

LIFE INSURANCE

COST DISCLOSURE



Staff Report to the Federal Trade Commission

BUREAU OF CONSUMER PROTECTION

BUREAU OF ECONOMICS

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INTRODUCTION

Recently much attention has been focused on the plight of people with relatively small amounts of savings.¹ Because of Federal regulations on the maximum interest rates that banks and savings and loan associations may pay, savers who have less than \$10,000 to invest have often had to settle for rates of 5 to 5-1/4 percent on their money, while open market rates are in the 9-1/2 to 10 percent range. Even the latter rates are barely sufficient to cover the current rate of inflation. Through a variety of exemptions and financial innovations, large savers have been able to obtain access to the open market rates from which small savers have been excluded by deposit rate ceilings. One economist has put the loss in interest earnings at over \$8 billion on passbook savings accounts at commercial banks, savings banks and S&L's in 1978 alone.² Based on similar findings, Mr. Robert Gnaizda, a public interest lawyer, petitioned Congress to require a "fair warning on every passbook, in every advertisement, and on the doors of every bank..." that "Savings may be hazardous to your wealth," if the government does not end the system of deposit rate ceilings.³

¹ See Hearings on "Regulation Q" Before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations, 96th Cong., 1st Sess. (1979) [hereinafter cited as 1979 Hearings.]

² See the testimony of Professor Edward Kane, id.

³ 1979 Hearings, supra n. 1. Mr. Gnaizda puts the loss at over \$17 billion.

Virtually no attention has been paid, however, to how small savers have fared during the current inflation in the one major consumer savings medium that is not subject to deposit rate ceilings. At the end of 1977, consumer savings held by the ordinary life insurance industry amounted to approximately \$140 billion.⁴ This amount is roughly equal to the total of all passbook savings accounts held by the savings and loan industry.⁵ A major portion of this report will be devoted to an examination of consumer savings through life insurance. The life insurance industry publishes no figures on the total consumer savings which it holds. Nor does the industry publish figures on the rate of return it pays on savings, either for the industry as a whole or on individual policies. This report will examine the rates of return being paid by the life insurance industry to the 45 to 50 million households that save through life insurance. Among the important findings of this report are:

1. The average rate of return paid by the industry to all ordinary life insurance policyholders in 1977 was between one and two percent;⁶

⁴ See pages 11-12, infra.

⁵ Passbook accounts amounted to almost \$144 billion in December, 1977. 1979 Hearings, supra n. 1, at 7, Table 3 (statement by Kenneth Thygerson, Chief Economist of U S. League of Savings Associations).

⁶ This is the average rate paid all ordinary life policy holders. Many policies currently on the market, if held for 20 years, will yield between 4 and 5 percent. See Tables II-7, II-8, infra.

2. The rate of return on new policies is, in many instances, substantially below alternatives readily available in the market place;
3. A significant number of holders of old policies are locked into a low-yield, fixed-dollar investment unsuited to cope with current inflation;
4. There are severe, but unannounced, penalties for early withdrawal of savings through life insurance policies. Unlike the withdrawal penalties mandated by Federal deposit regulations, the penalties imposed by life insurance companies do not merely reduce the return earned on the principal: they often reduce and sometimes even eliminate the principal itself. The consumer loss resulting from first-year lapse alone exceeds 200 million dollars a year. Just to break even, many policies bought in 1977 will have to be held until 1987.
5. Price competition is so ineffective in the life insurance industry that companies paying 20-year rates of return of 2 percent or less compete successfully against companies that pay 4 to 6 percent. This disparity should be contrasted with the banking industry, where differences of a quarter of a percent are considered to be competitively crucial.

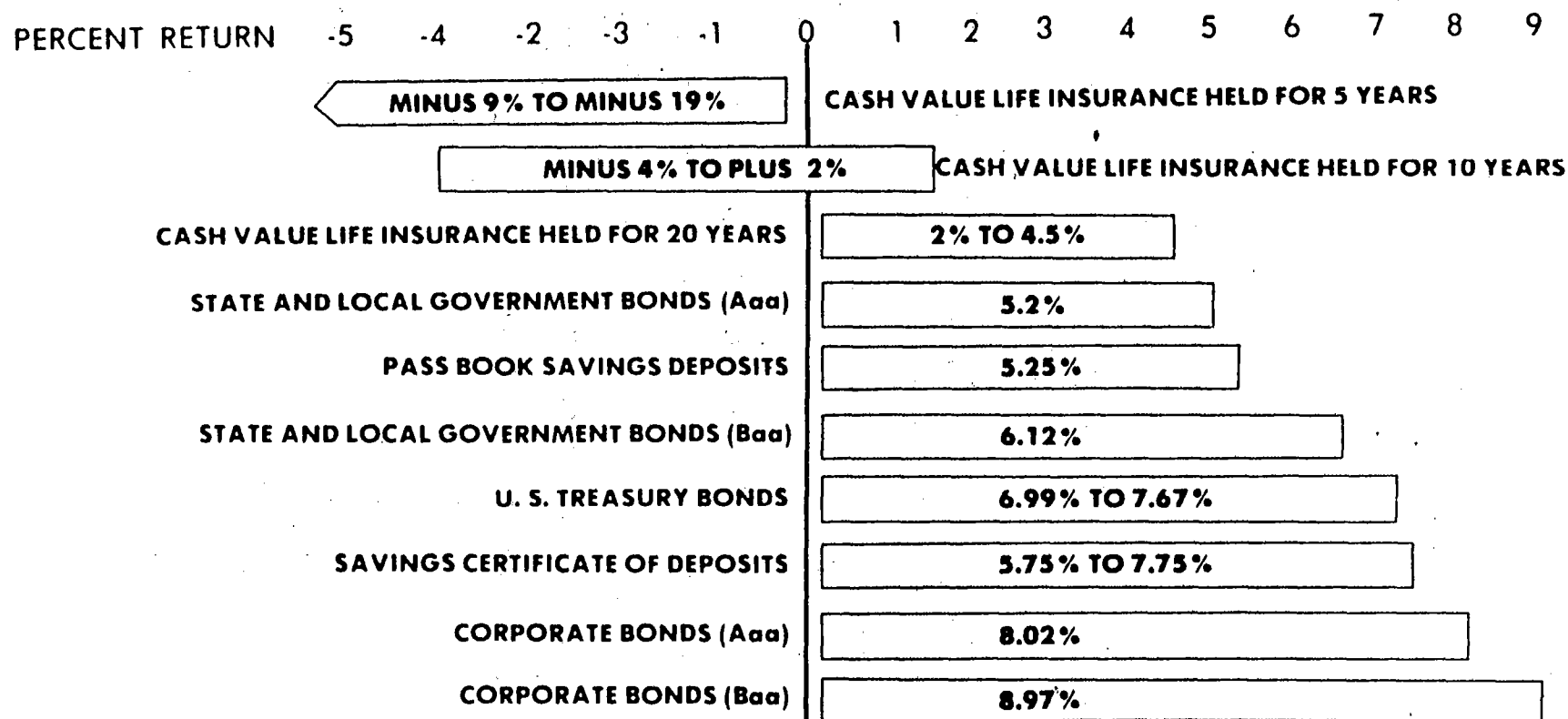
There are important differences between saving through life insurance and saving through the banking industry. In particular, the income generated through a life insurance policy

is essentially tax free; therefore, all the rates of return mentioned above should be compared to the after-tax return from other forms of savings or investments. Nevertheless the average rate of return on savings through life insurance is extraordinarily low even compared to current passbook rates offered by banks and S&L's, which are themselves kept artificially low by the deposit rate ceilings. We estimate that consumers would have had an additional \$3.7 billion in 1977 alone if the life insurance industry had paid only 4 percent on savings.⁷ Thus while deposit rate ceilings may have imposed great costs on small savers, those consumers who save through life insurance are in many instances far worse off. Indeed, life insurance savers would gain substantially if they were at least put on an equal footing with the current low deposit rate ceilings of banks and S&L's.

These problems led to this investigation of the life insurance industry. The investigation examined the magnitude of consumer injury and the extent to which life insurance cost disclosure can remedy these problems. This report is the end product of that investigation. It is divided into four parts: (1) An overview of the industry and an analysis of its role as a savings medium; (2) An analysis of consumer problems in the life insurance industry; (3) A description of some of the reasons for these problems; (4) A recommended system of life insurance cost disclosure which we believe is a prerequisite to any meaningful

⁷ See pages 18-19, infra.

RATES OF RETURN ON VARIOUS INVESTMENTS -- 1977



CAVEAT: PURCHASERS SHOULD CONSIDER TAX ADVANTAGES AND DISADVANTAGES OF ALTERNATIVE INVESTMENTS. RETURNS ON CASH VALUE INSURANCE POLICES ARE GENERALLY TAX FREE; SOME BONDS ARE TAX-EXEMPT.

SOURCE: FEDERAL TRADE COMMISSION

price competition in the life insurance industry.

I. THE LIFE INSURANCE INDUSTRY AND ITS SERVICES

A. Description of the Industry

The life insurance industry is a large and important part of our economy. The total income of domestic life insurance companies in 1977 was \$98 billion.⁸ While it is difficult to comprehend a figure this large, some comparisons may help. The \$98 billion received by life insurance companies in 1977 is approximately the same as the federal government spent for national defense in that year and more than twice as large as the total income of the entire farm population of the United States.⁹

The life insurance industry directly affects most families in this country. Seventy-two percent of the adult population of the United States and over 90 percent of all husband and wife families own some form of life insurance.¹⁰ In 1977, Americans purchased \$367 billion of additional life insurance coverage bringing the total of life insurance coverage to almost \$2.6 trillion.¹¹ Insured families paid an average of over \$500 a year in premiums and had approximately \$37,000 insurance in force.¹²

8 American Council of Life Insurance, Life Insurance Fact Book, at 56 (1978) [hereinafter cited as Fact Book].

9 Economic Report of the President, 339, 362 (1978).

10 Fact Book, supra n. 8, at 35. These figures are for 1976.

11 Id. at 7.

12 Id. at 7 and 56. This figure includes employer contributions
(Footnote Continued)

The primary focus of this report is ordinary life insurance. Ordinary life insurance policies are usually sold to individuals (as opposed to groups), and are usually sold by agents. Most ordinary life premiums are paid by mail rather than collected by an agent.¹³ In 1977 Americans paid \$24.2 billion in premiums for 140 million ordinary life insurance policies. This expenditure represented 1.9 percent of all personal income.¹⁴ In return for premiums paid, the life insurance industry performs two important services: it provides death protection and serves as a savings medium. The dual nature of the life insurance industry is reflected in the differences between the industry's two basic policies: "term" policies (which provide only insurance protection) and "cash value" policies (which provide both insurance protection and a form of savings). The following section describes these two basic types of policies.¹⁵

12 (Footnote Continued)

and is computed by dividing premium income by the number of insured families (88 percent of about 70 million families).

13 Besides ordinary life insurance, the other major products of life insurance companies are health insurance, annuities, group life, credit life and industrial life insurance. An economic profile of the whole industry is set forth in Appendix I.

14 Fact Book, supra n. 8, at 20, 58, 59.

15 All life insurance policies are either participating or non-participating. Non-participating policies do not pay dividends and are sold by stockholder owned insurance companies. Participating policies pay dividends and are primarily issued by mutual insurance companies but are also issued by stock companies. In dividend-paying policies, the premium is set at a level greater than the anticipated future cost
(Footnote Continued)

B. Basic Types of Life Insurance Policies

1. Term Insurance

Simply stated, term insurance provides solely death protection for a fixed period of time such as 1, 5, or 10 years or until the insured reaches a specific age such as 65. The face amount of the policy will be paid only if the insured dies within the time (or term) stated in the policy. Thus, a one year \$25,000 term policy, for example, obligates the insurance company to pay the beneficiary that amount should the insured die within the year. Term insurance policies are often renewable for additional terms without the insured's being required to take a medical examination. Each time the policy is renewed for another term, the premiums increase to reflect the greater likelihood of death as a person grows older.¹⁶ When the insured is young, term insurance is relatively inexpensive and provides the largest immediate death protection for the premium dollar. However, the premiums

15 (Footnote Continued)

of the policy. Dividends paid reflect the company's actual costs. See generally J. Belth, "Distribution of Surplus to Individual Life Insurance Policyholders," 45 Journal of Risk and Insurance 7 (1978).

16 Certain types of term policies provide for level premium payments. For example, "term to 65" has only one "term" and thus the premium remains at a constant level until the policy expires at the stated age. The early year premiums for this form of term insurance are significantly higher than traditional renewable term. Another level premium variant is "decreasing term", in which the face amount of the insurance decreases over time while the premiums stay the same. This type of policy is often marketed as protection for long-term decreasing debts such as mortgages.

steadily increase as the insured ages and become very high after age 65.

2. Cash Value Insurance

There are several types of cash value insurance. The most important type is "whole life" or "permanent life" insurance. Whole life insurance policies remain in force as long as the premiums are paid. They differ from term policies in three important ways. First, the premiums for a whole life policy are initially much higher than for term insurance for the same amount of insurance protection. Second, unlike the premiums for term insurance, whole life premiums do not go up with age but remain the same throughout the payment period. Third, whole life insurance policies develop cash values which increase each year.¹⁷

A whole life policy can have a premium that does not increase because during the early years of the policy the premiums are much higher than the amount needed to buy only death protection.¹⁸

¹⁷ In addition to whole life insurance, many other policies on the market combine savings and protection in various degrees. Examples include "life paid up at 65," "20-pay life," and "endowment policies." "Life paid up at 65" and "20-pay life" are policies in which the premiums are paid over a limited period instead of over the entire life of the policy. Endowments are policies in which the cash value equals the policy's face amount at the end of a limited period, usually 20 or 30 years.

¹⁸ A 35-year old man will typically pay an annual premium of \$15-20 per \$1,000 of coverage for a whole life policy, while a comparable size one-year renewable term policy would cost \$2.00 to \$6.00 per \$1,000. When the insured reaches ages 55-60, term premiums become greater than the \$15-20 level premiums of the whole life policy.

Part of these "overpayments" made in the early years of a whole life policy are invested by the company and set aside as a reserve to be used to pay part of the death benefit should the policyholder die. This reserve serves as the basis for a policy's cash values. The cash value of a whole life policy generally increases each year and is specified in the contract.¹⁹ While alive, the policyholder can either borrow against the cash value or receive it by surrendering the policy. If the insured dies, however, the insurance company pays only the face amount of the policy, not the face amount plus the cash value.

A whole life policy can be viewed as a combination of an increasing savings element (cash value) and a decreasing amount of pure life insurance protection. This is because as the cash value of the policy increases the actual amount of death protection being purchased decreases correspondingly--the sum of the cash value and the death protection always equals the face amount of the policy. The increasing cash value also explains why whole life insurance premiums stay the same throughout a person's life. Even though the chances of dying and thus the cost of pure death protection increases each year, the cash value reduces the amount of death protection that must, in effect, be purchased.

Although the description of whole life insurance as a

19

The increase in cash value in any given year is due to two factors--the excess premium payments for that year and the interest credited to the cash value that has been previously accumulated. The impact of compound interest is substantial. For example, \$1.00 invested at 7.2 percent will double in ten years.

combination of death protection and savings is commonly found in insurance texts,²⁰ many people in the insurance industry assert that the separation of whole life insurance into savings and protection components is improper and that the life insurance contract must be viewed as an undifferentiated whole. They argue that the purchase of a whole life policy should be viewed as simply buying insurance protection on the level-premium "installment plan. According to this view, under the level premium method, people "prepay" while they are young for insurance protection they will receive only many years later, while the savings element (cash value) is described as an "incidental"-by-product of the level premium method of paying for insurance.²¹

It is true that the policy's savings element is a by-product of the level premium method of paying for insurance. However, it can hardly be said to be "incidental". During the initial years of a typical whole life policy the portion of the premium that goes to build up the savings element of the policy will often be 70 percent of the total premium. Over the first twenty years of a typical whole life policy issued to a male aged 25, about 40-50 percent of the premium goes into the policy's savings element.²² The fact that a major portion of the premiums for

²⁰ See, e.g., S S. Huebner & K. Black, Life Insurance 7 (1976).

²¹ This argument is discussed in detail at pages 113-120, infra.

²² See J. Belth Life Insurance - A Consumer's Hand Book, 49-50, (1973).

whole life policies goes toward building up cash values makes the life insurance industry a major savings institution.

C. Life Insurance As A Savings Medium

Sales of cash value insurance policies, in conjunction with sales of annuities, make the insurance industry one of the country's major savings institutions.²³ Assets of domestic life insurance companies totaled more than \$350 billion at the end of 1977.²⁴ In recent years, life insurance companies have accounted for about 20 percent of the growth in all personal savings.²⁵ As a repository of personal savings, the life insurance industry has ranked second only to savings and loan associations among private savings institutions.²⁶

Individual savings through ordinary cash value insurance represent a significant part of the total consumer savings deposited with the life insurance industry.²⁷ Although the life insurance

23 Although term insurance sales have been growing more rapidly in recent years than cash value sales, the latter type is still the most common form of ordinary insurance purchased and owned. Cash value policies (on adult lives and sold by ordinary agents only) accounted for about 58 percent of premiums and about 39 percent of the amount of new ordinary insurance purchased in 1975. Life Insurance Marketing And Research Association (LIMRA), 1975 Buyers Study at 19.

24 Fact Book, supra n. 8, at 69.

25 G. Bishop, Capital Formation Through Life Insurance, 91 (1976).

26 Id. at 87.

27 The remainder consists primarily of annuities and amounts held under pension plans, Fact Book, supra n. 8, at 36-38, 49-54.

industry does not publish statistics on the total consumer savings through ordinary life insurance, this number can be estimated. In 1977, it totaled approximately \$141 billion or over \$1,000 for each of the 139 million ordinary life insurance policies in force.²⁸

An indication of the relative importance of savings versus protection in ordinary life insurance can be seen by comparing it to group term insurance. In 1977, the two lines provided roughly equal amounts of death protection.²⁹ Death claims paid on ordinary life policies amounted to \$4.9 billion versus \$4.8 billion on group contracts.³⁰ Yet the public paid over \$24 billion in premiums for its ordinary life insurance coverage compared to less than \$7 billion for its group coverage.³¹ There are two major reasons for this immense difference. First, the ordinary line is dominated by cash value policies, where the savings benefits are far larger than the death protection benefits. Second, selling costs are much higher for ordinary than for group policies.³²

28 Consumer savings consist of ordinary life cash values and accumulated dividends left with the companies at interest. For details of this calculation see Appendix II.

