must be shown. (Essentially, the Disclosure Model defines a non-guaranteed factor as any premium, dividend, death benefit, or cash surrender value that can be unilaterally changed by the insurance company.) The policy summary also must contain information regarding the effective policy loan annual percentage interest rate.

Other significant items that must be shown include two Cost Comparison Indexes (CCIs) for 10 and 20 years. Essentially, these CCIs function as an

estimate of the relative cost of the death benefit that will be provided over those durations. One of these indexes, the Net Payment Cost Comparison Index, is calculated by dividing (a) a yearly amount which, when accumulated at 5 percent interest, equals the accumulated premiums less dividends at 5 percent by (b) a level death benefit which, when accumulated at 5 percent interest, equals the accumulated yearly death benefits. The other, the Surrender Cost Comparison Index, is computed in the same fashion, except that any cash surrender value or terminal dividend available at the end of the 10- or 20-year period is subtracted from the accumulated premiums and dividends. Both of these indexes are computed twice, once for the policy's guaranteed values and again for the currently illustrated non-guaranteed factors.

While both methods have the advantage of being relatively simple to compute and provide a standardized measure of the cost of the policy, they also have been subject to some criticisms. Some critics contend that the meaning of the indexes is unclear to the consumer and the indexes do not fully reflect all of the benefits the policy provides (e.g., loan options). Furthermore, they argue that manipulation of the cash values and dividends may produce significant differences in the index value without fundamentally changing the value of the policy to the consumer.

In the late 1980s, the NAIC developed the Optional Form of the Life Insurance Disclosure Model Regulation with Yield Index. While this optional form of the model duplicated a great deal of its predecessor, it added another cost index (the yield index) which, instead of estimating the cost of insurance, utilizes specified mortality assumptions to determine an effective interest rate applicable to the policy. While the yield index represents an attempt to produce a number with some meaning for the consumer, it has been criticized by some as being too complicated to calculate and overly sensitive to the choice of the underlying mortality factors.

In the 20 years since its initial development, the Disclosure Model has been updated to reflect new realities in the marketplace, and complimentary model laws have been developed. Aspects relating to universal life policies were added, and a format for such policies was incorporated into the appendix to encourage uniformity in the presentation of policy values. Also, language was added to address certain products sold to senior citizens, and specific formats and tests for the presentation of policy values during the initial policy years were developed. Entirely distinct models relative to universal life, variable life insurance, and modified guaranteed life insurance addressing a broad range of regulatory concerns were also promulgated during this period.

While these efforts at updating and expanding the regulatory tools were occurring, the marketplace continued to grow in complexity and diversity, largely in response to the increased competition from non-insurance financial instruments and the relaxation of banking regulations. In particular, such products as fixed premium universal life insurance, flexible premium universal life insurance, and excess interest whole life insurance grew in popularity and were sold with the strong expectation of their paying cash values in excess of the minimum guarantees. However, periods of declining interest rates resulted in some illustrations never materializing. In some cases, premiums that were to "vanish" after some initial period did not, and either additional premiums were necessary or policies were lapsed.

The description of the various "non-guaranteed elements" in certain policies had not developed consistently among the companies. It was difficult for consumers to compare, for example, a policy that made "no charge" for mortality to one that periodically made such charges against the policy but capped administrative charges. More fundamentally, no formal standards guided the actuaries during their deliberations in developing future economic scenarios and illustrating how future policy values might fit into such scenarios. Add to this an increasingly litigious environment where several large insurers were facing lawsuits regarding their marketing practices, and the result was a very difficult environment for the consumers to make an informed purchasing decision.

Fundamental Aspects At Issue

As described above, two fundamental issues exist relative to the illustrations of life insurance values. First, what numerical values are fair to display relative to the underlying life insurance contract? Second, how are these values displayed in a manner that gives the consumer a sufficient yet understandable presentation of the policy values?

What Numerical Values Are Fair To Display?

In responding to this first fundamental issue, the Working Group sought the assistance of the Life Committee of the Actuarial Standards Board (Committee).[1] In the development of its draft regulation, the Working Group has identified (and asked for the Committee's assistance with) two aspects that are key to the development of fair and reasonable illustrations.

