

**TRANSACTIONS OF SOCIETY OF ACTUARIES
1991-92 REPORTS**

FINAL REPORT* OF THE TASK FORCE†
FOR RESEARCH ON LIFE INSURANCE SALES ILLUSTRATIONS
UNDER THE AUSPICES OF THE
COMMITTEE FOR RESEARCH ON SOCIAL CONCERNS

EXECUTIVE SUMMARY

Purpose

The Task Force for Research on Life Insurance Sales Illustrations reports to the Society's Committee for Research on Social Concerns. The Task Force was formed in recognition of the declining level of consumer confidence in the life insurance industry and, in particular, to investigate how sales illustration practices can add to, or detract from, consumer confidence.

In developing this report, the Task Force surveyed life insurance company illustration practices, reviewed available literature and regulatory requirements, held open forums at Society of Actuaries (SOA) and Canadian Institute of Actuaries (CIA) meetings, and considered the methodology applied to other financial products.

Situation Analysis

Sales illustrations have been developed to meet a variety of needs from a variety of consumers, all placing different requirements on an illustration. There are two major uses of illustrations:

- **Type A Usage** is intended to show the consumer the mechanics of the policy being purchased and how policy values or premium payments change over time. The emphasis is a matter of *how* and *what* rather than *how much*.
- **Type B Usage** tries to project likely or best estimates of future performance and compare cost or performance of different policies. It attempts to show *how much* on the premise that the *hows* and *whats* are comparable enough for this to be meaningful.

Illustrations handle Type A requirements well, especially if several illustrations are used to show different scenarios. Illustrations inherently do not

*Opinions expressed herein are those of the Task Force for Research on Life Insurance Sales Illustrations and of the Committee for Research on Social Concerns. This report does not purport to represent the views of the Society of Actuaries or of its Board of Governors.

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It can be seen that Type B usage is inappropriate unless the illustrations include a measure of relative risk. For example, if one illustration shows 15 percent lower premiums but has 60 percent greater risk of not achieving projected values, then lack of risk disclosure renders the comparison meaningless. Since relative risk cannot be calculated, Type B questions *assume* similar degrees of relative risk. Regulations try to assure “consistency” between illustrations as a way to keep relative risk equal. However, since there are really no practical means of assuring similar relative risks, Type B usage for illustrations is fundamentally inappropriate.

The incentives associated with Type B questions are considerable. However, an objective actuarial evaluation must conclude that typical life insurance products are too complex and the number of unknowable events is too great to allow for simple answers to questions of this type. Even when developed appropriately and with integrity, illustrations are structurally incapable of handling Type B questions. Illustrations, by their nature, cannot answer these questions. Problems arise because of the illusion that they can.

Many people believe that although illustrations aren’t perfect, they are the *best available indicator* of future performance. They may believe, for example, that all illustrations are somewhat optimistic, but then conclude, “Even if they’re all high by 15 percent, I’ll still do better with the one which shows the highest values on these illustrations.” Actuaries should oppose this myth.

V. OTHER ILLUSTRATION PRACTICES

It is easy to forget that sales illustrations in the U.S. and Canada have a unique history. Life insurance products sold in other countries, and other financial products sold in North America, do not share the same illustration practices. A review of these practices is helpful before evaluating alternatives for our system.

A. Other Countries

A quick survey of illustration practices in other countries reveals the importance of a historical and cultural context. In countries where insurance products are standardized by law, there is little controversy with respect to illustrations. This is the case for much of the Far East and Europe. Where product standardization is the rule, there is little product competition as we know it, and illustrations are naturally limited to noncontroversial Type A usage.

The Task Force strongly believes that consumers should be made aware of a product's sensitivity to changes in the environment. The range approach is one approach that might be considered.

CONCLUSION: We think further discussion on the range approach within the industry and within our profession is warranted. As stated in Section B-1 above, we encourage the AAA and the CIA to:

- **Review current regulations requiring the use of current experience or current dividend scales in life insurance sales illustrations;**
- **Suggest revisions to those regulations which would clarify the meaning of "current," and**
- **Recommend modifications to the regulations which would allow the use of both current experience and deviations from current experience, but, if the latter, only with appropriate and mandated disclosure of the assumptions used.**

E. Strategic/Educational Efforts

1. Change Use of Illustration in Sales Process: Consumer Disclosure

Consumer education efforts should focus on appropriate uses for illustrations. Usage disclosure should be clear and simple. It should indicate that illustrations are only useful for Type A questions, as defined in this paper. Required disclosures should make clear that it is inappropriate for agents, companies or advisers to use illustrations for Type B questions, regardless of the integrity of the illustrations involved.

This is not a ban on illustrations. Over time, however, such disclosure should reduce the occurrence of abusive practices. Previous regulations and disclosures have not been effective, because it has been possible to design around a rule while still using illustrations for comparative cost purposes.

Sample usage disclosures, for display at the top of the illustration:

- a. **Sales illustrations should not be used for comparative policy performance purposes.** Life insurance policies are complex financial instruments, which generally contain both guaranteed and nonguaranteed elements. A sales illustration may be helpful in understanding how a particular policy performs under specified circumstances. It is generally not feasible, however, to use sales illustrations to determine whether one policy is a better buy than another.
- b. The only promises a life insurance company makes when it sells a policy are the contractual guarantees. Policy illustrations are not promises. Rather, they are hypothetical examples of what might happen if certain assumptions are met.

- c. Policy illustrations should not be used for comparing the relative cost or performance of life insurance products.
- d. Most life insurance policies are complex financial contracts which contain both guaranteed and nonguaranteed features which depend on unpredictable future events. Consequently, the amount of risk associated with a particular sales illustration cannot be determined.

If illustrations cannot be used as a comparative performance measure, many people will demand to know, "What *can* be used?" The honest answer is that *there is no simple measure or analysis* which can be done for such complex financial products. The consumer bears a degree of future performance risk, and this cannot be readily estimated, especially for competing policies. This fact is already well understood in the securities industry. It needs to be assimilated in the life insurance industry.

Of course, there are other factors to consider, including rating agency analyses and retrospective cost measures. There are also many service and quality factors. Contractual features which have value to the consumer's individual situation may be more important than generalized cost estimates. Finally, an evaluation and recommendation by the agent or broker may be of critical importance. Ultimately, although many factors may be considered, the final decision on the *best* policy must be based on individual judgment.

CONCLUSION: The AAA and the CIA should encourage their respective regulatory bodies to mandate inclusion of sales illustration disclosures of the type shown above. At least one of the disclosures should be prominently displayed at the top of every page.

2. *Consumer Brochure*

A small, easy-reading brochure, developed by an industry or professional association, could supplement the proposed disclosures and explain proper and improper uses of policy illustrations in more detail. It could also cover other due diligence questions which a consumer might want to ask before making a decision. The brochure should be offered in every situation in which an illustration is used as part of a decision to buy, lapse or replace life insurance coverage. It should be designed as a way to educate the consumer about both insurance and illustrations.

CONCLUSION: There are many associations that could sponsor or contribute to this effort, including the ACLI and the Canadian Life and Health Insurance Association (CLHIA). We believe that it is important to have active actuarial sponsorship of this publication. We recommend