29 Ordinary life insurance in force amounted to \$1,289 billion, compared to \$1,115 billion for group. Fact Book, supra n. 8, at 18.

30 Id. at 41.

31 Id. at 57.

32 For example in 1975, commission costs were about \$1.97 per thousand of coverage on ordinary policies versus 12 cents
(Footnote Continued)

The following tables show the relative importance of ordinary life insurance as a savings institution and as a provider of death protection. Table I-1A is a summary of the total cash flows and the increase in consumer savings in the ordinary life insurance line in 1977. Table I-1B contains the same information broken down by insured household.³³

These tables show how much money flowed from policyholders (directly and indirectly) into the industry. The money flowing into the industry consists of premiums and the investment earnings from consumer savings through ordinary cash value insurance.³⁴ The tables also show how much money flowed back from the companies to policyholders in the form of benefits. Finally, the tables show a breakdown of the money remaining with the companies broken out by the amount used to increase policyholders' savings and the amount retained for expenses and profits.

32 (Footnote Continued)

for group. Home office expenses averaged \$3.02 per thousand on ordinary versus 30 cents for group. These figures were derived from Table 2 in Appendix II.

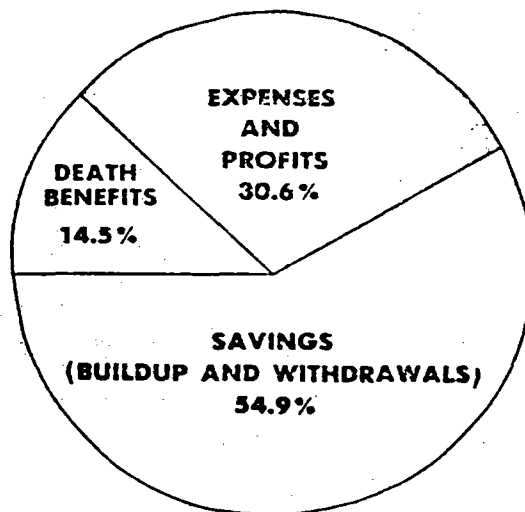
33 The numbers in Table I-1B are based on the assumption that there are 46 million households with ordinary life insurance. The derivation of the number of insured households is set forth in Appendix II.

34 These reserves are technically not owned by the policyholders. However, policyholders can surrender their policies at any time and receive their accumulated cash values and dividends. Thus, we think it is appropriate to view investment income on these reserves as funds indirectly contributed by policyholders.

The overwhelming importance of the saving element of ordinary cash value insurance is shown by the fact that, although approximately \$34 billion was contributed by policyholders to the industry, only about \$5 billion was returned in the form of death benefits. The death benefits paid are only slightly larger than the dividends paid and are much smaller than either the withdrawals from savings or the buildup of savings. From the perspective of the individual household, an average of \$525 was paid in premiums and only \$107 was received back in death benefits. This comparison excludes an additional indirect contribution of \$212 per household derived from investment income.

Table I-2 is a breakdown showing approximately how policyholder-provided income (premiums plus investment income) is used in ordinary insurance. Table I-2 shows that death benefits paid in 1977 represented only 14.5 percent of the cash flow of the industry, whereas the savings element was more than 3-1/2 times as large at 54.9 percent.

Table I-2³⁵



³⁵ Table I-2 is based upon the data contained in Table I-1A.

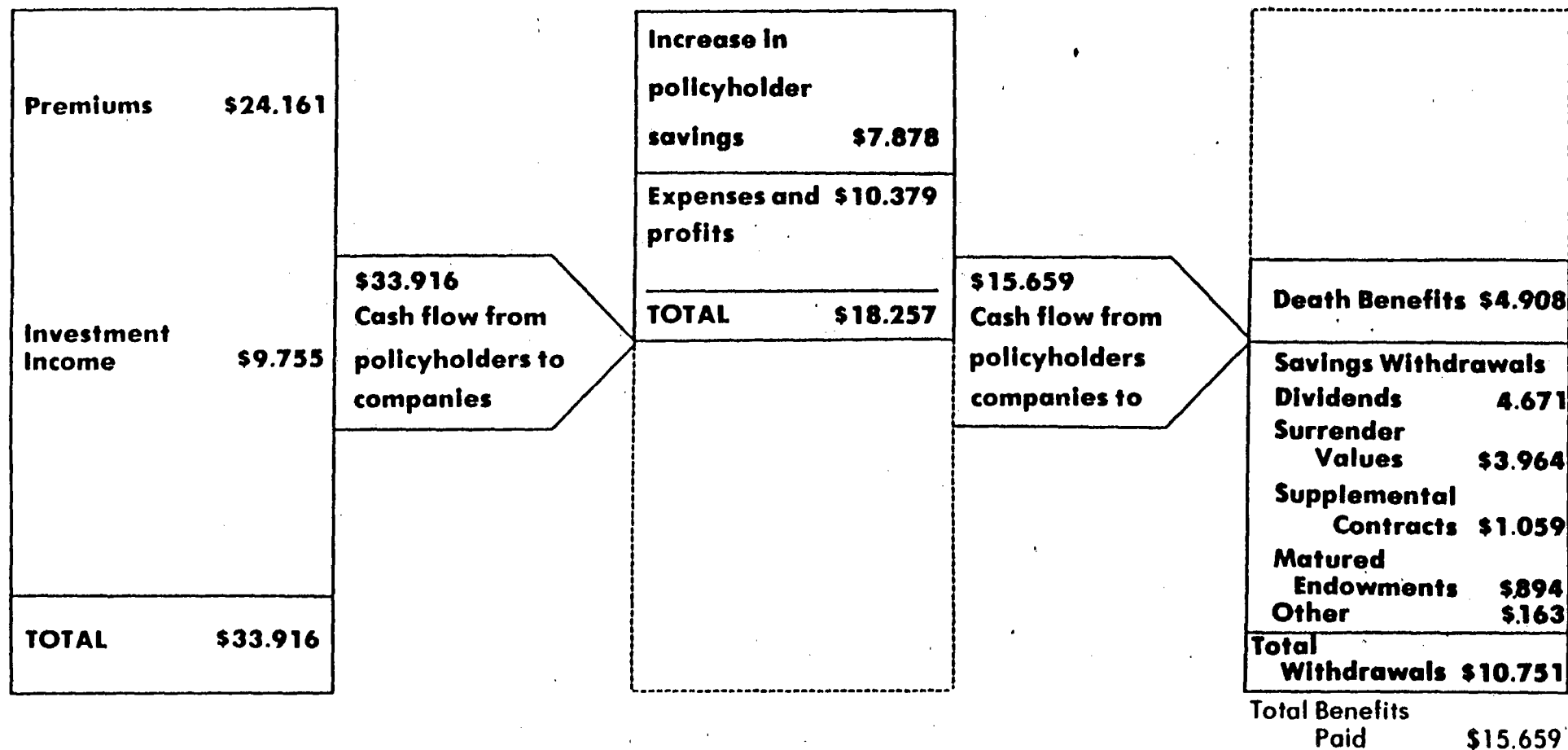
TABLE I - 1A

**TOTAL CASH FLOWS BETWEEN POLICYHOLDERS
AND LIFE INSURANCE COMPANIES IN 1977**
(Amounts in billions of dollars)

**AMOUNTS CONTRIBUTED BY
POLICYHOLDER**

**AMOUNT RETAINED BY
COMPANIES**

**AMOUNTS OF BENEFITS
PAID**



SOURCE: FEDERAL TRADE COMMISSION

*/ The source of the information in Table I - 1A is set forth in Appendix II.

TABLE I - 1B
**AVERAGE CASH FLOWS BETWEEN POLICY HOLDERS
 AND LIFE INSURANCE COMPANIES
 BY INSURED HOUSEHOLD IN 1977**

(Amounts in dollars)

**AMOUNTS CONTRIBUTED BY
 POLICY HOLDER**

Premiums	\$525
Investment Income	\$212
TOTAL	\$737

**\$737
 Cash flow from
 policyholders
 to companies**

**AMOUNT RETAINED BY
 COMPANIES**

Increase in policyholder savings	\$171
Expenses and Profit	\$226
TOTAL	\$397

**\$340
 Cash flow from
 companies to
 policyholders**

**AMOUNTS OF BENEFITS
 PAID**

Death Benefits	\$107
Savings Withdrawals	
Dividends	\$102
Surrender Values	\$85
Supplemental Contracts	\$23
Matured Endowments	\$19
Other	\$4
Total Withdrawals	\$233

**TOTAL BENEFITS
 PAID \$340**

These tables demonstrate that the life insurance industry is a major savings medium. We now turn to an examination of the average rate of return the life insurance industry pays ordinary policyholders. The life insurance industry, in return for the premiums it receives, both provides insurance protection and serves as a savings medium. By subtracting the portion of the total premium that goes to provide insurance protection it is possible to compute the average rate of return the insurance industry is paying on policyholders' savings. This rate is calculated in much the same way as the rate of return from any other savings medium such as a bank. The general formula for calculating rate of return is set forth below:

$$r = \frac{\text{savings at the end of the year}}{\text{savings at beginning of the year} + \text{deposits} - \text{withdrawals}} \quad -1$$

Using this formula, the average industrywide rate of return paid ordinary policyholders in 1977 can be calculated. Total consumer savings in ordinary life insurance were \$137.032 billion at the beginning of 1977 and \$140.910 billion at the end.³⁶ The withdrawals from savings were paid as dividends, surrender values, supplemental contracts, matured endowments and other miscellaneous benefits and totaled \$10.7 billion.³⁷ In 1977, \$24.161 billion was paid in premiums. Part of the total premiums can be allocated to the industry's cost of providing death protection and the remainder is the deposit added to existing savings.

36 See Appendix II.

37 See Table I-1A.

* The source of the information in Table I - 1B is set forth in Appendix II.

SOURCE: FEDERAL TRADE COMMISSION

To determine the size of the deposit it is necessary to estimate the portion of the premiums needed to provide death protection. This can be done simply by taking the cost of providing death protection (term insurance) to be some multiple of death benefits actually paid. For purposes of this calculation we used a multiplier of 1.5. That is, people pay \$1.50 in premiums to get back \$1.00 in death benefits.³⁸ Applying this 1.5 multiplier to all death benefits paid in 1977, the amount of premium dollars needed to provide death protection is \$7.364 billion:

Death benefits paid in 1977	\$4.909 billion
	<u>X 1.5</u>
Premiums needed to provide death protection	\$7.364 billion

The deposit to savings is the total premiums minus the cost of providing death protection or \$16.8 billion.

Total Premiums	\$24.161 billion
Cost of Pure Insurance	<u>7.364 billion</u>
Deposit to Savings	\$16.797 billion

Table I-3 illustrates the rate of return calculation for 1977 using the 1.5 ratio to estimate cost of providing death protection.

³⁸ A 1.5 multiplier is the same as a 66.6 percent loss ratio. This means that for each \$1.00 in premiums paid the company returns 66.6 cents in benefits. The industrywide ratio of benefits to premiums for all business in 1977 was 79 percent. Fact Book, supra, n. 8, at 62. The higher the loss ratio assumed, the lower the rate of return. The rate of return assuming different loss ratios is set forth in Table I-4, infra.

Table I-3

Rate of Return Paid by Life Insurance Companies to Ordinary
Policyholders in 1977³⁹

Savings at end of 1977	\$140.910 billion
Savings at end of 1976	\$133.032 billion
Deposit: Premiums	\$ 24.161 billion
less (1.5) X Death Benefits (4.908)	7.364 billion
	<u>\$ 16.797 billion</u>
Withdrawals: Dividends	\$ 4.671 billion
Surrender Values	3.964
Supplemental Contracts	1.059
Matured Endowments	.894
Other	.163
	<u>\$ 10.751 billion</u>
Deposit less withdrawals	\$ 6.046 billion

$$r = \frac{\text{Savings end of 1977}}{\text{Savings end of 1976 plus Deposit less Withdrawals}} - 1$$

$$= \frac{140.910}{133.032 + 6.046} - 1 = \frac{140.910}{139.078} - 1 = 1.013 - 1 \text{ or } r = 1.3 \text{ percent}$$

The industrywide rate of return depends upon the amount of the total premium dollars that are allocated to providing death protection. The dollars allocated to insurance depend upon the loss ratio assumed. Table I-4 shows the rate of return using both a 66.6 percent and other loss ratios for the years 1970, 1975 and 1977.

39. For the sources of these figures see Table I-1A, *supra* and Appendix II. The rates of return in Tables I-3 and I-4 do not take into account one of the important special features of cash value contracts, namely, the right to borrow against the cash value at a rate of interest specified in the policy. The calculations in the text are concerned with what the industry pays and treat policy loans as a separate transaction for reasons that are discussed in Appendix III. Nevertheless, the policy loan provision is of considerable value to those policyholders who can borrow funds at 5 or 6 percent, when their alternative would be at 10 or 12 percent. It is difficult to quantify this benefit since we have no information on the alternative rates of interest that the borrowers would have had to pay and because we would also have to reflect the value of the loss in insurance protection that occurs when a policy loan is made.

Table I-4

Rates of Return to Ordinary Policyholders in 1970, 1975
and 1977 Using Alternative Loss Ratios

<u>Year</u>	<u>Loss Ratios</u>		
	79% (1.2658)	66-2/3% (1.5)	60% (1.66)
1970	-1%	-0.15%	0.46%
1975	0.03%	0.86%	1.45%
1977	1.2%	1.3%	1.85%

Table I-4 shows that, depending upon the loss ratio assumed, the average rate of return paid to ordinary policyholders in 1977 ranged from 1.2 to 1.85 percent. No matter which loss ratio is assumed the rate of return is extraordinarily low, even considering that it is essentially tax-free. The extremely low industrywide rate of return reflects the consumer problems discussed in the next part of this report: low average rates of return paid on individual policies, great variability in the rates of return paid on policies, negative rates of return when early lapsation occurs, and extremely low rates of return paid to policyholders who purchased their policies many years ago when inflation and interest rates were much lower.

The industrywide rate of return can be used to estimate the total loss to consumers in 1977 from all of these problems. This is done by comparing the amount of savings that would have been available if the industry had paid a competitive tax-free rate of return on policyholder's savings rather than the approximately 1.3 percent it actually paid. A reasonable

tax-free rate of return in 1977 would have been at least 4 percent (see page 31, infra). If the life insurance industry had paid ordinary policyholders 4 percent interest, total savings would have amounted to (139.081×1.04) or \$144.644 billion instead of \$140.910, a difference of over \$3.7 billion in 1977 alone.⁴⁰

It is important to note that the available evidence does not indicate that life insurance companies are earning massive profits on the difference between their return on investments and what they pay policyholders. In 1977, life insurance companies earned an average of 6.9 percent on their investments before Federal taxes,⁴¹ while they paid approximately 1.3 percent to policyholders on funds invested with them. The large differential, however, does not necessarily result in excessive profits for the companies. The available evidence suggests that most of the differential is absorbed by high home office expenses, sales commissions to agents, and Federal and state taxes.⁴²

40 The difference in 1977 would be substantially greater if the industry had been paying 4 percent in earlier years as well, since the total savings at the beginning of the year would have been larger and the policyholder would have earned interest on the earlier paid interest.

41 Fact Book, supra, n. 8, at 61.

42 A recent study of the profitability of capital stock life insurance companies found that their rates of return on net worth were higher than that of other service industries, such as banking and real estate, but lower than for manufacturing and wholesale and retail trade. Since life insurance company profits are much more stable than profits in other businesses, the authors of the study also estimated rates of return adjusted for risk. Their tentative conclusion
(Footnote Continued)

It does not really matter to consumers who purchase cash value insurance whether the low average rate of return paid ordinary policyholders is due to excess profit of companies, high expenses, or the cost of supporting an extensive agency system. What is important is that in far too many instances consumers who use cash value insurance as a way to save receive a rate of return which is substantially below what is readily available in the marketplace. The next part of this report analyzes the consumer problems in life insurance from the perspective of the individual policyholder.

42 (Footnote Continued)

was that the risk adjusted rates of return for life insurance companies are high relative to other industries but not excessively so. See S. T. Pritchett and R. Wilder, "A Comparative Study of Stock Life Insurer Profitability: Implications for Workable Competition" (Preliminary Draft), prepared for the Huebner Foundation, Wharton School, University of Pennsylvania. A further discussion of the profitability of life insurance companies is contained in Appendix I.

II CONSUMER PROBLEMS IN LIFE INSURANCE

Our study of this industry discloses that American consumers are losing billions of dollars yearly as a result of ill-informed and inappropriate life insurance purchase decisions. The basic problem is that the life insurance market does not provide adequate and meaningful information for purchasers to make intelligent, reasoned decisions. In the last few years, significant developments--such as the NAIC model cost disclosure regulation proposal--have resulted from increased recognition of this problem. However despite these initial efforts, the lack of meaningful cost disclosure remains an acute problem.¹ As one commentator recently observed:

Inadequate financial disclosure is indeed a consumer problem. Americans carry more than \$2 trillion worth of life insurance. However, their ability to act responsibly and make informed decisions as purchasers is seriously impeded by sales pressure, confusing terminology, numerous rows of seemingly meaningless figures, and most of all, by the lack of solid, comprehensible

¹ See Subcommittee on Oversight and Investigations of the House Comm. on Interstate and Foreign Commerce, Report on Life Insurance Marketing and Cost Disclosure 95th Cong., 2d Sess. 3 (1978) [hereinafter cited as Moss Subcommittee Report]. As part of its findings and conclusions, the subcommittee stated:

[t]he solution proposed by the NAIC, while a step in the right direction, is not satisfactory. It contains a number of provisions that unnecessarily blunt its effect and omits altogether certain essential remedies. Id.

In subsequent sections of this report, we will present our analysis of the NAIC model regulation and suggest certain modifications to increase its effectiveness.

and comparable information. Often consumers do not even know which question to ask the agent to obtain the correct cost information; thus they become doubly frustrated. Simple requests for information are often met by condescending attitudes or misleading data.²

To indicate the magnitude of the problem created by the failure of the market to generate meaningful cost information, we reiterate that consumers paid \$24.2 billion in premiums for ordinary life insurance in 1977. A large percentage of these premium dollars were spent on whole life or cash value insurance. This type of insurance is often sold as a convenient way to combine insurance with a plan to save for retirement or other purposes. This dual function of the cash value contract is often stressed during the sales presentation and in industry advertisements.³ Indeed,

² Hearings on Life Insurance Marketing and Cost Disclosure Before the Subcomm. on Oversight and Investigations of the House Comm. on Interstate and Foreign Commerce, 95th Cong., 2d Sess. 542 (1978) (Statement of National Consumers League [hereinafter cited as Moss Subcommittee Hearings]).

