Comments of Consumer Representatives

Proposed Revisions to Actuarial Guideline for Indexed Universal Life Illustrations

May 11, 2015

The undersigned consumer representatives offer the following comments on the proposal before the NAIC Life Insurance (A) Committee from the Life Actuarial Task Force (LATF) regarding interim guidance on illustrations for Indexed Universal Life Insurance (IUL) products. We appreciate the fact that the NAIC has acknowledged the serious problems with illustrations for IUL and other life insurance products and we greatly appreciate the efforts of LATF to address these shortcomings. However, we do not support adoption of the proposal from LATF by the A Committee for the following reasons.

1. The guideline does not address key failures of current illustrations – understating the gross return of the index investment and overstating the net returns of the IUL investments. The net IUL investment returns may be overstated by including some investment-related charges/fees included in the cost of insurance instead of in IUL net returns. For example, although negative returns are possible with a 0% floor when returns are reduced by investment-related fees, it does not appear that the guidelines reflect or require illustration of such outcomes. The guideline also fails to require disclosure of dividends received from an investment in the actual index – the total return of the index investment – with the result that index investment returns are understated. The IUL guarantees have value and the hedging by insurers that enables the guaranties has a cost which is reflected in caps on returns. A consumer should be in the position to evaluate the cost of the guarantees. This cost is the foregone investment returns from purchasing the IUL instead of the index fund itself. It is only with an accurate illustration of costs versus benefits that a consumer has the basic information to make an informed decision. The failure to accurately present the gross return of the index investment and the net return of the IUL investment thwart this fundamental purpose of the illustration.

2. The guidelines reflect fundamental policy decisions by actuaries about what effective disclosure and information for consumers should be. These policy decisions must be informed by experts in consumer information and disclosure and subject to consumer testing. It is well-established that consumers experience information overload with the purchase of financial products. Consequently, more numbers and more information does not necessarily improve consumer decision making.

3. While LATF has identified a key problem with current illustrations – use of unrealistic index returns – the proposal to address only some of the problems on an interim basis will lead to a failure to address remaining problems and/or frequent changes in regulatory requirements leading to confusion among regulators, insurers and consumers. This problem is further exacerbated by the different implementation dates of separate provisions of the interim guidance and by the proposal to require application of the new requirements only to policies sold after the implementation date (as opposed to policies in force after the implementation date).
Illustration of Potential for Negative Returns with a 0% Floor

We suggest that an illustration for an investment tied to an external index should include;

1. The gross return of the index, meaning the actual historical total return of the index;
2. The net return of the index, meaning the historical amount that would have been credited to the policyholder's investment account net of all investment-related charges; and
3. The guaranteed returns to the policyholder, net of all investment related charges.

It should be non-controversial that provision of the net return is essential for a consumer to evaluate the cost of the benefits provided by the IUL product. If insurers are moving some of the investment-related costs – which would otherwise reduce the net return – to the cost of insurance, the result is that the illustrated returns and the cost of insurance are both inflated, preventing the consumer from seeing the true net return necessary for an evaluation of the costs and benefits of the product.

It should also be non-controversial that a product which promises to protect a policyholder’s principal, but which can result in reduced principal because of investment-related fees, should illustrate this downside risk.

Consider the following scenarios:

*Product provides floor of 0%, cap of 8%, but for 0.5% of asset fee, policyholder can buy up to 12% cap. In this instance, if the gross index return is zero, then the net earned rate is -0.5% (assuming no other investment-related charges).*

*Product provides floor of 0%, cap of 8%. Actual Cost of Insurance -- mortality charge, policy administration fee, and amortization of acquisition cost -- is 1% of coverage amount per period. Cost of investment account management to insurer assessed as fee to policyholder investment account is actually 3% per period. Under this scenario, if index gross return is 8%, then policyholder receives a 5% net earned return and a 1% COI charge. The investment return is presented as 5%. However, if the insurer calls part of the 3% investment management fee a cost of insurance -- say 1.5% or half -- then the insurer presents the COI as 2.5% and the investment return as 6.5%. In an illustration showing investment returns over time, it would be misleading to use 6.5% instead of 5.0%. In such a case, the insurer is inflating the actual net earned rate to show a more favorable comparison with the gross return of the index and alternative investments.*

The guideline fails to address the key issue of requiring all investment-related charges to be reflected in an illustrated return with the results that downside risk is not fully illustrated and that investment returns may be overstated.
In addition, the guideline fails to require disclosure of current dividends paid by the actual index fund. For example, an investment in an S&P index fund or the same fund within a variable universal life (VUL) policy will return both appreciation in prices of the stocks of companies which comprise the fund and dividends paid by the companies included in the index. For a consumer comparing two investments – an S&P index fund and an IUL policy with investment returns indexed to the S&P – the relevant comparison is total return of the index fund (historical stock price appreciation plus dividends from an investment in the S&P index fund) versus the capped returns of the IUL. These two data points would provide a consumer with accurate information to evaluate the cost – in terms of foregone investment returns – of the IUL guarantees and be in a better position to compares costs and benefits.

