Comments of the Center or Economic Justice

To the NAIC Life Insurance and Annuities (A) Committee

November 11, 2022

2023 Charges

CEJ writes to request the Life (A) Committee add a charge for 2023.

New Charge

The **Life Insurance and Annuity Illustrations** (A) Working Group will **r**eview the NAIC Life Insurance Disclosure, Life Insurance Illustration, Annuity Disclosure and Advertisement of Life Insurance and Annuity models and develop the key content and principles for illustrating the operation of the insurance policy or contract, including:

- Ensure consistency between the Life Insurance Disclosure and Life Insurance Illustration models and advise if the models should be combined;
- Ensure consistency between the Life Insurance Illustration and Annuity Disclosure Model for approaches to illustration of indexed products;
- Develop key content and principles for illustrations to improve consumer protection and consumer comprehension of products; and
- Identify major consumer protection concerns with life insurance and annuity advertising;

Discussion

CEJ requests and cannot over-emphasize the urgency of the NAIC addressing the sorry state of life insurance and annuity illustrations and the related harm to consumers. Current NAIC model regulations regarding life insurance and annuity illustrations and advertising permit – and in some cases, require – misleading, confusing and/or deceptive information be provided to consumers in the form of illustrations.

As you know, the Life Actuarial Task Force is now working on the third or fourth revision to the actuarial guideline intended to stop unrealistic and deceptive illustrations for indexed universal life ("IUL"). The latest "quick fix" may address the current product designs insurers have developed to game the last version of AG-49A, but will not address fundamental problems with illustrations or the fact that the Life Illustrations model was created before the advent of indexed products. There is now consensus that the Life Illustrations model should be opened for review and revision.

With all respect to the life actuaries, the issue of illustrations for life insurance and annuities should be moved to a group with specific expertise in consumer financial information and disclosures as well as knowledge of financial disclosures for other types of financial products.

Attached to these comments are recent illustrations for IUL from three companies. They range from 50 to 100 pages and contain page after page of financial projects 50 years or more into the future. These documents fail the basic purpose of an illustration – to help the consumer understand how the product operates. Instead, the illustrations reflect product designs intended solely to maximize annual crediting rates and accumulation values. Despite the pro forma disclaimer that the product is insurance and not an investment, the illustration is all about how the consumer can invest money and realize outsized returns. The illustration employs practices and techniques not permitted for any other type of investment product – even though the insurance products are simply chassis for investments in all manner of financial instruments.

Some of the core problems with illustrations:

- The illustration takes historical returns and projects those returns into the future. No other investment type product is permitted to project future returns based on past results. In fact, all investment products contain a warning that past returns are not a guaranty of future returns.

- The historical returns are data-mined to identify the financial instruments that have produced the best results over the recent past. The problem of relying on past results to display expected future performance is exacerbated by no restrictions on insurers' ability to cherry pick the financial instruments producing the best results in the recent past. This guarantees an unrealistic crediting rate.

- The historical returns can be and are based on made-up historical performance. If the index didn't exist in the past, the insurer can create a hypothetical history. Putting these first three bullet points together – an illustration can project future returns based historical returns and those historical returns can be cherry-picked from the best historical results and, even when there is no actual history, the insurer can create a hypothetical history.

- The providers of bespoke indexes for insurance products are often the same entities providing the hedging program for the insurer – creating a massive conflict of interest.

- The illustrations assume a constant annual return, resulting in depictions of the rewards of risky types of investments without showing the risk. Over time, an investment in the stock market will earn a higher return than an investment in government bonds. Higher returns always come with greater risk – meaning greater variability in returns and the possibility of losses. Since the illustrations show monotonic returns, riskier investments or investment strategies that, over time, may produce higher returns than less risky investments, the illustration will simply show higher accumulation values without any indication of risk of sequence of returns.

- The monotonic annual crediting rate is used to promote premium financing and illustrate policy loans that need never be paid back because the interest rate on the policy loan or premium financing is illustrated as less than the annual crediting rate. This means that, over lengthy illustration periods, premium finance or policy loans never need to be paid off. What could possibly go wrong with this scenario? See vanishing premium debacle. No illustration ever shows that during an experience period in which the product has a zero return, the loan obligation remains, must be paid and may deplete the policy value.