³ A typical example is contained in a brochure prepared by Government Employees Life Insurance Company (GEICO), which states:

A whole life or endowment policy will guarantee to pay your family a regular monthly income or a cash sum, or both, if you die. And if you live, the cash values provide a nice "nest egg" you can use as a family emergency fund for your children's college tuition costs or for additional retirement income.

A similar theme is sounded in a recent brochure put out by the National Association of Life Underwriters (NALU):

Permanent forms of life insurance provide guaranteed protection you can't outlive. So your policy benefits are there if you die or, far more often, are there to supplement

(Footnote Continued)

it is the savings element of the cash value policy which is often extolled as the best way to provide funds for retirement. This position is stated with appropriate eloquence in one company's agent training manual:

[L]ife insurance guarantees safe and successful investment. The dollars men are saving to provide a future income for their families and themselves probably will have to go through three or four complete swings of the business cycle. What type of institution can best be trusted to handle those dollars? A study of the various fiduciary institutions leads to the conclusion that the best of all trustees to guard the sacred dollars set aside to provide future family and personal income is the institution of life insurance.⁴

While cash value insurance is often sold and purchased on the basis of its investment utility, the consumer is given virtually no meaningful information to compare the true costs of similar policies or compare the benefits of the cash value purchase with alternative forms of savings or investment. Due to this alarming dearth of information, the life insurance purchaser buys a protection and retirement savings plan on the faith that an agent will select an appropriate policy for his or her needs. As we demonstrate below this faith is often misplaced. Moreover,

³ (Footnote Continued)

other income and resources for your retirement years.

Moss Subcommittee Hearings, supra n. 2, at 766,759.

⁴ Occidental Life Insurance Company of California, An Introduction to Life Insurance (agents' training manual) 3-3 (1970).

the consumer is confronted by a market that has an industrywide rate of return of between 1 and 2 percent and is subject to extreme variations in costs that could result in the individual losing thousands of dollars in lost savings and unnecessary premium payments. The life insurance industry in its role as "the best of all trustees" pays in many instances an individual rate of return that is 4 to 5 percent below alternatives readily available in the marketplace. Millions of consumers who have entrusted their retirement savings to this industry will find that the 2 to 4 percent 20-year return on their cash value insurance policies will have been almost completely eroded by inflation.

As we noted at the outset, we believe that the central problem is a lack of adequate and meaningful information. In our view, this problem manifests itself in four significant ways:

- A. The rate of return consumers receive on the savings component of cash value insurance is often very low.
- B. Consumers lose substantial amounts of money through termination of cash value policies within the first few years of purchase.
- C. The costs of similar life insurance policies vary widely.
- D. Consumers receive a small amount of protection against premature death relative to the premiums they pay for private life insurance protection.

In this section we will discuss in detail each of these areas and the manner in which they impact on the individual consumer.

A. The Rate of Return Consumers Receive on the Savings Component of Cash Value Insurance Policies is Often Very Low

Consumers do not know the rate of return they will earn on the savings element of their whole life policies. This prevents comparison shopping with other types of savings or investments; the potential for consumer loss can be staggering. For example a person who invests \$1,000 each year at 3 percent, will have, at the end of 30 years, approximately \$46,000. One who invests the same amount at 6 percent will have \$80,000 at the end of 30 years. In many instances this is precisely the choice unknowingly faced by consumers..

The individual rate of return concept, used in this section, is similar to the holding period yield of a bond and provides a uniform means to compare alternative forms of savings and investments.⁵ In essence, it is the average annual rate of return on a particular policy if it is held for a given number of years.⁶ This calculation is based on the assumption that a cash value insurance product can be viewed as a combination of death protection and savings. To compute the average annual

⁵ For a discussion of bond yields, see S. Homer and M. Leibowitz Inside the Yield Book (1972). A more detailed, but more technical discussion can be found in Malkiel, The Term Structure of Interest Rates 40-49 (1966).

⁶ The rate of return on individual policies is conceptually distinct from the industrywide rate of return discussed in Part I. As noted there, the industrywide rates show the average rate of return in a particular year for all savings consumers have in ordinary life insurance, assuming a cost for the pure insurance coverage.

rate of return for an individual policy, it is necessary to determine the portion of the yearly premium that constitutes the "deposit" to the savings fund. This is done by subtracting the cost of insurance protection for that year from the premium (less any dividend); the remainder is the savings fund deposit.⁷ The rate of return, then, is the interest rate required to make these deposits, accumulated at interest, equal the cash value of the policy at the end of the period of years chosen for the computation.⁸

1. Many New Cash Value Policies Earn Relatively Low Rates of Return

Our analysis of individual policy rates of return is divided into two parts. The first part discusses the rates of return being offered to new policyholders in 1973 and 1977. The second part presents some evidence that the rates being offered to exist-

7 The amount of term insurance purchased each year for purposes of the rate of return calculation is determined in such a way that the sum of the term policy's death benefit and the amount accumulated in the savings fund equals the face amount of the policy. For example, if the savings fund amounted to \$10,000 after 10 years, and the face amount of the cash value policy was \$25,000, the amount of coverage which must be purchased is \$15,000. The cost of the term coverage in any year is the product of the term insurance premium rate for that year and the amount of protection needed.

8 This rate of return calculation is known as the "Linton Yield." It was developed by Mr. Albert Linton, a life insurance actuary, from 1927 to 1963. Mr. Linton was President of the Actuarial Society of America as well as President of Provident Mutual Life of Philadelphia. For a more technical description of the Linton Yield and the yearly renewable term rates used to calculate the Linton Yield in this report see Appendix VI.

ing policyholders are substantially lower than those being offered to new policy holders.

This section examines the rates of return on new policies issued in 1973 and 1977.⁹ It then compares these rates of return with the higher rates available in alternative savings media and shows the significance of the difference to the individual policyholder.

Table II-1 shows the average rate of return on various new policies issued in 1973 and 1977.¹⁰ It shows that the 5-year

⁹ In 1977, new policies accounted for \$4.8 billion of the \$24.2 billion paid in premiums. American Council of Life Insurance, Life Insurance Fact Book 59 (1978) [hereinafter cited as Fact Book].

¹⁰ Data for 1973 comes from information furnished by 197 life insurance companies to the Hart Antitrust and Monopoly Subcommittee. Each company submitted data on its three best selling policies. 349 of these policies were whole life and are represented in Tables II-1, II-7, and II-8. Sample sizes for various ages and sizes are as follows:

	<u>Participating</u>		
	\$10,000	\$25,000	\$100,000
25	116	141	138
35	120	145	142
45	120	145	142
55	118	143	140
	<u>Non-Participating</u>		
25	138	162	166
35	136	162	166
45	135	161	165
55	135	161	165

Data for 1977 comes from information furnished by 71 large life insurance companies to the Federal Trade Commission. Each company was asked to submit, among other things, data for its three best selling whole life policies. Sample sizes for various ages and sizes are as follows:

(Footnote Continued)

rates of return range from minus 9 to minus 19 percent, the 10-year rates are around 1 percent, and the 20-year rates range from 2 to 4.5 percent. The effects of negative rates in early policy years is discussed in Section II(B).¹¹ No matter what duration is looked at, the average rates of return appear low relative to market alternatives.

To place these 20-year rate of return figures in perspective, it is useful to compare these rates to alternative forms of savings

10 (Footnote Continued)

	<u>Participating</u>		
	\$10,000	\$25,000	\$100,000
25	77	88	95
35	104	119	128
45	74	85	92
55	74	85	91
	<u>Non-Participating</u>		
25	39	50	51
35	39	51	52
45	39	50	50
55	39	50	49

Some companies issued the same policy with two different policy loan interest rates, and dividends adjusted accordingly. These companies were asked to submit data for the rate under which the policy was most recently issued. In addition, they were asked to submit data for the other interest rate for issue age 35 only.

This explains the large sample size for participating policies, age 35. The 1977 data is in the process of being verified by the individual companies.

¹¹ There is a negative rate of return whenever the principal at the end of the period is less than the sum of the deposits.

and investments. Because the return on cash value insurance policies is generally tax free, a distinction is drawn between alternatives which are and are not subject to taxes.¹² Table II-2 shows the rate of return from both alternatives in 1973 and 1977. Alternative tax exempt investments range from 1 to 3 percent higher than the average 20-year rates for dividend and non-dividend-paying cash value policies. For returns that are taxable, the difference is between 4 and 6 percent.¹³

Table II-1

Average Rates of Return (Tax Free) on Whole Life Insurance Policies
1973 and 1977

Age at Issue	Face Amt of Policy	If Policy is Held For	1973		1977	
			Dividend Paying	Nondividend Paying	Dividend Paying	Nondividend Paying
25	\$ 10,000	5 years	-12.04	-17.97	-12.28	-19.78
		10 years	0.51	-0.99	1.93	-1.25
		20 years	3.71	2.40	4.61	2.34

12 The interest buildup in the savings element of cash value insurance is not subject to tax as it accrues. If a policy is cancelled and the cash value withdrawn, only the amount in excess of the total premiums paid is subject to federal income tax.

13 The tax advantages of savings through life insurance must be considered in comparing saving through insurance with other forms of savings. For most people, the after-tax return from the alternatives in Table II-2 are substantially greater than the yield from insurance policies. This is because very few consumers pay taxes at anything near the maximum rate. In 1975, the latest year for which data is available, only approximately 1 percent of federal tax returns were in a 50 percent or greater marginal tax bracket. In contrast, approximately 47 percent of all returns were in a marginal bracket of 19 percent or less and 83 percent were in a marginal rate of 25 percent or less. Internal Revenue Service, Statistics of Income, Individual Income Tax Returns 105 (1975).

	25,000	5 years	-11.73	-18.29	-11.99	-17.51
		10 years	-0.16	-1.54	1.25	-0.61
		20 years	3.28	2.14	4.21	2.71
	100,000	5 years	-12.59	-18.42	-12.25	-16.81
		10 years	-0.67	-1.78	0.96	-0.38
		20 years	3.04	2.03	4.09	2.83
35	10,000	5 years	-9.73	-13.35	-8.43	-14.31
		10 years	0.33	-1.03	1.74	-1.25
		20 years	3.33	1.98	4.32	1.91
	25,000	5 years	-9.39	-13.22	-8.36	-11.96
		10 years	-0.04	-1.20	1.43	-0.26
		20 years	3.09	1.91	4.12	2.47
	100,000	5 years	-9.99	-13.24	-8.53	-11.28
		10 years	-0.38	-1.30	1.28	-0.05
		20 years	2.93	1.87	4.06	2.64
45	10,000	5 years	-10.04	-13.28	-9.84	-14.11
		10 years	-0.66	-2.24	0.63	-2.48
		20 years	2.58	1.06	3.56	0.94
	25,000	5 years	-9.48	-12.84	-9.13	-11.65
		10 years	-0.77	-2.16	0.68	-1.34
		20 years	2.49	1.12	3.57	1.60
	100,000	5 years	-9.90	-12.75	-9.08	-10.88
		10 years	-1.00	-2.17	0.62	-0.96
		20 years	2.40	1.14	3.57	1.82

Table II-2

Rates Payable on Time and Savings Deposits and Bond Yields
1973 and 1977

Tax Exempt

Subject to Tax

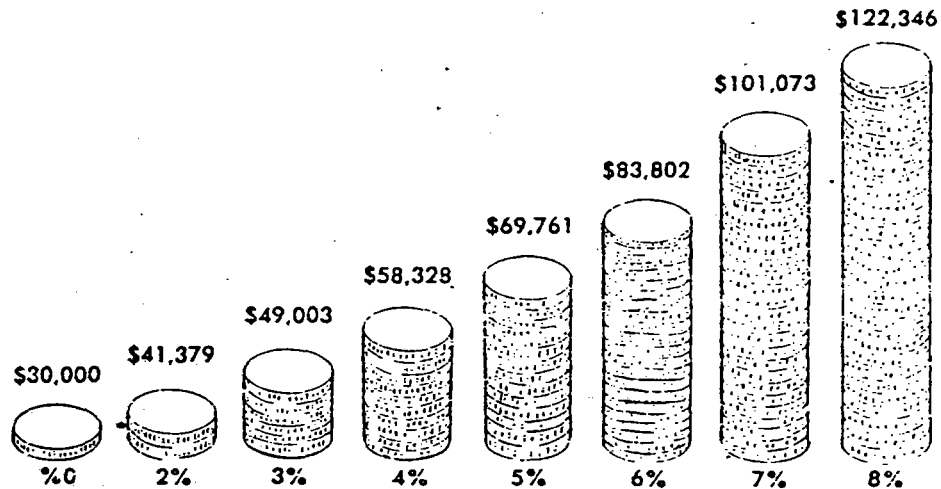
	<u>1973</u>	<u>1977</u>	Savings and Loan Associations ¹⁴ (1973 and 1977)		
High Grade Municipals	5.18%	5.56%	Savings deposit 5.25%		
			Time deposits		
(Standard and Poors)			1 to 2 years	6.50%	
State and Local Govt. Bonds (Aaa)	4.99	5.20	2-1/2 to 4 years	6.75%	
			4 to 6 years	7.50%	
			6 to 8 years	7.75%	
State and Local Govt. Bonds (Baa)	5.47	6.12	U. S. Treasury Bonds		
				<u>1973</u>	<u>1977</u>
			5 year	6.87%	6.99%
			10 year	6.84	7.42
			20 year	7.12	7.67
			Corporate Bonds		
			Aaa	7.44%	8.02%
			Baa	8.24	8.97
			By Years to Maturity		
			5 year	6.88%	7.25%
			10 year	7.05	7.60
			20 year	7.20	7.75

Consumers who purchase a low-yield cash value policy stand to lose a considerable amount of money over the life of the policy. A difference in a rate of return of even 1 percent when compounded over a long period of time is extremely significant. Table II-3 shows the before-tax value at the end of 30 years (which can be the duration of a whole life policy) of \$1,000 deposited each year in a bank account at various interest rates.

¹⁴ These are technically the maximum interest rates payable, but almost all S&L's were paying the maximum rates in both 1973 and 1977. These rates went into effect in July 1973, so they only applied to a portion of that year.

Table II-3

**\$1000 PER YEAR INVESTMENT
OVER 30-YEAR PERIOD (Compounded)**



This table demonstrates that the rate of return is critical whenever a person is contemplating saving over a long period of time such as for retirement.

The importance of rate of return for a person buying a \$25,000 whole life policy can be illustrated by comparing the purchase of a whole life policy with a 20-year yield of 2 percent to buying term insurance and investing the difference between the term and whole life premium at 5 percent. The amount expended for each plan is the annual premium for the whole life policy (\$545) less the illustrated dividends for that year. Both plans require the same expenditure each year and will provide the insured's beneficiaries \$25,000 if death occurs before the 20th policy year.¹⁵ The difference between the two plans is between the amount in the side or savings fund and the cash value of

¹⁵

Under the term and invest the difference plan, the amount that is deposited in the side fund each year is the net premium payment less the amount of money needed to purchase term insurance. The amount of money needed to buy term insurance (term expenditure) is determined by multiplying the cost of term insurance per \$1,000 for the given year by the number of thousands needed.

the whole life policy.

Table II-4 compares these two plans. After 5 years the difference between the savings fund and the cash value is more than \$1,350. The difference increases every year and at the end of 20 years is more than \$4,000.

Table II-4

"Buying Term and Investing the Difference" at 5 Percent,
Compared With a \$25,000 Whole Life Policy--1973

Policy Size (face amount): \$25,000

Premium Rate Per \$1,000 of Face Amount: - \$21.82

Total Premium: \$545.50

Annual Rates of Return: 5 Years - 17.9 Percent
10 Years - 3.4 Percent
20 Years + 2.16 Percent

Issue Age 35

Interest Rate on Savings: 5.00 Percent

Year	Net Premium Payment	Term Insurance Protection	Term Rate Per \$1,000	Term Expenditure	Savings Deposit	Side Savings Fund	Whole Life Cash Value
1	545.50	24,517.62	2.57	63.12	482.38	506.50	0.0
2	545.50	24,013.93	2.75	65.93	479.57	1,035.37	35.25
3	510.25	23,525.00	3.00	70.62	439.63	1,548.75	440.50
4	505.00	23,018.85	3.15	72.60	432.40	2,080.21	845.75
5	499.75	22,494.41	3.31	74.37	425.38	2,630.87	1,276.00
6	494.50	21,951.79	3.51	77.16	417.34	3,200.62	1,706.25
7	489.25	21,391.22	3.79	81.08	408.17	3,789.22	2,136.50
8	484.00	20,811.00	4.05	84.22	399.78	4,398.45	2,566.75
9	478.75	20,210.93	4.35	88.13	390.62	5,028.53	3,024.25
10	471.25	19,592.92	4.73	92.69	378.56	5,677.44	3,481.75
11	463.75	18,955.52	5.10	96.70	367.05	6,346.71	4,001.25
12	444.25	18,311.85	5.61	102.81	341.44	7,022.55	4,520.75
13	424.75	17,661.25	6.15	108.55	316.20	7,705.69	5,040.25
14	405.25	17,002.78	6.69	113.71	291.54	8,397.08	5,559.75
15	385.75	16,336.83	7.32	119.66	226.09	9,096.33	6,104.25
16	366.25	15,660.15	7.84	122.74	243.51	9,806.84	6,637.25
17	358.25	14,959.98	8.36	125.07	233.18	10,542.02	7,171.00
18	349.50	14,236.83	9.02	128.35	221.15	11,301.33	7,729.75
19	340.75	13,489.66	9.77	131.74	209.01	12,085.86	8,263.50
20	332.00	12,715.99	10.53	133.85	198.15	12,898.21	8,822.25

This example is not intended to show that term insurance plus a side fund is a better buy than whole life insurance. The comparison is between a 2 percent and a 5 percent rate of return. Similar results could be obtained by comparing a whole life policy that has a 20-year return of 5 percent to one that has a return of 2 percent. See Table II-9, infra.