**Policy Decisions Informed by Experts in Consumer Information and Disclosure**

LATF’s cover letter to the A Committee states:

*This guideline provides uniform guidance for policies with index-based interest. In particular, this guideline:*

1. Provides guidance in determining the maximum crediting rate for the illustrated scale and the earned interest rate for the disciplined current scale.
2. Limits the policy loan leverage shown in an illustration.
3. Requires additional consumer information (side-by-side illustration and additional disclosures) that will aid in consumer understanding.

Item 3 indicates LATF’s view of what information should be disclosed to a consumer and how that information should be disclosed. We greatly value the expertise and efforts of actuaries in many areas. However, it has been a persistent failure of state insurance regulation to develop and craft consumer information and disclosures without involving experts in consumer information and disclosure or testing the effectiveness of the disclosures with consumers. The need for expert guidance and consumer testing is greater for very complex products and complex illustrations. Unfortunately, the current LATF proposal continues the shortcomings of the past by reflecting only the actuaries’ view of what constitutes useful consumer information. It is highly unlikely that disclosures developed through discussions between actuaries and insurer lobbyists alone will produce the same work product as a discussion informed by experts in consumer disclosure and consumers themselves.
Piecemeal Approach Is Bad Regulatory Practice

LATF rightfully has identified a key problem with IUL illustrations – the use of inflated index returns and inconsistencies in illustrations across insurers offering products with the same features. The LATF proposal partially addresses the first issue of inflated index return illustrations. LATF proposes to stagger implementation of the partial solution / revised guidance by phasing in the requirements for the “illustrated scale” and the “disciplined scale,” effective September 15, 2015, and, then later, requirements for policy loan illustrations and additional standards, effective March 1, 2016. In addition, the proposal calls for the new guidance to apply only to policies sold on and after these dates.

LATF also indicates that further work is needed on illustrations and that LATF “will consider requesting approval from the Life Insurance and Annuities (A) Committee to open Model 582 to incorporate the changes specified in the guideline and to address similar issues in other product illustrations. Revising Model 582 will provide the opportunity for the Task Force to ensure that a level playing field for all product illustrations is attained.”

We note the rapid growth in life insurance – long term care hybrid products. Given the complexity of these new products, guidance on illustration of the additional costs and long term care benefits of such hybrid products is needed to ensure consumers have some understanding of how use of a long term care benefit affects the other pieces of the life insurance product.

While we appreciate LATF’s concern about quickly addressing a particular problem with illustrations, we have great concern with this piecemeal approach, the failure to address and require a true net return scale and the phase-in of the interim guideline. First, we have concern that LATF’s failure to address and adopt an accurate net return scale requirement, as discussed above, for the interim rule reflects an inability of LATF to counter industry resistance as opposed to a lack of time. Second, the piecemeal approach of modifying the guidelines every six months – assuming that LATF or the A Committee is successful in addressing other problems with illustrations – will create great difficulty in regulatory compliance and oversight. This problem is exacerbated by the third point – the revised guidance is applied only to policies sold on or after certain effective dates. This means insurers will have to maintain multiple illustration engines based on different regulatory requirements and that regulators will have to sort through when policies were sold and what requirements were in place to evaluate compliance. This is a much greater problem with changes in regulatory requirements every six months. The problem can be partially addressed by changing the application of the effective dates to policies in force on or after the dates. There is no reason for an insurer to continue illustrating a policy sold last year with misleading illustrations.
In conclusion, we ask that the A Committee not adopt the current LATF proposal and direct LATF to

1. Develop guidance for three illustration scales for IUL products:
   a. The gross return of the index, meaning the actual historical total return of the index;
   b. The net return of the index, meaning the historical amount that would have been credited to the policyholder’s investment account net of all investment-related charges; and
   c. The guaranteed returns to the policyholder, net of all investment related charges.

2. Require that new guidance be applied to policies in force on or after an effective date.

3. Secure input from experts in consumer information and disclosure to inform the development of the guidance and test the disclosures required by the guidance with consumers

4. Identify other issue of concern with illustrations for IUL and other products which need to be addressed, provide an estimate of the time necessary to develop the regulatory guidance for these issues and seek direction from the A Committee about what issues to address in what time frame. One of these issues should be guidance for illustration of long term care benefits and costs in an IUL or other life insurance policy providing long term care benefits.

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