- The illustrations don't show the consumer how the policy actually operates! There is no clear demonstration of what happens in any given period for different outcomes of the index. There is no clear demonstration of how policy and mortality expenses can change and affect accumulation values in a particular experience period or over, say, a five-year experience period.

One result of the structural flaws in illustrations (and illustration models) is that product design is driven by how to illustrate the highest accumulation value as opposed to responding to actual consumer demand – with the added result that product designs become more complex and more opaque to consumers because of the insurers' use of ever more exotic and new bespoke indexes to game existing illustration requirements to produce the highest accumulation values.

Another result of structural flaws in illustrations is product designs that make insurance producers into financial advisers without the relevant training. For example, new product designs include the ability of a consumer to lock in a return at any point in time during the indexing period and the insurance producer is coached to reach out to consumers during the indexing period to highlight this feature. While producers selling annuities are subject to a suitability/best interest standard of care, producers selling indexed universal life are not.

Another major problem is that the approaches to illustrations for life insurance and annuities – particularly for indexed products – are radically inconsistent even for products that operate in a similar fashion. Annuity illustrations requirements don't cap crediting rates, so insurers turn to bespoke indexes created by investment banks by data-mining historical experience to falsely present potential future earnings.

But, the annuity illustration at least requires a best and worst ten year scenario in an effort to get at sequence of return risk. In contrast, IUL illustrations cap the crediting rate, so indexes other than the S&P are rare, but AG 49 has encouraged the type of products that game the provisions of AG 49. AG 49 was created to stop the use of unrealistic crediting rates that produced unrealistic accumulation values. But, insurers turned to new product features – multipliers and bonuses – with the result that despite lower crediting rates and significantly higher expenses, accumulation values have increased in comparison to pre-AG 49 products. The insurers have taken a product that purports to eliminate downside risk and added that very downside risk with asset charges. And insurers have now gamed AG49-A with the use of data-minded volatility control indexes and crediting strategies that generate unrealistic illustrated crediting rates. And that practice has spread to indexed annuities.

In addition, IUL illustrations also differ from indexed annuity illustrations because of the absence in the IUL illustration requirements of any disclosure of sequence of return risk. IUL illustrations show monotonic returns every year – with the result that loans, which can be illustrated at a lower cost than the crediting rate, are illustrated as cash withdrawals that cost the policyholder nothing. One result of IUL product designs and illustrations is that a significant portion – perhaps the majority – of IUL sales is premium-financed.

The state of illustrations today is far worse than in 2015 (see discussion below) and the NAIC models create diametrically-opposed approaches for illustration of indexed life insurance and indexed annuities despite the fact that the indexed products have more similarities than differences for purposes of illustration.

Finally, advances in understanding of consumer biases regarding financial services products and of design of consumer disclosures to empower consumers requires a thorough review of the current illustration regime. In support of this last point, we attach a very recent joint report by the financial service regulators in Australia and the Netherlands,

We recognize that regulators are hesitant to open existing model laws and regulations for broad or significant change. Indeed, insurers participating in the LATF IUL Subgroup have indicated support for opening the Life Illustrations model for a "targeted" change to essentially memorialize current insurer IUL illustration practices.

We request the broader charge stated above for several reasons. First, it makes no sense to have one approach for an indexed life insurance product and another approach for indexed annuity products when both are marketed and recommended based on similar benefits and mechanics.

Second, the problems with illustrations cannot be fixed with a tweak for indexed universal life.

Third, while actuaries have many virtues and skills, designing effective consumer information and disclosure is not part of that skill set. There is a need to bring in other subject matter experts in effective consumer financial information and disclosure.

Our proposed charge starts by establishing the core features of effective consumer information through illustrations. Once these core features are established, the specific guidance would then be developed. We do not want to downplay the amount of work required, but illustrations re-engineered to effectively educate consumers about how the product operates will necessarily be far simpler and shorter than current illustrations and the related regulatory guidance will also be simpler and shorter.