First, the regulation calls for companies to appoint an "illustrations actuary" who will be responsible for certifying that the illustrations utilized by the company and its agents comply with the Standard of Practice (SOP) the Committee is developing. (It should be noted that at the time this article is being written, the SOP is still under development and may undergo substantial changes.) While the illustrations actuary may also serve as the company's "valuation actuary," it is not necessary that the two roles be filled by the same individual. For larger companies the illustrations actuary will usually be a full-time employee of the company, while for some smaller companies a consultant may fill this role. Secondly, the regulation calls for the illustrations actuary to develop a Disciplined Current Scale (DCS) to use in illustrating the non-guaranteed elements of the policy, with the DCS being subject to the conditions imposed by the SOP.

The guidance the SOP provides regarding the DCS is the primary reason for its development. As described in the draft regulation, the DCS mandates that the scale being illustrated "is logically and reasonably based on actual recent historical experience." While the SOP allows the actuary to exercise a high degree of professional judgment in determining what experience is consistent with "actual recent historical experience," the SOP also states the actuary "must be prepared to defend the use of any procedure that departs materially" from the SOP. In the final analysis, this approach was thought to be the most workable compromise between allowing companies the needed flexibility in illustrating their products while imposing a level of accountability that is intended to produce realistic illustrations.

In the draft regulation, three tests are imposed upon the DCS to assure that the illustration of values which are not guaranteed is reasonably likely to be met. First, the regulation requires that the DCS be "self-supporting." As described in the SOP, this means that cash values illustrated after 15 years must not be greater than the underlying accumulated cash flows predicted by the assumed interest, mortality, lapses and expenses. The SOP imposes upon the actuary the responsibility of determining that these assumptions are reasonably based on recent historical experience. Second, the draft also requires that the DCS not be "lapse supported." In order for the illustrations actuary to certify that this condition is met, the SOP requires that the same test conducted to satisfy the "self-support" test be met, with the exception that no lapses are assumed to occur after five years from issue. The members of the Working Group have expressed concerns that, in the absence of this second test, companies may be marketing products that cannot meet the underlying promises in the absence of excessive lapses.

At the time this article is being written, the draft regulation also requires that the DCS not be constructed to allow the illustration of "persistency bonuses." As used in the regulation, this term describes an illustration where the illustrated cash values do not grow in a smooth relationship to the underlying accumulated cash flows, as determined by the interest, mortality, lapse, and expense assumptions of the DCS. (As an example of a persistency bonus, one policy brought to the Working Group's attention had a 20th year cash value approximately four times the sum of the 19th year premium and cash value.) Those advocating that this test also be applied to the DCS argue that it is needed to impose a rational standard on the pattern of illustrated cash values. They also maintain that the latitude allowed the actuary under the SOP is sufficiently broad that this constraint is needed to add credibility to the certification process. Opponents of this provision argue that the first two tests (self-support and lapse-support) are adequate to impose a measure of conservatism to the actuarial assumptions, and that any significant imposition of "smoothness" would preclude such historically acceptable practices as termination dividends.

[1] *The Actuarial Standards Board is an independent entity within the American Academy of Actuaries. One of its goals is the development of standards of practice for the actuarial profession.*

Many other actuarial considerations will be debated before the regulation is finalized. First, while the SOP imposes discipline on the totality of the actuarial assumptions, it does not in its current form mandate that the specific individual assumptions (e.g., interest rate, mortality level) closely correspond to actual experience underlying a block of business. Critics argue that this may lead companies to illustrate a high rate of interest, while not calling attention to large offsetting expense charges. Defenders of the SOP maintain that the issue is not really an actuarial one, but rather a matter of proper disclosure. They also argue that oftentimes, policies will use such techniques as "zero mortality charges" to simplify the explanation of how cash values are determined.

How Should Policy Values Be Displayed In A Simple And Understandable Manner?