We want to emphasize that we are not opposed to saving through life insurance. There are some policies available offering 20-year rates of return that are competitive with other savings media (see Tables II-7, II-8, infra). Moreover, there are reasons for saving through insurance: it is convenient, many people like the forced saving aspect, and there are definite tax advantages. There are also certain attractive features of a whole life policy which cannot be duplicated in term insurance plus a side investment.¹⁶ These reasons could well support a decision to purchase a whole life policy whose rate of return is lower than that which is available elsewhere. However, these advantages must be weighed against the extremely low rates of return that are paid on many whole life policies. Only if consumers are told

¹⁶ In addition to tax advantages, these include the ability to use the cash value of the whole life policy to purchase paid-up insurance benefits, guarantees with respect to annuity purchase rights, and the ability to use the cash value as collateral for a relatively low-cost loan. Further, a bank or S&L cannot provide the long term investment guarantees of whole life policies, and there is no counterpart in alternative investments to the waiver of premium in the event of disability. See discussion, pages 118-119, infra.

what rate of return they will earn on savings deposited with insurance companies will they be able to make an informed judgment whether to save through cash value insurance or through some other savings medium.

2. Substantially Lower Rates of Return Are Being Paid on Older Whole Life Policies; Especially Non-Participating Policies

The previous section showed that the rate of return on cash value insurance policies is often extremely low compared to alternatives in the marketplace. This section documents the problem that existing whole life policyholders often earn significantly lower rates of return than the rates paid on new policies. It explains the special plight of holders of old non-dividend-paying policies, and considers the potential dollar loss they suffer and possible solutions to the problem.

The magnitude of the problem facing existing policyholders can be demonstrated by comparing the 1977 industrywide rate of return to the 20-year rate of return on new policies. As seen in the previous section, the average 20-year rate of return on new policies ranged from about 2 to 4 percent in 1973 and from about 2 to 5 percent in 1977.¹⁷ In comparison, the industrywide average rate of return for 1977 was approximately 1.3 percent.¹⁸ The extraordinarily low rate of return earned by many policies sold in the 1950's and early 1960's is one reason for the disparity

17 See pages 29-30, supra.

18 See pages 17-18, supra.

between the industrywide average rate of return and the new policy rate of return. In effect, old low-yielding policies bring down the industrywide average.¹⁹

The low rates of return on existing policies issued in the 1950's and early 1960's reflect the low interest and inflation rates existing at the time the policies were sold. For example, in 1960 the average corporate bond (Aaa) yield was 4.41 percent, saving deposits in banks paid 3.52 percent, and the rate of inflation was approximately 1.6 percent.²⁰ Over the past few years there have been dramatic changes in both the rate of inflation and the rate of return available from investments. These changes have had profound consequences on persons who purchased whole life insurance in the late 1950's and early 1960's. The problems facing whole life policyholders, especially those with old low-yield non-dividend-paying policies, in this age of inflation have not gone unnoticed. For example,

¹⁹ The other main reason for the disparity is the effect of early lapse of cash value policies. See pages 47-50, infra.

The impact of the low rates of return earned on many existing policies can also be seen by comparing the 1970 industrywide rate of return (-.15%) with the 1977 figure (1.3%). The 1970 average reflects the very low rate of return paid on many older policies. In part, the 1.5 percent rise in the industrywide rate of return over this period is due to the somewhat higher rate of return being paid on policies issued since 1970.

²⁰ 1971 Business Statistics, Dept. of Commerce, Office of Business Economics at 105 (bond yield); National Association of Mutual Savings Banks, Annual Fact Book, 23 F at Table 35 (1961) (Savings bank rate); Economic Report of the President 220 (1976) (inflation rate).

Mr. James Anderson, a consulting actuary, recently stated:

Consider the case of a 25-year-old buyer with a young family and a current annual income of \$10,000. With an annual productivity gain of 2% and no inflation, he might expect an equivalent income at age 55 of \$18,000. If however, inflation is assumed to continue throughout the 30-year period at a rate of only 5 percent, his nominal annual income at age 55 would be \$78,000. If this buyer purchased a \$10,000 policy at age 25, its value in constant dollars would be only \$2,300 30 years later. I do not believe that fixed premium, fixed benefit, permanent, cash value life insurance has any relevance to this potential buyer's financial requirements over 30 years, considering only the consequences of inflation. I believe that most actuaries would agree that the assumptions underlying the illustration are quite modest and that even more radical changes in the financial circumstances of such an individual are more likely to occur than not.²¹

Hardest hit by inflation are consumers who purchased non-participating whole life policies during the 1950's and early 1960's. Non-participating cash value insurance policies are a low-yield, fixed-dollar saving medium, uniquely unsuited to cope with accelerating inflation.²²

The problem of the old non-participating policyholder is

²¹ Anderson, "Is the Life Insurance Business in its Terminal Stages?" Best's Review 10, 12 (July, 1977).

²² Participating policyholders have had some measure of relief. Over the past twenty years, the dividends actually paid on most participating policies have been higher than those illustrated when the policies were sold. See, e.g., "20-Year Dividend Comparisons," Best's Review 36-41 (December 1977). Thus, some of the increased earnings of the companies resulting from higher interest rates have been passed on to policyholders and the impact of inflation has been somewhat diminished.

vividly illustrated by the actual case of a man who purchased a typical \$50,000 non-participating policy in 1960 when he was 20 years old.²³ The rates of return on this policy are shown below:

<u>Years Held</u>	<u>Rate of Return</u>
5	- 17.0%
10	-1.1%
15	1.23%
20	1.96%
30	2.11%

In 1975, when he was 35 years old, his policy had a cash value of \$8,450, reflecting a 1.23 percent rate of return. Even at the 1960 inflation rate (1.6 percent), his policy would not have kept pace with inflation. The heightened inflation during the policy's first 15 years has severely eroded its real value. The cash value of \$8,450 in 1975 dollars is equivalent to only \$4,650 in 1960 dollars. Thus, unanticipated inflation has wiped out almost \$4,000 of the savings accumulation. If he had earned 5 percent from 1960 to 1975, his savings fund would have surpassed \$11,000 and the ravages of inflation would have been at least partially mitigated.

If the policyholder continues to hold this policy, he continues

²³ This case of an actual policyholder was discussed by Professor Joseph Belth in the Insurance Forum, February 1976. Professor Belth supplied the FTC staff with sufficient data to perform the calculations shown in Table II-5, *infra*. The policy in question was purchased from the Traveler's Insurance Co., the third largest stock company in the United States. Stock companies sell virtually all of the non-dividend-paying policies being offered on the market. Traveler's is the eighth largest life insurance company in the United States ranked by assets. Fortune Double 500 Directory 60 (1978).

to lose. The extent of his loss can be seen by comparing what would happen over 30 years if he surrendered his policy in 1975 when he was 35 years old and bought term insurance and invested the difference at 5 percent (after taxes).²⁴ For purposes of this comparison it is assumed that he deposits the \$8,450 surrender value in a savings account and continues to spend \$627.50 annually. The difference between the whole life premium he had been paying and the term premiums now used to buy an equivalent amount of death protection is deposited in the savings account. He will continue to guarantee his beneficiary \$50,000 if he should die by buying an amount of term insurance which together with the balance in savings equals \$50,000.

Table II-5 shows his relative position at 5-year intervals under both approaches for 30 years. Three points about Table II-5 bear emphasis. First, the policyholder can stop buying any term insurance at age 59, since at that age the savings fund alone is greater than \$50,000. Second, while his existing policy accumulates a cash value of \$36,300 at age 65, the alternative plan builds a saving fund of \$75,813, a difference of almost \$40,000. Lastly, the policyholder could do equally well by surrendering his existing policy and buying a cash value insurance policy with a 5 percent rate of return.

²⁴ This example assumes the policyholder is in good health and could qualify as a standard risk to buy the needed term insurance.

Table II-525

A Comparison Between Retaining a Non-dividend-paying Policy Purchased in 1960 at Age 20, and Surrendering the Policy in 1975 and Buying Term and Investing the Difference at 5 Percent (after taxes)

<u>Age</u>	<u>Cash Outlay</u>	<u>Amt of Term Insurance Purchased</u>	<u>Term Rate Per \$1,000</u>	<u>Savings Fund</u>	<u>Cash Value If Existing Policy Is Maintained</u>
35	\$627.50	\$41,028	\$ 2.57	\$ 9,410	\$ 9,250
40	627.50	35,737	3.51	14,976	13,350
45	627.50	29,098	5.10	21,947	17,400
50	627.50	20,744	7.84	30,719	21,750
55	627.50	9,967	11.30	42,035	26,450
58	627.50	1,871	14.38	50,535	29,400
60	627.50	0	--	57,066	31,450
65	627.50	0	--	75,813	36,300

The relative attractiveness of non-participating and participating insurance has been fundamentally changed by inflation. When rates of interest and inflation were lower, the difference in value between these two types of insurance was not great. The premiums for participating policies were generally higher, but a portion of the higher premium was returned to the policyholder in the form of dividends. If the company's actual dividends (which are determined to an extent by the company's mortality experience and investment income) exceeded the assumptions used in calculating illustrated dividends, then the policyholder would often be better off in the long run buying participating insurance. On the other hand, non-participating policies offered rela-

25 The existing policy is a life paid up at 65 (no premiums after age 65), purchased at age 20.

Face Amount - \$50,000
 Premium - \$627.50 per year
 Dividends - none

tively more security because all of the values in the contract were guaranteed no matter what happened to economic conditions. When banks were paying 3-4 percent on deposits and the rate of inflation was 1-2 percent, a guarantee of 2-2.5 percent may have been important. In that situation one gave up relatively little in return for certainty. A fundamentally different situation is presented, however, when tax-free returns of 5-6 percent are readily available in the marketplace and the rate of inflation is between 7-10 percent. In this case the non-par policyholder gives up a great deal for a guaranteed 2 percent rate of return. Table II-6 demonstrates why. It shows the value of \$1,000 a year invested each year for 20 years at different interest rates.

Table II-6

<u>Rate of Interest</u>	<u>Amount Accumulated</u>
1%	\$22,239
2%	24,783
3%	27,676
4%	30,969
5%	34,719
6%	38,993

Consider the person who deposits an average of \$1,000 a year in the savings element of a non-participating contract that has a 20-year rate of return of 2 percent. If for some reason interest rates plummet to 1 percent over the next 20 years, then the 2 percent guarantee will have been worth approximately \$1,500 -- the difference between the return at 1 percent (\$22,239) and 2 percent (\$24,783). If, on the other hand, current conditions continue and a person is able to earn an average of 5 percent after taxes, he would have \$34,719 at the end of 20 years--a difference of

almost \$10,000 over the 2 percent return. It is difficult for a non-par company to offer a competitive rate of return because of the need to guarantee this rate for 30 to 40 years. The rate offered must of necessity be very conservative which in part accounts for the fact that the 20-year rate of return on non-participating policies issued in 1977 averages between 2 and 2.5 percent.²⁶

Very serious problems currently exist in the non-participating segment of the life insurance industry. The example of the holder of the 1960 non-par policy, discussed above, indicates that a great

²⁶ Mr. E. J. Moorhead, writing in Best's Review, points out the problem facing the actuary in attempting to develop a competitive non-par product:

[A]ctuaries attempting to calculate nonpar premiums that will be competitive with illustrated prices of participating policies are faced with a problem that has no satisfactory solution. The actuary, concerned as he must be with company solvency and prosperity, dares not assume in his calculations that high investment yields will continue for many future years even though he usually is personally convinced that continuing inflation will produce that result. Hence, he calculates nonpar premiums by allowing for high interest rates in the early years (when it really makes little difference what interest rate he assumes); and he grades the assumed interest rate downward in later policy years (when the policy reserve will have reached a size that makes even small interest rate differences of material consequence). In the past several years during which this observer has been publicly pointing this out, no actuary experienced in nonpar premium calculation has risen to dispute its validity.

Moorhead, "Doomsday Just Ahead for Life Insurance? Not Necessarily!" Best's Review, 10, 12 (August, 1977). [hereinafter cited as Moorhead]

many policyholders similarly situated would be well advised to surrender their old policies and purchase new participating or term policies. Further, the extraordinarily low rates of return on many non-participating policies issued in 1973 and 1977 (see pages 29-30, supra) indicates that millions of consumers may be currently locking themselves into a low-yield, fixed-dollar saving vehicle which is highly vulnerable to inflation.²⁷ The challenge facing the industry was succinctly stated by Mr. E. J. Moorhead:

[I]f interest rates stay up, companies with non-par policies on the books will be in the same untenable position that many of them are today; their informed policyholders still in good health will drop their policies to replace them by new participating policies or by term policies; only their ignorant or impaired-in-health (or lazy) policyholders will keep their policies.

* * *

Each--the industry and government-- has part of the task to do, but in neither case is it self-evident that the task will be performed with enough speed and effectiveness to maintain public confidence in cash value life insurance.

The industry will have to improve its record of initiating and supporting constructive change even when the points at issue are thorny and controversial ... State insurance departments too will have to show clear success in taking care of matters that only they can cope with, i.e., failures of elements of the industry to put policyholder well-being ahead of marketing considerations

²⁷ In 1975, some 34 percent of the 12.5 million ordinary cash value policies that were sold were non-participating. LIMRA, 1975 Buyer Study 6, 14.

and profit margins.²⁸

In Part IV of this report we recommend a system of life insurance cost disclosure as a solution to many of the consumer problems in the life insurance industry. Cost disclosure alone will not solve the problems created by the sale of non-participating insurance, especially the problems facing the holders of old policies. If non-participating cash value insurance is to warrant public confidence, two things must be done. First, action must be taken on the part of non-par companies to alleviate the problems facing older non-par policyholders. This can be accomplished by companies unilaterally either reducing the premiums on these policies or increasing cash values or death benefits. It is not a germane response to say that these policyholders are not entitled to relief because they did not anticipate rising inflation and interest rates and therefore should be stuck with their mistakes. If companies do not improve the quality of existing non-par policies, consumers do have a choice -- they can replace the policies.

We want to stress that we are not recommending the wholesale replacement of cash value insurance policies. If a person has purchased an attractively priced policy that has an adequate yield, replacement in many instances will be harmful. This is because the person will again have to pay a heavy front-end load.²⁹ Moreover, a person considering replacement has to be

²⁸ Moorhead, supra n. 26, at 12, 13.

²⁹ The 5-year return on whole life policies is strongly negative, see pages 29-30, supra. However, in many instances
(Footnote Continued)

very careful to insure that the policy substituted for the existing policy is competitively priced. Unfortunately, in many instances this is not the case.³⁰ Nevertheless, as we have shown, consumers can often save considerable amounts of money by replacing old non-participating policies. In many cases they should do so unless the industry takes some action to improve the quality of these policies.

Second, the quality of non-participating policies currently being issued must be substantially improved. In 1977, the average 20-year rate of return on \$25,000 non-participating policies was approximately 2.5 percent. Well over one-half of these policies had a 20-year rate of return of less than 3 percent. (See Table II-8, infra). With current rates of interest and inflation it is difficult to see any reason for consumers to put money into a long-term, fixed-dollar contract that has a 20-year yield

29 (Footnote Continued)

after a policy has been held for 5 years the initial loss has been taken and the policy has a good rate of return if held from years 5 through 20. This is especially likely to be the case if the policy is attractively priced. For such policies, replacement is rarely desirable. Further, there may be other disadvantages to replacement, such as being subject to a new contestability period, that should be considered before replacement.

30 For example, whole life policies are often replaced with deposit term insurance, see Skipper, "An Analysis of Deposit Term Life Insurance," Best's Review, 10 (August, 1978). There is an enormous variation in the quality of deposit term products on the market. See pages 108-109, infra. Substantial consumer injury can result if a low cost (high-yield) whole life policy is replaced with a high cost (low-yield) deposit term policy.

of less than 3 percent.

It may well be that the problems facing the non-par actuary of guaranteeing a competitive rate of return for 30 to 40 years are insoluble. If this is true, then the challenge facing stock insurance companies is to come up with new products that are better suited to cope with inflation. One promising development is the recent introduction by some stock companies of what are known as "combination policies." These are policies that combine term insurance with a flexible premium deferred annuity. These policies are very similar to participating cash value insurance.³¹ Death protection is provided through term insurance. The savings build-up takes place in the annuity which often offers a competitive rate of return.³² We are confident that the industry can develop other alternatives to the traditional non-par whole life

³¹ Deferred annuities do not share all of the tax advantages of participating insurance. In deferred annuities, like whole life insurance, the interest buildup is not taxed as it accrues. Unlike whole life insurance, however, if the person dies, income tax on the accrued interest must be paid. Compare IRC § 101(a)(1) [life insurance] with IRC § 72(a)(b) [annuities]. One effect of the different tax treatment between life insurance and annuities is to restrict the development of alternatives to the traditional whole life contract. Serious consideration must be given to whether this different treatment is warranted.

³² There is very little difference in the rate of return on annuities sold by stock and mutual companies. See Greene, Neter, and Tenney, "Annuity Rents and Rates--Guaranteed vs. Current." 44 J. Risk & Insurance 383 (1977). Most annuities have a guaranteed rate of interest of between 3 and 4 percent and a current rate of interest which is substantially higher. Although the current rate of interest is not guaranteed, it is related to what the company is earning and thus will reflect to a considerable degree the rate of return available from alternative investments in the marketplace.

policy that are relevant to the needs of consumers in today's economy.

B. Consumers Lose Substantial Amounts of Money Through Termination of Whole Life Policies Within the First Few Years of Coverage

Purchasers of whole life insurance frequently do not realize the severe economic consequences that result from allowing a cash value policy to lapse within the first ten years. For example, a 35-year old person who spends \$20 per \$1000 of the face value amount for a whole life policy (when he could have purchased term insurance for less than \$5 per \$1000) has used 75 percent of the premium to make a "savings deposit" with the life insurance company. If the policy is canceled or lapsed during the first year, it will, in most cases, result in loss of this entire "savings deposit." Thus, the customer has, as the Moss Subcommittee observed, ". . . in essence, purchased one year of extremely expensive term insurance."³³ This is precisely what occurs in approximately 20 percent of all new ordinary life policy purchases within the first two years.³⁴ The aggregate

³³ Moss Subcommittee Report, supra n. 1, at 17-18.

³⁴ In 1977, the average lapse rate for policies in force less than 2 years was 19.5 percent. Fact Book, supra n. 9, at 55. The lapse rates for many individual companies are much higher. The Hart Subcommittee on Antitrust and Monopoly, in its investigation of the life insurance industry, collected extensive data on lapses by company. A review of this data led Senator Hart to conclude, ". . . average industry figures for all policies do not sufficiently indicate just how high early lapse rates are. A better indicator is the 13-month lapse rate of the biggest selling cash value policy of each company. For instance, of 148 companies surveyed by the subcommittee, one out of four policyholders

(Footnote Continued)

consumer losses due to first year lapsation alone exceeded \$200 million in 1977.³⁵

34 (Footnote Continued)

of 64 companies dropped the best selling policy within 13 months after buying it in 1971. Fifteen of these companies had unbelievable high early lapse rates ranging from 40 to 50 percent." 121 Cong. Rec. 21476 (1975), S 11976 remarks by Senator Hart on the occasion of his introduction of the Consumer Information and Fairness Act.