Encompassing all of the life insurance products into one simple and understandable format is a project that has occupied a considerable amount of the Working Group's time. How, for example, does one construct a simple illustration for a universal life product showing both the basic guaranteed values as well as whatever allocation might occur under a split-dollar arrangement?[2] In short, how do the regulators assure that basic policy information will not be obscured while still allowing companies the flexibility of showing how their particular products will function?

The answer the Working Group is pursuing is to require that all illustrations include a "basic illustration." As currently envisioned, this basic illustration would show policy values for a relatively standard pattern of premium payment and would always include a prominent display of the minimum guaranteed values. Additional non-guaranteed values could also be displayed, but these would be subject to the DCS described above. The regulation also mandates with a high degree of specificity the format that must be followed in presenting the basic illustration. Specifically, as currently drafted, the regulation would require that the basic illustration begin with such objective information as the names of the insurer, agent (if any), and insured, and a brief description of the policy being illustrated, including any options or riders, shown in the basic illustration. Next would come the numeric summary that would show the death benefits, cash values, and premiums at various standardized intervals on three different bases: policy guarantees; the DCS or some lower scale; and a scale which assumes that the non-guaranteed elements are the average of the factors of the two preceding bases. Finally, a signature page would be included that is signed by the applicant and either the agent or other authorized company agent; the statements would be designed to emphasize the non-guaranteed nature of those items that are not labeled "guaranteed." The regulators believe that standardization is essential in the basic illustration if the consumer is to be able to understand how the provisions of one policy compare with those of another.

If the consumer's needs were such that a more customized illustration were required, the basic illustration described above could be accompanied by a supplemental or "concept" illustration. As envisioned in the current draft, this illustration would follow the basic illustration in the material presented to the consumer. An item such as assumed borrowing against the policy would be an example of a condition that might necessitate a supplemental illustration. The questions of exactly what parameters exceed the scope of the basic illustration and exactly how much "flexibility" should be allowed in constructing the concept illustration are matters that have not been finalized. In reality, there undoubtedly will be a large amount of judgment required of both company personnel and regulators in determining what constitutes reasonable applications of these principles.

In addition to the illustration provided at the time of sale, the draft regulation would also require that a brief annual update on the status of the policy be provided to the policy owner. If an updated illustration is not also provided at the same time as the annual update, then a notice to the policyholder is provided informing them of the availability and usefulness of requesting the updated illustration.

---

[2] *"Split dollar plans" are funding arrangements where typically the employer will pay the portion of the premium necessary to fund the increase in the cash value, and the employee will pay the rest. Generally, this will entitle the employer to collect the cash value at the death of the employee, with the remainder of the death benefit going to the employee's beneficiary.*

Many difficult questions remain in developing and implementing the regulation. Undoubtedly the market will continue to evolve in an effort to meet consumers' changing needs, as well as to compete with other financial instruments. A big issue that has not yet been resolved is how to allow traditional and universal life insurance products to compete equitably with variable life insurance. Currently, illustrations of variable life products are subject to various requirements imposed by both the Securities and Exchange Commission and the National Association of Securities Dealers. One significant element of the SEC rules allows the insurer to display specified investment returns up to 12 percent. The NASD rules generally apply to personalized sales illustrations and require that investment returns used in that context must be reasonable. Resolving the existing inconsistencies in a manner that assures a "level playing field" will not be complete by the time the regulation is finalized and will require ongoing efforts.

Another large issue to be dealt with concerns the exact nature of what constitutes an illustration. While the need exists to protect the consumers from false or misleading information, it is obviously impractical to control every scrap of numerical and narrative data the consumer might see. Deciding where that line is crossed and imposing the full constraints of the regulation on such data will be a major hurdle that will have to be overcome.

Conclusion

The preceding discussion represents only the tip of the iceberg in terms of the level of detail that the model regulation should incorporate within its provisions. Continuing feedback on how the regulation is being implemented, as well as changing technologies, sales methodologies, and financial markets, will require that it be continually updated. Throughout the development of the model regulation, a high level of cooperation has been achieved among regulators, consumers, representatives of the actuarial profession, and representatives of industry, and it is critical that this cooperative effort continue.While the complexities are great, the effort is necessary to assure that consumers understand the products they are buying.