35 The details of this calculation are set forth in Appendix V. We note that the draconian consequences flowing from early lapse of whole life insurance have been recognized as a serious problem in this industry for over 100 years. In 1872, the Massachusetts Insurance Commissioner in speaking to the National Insurance Convention noted the growing difficulties created by lapsation and recommended that "some measures should be adopted to prevent this wholesale slaughter of policies of life insurance." Official Report of the Proceedings of the National Insurance Convention, (New York, 1872) at 161 (Reprinted in Moss Subcommittee Hearings, supra n. 2, at 706,709). A similar call for action was issued in 1915 by the West Virginia insurance commissioner in an address to the National Convention of Insurance Commissioners:

Instead of agency service they [policyholders] too often receive high pressure methods, in which the needs of the insurer and his ability to continue are given slight consideration. This is evidenced by the amount of business lapsing in the first and second years.

* * *

Are the companies in the mad rush for new business giving too little attention to that already on their books? There is an enormous wastage here, and it can be materially reduced. I submit that this problem is worthy of the best thought of those responsible for conditions in the field of life insurance. There is no more important question before them today.

Reprinted in Moss Subcommittee Hearings, id. at 704-705.

The reason for the severe economic consequences of early lapse is the manner in which cash values accumulate. As noted previously, cash values build up very slowly during the early years of the policy. To a significant extent, this is due to heavy sales and administrative expenses levied against the first year premium which is commonly referred to as the "front-end load." This initial premium payment is normally used to pay the agent's first year commission (which is usually at least half of the first year's premium) and other administrative costs.³⁶ Consequently, most whole life policies do not have any cash value in the first year and have a fairly low accumulation during the remaining early years of the policy. Indeed, as Table II-1 demonstrates, the annual rate of return on whole life policies averages approximately minus 10 percent if the policy is surrendered after 5 years and between minus and plus 1 percent after 10 years. A negative rate of return means that the amount of money at the end of the period is less than the sum of the deposits.³⁷

36 Moss Subcommittee Report, supra n. 1, at 17.

37 While other types of savings such as savings and loan certificates of deposit and U.S. Government Series E bonds have penalties for early withdrawals, they are not nearly as severe as the life insurance penalties. For example, the penalty on an 8-year certificate of deposit is forfeiture of 3 months' interest and credit for the remaining months at the passbook rate of 5 1/4 percent. Thus, if an 8-year certificate of deposit with a 7 3/4 percent interest rate is surrendered after 5 years, it would yield about 4 1/2 percent instead of the full 7 3/4 percent. In no case except life insurance is the penalty severe enough to result in a negative rate of return. Moreover, in all advertise-
(Footnote Continued)

In view of these facts, whole life insurance is rarely a desirable purchase unless held for substantially more than 10 years. Yet for every 1000 whole life policies that are sold, approximately 450 lapse by the end of the 10th year resulting in economic loss for the policyholder.³⁸

C. The Cost of Similar Life Insurance Policies Varies Widely

Section IIA, supra, demonstrates that the average rates of return on cash value policies are often low compared to those available in alternative savings media. This fact indicates that there is little price competition between the life insurance industry and alternative savings media. This section considers additional evidence of weak competition and attendant consumer injury within the life insurance market--the extreme cost variation among similar policies around those low average rates of return. Undue cost dispersion also means that the

37 (Footnote Continued)

ments and promotional material, savings and loans must disclose to the consumer the nature and amount of these penalties for early withdrawal. 12 C.F.R. 526.6(e) (1978).

38 See Moss Subcommittee Hearings, supra n. 2, at 775. In the previous section, it was shown that the industrywide rate of return for 1977 was substantially lower than the 20-year rate of return on new policies issued in that year. One of the important factors that explains this difference in rates of return is the effect on the overall industry rate of lapse. Besides those who keep their policies for 20 years, the average industrywide rate of return reflects the 20 percent of all policyholders who lapse in the first year and generally earn a minus 100-percent return, and the approximately one half of all policyholders who lapse within the first ten years of the policy and usually earn a negative rate of return.

injury caused by low rate of return falls unequally on life insurance purchasers. In many cases, those consumers who least understand and are least able to judge the costs of whole life policies are most likely to buy the most expensive policies. (Part III discusses the relationship between the lack of meaningful cost information and increased dispersion and low average rates of return).

The existence of extreme cost variation among similar policies is strong evidence of the lack of effective price competition. In an efficiently functioning competitive market the prices of very similar products will tend toward uniformity.³⁹ This section shows that life insurance costs are much more widely dispersed than the costs of a variety of other products. It also shows that there is little relationship between the cost of a life insurance policy and its market share. If there is effective price competition, to the extent prices do vary, the lower cost products should win larger shares of total sales.

1. Evidence of Cost Dispersion Among Similar Policies

Various studies conducted over the past ten years have documented the extreme variation in the costs of similar life insurance policies. Professor Joseph Belth, the Society of Actuaries, and others have "shown conclusively . . . that costs vary over a wide range."⁴⁰ As a result of this wide variation

³⁹ See Mansfield, Microeconomics 222-226 (1970).

⁴⁰ See Moss Subcommittee Report, supra n. 1, at 34 and studies cited therein. The term "costs" does not simply mean premiums, (Footnote Continued)

for similar policies, consumers often spend more than they need to for the insurance they buy. For example, consumers can save as much as \$4,700 over a 20 year period by buying a low rather than a high cost \$25,000 whole life policy. (See pages 55-56, infra.)

An American Council of Life Insurance (ACLI) study attests to this cost variation and what it can mean to unfortunate consumers who buy the most expensive policies. Although the ACLI, in testimony before the Moss Subcommittee, contended that the cost variations for similar policies were insubstantial,⁴¹ the data submitted in support of this conclusion ironically demonstrate the impact of the problem for the average consumer.⁴² The ACLI stated that

40 (Footnote Continued)

but rather an index measure which takes into account cash values and dividends, as well as premiums and the value of money over time. See page 127, infra.

41 In its statement, ACLI observed, "[t]he dispersion . . . [of rates in its sample] . . . is small enough to suggest that it is difficult to sell life insurance where the premiums or interest adjusted cost indexes for similar competing products differ drastically from the average." Statement of Julius Vogel, Senior Vice President and Chief Actuary, Prudential Life Insurance Co. of America on behalf of the American Council of Life Insurance, Moss Subcommittee Hearings, supra n. 2, at 337.

42 The ACLI analyzed 116 different participating and non-participating whole life policies, issued by companies licensed in New York State, with face amounts of \$25,000 sold to males aged 35 and tabulated 20-year interest adjusted cost indices for these policies. As described in its prepared statement, the ACLI study showed (Id. at 336):

One: For non-participating policies, the average premium per \$1,000 was \$16.70. Of the 53 policies shown, 44 had premiums ranging from \$1.50 less to \$1.50 more
(Footnote Continued)

the cost differences in a \$25,000 whole life policy (marketed to men 35 years of age) generally ranged between \$1.50 per thousand below the mean and \$1.50 per thousand above the mean. This \$3.00 spread between the indices for the lower cost and higher cost policies translates into a consumer savings of \$75.00 per year. If these savings were deposited in an account earning 5 percent a year, the individual buying the lower cost policy would have \$2,604 at the end of the twentieth year. In our view, this is not an insubstantial amount of savings.⁴³

The large variation in the cost of similar policies can be

42 (Footnote Continued)

than this average. The average interest-adjusted cost index was \$7.55 per \$1,000 of insurance. Of the 53 policies shown, 46 had indexes ranging from \$1.50 below the average to \$1.50 above the average.

Two: For participating policies, the average premium per \$1,000 was \$21.50. Of the 63 participating contracts shown, 39 had premiums within \$1.50 of the average. The average interest-adjusted cost index was \$6 per \$1,000 of insurance. Of the 63 policies shown, 54 had indexes ranging from \$1.50 below the average to \$1.50 above the average.

43 The potential savings to a consumer in buying a low rather than high cost \$25,000 whole life policy is greater than \$2,600. The ACLI study was based on information contained in a shoppers guide put out by the New York Department of Insurance in 1977. Many higher cost companies do not do business in New York. Cf. First Report of the Industry Advisory Committee to the Agent's Compensation Systems Task Force of the NAIC C-3 Life Insurance Subcommittee at 47 (1976). Moreover, the ACLI study had separate categories for participating and non-participating insurance. It is our position that these policies can be compared, see Part III.B., infra. If this is done, the spread in the surrender indices between high and low cost policies becomes 4.50. This disparity translates into a 20-year difference of savings of approximately \$3,800.

Variation in Rates of Return on \$25,000 Whole Life
Insurance Policies Issued in 1973 and 1977

Dividend Paying Policies

<u>Age at Issue</u>	<u>Year of Issue</u>	<u>Duration of Holding Period</u>	<u>Average Rate</u>	<u>Lowest Rate</u>	<u>Highest Rate</u>	<u>Standard Deviation</u>	<u>Coefficient of Variation</u>	
25	1973 N= (141)	5 years	-11.73	-28.84	0.67	7.48	64	
		10 years	- 0.16	- 6.62	3.68	2.10	--	
		20 years	+ 3.28	- 0.22	4.78	0.75	23	
		30 years	+ 3.71	+ 0.84	4.84	0.58	16	
	1977 N= (92)	5 years	-11.99	-48.04	0.54	8.70	73	
		10 years	+ 1.25	- 3.47	5.99	1.89	151	
		20 years	+ 4.21	+ 1.88	7.33	0.84	20	
		30 years	+ 4.58	+ 2.22	7.63	0.72	16	
	35	1973 N= (145)	5 years	- 9.39	-22.59	+0.47	5.57	59
			10 years	- 0.04	- 6.53	+3.14	1.83	--
			20 years	+ 3.09	- 0.57	+4.41	0.73	24
			30 years	+ 3.49	+ 0.45	+4.55	0.59	17
1977 N= (123)		5 years	- 8.36	-30.07	0.58	4.64	56	
		10 years	+ 1.43	3.35	5.55	1.56	109	
		20 years	+ 4.12	+ 1.52	7.61	0.78	19	
		30 years	+ 4.45	+ 1.79	7.75	0.69	16	
45		1973 N= (145)	5 years	- 9.48	-21.66	-0.66	4.81	51
			10 years	- 0.77	- 7.76	+2.02	1.77	--
			20 years	+ 2.49	- 1.55	+3.89	0.79	32
			30 years	+ 2.94	- 0.48	+4.25	0.64	22
	1977 N= (89)	5 years	- 9.13	-72.03	1.92	8.12	89	
		10 years	- 0.68	- 4.63	5.58	1.69	--	
		20 years	+ 3.57	- 0.15	7.44	0.94	26	
		30 years	+ 3.91	+ 0.20	7.59	0.93	24	

Table II-7

Note: In these instances when the average rate of return was close to zero, a coefficient of

Note: In these instances when the average rate of return was close to zero, a coefficient of variation was not computed.

Variation in Rates of Return on \$25,000 Whole Life Insurance Policies Issued in 1973 and 1977

Non-Dividend Paying Policies

<u>Age at Issue</u>	<u>Year of Issue</u>	<u>Duration of Holding Period</u>	<u>Average Rate</u>	<u>Lowest Rate</u>	<u>Highest Rate</u>	<u>Standard Deviation</u>	<u>Coefficient of Variation</u>
25	1973 N= (163)	5 years	-18.29	-56.64	1.60	8.72	48
		10 years	- 1.55	-21.27	5.20	2.77	181
		20 years	+ 2.14	- 3.08	4.29	0.97	45
		30 years	+ 2.44	- 0.50	6.12	0.66	27
	1977 N= (50)	5 years	-17.51	-38.96	3.25	10.00	57
		10 years	- 0.61	- 9.54	3.83	2.71	--
		20 years	+ 2.71	- 1.10	4.67	1.14	42
		30 years	+ 2.83	+ 0.84	4.30	0.75	27
35	1973 N= (162)	5 years	-13.22	-45.05	+0.18	5.78	44
		10 years	- 1.20	-20.02	+4.98	2.25	188
		20 years	+ 1.91	- 3.77	+4.23	0.85	45
		30 years	+ 2.17	- 1.22	+3.88	0.55	25
	1977 N= (51)	5 years	-11.96	-26.86	1.88	6.09	51
		10 years	- 0.26	- 7.14	2.90	2.02	--
		20 years	+ 2.47	- 0.66	3.93	1.03	42
		30 years	+ 2.56	+ 0.17	3.86	0.79	31
45	1973 N= (161)	5 years	-12.84	-43.11	-1.80	4.74	37
		10 years	- 2.16	-22.37	+2.94	2.30	106
		20 years	+ 1.12	- 5.63	+3.14	0.99	88
		30 years	+ 1.48	- 3.98	+3.07	0.72	50
	1977 N= (50)	5 years	-11.65	-22.06	-1.24	4.82	41
		10 years	- 1.34	- 6.36	+1.80	1.84	137
		20 years	+ 1.60	- 1.99	+2.86	1.09	68
		30 years	+ 1.80	- 1.41	+3.08	0.94	52

Table II-8

Note: In these instances when the average rate of return was close to zero, a coefficient of variation was not computed.

demonstrated by an analysis of the variation in average annual rates of return for various policies issued in 1973 and 1977. Tables II-7 and II-8 show the variation in rates of return for participating and non-participating policies by issue age, issue year, and duration of holding period. Using the standard \$25,000 whole life policy issued to males aged 35, the twenty-year rates of return in 1973 varied from minus .57 to plus 4.41 percent for participating policies and from minus 3.77 to plus 4.23 percent for non-participating policies. In 1977, the twenty-year rates of return for the same whole life policy varied from 1.52 to 7.61 percent for participating policies and from minus .66 percent to plus 3.93 percent for non-participating policies. The range in cost is even more extreme for shorter holding periods of 5 and 10 years.

In addition to the range in rates of return, Tables II-7 and II-8 contain more meaningful statistical measures of variation: the standard deviation and the coefficient of variation. Because the range depends only on the highest and lowest observation, it is sensitive to a single extreme rate of return. The standard deviation, on the other hand, reflects the variation in all the rates of return for all policies. (The coefficient of variation is simply the standard deviation divided by the average.)

The standard deviation is especially helpful because it can be used to estimate how close a certain percent of the policies

Table II-9*_/_

Year	(1) 2% Policy Premium	(2) 2% Policy Cash Value	(3) 5% Policy Net Premium**/ Value	(4) 5% Policy Cash Value	(5) [1-3] Savings Deposit	(6) [5 Accumulated at 5%] Side Fund	(7) [4 + 6]* Total Savings -5% Policy (Cash Value + Side Fund)	(8) [(4-2) + (6)] Savings Difference
1	478.25	200	507.50	35.25	- 29.25	- 30.78	4.47	- 195.53
2	478.25	575	490.50	436.25	- 12.25	- 45.30	390.95	- 184.05
3	478.25	1,000	473.00	846.50	5.25	- 42.20	804.30	- 195.7
4	478.25	1,409	454.75	1,265.25	23.50	- 19.71	1,245.54	- 163.46
5	478.25	1,825	436.00	1,692.25	42.25	23.78	1,716.03	- 108.97
6	478.25	2,250	416.75	2,198.00	61.50	90.05	2,288.05	38.05
7	478.25	2,700	396.50	2,711.50	81.75	181.57	2,893.07	193.07
8	478.25	3,150	376.25	3,232.75	102.00	299.94	3,532.69	382.69
9	478.25	3,625	356.00	3,761.50	122.25	446.93	4,208.43	583.43
10	478.25	4,100	335.50	4,297.75	142.75	624.24	4,922.49	822.49
11	478.25	4,575	314.25	4,770.00	164.00	836.3	5,606.35	1,031.35
12	478.25	5,075	293.25	5,249.25	185.00	1,083.93	6,333.18	1,258.18
13	478.25	5,575	272.25	5,735.25	206.00	1,370.13	7,105.38	1,530.38
14	478.25	6,075	250.75	6,227.25	227.50	1,698.44	7,925.69	1,850.69
15	478.25	6,600	230.00	6,725.50	248.25	2,071.26	8,796.76	2,196.76
16	478.25	7,125	208.50	7,229.25	269.75	2,492.26	9,721.51	2,596.51
17	478.25	7,675	186.00	7,738.25	292.25	2,968.76	10,707.01	3,032.01
18	478.25	8,200	167.50	8,252.50	310.75	3,498.24	11,750.74	3,550.74
19	478.25	8,775	149.25	8,771.50	329.00	4,085.52	12,857.02	4,082.02
20	478.25	9,325	130.25	9,295.50	348.00	4,736.38	14,031.88	4,706.88

*/ In this comparison the amount paid for both plans is the same. It is assumed that the difference between the 5% and the 2% policies' premiums is deposited in a side fund that earns 5% (after taxes). The total savings under the 5% policy (Column 7) is the sum of the policy's cash value and the side fund.

**/ The net premium for the 5% policy is the yearly premium minus illustrated dividends.

are to the average.⁴⁴ For example, the average 20-year rate of return on dividend-paying whole life policies issued to men age 35 in 1973 was 3.09 percent with a standard deviation of .73. This means that about 32 percent of all the policies had rates of return below 2.36 percent or above 3.82 percent. Likewise, the average 20-year rate of return on dividend-paying policies sold in 1977 was 4.12 percent with a standard deviation of .78. This means that about 32 percent of all policies had rates of return below 3.34 percent or above 4.90 percent. For non-dividend-paying policies issued in 1977, 32 percent fell below 1.44 percent or above 3.50 percent. The variation in cost is even more extreme when dividend and non-dividend-paying policies are compared. In this situation differences in rates of return of three to four percent are common.

A difference in rate of return of 3 percent between two whole life policies translates into a considerable amount of money. Table II-9 sets forth a comparison between buying two \$25,000 whole life policies where one has a 20-year yield of 2 percent and the other has a 20-year yield of 5 percent. It demonstrates that a consumer can save over \$4700 by buying a

⁴⁴ For normal or bell-shaped distributions, 68 percent of the population will fall within one standard deviation of the average and 95 percent will fall within two standard deviations of the average. The figures in the text assume that the rates of return are normally distributed. In fact, they are skewed downward. Therefore, slightly more policies are below the average.

low rather than high cost \$25,000 policy.⁴⁵

2. Cost Dispersion Among Similar Policies Exceeds That Found for Other Products

This part compares how cost variation for similar insurance policies compares with the price variation in other products. The prices of most goods and services show some price dispersion. Table II-10 contains a summary of a limited number of studies of price variation among various products.⁴⁶ It shows that the

45 There also exist substantial variations in the cost for similar term insurance policies. The state of Wisconsin in the fall of 1978 conducted a survey of the cost of insurance policies sold in that state. They found that the interest-adjusted surrender index for \$50,000 term policies ranged from 2.31 to 15.00. Twenty-five percent of the policies had indices equal to or below 4.68 and 75 percent of the policies had indices equal to or below 5.82. Partial results of the Wisconsin survey were set forth in the Life Insurance Buyer's Guide which is contained in Appendix X. For an explanation of the interest-adjusted index, see pages 129-131, infra.

46 The systematic study of price dispersion by economists is of relatively recent origin. A good survey of the theoretical literature can be found in Rothschild, "Models of Market Organization with Imperfect Information: A Survey," 81 Journal of Political Economy 1283-1308 (1973). Empirical studies are listed in Table II-10.

coefficients of variation of the cost of insurance policies are extraordinarily high compared to the variation in prices for other products. For example, the coefficients of variation of rates of return for \$25,000 participating policies is 24 percent, and 45 percent for non-participating policies. This compares with a coefficient of variation of approximately 6 percent for automobiles, appliances and gasoline.⁴⁷

Table II-10⁴⁸

<u>Product</u>	<u>Average Price</u>	<u>Coefficient of Variation</u>
----------------	----------------------	---------------------------------

47 The nationwide variation in Heinz catsup prices was more than double the variation of the other products. However, given the small unit price this degree of variation is expected. The 1962 auto insurance premium rates appear to be comparable to other products at about 9 percent. The 1976 survey showed much greater dispersion (23 percent). The difference may be due to the fact that in 1962 the State of Illinois had a system of prior approval of automobile insurance rates while in 1976 they did not regulate automobile insurance rates.

48 Jung, "Price Variations Among Automobile Dealers in Metropolitan Chicago," 33 Journal of Business 31-42 (1960). Jung, "Major Appliance Prices in the Chicago Area," 50 Journal of Business 231 (1977). Maurizi and Kelly, "Prices and Consumer Information," American Enterprise Institute (1973). R. Steiner, "Brand Advertising in the Consumer Goods Economy," American Enterprise Institute (forthcoming). Jung, "Automobile Insurance Rates in Chicago, Illinois," 45 Journal of Risk and Insurance 507 (1978). Greene, Neter, and Tenney, "Annuity Rents and Rates--Guaranteed vs. Current," 44 Journal of Risk and Insurance 383 (September 1977).

		(%)
Automobile Price Chevrolets, Chicago (1959)	\$2,436.00	1.7
Prices of Washing Machines and Refrigerators, Chicago	(1955) \$ 230.00	5.89
	(1975) \$ 420.00	4.68
Retail Price of Gasoline in 17 Areas (Nov. 1970)		
Leaded Regular	\$.36	5.8
Leaded Premium	\$.40	4.9
Heinz Catsup Prices (August, 1975)	\$.71	12.77
Automobile Insurance Rates, Chicago		
(1962)	\$ 175.00	8.7
- (1976)	\$ 578.00	22.9
Interest Rates Paid on Annuity Accumulations 42 Life Insurers (1975)	6.9%	16.5
Life Insurance 20 Year Rates of Return on \$25,000 Whole Life Policies Male, Age 35		
(1973) (Participating)	3.09%	24
(Non-Participating)	1.91%	45
(1977) (Participating)	4.14%	19
(Non-Participating)	2.47%	42

If meaningful cost disclosure can increase the amount of price competition within the life insurance industry and thus reduce the amount of cost variation for similar policies, the savings to consumers would be large. It is impossible to precisely measure these potential savings, since it is not known exactly how individual companies would change their policies in order to make them more competitive. One can get a crude measure of the potential impact by assuming that the highest cost (lowest yielding) 20 percent of the policies are eliminated

and that the remaining policies have lower dispersion (a coefficient of variation of about 10 percent) around the new average rate of return. The average 20-year rate of return on dividend-paying policies in 1977 would rise from 4.14 percent to 4.40 percent and from 2.47 percent to 2.88 percent on non-dividend-paying policies. Some 68 percent of the dividend-paying rates of return would be between 3.96 percent and 4.84 percent and between 2.59 percent and 3.17 percent for the non-dividend-paying policies.

However, even if disclosure resulted in increased price competition among whole life policies, substantial consumer problems would remain.⁴⁹ Even if the highest cost 20 percent of policies were eliminated, and if the coefficient of variation in the rates of return on whole life policies issued in 1977 were reduced to 10 percent, the average 20-year rate of return on participating policies would still only be 4.4 percent. Average non-participating rates of return would be even lower at 2.88 percent. The 5- and 10-year rates would be substantially lower. As shown in Part IIA, these rates of return are lower than those readily available elsewhere in the marketplace. Thus, to have effective competition in the life insurance market, there must be both price competition among similar policies and competition between life insurance and alternative savings media.

3. There is Little Relation Between the Cost of Policies and Their Market Shares

⁴⁹ Most cost disclosure proposals, including that adopted by the NAIC, only address the problem of similar policy comparisons. See discussion, Part IV.A.2, p. 102, infra.

As shown above, cost dispersion among similar life insurance policies exceeds that found in other products. This wide cost variation is evidence of a lack of effective price competition among similar policies. High and low cost policies are not punished and rewarded as would be expected in a price competitive system. Some high cost policies have large market shares. Some low cost policies have small market shares. As Mr. E. J. Moorhead has observed:

Individual life insurance marketing seems to be demonstrating that it is an exception to the pronouncement made two centuries ago by Adam Smith--his contention being that the choices made by buyers in a free market have the effect of rewarding the efficient seller whose prices are low, and correspondingly penalizing the inefficient or greedy seller whose prices are high.⁵⁰

This section demonstrates that policy cost does not correlate with market share in a fashion consistent with effective price competition.

To determine the correlation between cost and sales, data supplied to Senator Hart's subcommittee during its investigation of the life insurance industry for best selling whole life policies issued in 1973 was examined.⁵¹ The policies were ranked by cost and grouped in deciles.⁵² The lowest cost poli-

50 Moss Subcommittee Hearings, supra n. 2, at 509.

51 The sample was subdivided by type (participating or non-participating) and size (face value at which the policy was most frequently issued). For details of this categorization see Appendix IV.

52 The results for other policy sizes and the Pearson
(Footnote Continued)

cies are in decile 1 and the highest cost policies are in decile 10. Table II-11 shows the total sales by face amount for the policies in each decile for \$25,000 whole life policies issued to males aged thirty five.

Table II-11 - Sales by Cost Decile⁵³

<u>Non-Participating</u>			
<u>Decile</u>	<u>Face Value of Sales (000)</u>	<u>Number of Policies in Decile</u>	<u>Median Cost</u>
1	656,469	5	39.08
2	99,870	5	40.93
3	100,763	5	41.62
4	334,112	5	43.32
5	71,686	5	45.18
6	84,353	5	47.88
7	97,344	5	48.17
8	408,042	6	50.46
9	104,365	6	54.20
10	117,308	6	60.54
Total	2,071,312	53	

<u>Participating</u>			
1	886,782	5	29.72
2	393,263	5	34.27
3	1,115,373	5	36.37
4	770,059	5	38.21
5	1,213,673	5	39.70
6	1,314,155	5	40.41
7	626,327	5	42.89
8	2,709,282	5	46.07
9	424,271	6	50.61

52 (Footnote Continued)

correlations between cost and market share are contained in Appendix IV.

53 The measure of cost used in Table II-11 is the Company Retention Index computed using a 5 percent rate of interest and Moorhead's lapse table "S". For an explanation of the Company Retention Index see pages 144-146, infra.

10	65,713	6	57.84
Total	9,518,898	52	

Table II-11 shows that there is little relationship between policy cost and market shares. For participating policies, for example, the five policies in the eighth decile ranked 40th to 45th in cost out of the 52 policies examined. Yet the face amount of sales for these policies exceeded \$2.7 billion in 1973, or approximately 29 percent of the total sales for all 52 policies studied.

The life insurance industry competes for agents and in designing unique policies that are often merely sales tools. But as shown in this section, it does not compete vigorously on the basis of price. Without meaningful cost disclosure, effective price competition is impossible.⁵⁴

⁵⁴ See pages 81-83, infra.

D. Consumers Often Receive a Small Amount of Protection Against Premature Death Relative to the Premiums Paid for Ordinary Insurance.

The amount of protection against premature death that Americans buy with their ordinary life premiums is small relative to the amount that same expenditure would purchase through low cost term insurance (either individual or group). This relatively small amount of insurance protection (per dollar of premium) appears to result from a lack of consumer knowledge concerning alternatives and from certain features of the agency system which favor the sale of cash value insurance, rather than from an informed consumer preference for savings intensive types of insurance policies. This section examines the dimensions of this problem and the extent to which the Social Security system compensates for the small amount of protection against premature death provided by ordinary insurance.

Ralph Nader, in testimony before Senator Hart's Subcommittee in 1973, stated that the life insurance industry's principal shortcoming was its failure to sufficiently protect its ultimate consumers -- the widows and children -- from the financial risks of the premature death of the breadwinner.⁵⁵ Mr. Nader then observed:

The Institute of Life Insurance--the public relations arm of almost the entire industry-- maintains that "the main reason why a man buys life insurance is to protect his family

⁵⁵ The Life Insurance Industry: Hearings Before the Subcomm. on Antitrust & Monopoly of the Sen. Comm. on the Judiciary, 93rd Cong., 2nd Sess. 8 (1974) [hereinafter cited as Hart Subcommittee Hearings].

from financial hardship when he dies." Whether or not companies sell life insurance for other purposes such as to provide a savings or investment medium or to make a profit, the primary measure of their performance is the extent to which the financial needs of widows and children are being met. The real consumers of life insurance are those who survive after the premature death of the breadwinner. The industry's own analysis of the benefits received by survivors demonstrates that it has failed miserably.

"The Widows Study" conducted by the Life Underwriter Training Council and the Life Insurance Agency Management Association and published in 1970--but never widely circulated within the industry--provides shocking and tragic evidence of this failure. Fifty-two percent of a representative sample of all widows received less than \$5,000 in benefits even though 92 percent were covered by some form of life insurance.⁵⁶

As Mr. Nader noted, slightly more than one-half of the widows studied received less than \$5,000 in insurance benefits.⁵⁷ This "less than \$5,000" figure included proceeds from all forms of life insurance held, including group, veterans and credit life insurance. The study concluded that "[j]udged by any standard,

⁵⁶ "The Widows Study" referred to in Mr. Nader's testimony was sponsored by the industry to evaluate its success in accomplishing the goal of alleviating the hardships caused by the premature death of the family head. The information was gathered in a series of personal interviews conducted in 1968 and 1969 from among a sample of women whose husbands had died prematurely (under the age of 65) in 1965. Life Insurance Underwriter Training Council and Life Insurance Agency Management Association, The Widows Study (1970), Vol. 1 at 2. Reprinted in Hart Subcommittee Hearings, id., Vol. 1 at 313.

⁵⁷ In the lowest income range, 93% of the widows received less than \$5,000 in proceeds, while even at the highest income level displayed, 1 in 5 had life insurance benefit payments of less than \$5,000. Id. at 363.

the amounts of life insurance received by the widows were low."⁵⁸

Furthermore, the situation does not appear to have improved since 1966. In the intervening years, the average amount of life insurance per family has risen from \$15,800 to \$32,400. However, the average disposable personal income has also doubled, from \$8,200 in 1966 to \$16,400 in 1977.⁵⁹ Yet, the average death claim per policy was only \$4,465, an increase of only \$1,100 since 1966. Thus, if decedents in 1977 were insured under three policies, the average death benefit from ordinary insurance would have amounted to ten months of the average personal disposable income per family.⁶⁰

This report considers two phenomena--agent bias for whole life insurance and the lack of consumer understanding about term insurance--which partially explain why many consumers receive less death protection than they need from ordinary insurance. Part III D, infra, discusses how agent training and compensation creates a system that often promotes whole life insurance regardless of a person's needs.

Another reason many consumers purchase inadequate amounts of insurance protection with the dollars they spend for ordinary insurance is because they are either uninformed or misinformed

58 See Hart Subcommittee Hearings, supra n. 55, at 322.

59 Fact Book, supra n. 9, at 24.

60 Id. at 41. As the Moss Subcommittee Report notes, the death benefits of the average life insurance policy (per family) would only be sufficient to cover the average family's needs for two years or so. Moss Subcommittee Report, supra n. 1, at 19.

as to the best type of insurance for their particular needs.⁶¹ Purchasers often do not realize when they are young and their needs for protection are generally the greatest that they can obtain three to five times as much initial death protection by buying renewable individual or group term insurance as they can for the same amount spent on ordinary whole life insurance. For example, in 1977, the public owned about the same amount of group insurance as ordinary life insurance.⁶² Although group insurance paid somewhat higher amounts in average death benefits,⁶³ the public paid over 3.5 times more for its ordinary coverage than for its group coverage.⁶⁴

Since the "right amount of life insurance" is something that individuals must decide for themselves, taking cost as well as their special circumstances into account, it is difficult to make a blanket determination that people are generally under or overinsured. Accordingly, we make no general recommendation that people buy more life insurance, nor do we recommend that consumers only buy term insurance. However, for certain groups -- households with young children and low incomes -- term insurance is the only way they can afford adequate death

61 For a detailed discussion of consumer knowledge in the field of life insurance see Part III C, p.74, infra.

62 Fact Book, supra n. 9, at 18.

63 Id. at 41. The average death benefit paid on ordinary insurance was \$4,466, while the average death benefit paid on group insurance was \$5,597.

64 Id. at 57.

protection.⁶⁵ To the extent these people are unaware of the low cost death protection available in term insurance, they are likely buying less death protection than they want. The Moss Subcommittee Report acknowledged this potential for inappropriate purchase:

Thus, for persons who do not have enough premium dollars to purchase adequate whole life coverage, term insurance is likely to be the best choice. Allocating all premium dollars to purchase whole life will, in such a situation, lead to underinsurance.⁶⁶

Although many consumers are receiving less death protection than they need from the dollars they spend for ordinary insurance, the impact on society of the problem of underinsurance has been reduced by the expansion of survivor benefits under Social Security. The U.S. public now has far more total life insurance protection, relative to income than ever before. This is primarily due to the dramatic increase in life insurance protection provided to survivors under the OASDI program of Social Security. As shown in Table II-12, the total amount of equivalent life insurance in force was almost four times disposable income in 1977, up from less than twice disposable income 20 and 30 years ago.

⁶⁵ As Ralph Nader noted in the 1974 Hart Hearings:

Husbands do buy life insurance, but they buy too much of the wrong kind. With limited funds available, they are too often misled into putting them all into low benefit cash value policies at inflated prices.

Hart Subcommittee Hearings, supra n. 55, at 8.

⁶⁶ Moss Subcommittee Report, supra n. 1, at 18.

The amount of private life insurance has risen roughly in proportion to disposable personal income in the past 25 years, but the amount of equivalent life insurance through Social Security has risen more rapidly. Since 1973, the equivalent life insurance inherent in the OASDI program has exceeded the total for all private life insurance. This massive increase in governmentally provided life insurance protection appears to have had little effect on the private sales, with the result that the total amount of life insurance coverage has doubled.

Table II - 12

	(1) Est. Amt. of Life Ins. in force as survivor benefit under OASDI as of beginning of Yr. (\$ billions)	(2) Private Life Ins. in force (\$ billions)	(3) Total Life Ins. in force (\$ billions)	(4) Total Dispos- able Personal Income in cur- rent dollars (\$ billions)	(5) Ratio of Private Life Ins. in force to Disposable Personal Income	(6) Ratio of total life Ins. in force to Disposable Personal Income
1940	\$37	\$112	\$149	\$75.2	1.49	1.98
1951	170	234	404	224.8	1.04	1.80
1955	345	334	679	273.4	1.22	2.48
1961	547	586	1,133	362.9	1.61	3.12
1962	585	629	1,214	383.9	1.64	3.16
1966	700	901	1,601	510.4	1.77	3.14
1968	930	1,080	2,010	588.1	1.84	3.42
1970	1,100	1,285	2,385	685.9	1.87	3.48
1972	1,310	1,503	2,813	801.3	1.88	3.51
1973	1,760	1,628	3,388	901.7	1.81	3.76
1974	2,040	1,778	3,818	984.6	1.81	3.88
1975	2,269	1,925	4,254	1,084.4	1.83	3.92
1976	2,556	2,140	4,696	1,185.8	1.80	3.96
1977	2,829	2,343	5,172	1,308.6	1.79	3.95

Sources: Col. (1) - Data from 1940-1974 from Robert J. Myers, Social Security 395, table 10.37, (1975). The remaining figures come from Kevin Wells, Estimated Amount of Life Insurance In Force As Survivor Benefits Under OASI 1975-77, Office of the Actuary, Social Security Administration, Actuarial Study No. 79, November 1978. Various other Federal government insurance programs such as Veterans life insurance and Civil Service Commission insurance are not included.

Col. (2) - Fact Book, supra note 9 at 18. Includes ordinary, group, industrial and credit life insurance, but excludes fraternal and savings bank life. To correspond to column (1), the figures are given as of the beginning of the year. The Fact Book figures are as of the end of the year. Therefore the figure given in column (2) above is listed in the Fact Book as the total for one year earlier.

Col. (3) - Col. (1) + Col. (2).

Col. (4) - Economic Report of the President, 1978, table B-22, p.283.

Col. (5) - Col. (2)/Col. (4).

Col. (6) - Col. (3)/Col. (4).

III. SOME REASONS FOR THE PROBLEMS

A. Introduction

The problems discussed in the preceding section are very serious ones: average rates of return that are 3 to 6 percentage points below alternative rates, extreme variation in rates of return, large but undisclosed penalties for early lapse, low rates of return earned on old policies, and relatively small per capita amounts of private insurance protection. The first four problems imposed on consumers unnecessary costs of billions of dollars in 1977 alone, while the underinsurance problem defies any simple dollar measure of loss. This section offers some explanations why these problems have arisen and persist in an industry which in terms of the number of companies and agents vying for sales ought to be competitive.

The single most important cause of these problems is the lack of meaningful information by which the quality and cost of one life insurance policy can be compared to another and to alternative forms of saving. Currently, the marketplace is not providing this information. Two factors explain this lack of information: the inherent complexity of life insurance, and the confusing variety of products companies offer, which complicates cost comparison. This section examines the complexities of the life insurance market and considers evidence documenting consumer inability to evaluate life insurance costs. It explains how this inability to judge cost in turn is a primary cause of the lack of price competition which in large part explains the problems discussed in Part II. Finally

this section considers various incentives in the agency system favoring whole life insurance which in conjunction with the absence of price information contribute to the lack of meaningful price competition in the life insurance market.

B The Cost of Insurance Is Difficult to Evaluate

The current complexity of the life insurance market makes it difficult for consumers to evaluate the cost of a life insurance policy. Part of this difficulty arises out of the fact that premiums are not an accurate measure of cost. Part is attributable to the wide variety of policy types offered in the market. We consider each of these causes in turn.

Comparing whole life insurance costs is difficult because the amount paid for the policy (the premium) does not accurately measure the actual cost. This is because policies accumulate cash values and often pay dividends. Moreover, it is not enough simply to subtract illustrated dividends and cash values from total premiums. Because of the time value of money, real cost depends heavily on how quickly cash values and dividends accrue as well as their eventual size.

The following analysis of the correlation between premiums and real cost demonstrates the dubious reliability of premiums as a predictor of real cost. Table III-1 is an array of 306 best selling whole life policies issued by almost 200 life insurance companies in 1973. Using "deciles," Table III-1 ranks policies by premium and by the 20-year rate of return. If a policy ranks in the first premium decile, it has a lower premium than at least 90 percent of all of the policies. Similarly, if a policy

Table III - 1

Decile Comparisons Between Premium Size and 20-Year Average Annual Rates of Return - \$25,000 Whole Life Policies Issued to Men Aged 35 in 1973

		Average Annual Rate of Return Decile											
		1	2	3	4	5	6	7	8	9	10		
Premium Decile	1	1	2	5	3	8	6	5	0	0	0	30	
	2	0	0	2	5	5	7	8	2	2	0	31	124
	3	0	2	0	3	2	4	7	8	5	1	32	
	4	2	1	0	0	2	4	1	5	10	6	31	
	5	2	0	0	0	0	3	1	3	10	11	30	
	6	7	2	2	1	2	1	1	3	3	9	31	
	7	11	5	3	4	0	2	2	2	0	2	31	
	8	3	8	7	3	6	0	2	0	0	0	29	121
	9	3	10	7	5	2	0	1	2	0	1	31	
	10	1	0	5	7	4	4	3	4	1	1	30	
		30	30	31	31	31	31	31	29	31	31	306	

Note: The first decile corresponds to the lowest premiums and the highest average rates of return. The number of policies in each decile differs because of ties in the rankings.

Source: FTC staff computations, using the data collected by the Senate Anti-Trust and Monopoly Subcommittee. The sample of 306 whole life policies includes both dividend-paying and non-dividend paying policies.

ranks in the first rate of return decile, it has a higher rate of return than at least 90 percent of all of the policies.

Table III-1 demonstrates the weak correlation between premium and actual cost in two ways. First, the upper left hand entry of Table III-1 indicates that only one of the 30 policies with the lowest premiums also has a rate of return sufficiently high to place it in the first rate of return decile. To put it another way, only one policy is common to both the 30 policies with the lowest premiums and the 30 policies with the best rates of return. Second, Table III-1 shows that 124 policies are in the first four premium deciles; that is, they have lower premiums than at least 60 percent of all of the policies. Only 26 of these 124 policies, however, have better than average rates of return (i.e., rank in the first four rate of return deciles). In contrast, more than twice as many (60) have worse than average rates of return (i.e., at least 60 percent of the policies offer higher rates of return). Conversely, a high premium policy can be mistaken for a high cost policy. Of the 121 policies whose premiums are higher than at least 60 percent of all the policies (premium deciles 7-10), two out of three (82) have higher than average rates of return (rate of return deciles 1-4). Furthermore, only one out of five have below average rates of return. Therefore, Table III-1 supports the rather surprising conclusion that consumers have a better chance of buying a low cost policy if they restrict their choice to the higher than average premium policies rather than the lower

than average premium policies.¹

Since premium size is an unreliable measure of cost, and the simultaneous analysis of premiums cash values, and dividends is so difficult, the vast majority of consumers are unable to calculate the actual cost of a particular policy or compare different policies. Further, this difficulty of evaluating cost applies after as well as before purchase. Few people who bought a non-competitively priced policy 10 years ago could determine now that they made a bad buy when they purchased. Friends are not likely to compare their policies' dividends or cash values. Nor do most consumers buy insurance frequently enough to learn through experience.² Consequently, even consumers who have bought life insurance in the past are not likely to be able to evaluate its real cost.³

¹ This arises because many of the dividend-paying policies are low in cost, but have higher than average premiums. Looking at non-dividend-paying policies alone, premiums are a fairly good guide to cost. Premiums are not a good guide to costs for dividend-paying policies. Given the public's low level of knowledge regarding participating versus non-participating policies, many people will not distinguish between the two (in fact, persons should often compare the two, see n.71 at page 140, *infra*). Thus, direct premium comparisons are often likely to be unproductive, or even counter-productive.

² About the only way a consumer could learn that a prior life insurance purchase was bad would be if another agent tried to replace that policy.

³ Economists refer to products whose performance cannot be evaluated through normal use as "credence goods." One of the main reasons for poor market performance in life insurance is that the policies are very good examples of "credence goods." See Darby and Karni, "Free Competition and the Optimal Amounts of Frauds," 16 Journal of Law and
(Footnote Continued)

Besides the difficulty of evaluating the cost of an insurance policy, the life insurance market is made even more confusing for consumers by the near endless variety of policies offering slightly different benefit features. As stated by Professor Joseph Belth:

[T]he proliferation in life insurance has reached large proportions. There are many so-called specialty policies. These usually are designed to fit an elaborate sales presentation, rather than to perform real services for the buyer. There are also many different policies of the so-called conventional type -- so many, indeed, that it is difficult to distinguish between conventional policies and specialty policies.⁴

Similarly, Spencer L. Kimball, professor of law at the University of Chicago, stated at the Hart Hearings on the life insurance industry: "Product differentiation, partly produced by advertising and sales efforts and partly by the wide range of variations in the content of the life insurance contract fragment the

³ (Footnote Continued)

Economics 67-88 (April 1973). Professor Neil Borden many years earlier made a somewhat similar distinction between goods with "external" characteristics that could be used to judge quality before purchase such as green vegetables, clothing, etc. and those with "hidden" characteristics where quality cannot be judged before purchase such as watches, refrigerators and drugs. In discussing drugs and cosmetics, Borden noted that for some goods the "hidden" characteristics might stay hidden even after purchase. See N. Borden, The Economic Effects of Advertising, 425-426 (1942).

⁴ The Life Insurance Industry, Hearings Before the Subcomm. on Antitrust and Monopoly of the Senate Judiciary Comm., 93d Cong., 2d Sess. 568 (1974) [hereinafter cited as Hart Subcommittee Hearings].

market."⁵

In short, the inherent complexity of the product and the confusing array of policies make informed shopping for life insurance difficult. At the same time, these factors contribute to a widespread lack of knowledge among consumers about life insurance.

C. Consumer Inability to Determine the Real Cost of Insurance

The previous section considered aspects of the life insurance market which makes comparison shopping by consumers difficult. This section examines evidence tending to show that consumers are not well informed about insurance in general or about how to evaluate its real cost in particular. Specifically, this lack of knowledge appears to show up in consumer behavior in four important ways. First, many consumers are not well informed about the general aspects of life insurance. Second, most people are uncertain about how to define the "cost" of a life insurance policy, yet lean heavily on the premium as the measure of cost. Third, in part because of uncertainty as to cost, most people do not attempt to compare costs of different policies. Fourth, many people do not understand the

⁵ Id. at 1087. Whatever the reason for its existence, many commentators have remarked on the extent of product differentiation in life insurance. Mark S. Dorfman, professor of finance at Miami University of Ohio, and Albert L. Auxier, professor of finance at the University of Tennessee, have testified on separate occasions that there is undue product differentiation in the life insurance market. Statement of Mark S. Dorfman, id. at 1237; testimony of Albert L. Auxier, presented at Wisconsin Insurance Department Hearings on proposed regulation 2.14, July 19, 1977.

major differences between term and whole life insurance.

1. Consumers Are Uninformed About Life Insurance

Many observers of the life insurance industry have commented on the public's relatively low level of knowledge about life insurance. For example, the Daniel Yankelovich organization, on the basis of an extensive survey carried out in 1967 and 1968, reported to the major company trade association (which had sponsored these studies) that:

Due in part to the inherent characteristics of the product, the average person feels far less self-confident as a buyer of life insurance than of any other major purchase. Indeed, the entire act of purchasing life insurance is fraught with anxiety; people are not confident about their ability to comprehend the pros and cons of alternative plans; they are unsure of how much influence the agent's commission has on his recommendations (they suspect that it is substantial); they are unsure about what amount of coverage is adequate or desirable; they feel locked into their policy choice once it is made; they have a suspicion of the "fine print" in the life insurance contract; and their most basic anxieties are aroused by the subject of death and the need to provide for others in the event of death.⁶

In seven out of the eight surveys conducted since 1968, more than half of the respondents have described themselves as either "not too well informed" or "not at all informed" about life insurance. In a survey conducted in 1976, only one in four said that he or she did not feel uneasy about selecting a life

⁶ Institute of Life Insurance, Monitoring Attitudes of the Public (MAP) 23 (1969).

insurance policy.⁷

2. Consumers Are Unable to Evaluate Cost

In a 1975 Life Insurance Marketing and Research Association (LIMRA) study, a large number of people were asked what they meant by the "cost" of a life insurance policy. More than half responded that cost meant the premium or the premium per \$1,000 of coverage. Only about one in five stressed the value they would get for their money.⁸ Over 6 in 10 of these same people said that they "have a lot" or "some" difficulty in determining whether they're getting their money's worth.⁹ Thus, although some people were aware that aspects of the contract (e.g., cash values and dividends) could differ even though two policies had the same premiums, most of them were vague about how they would compare two policies that differed in benefits, saying that they would try to get the "best value" or "return" for their money.

The finding that purchasers often equate premium with cost is confirmed by evidence of actual behavior. In Part II.C. (Tables II-7 and II-8), supra, it was seen that similar policies

7 American Council of Life Insurance, Monitoring Attitudes of the Public (MAP) 50-51 (1976).

8 Institute of Life Insurance and Life Insurance Marketing and Research Assn., Life Insurance Consumers: A National Survey of Cost Comparison Attitudes and Experience 11 (August 1975).

9 Id. at 12.

varied widely in terms of actual cost. Premium dispersion, however, is much lower than cost dispersion. This evidence is consistent with survey results that consumers are unable to gauge the true cost of a policy without cost disclosure. Indeed, it indicates that they rely on very inexact substitutes for cost, such as premiums.

Table III-2 (below) shows the coefficient of variation for premiums of selected policies issued in 1973. The coefficients of variation in life premium rates are between 6 and 8 percent, which is midway between the 1 to 13 percent range for other products shown in Table II-10, supra. The rates of return (which are an accurate measure of cost) show an immense variability (24 percent and 45 percent for par and non-par policies respectively). This difference in dispersion rates indicates that policyholders often (mistakenly) view the premium as the "cost" of the policy and that price comparisons are often limited to premium comparisons.

Table III-2

Variance in Premium Rates, 1973¹⁰

<u>Type Policy</u>	<u>Mean</u>	<u>Standard Deviation</u>	<u>Coefficient of Variation</u>
Non-par, 10,000	\$18.72	1.06	6%
Non-par, 25,000	17.16	1.11	6%
Par, 10,000	23.12	1.56	7%
Par, 25,000	21.99	1.75	8%

An experimental study found that even people with training in finance and insurance did only slightly better than chance in

¹⁰ See Appendix IV.

distinguishing between high and low cost policies. Professor Albert Auxier asked the 32 members of his life insurance class to rank whole life policies on the basis of what they judged was the average rate of return for the policy. These students averaged almost 4 college level courses in insurance and finance. Given the raw information on premiums, dividends and cash values, the students did only slightly better than chance at choosing those policies that actually ranked in the best third.¹¹ They averaged 2.75 right as compared to an expected value of 2 right if they had chosen randomly. Professor Auxier also notes that the students "exhibited a disturbing tendency to select poor-value policies (those ranked in the lower one-third) despite a wide range of policies from which to select." The students did worse than chance in mistaking high cost policies for low cost policies. He concluded that "the participants demonstrated little ability to discriminate correctly among policies on a cost basis without the aid of a summary cost measure."¹² In view of the ideal test conditions and the sophistication of the subjects, the general life insurance buying public is likely to discriminate even more poorly than this group of students.¹³

11 The students had become familiar with the method of computing the rate of return. See "A Test of the Usefulness of Policy Information in Ranking Life Insurance Alternatives," 43 Journal of Risk and Insurance 87-98 (1976).

12 Id at 98.

13 The Commission conducted experimental studies concerning
(Footnote Continued)

Thus, most people have a natural tendency to equate premium with cost, but, as we have seen, the premium is a poor guide to cost. And although many people recognize that comparing premiums alone is insufficient, they are unsure of how to make a more meaningful comparison.

3. Most Consumers Do Not Compare Policies For Cost

Perhaps because of these difficulties in evaluating costs, few people try to compare cost even when they think that policies differ substantially. For example, in the 1975 study previously discussed (page 76, supra), 65 percent of the participants thought that there were differences in policy costs, yet only 42 percent of those people said that they had ever compared company costs.¹⁴ A subsequent question suggests that the difficulty of comparing costs may explain why many participants did not try to comparison shop.¹⁵ Asked what they would do when an agent presented a policy

13 (Footnote Continued)

the ability of consumers to evaluate insurance policies. Appendix IX summarizes the results of these studies.

14 Institute of Life Insurance, Monitoring Attitudes of the Public (MAP) 54-55 (1975).

15 An additional reason that people do not shop for insurance is that substantial numbers of people still believe that policies cost about the same. In the 1975 LIMRA survey, 35 percent of the respondents said that all insurance policies cost about the same or that they didn't know. As previously discussed, 65 percent equated premium with cost. Other surveys have indicated that substantial numbers of people mistakenly believe that all insurance costs about the same. Subcommittee on Oversight and Investigations of the House Comm. on Interstate Commerce, Report on Life Insurance Marketing and Cost Disclosure, 95th Cong., 2d Sess., 37 (1978) [hereinafter cited as Moss Subcommittee Report].

if a standard way to compare costs existed, 85 percent said that either they would do nothing until they had a chance to compare the costs of policies offered by the particular agent with those of other companies or they would ask the agent how his company compared to others.¹⁶ Only 13 percent said they would buy the policy without comparing costs if the policy seemed right for their needs. Therefore, while it appears that most people currently do not try to compare costs because they don't know how, they would compare costs if a standard way existed.¹⁷

Finally, survey evidence indicates that many people do not fully understand the differences between term and whole life insurance. In one study, for example, participants were asked to describe the differences between term and whole life insurance: 33 percent could give no answer, 10 percent gave incorrect answers, only 3 percent mentioned that term insurance is "cheaper (more coverage for lower premiums than whole life)," only 4 percent mentioned that term policies generally do not have cash values, while only 13 percent mentioned cash values or living benefits of whole life policies.¹⁸ About 50 percent of the people correctly indicated that coverage under term insurance

16 Institute of Life Insurance, Monitoring Attitudes of the Public (MAP) 55 (1975).

17 The 85 percent who answered that they would use additional information in deciding what to buy may overstate the percentage who would use the newly disclosed information in an actual purchase situation. See Appendix IX.

18 Institute of Life Insurance, Monitoring Attitudes of the Public (MAP) 40-41 (1972).

is for a prescribed period of time, whereas whole life coverage remains available for life. As the researchers point out, however,

The frequent mention of limited duration of "term" insurance, and the permanence of "whole life" suggest that these are educated guesses based upon the names of these policy types.¹⁹

In sum, the available evidence indicates that most consumers have great difficulty understanding how to compare the cost of one life insurance policy to another. Premium tends to be equated with cost, a mistake which can prove to be very expensive. Most consumers appear unsure of how to compare cost and relatively few do. In general, they know little about the different types of life insurance policies available and, in particular, they know little about the important differences between term and cash value insurance.

D. The Relationship Between the Lack of Price Information and Reduced Price Competition

Thus far, Part III has examined why and to what extent consumers do not know how to determine the real cost of life insurance. We now consider how such lack of knowledge relates to the problems discussed in Part II. The short answer is that the absence of cost information reduces the price competition which cash value policies face from alternative savings media and from each other.

How consumer inability to compare prices can reduce price

¹⁹ Id. at 30.

competition is best illustrated by its effect on price dispersion among similar policies. Many economists argue that those markets in which consumers have a difficult time evaluating and comparing prices will be characterized by more price dispersion.²⁰ Moreover, this increased price dispersion, according to the theory, will be skewed upwards and therefore raise the average price. Simply put, the idea is that when price shopping is more difficult the individual seller will lose fewer sales if he increases his price above the competitive price. Although he will lose the business of comparison shoppers, he will get a higher than competitive price from all those customers who continue to buy from him. In other words, where comparison shopping is difficult at least some sellers will have an incentive to charge higher than competitive prices. As George J. Stigler put it: "price dispersion is a manifestation -- and, indeed, it is the measure -- of ignorance in the market."²¹

The absence of cost information also reduces the price competition which cash value insurance policies face from alternative savings media. Because consumers do not fully understand the savings aspect of cash value insurance and are unable to determine its actual rate of return, it follows that competition from alternative savings media is muted. To that extent, insurance

20 See, e.g., Rothschild, "Models of Market Organization with Imperfect Information: A Survey," 81 Journal of Political Economy 1283 (1973).

21 Stigler "The Theory of Information," 69 Journal of Political Economy 171, 172 (1961).

companies can offer lower rates of return than are available from bonds or savings and loans, for example, and still successfully sell cash value insurance.

Finally, many observers believe that the lack of cost information might channel competition away from prices towards non-price competition. In a statement submitted to the Hart Subcommittee, Spencer Kimball stated:

In the present market, there is no real price competition. There is competition among insurance companies for agents who can effectively sell, and then among agents for applicants. Price competition is greatly muted; it can hardly be said to exist at all.²²

There can be no effective competition in the life insurance industry without meaningful cost information. As long as buyers are unable to compare the cost of similar policies, companies that charge high prices can sell as successfully as companies that charge low prices.²³ Further, until consumers are aware of the rates of return they receive on their savings through ordinary life policies, insurance companies will be able to compete effectively for savings dollars even though they often pay a rate of return that is several percentage points below alternatives available in the marketplace.

E. The Agency System Exacerbates the Competitive Problems

The agency system is another reason for the problems

²² Hart Subcommittee Hearings, supra n. 4, at 1088.

²³ See pages 59-62, supra.

discussed in Part II. In view of the complexity of the life insurance market it is not surprising that many consumers consult an "agent". Besides being well informed, an agent's financial incentives should ideally foster choices in the client's best interests. Indeed, the "golden rule of agency" provides that the agent should recommend the choice the client would make himself if he had expert knowledge. The reality of the life insurance agency system is far from this ideal. This section examines how certain aspects of the agency system contribute to the consumer and competitive problems discussed in this report.

1. Many Agents Do Not Believe There Are Substantial Differences in Policy Costs

Many agents and their supervisors appear to be misinformed on whether costs for similar policies differ significantly.

As stated in the Moss Subcommittee Report:

... the stunning fact, revealed in a 1976 survey, [is] that 37 percent of full time life insurance agents, and 45 percent of their supervisors, believe that 'there is little difference in net cost for similar policies.' A further 11 per-cent of both agents and supervisors had no opinion on the question. This presumably means that nearly half of all agents in the field would not think it important to advise their clients about the savings possible from purchasing low cost insurance.²⁴

Two principal factors explain agents' lack of awareness of cost differences. First, because of extremely high turnover, a great many agents are inexperienced. For example, in 1975,

²⁴ Moss Subcommittee Report, supra n. 15, at 37. The data cited came from a joint study conducted by the National Association of Life Underwriters and LIMRA, Survey of Agency Opinion 33 (1976) (Question 6).

59 percent of all ordinary life agents had less than four years experience. (see pages 89-90, infra). Second, many companies' agent training programs place little emphasis on cost comparison methods.²⁵ Agents' lack of awareness of cost differences contribute to the lack of price competition in the industry. As stated by Mr. E.J. Moorhead:

Life insurance is a competitive business, but in the individual insurance market the direct competition is heavily in the finding and keeping of productive agents. Price competition is indirect in nature, being dependent upon insistence by those agents that they be given attractively priced products to sell. A weakness of this indirect pressure is found in the widespread lack of agent recognition...that large price

25 See Life Insurance Marketing and Cost Disclosure: Hearings Before the Subcomm. on Oversight and Investigations of the House Comm. on Interstate Commerce, 95th Cong., 2d Sess. 511 (1978) (statement of Mr. E. J. Moorhead) [hereinafter cited as Moss Subcommittee Hearings]. Professor Joseph Belth has observed,

Many if not most life insurance agents are ill-equipped to provide reliable financial advice to their customers. State licensing examinations require a minimum of knowledge about life insurance. Company training programs and most industrywide training programs place the emphasis on sales skill rather than technical knowledge....[T]hose responsible for sales development generally have come up through the sales ranks. Many of these sales executives were successful in the field, but sales success is not synonymous with technical knowledge. Indeed, it is often argued that technical knowledge tends to hamper sales efforts.

Statement of Joseph Belth, Hart Subcommittee Hearings, supra n. 4, at 567.

differences are prevalent.²⁶

The second aspect of the agency system that contributes to the lack of price competition and the consumer problems discussed in Part II is the preference many agents have for cash value insurance. The next section examines the reasons for this preference and its impact on consumers.

2. The Commission Structure Provides Financial Incentives Favoring Whole Life Insurance

The agent commission structure in most cases strongly favors the sale of cash value policies. For most companies, the first-year commission rate on a typical whole life policy is substantially larger (per premium dollar) than that on a typical term policy. Table III-3 sets out the differences in rates which the Hart Subcommittee found between whole life and five-year renewable term policies issued to a male age 35.²⁷ As that table shows, first-year commissions on whole life policies average 55 to 60 percent, compared to 35 to 40 percent for term policies.²⁸ Renewal commissions are similar for both types of policies.

Table III-3

Commission Rates on Whole Life and Term Policies By Company
Asset Size, 1973²⁹

²⁶ Moss Subcommittee Hearings, supra, n. 25, at 510 (statement of E. J. Moorhead).

²⁷ Hart Subcommittee Hearings, supra n. 4, at 2858.

²⁸ For a detailed discussion of these rates see Appendix VII.

²⁹ See Hart Subcommittee Hearings, supra n. 4, at 2858-2859. Figures are given for only those companies not licensed
(Footnote Continued)

First-Year Commission Rates

Asset Size	Whole Life ³⁰	Term Insurance ³¹
Top 20 Companies	59%	36%
21st-50th	57	36
Not in top 50	64	41

2nd to 10th Year Renewal Commissions

Top 20 Companies	5%	5%
21-50	5	5
Not in top 50	5	5

11th and 12th Year Commissions³²

Top 20 Companies	1%
21-50	2
Not in top 50	2

An agent's commission income depends not only on the commission rate, but also on the amount of premium. The amount of premium, in turn, is a product of the premium rate and the face value of the policy. The premium rate at any given age is likely to be several times higher for whole life than for term. These factors combine to give agents a strong financial incentive to sell whole life insurance. Table III-4 shows that ordinary agents in 1974 averaged 176 percent more in first-

29 (Footnote Continued)

in New York. With minor differences, the figures for New York licensed companies show the same marked difference in first year commission rates for whole life and term.

30 Whole life policies issued to males age 35.

31 5-year renewal term policies issued to males age 35.

32 No summary data was given for years 11 through 20 for term policies.

year commissions on whole life sales than on level term sales. They also averaged 370 percent more on whole life than on decreasing term sales. Since the established agents (five years or more as an agent) average less than one sale a week and since renewal commission income is likely to be 25 percent or less of total commission income,³³ the commission rate structure provides the agent with a strong financial incentive to sell cash value contracts regardless of the needs of the client. Assuming the average agent depicted in Table III-4 received a weekly renewal commission income of \$90, his total commission income per week would be \$363 if he sold the average size whole life policy, \$188 if he sold the average size level term policy, and \$148 if he sold the average size decreasing term policy.

Table III-4³⁴

Commission Income to Ordinary Agents from Different Types of Policies, 1974

Type of policy	Avg. Size Policy	Prem. Per \$1000	Prem. Per Policy	1st-Yr. Comm. Rate	Amt. of 1st-Yr. Comm.
Whole Life	\$19,560	\$25	\$497	55%	\$273
Level Term	46,430	6	280	35	98
Decreasing Term	30,610	5	167	35	58

During the Hart Hearings, the president of one large insurance

³³ See Rappaport, "Consumerism and the Compensation of the Life Insurance Agent," 26 Transactions of the Society of Actuaries 529 (1974) [hereinafter cited as Rappaport].

³⁴ The 1974 Buyers Study, at 17. Note: Sales on adult male lives only.

company candidly stated: "No agent, manager, general agent, or agency system can live very well on the commissions from only term insurance."³⁵

The job and financial pressures which agents face are reflected in the high turnover rate among agents. A large number of newly-recruited agents quit in their first years. According to a LIMRA study of several companies, only an average of 15 percent of recruits remain agents with a company four or more years.³⁶ Also, LIMRA surveys consistently show that more than one-third of the inexperienced ordinary recruits leave their companies before the end of the year in which they are hired.³⁷ Moreover, this group of new agents (characterized by high turnover rates) constitutes a significant portion of all life insurance agents. For example, in 1975, agents with four or less years experience comprised 59 percent of all agents working for ordinary life

35 Hart Subcommittee Hearings, supra n. 4, at 1922.

36 Dorfman, "Reformation in Life Insurance Agents' Compensation," 43 Journal of Risk and Insurance 447 (1976) [hereinafter cited as Dorfman].

37 LIMRA, Insurance Report 1972-11 -- Factors Related to Salesman Turnover 1. There are a variety of reasons for high turnover rates among agents. According to a 1970 study, 43 percent of those agents who left did so for financial reasons. Another 32 percent left because they were dissatisfied with aspects of the job. Some of the job features singled out were "hours," "prospecting," and "dislike of selling." Besides not making enough money, the financial reasons for leaving included "security," "fringe benefits," and "stability." LIAMA, Research Report 1970-7 -- Where Do They Go?, A Statistical Study II.

companies and generated 38 percent of the total volume of sales.³⁸
Thus, a substantial amount of insurance is sold by agents who have not been working long and are likely to be less informed about insurance. For many struggling agents, the two-tier commission structure is likely to present an extremely strong incentive to sell cash value insurance.

3. Agent Training Often Emphasizes Selling Cash Value Policies

The training received by agents may also explain why many agents favor cash value policies. The NAIC Advisory Committee hypothesized that "the compensation bias may not be as important as those [biases] that the agent is taught."³⁹ An agent of 19 years gave three reasons why many agents seldom sell term:

First, when they were trained, it is possible that term life insurance was ignored. Second another possibility is that they were told the premium is lower and so is the commission, therefore agents shied away from term. Third, it could be that they have never been taught what term insurance really is and its various uses.⁴⁰

Aside from the reference to the lower commission rate paid on the sale of term insurance, this agent's reasoning boils down to a lack of agent training on term insurance.

38 LIMRA, The Manpower and Production Survey, Ordinary, Multiple-Line Exclusive-Agent, and Combination Companies 13 (1975).

39 NAIC, First Report of the Industry Advisory Comm. to the Agent's Compensation Systems Task Force of the NAIC C-3 Life Insurance Subcomm. 42 (June 6, 1976) [hereinafter cited as NAIC Industry Advisory Committee Report].

40 Dorfman, supra n. 36, at 455, quoting Kalmowitz, "Term Conversions are Beautiful," Life Assoc. News 83 (April 1975).

Industry publications, produced by LIMRA and used to train and assist agents, often reflect a bias for whole life insurance. For example, a section on opening comments which an agent should give at an interview recommends emphasizing the savings aspect of insurance:

Many agents like to put something into the prospect's hand immediately to get the heat off themselves and to capture the prospect's attention. A reprint of the company's retirement ad showing a couple basking on the Florida sands: "I came to talk to you about the Wilsons. Can you picture yourself retired some day like them?"⁴¹

In a LIMRA publication entitled Profitable Selling, the agent is told that whole life is almost always the best sale:

Temporary insurance is often both necessary and desirable. But if an agent sells a high proportion of temporary insurance because of its lower first cost, not only will persistency be less favorable, but policyowners will neither be satisfied nor well served. The policyowner receives premium notices regularly, but finds that no cash value or paid-up values accumulated for emergency use -- the premiums will increase with each renewal of the term period -- and that the time almost has to come when he or she will not be insured.

It is profitable to recommend that permanent life insurance is nearly always the best sale -- for the buyer and the agent.⁴²

We do not question the sincerity or integrity of those companies or agents who believe in the superiority of cash value

41 LIMRA, Getting the Interview 42 (1974).

42 LIMRA, Profitable Selling 42 (1976).

insurance.⁴³ Nor do we challenge the right of companies to determine how they compensate their agents. As we show in the next section, however, the agent compensation system and the bias in favor of cash value insurance contribute to the consumer and competitive problems discussed in this report.

4. The Impact of the Agency System

The agency system has arisen in the life insurance industry, in part, because many consumers know very little about life insurance. Thus, they rely upon the advice of an agent. Ideally, an agent will recommend the plan of insurance that best fits the buyer's needs. The ideal is often not realized in practice because substantial numbers of agents have a strong philosophical or financial bias favoring one form of insurance over another. In such a situation it is unlikely that an agent will provide consumers with all the information they need to make an informed purchase decision. For example, an agent attempting to sell whole life insurance is unlikely to compare the rate of return available from the whole life policy to alternative savings plans.⁴⁴ Although the rate of return is not the only thing a person should consider in choosing between term and whole life, it is certainly an important factor (see page 103, infra).

⁴³ We note that many agents are equally strong in their conviction that term insurance is almost always a more desirable purchase.

⁴⁴ In most cases companies do not supply rate of return information to agents. Thus, they are unable to supply this information even if they want to.

Because many agents have little incentive to disclose the rate of return, the amount of price competition between life insurance and alternative savings media is decreased.⁴⁵

The bias of many agents in favor of whole life insurance also contributes to the problem of underinsurance. The insurance needs of some people, especially young families with modest incomes and several small children, can be met only through the purchase of term insurance. Yet, in many cases, they may be sold insurance by an agent who has a strong philosophical and financial bias in favor of whole life insurance. As stated in the Moss Subcommittee Report:

[W]e think it worthwhile to say that any agent who sells \$10,000 of whole life rather than \$40,000 of term to a young, asset-poor family head is probably doing his client a gross disservice. The NALU witness admitted that such sales do occur and agreed that they were deplorable. It is evident to us that many purchasers in such situations have acted solely on the agent's advice and without any real understanding of what they were doing.⁴⁶

⁴⁵ Moss Subcommittee Report, supra n. 15 at 12-13, discussed this problem:

We want to make clear that we are not ascribing any improper acts or unethical conduct to agents in promoting their views to their customers. We are simply determining that the natural operation of the ordinary life insurance marketing system is not very likely to foster the informed consumer choices necessary to produce benefits from competition and maximize consumer welfare. It is clearly undesirable for a consumer's purchase decision to be determined by the views of whichever agent gets to him first.

⁴⁶ Id. at 19.

The agent compensation system also contributes to the problem of early lapse. As shown in Part II, a serious consumer problem is the early lapsing of cash value policies. The agent compensation system does little to deter lapse. As Table III-3 shows, commissions are generally heavily "front loaded," that is, the agent gets most of the total commission in the first year. The commission structure provides only small rewards for good "persistency" (low early lapsation) and small penalties for bad persistency. Ms. Anna Maria Rappaport, an observer of the agency system, has estimated that an agent in his fifth year who has much better than average persistency will only earn about 5 percent more than an agent with average persistency.⁴⁷ Similarly, the penalty for poorer than average persistency is small. Therefore, because low persistency sales do not come at the expense of high persistency sales, many agents may regard any sale--even a sale which will lapse early--as more profitable than no sale.

The same is not true for the company. Typically the first-year expense of putting new business on the books exceeds the first year premium. If the policy lapses in the first year both the consumer and the company lose money (although the former loses much more than the latter.)⁴⁸ Only the agent gains.

⁴⁷ Rappaport, supra n. 33, at 544.

⁴⁸ See Richardson, "Expense Formulas for Minimum Non-forfeiture Values," 29 Transactions of the Society of Actuaries 44 (1977) for estimates of the excess of first year costs over renewal cost for various types of policies.

Rappaport estimates that the company is hurt four times as much as the agent by low persistency.⁴⁹ In view of this fact, it is rather surprising that the companies have only recently been trying to improve the quality of their business by giving persistency bonuses to their ordinary agents. The commission structure contains little in the way of penalties for agents who consistently produce low persistency business.

In recognition of this problem, an advisory committee to the National Association of Insurance Commissioners (NAIC) has recommended that companies begin giving agents smaller first year commissions and larger renewal commissions.⁵⁰ This recommendation and various adaptations of it have been implemented by some companies.⁵¹ The NAIC advisory committee also concluded that there is a trend among companies toward installing some sort of persistency bonus system.⁵² Notwithstanding some adjustments in company commission structures, however, the evidence is that first year commissions remain large.⁵³ Consequently, while

49 Rappaport, supra n. 33, at 545. Brzezinski criticizes this estimate, but he agrees that the company is hurt more than the agent by bad persistency. Id. at 576.

50 NAIC Industry Advisory Committee Report, supra n. 39, at 8.

51 Id. at 9.

52 Id. at 13.

53 Id. at 9. Rappaport states that Metropolitan has begun using quality payments to spur persistency. Rappaport supra n. 33, at 568. Similarly, Equitable is said to be shifting away from a front load commission to a servicing fee that follows the account to provide continuing service.

(Footnote Continued)

the various bonus plans may ameliorate the lapse problem, the agent commission structure continues to contribute to lapsation.

53 (Footnote Continued)

LIAMA, Proceedings of 1973 Annual Meeting 81 (November 14, 1973).

IV. RECOMMENDATION: A COST DISCLOSURE SYSTEM FOR LIFE INSURANCE

The recommendations in this report focus on the lack of adequate information available to consumers and agents on the types and relative costs of life insurance policies. While these recommendations deal with only one of the causes of the problems discussed in this report,¹ this one cause is basic. No reform of the industry will be completely effective unless consumers and agents are provided with sufficient, clear information to compare the benefits and costs of different life insurance policies and to compare saving through life insurance with other savings media. Therefore, while perhaps not the total solution, cost disclosure is a necessary first step to any effective reform in the life insurance industry.

In May 1976, the National Association of Insurance Commissioners (NAIC) adopted a "model" cost disclosure regulation. The NAIC regulation requires that insurance companies give purchasers two documents at the time their new policies are delivered:

(1) a "buyer's guide," which contains general information about life insurance, and (2) a "policy summary," which sets forth the basic financial information about the policy and cost indices

¹

A complete discussion of possible remedies for the problems analyzed in this report would require that some consideration be given to changing the manner in which agents are compensated, possible changes in the solvency regulations, and the anti-rebate and replacement laws. These subjects are important, but they are beyond the scope of this report. (See Appendix VIII).

used to compare the costs of similar policies.² This regulation addresses some of the problems discussed in this report, and we commend the NAIC's sensitivity to the need for disclosure. Our analysis of the problems begins from the NAIC's recognition of the fundamental need for information disclosure. Our review of the NAIC model is designed to bring about essential improvements in the information presented to consumers.

The merits of any proposed disclosure system must be measured by its effectiveness in redressing the problems that have been detailed in Parts I and II. To summarize they are: (1) low average rates of return on life insurance savings; (2) severe but undisclosed penalties for early lapse of cash value policies; (3) widely varying costs for similar policies; (4) low rates of return received by existing policyholders, compared to the rates offered to new policyholders; and (5) the small average amount of individual ordinary life insurance protection against premature death relative to the premiums paid.

The following sections describe our recommendations on how to modify the NAIC model regulation to address these problems more effectively. Appendix X contains a draft regulation, buyer's guide and disclosure statements which incorporate these recommendations. The documents in Appendix X are not meant as the definitive solution to the cost disclosure problem. Rather they are provided to illustrate how the necessary elements of

² A copy of the NAIC model regulation is contained in Appendix X.

a cost disclosure system can be incorporated into an effective cost disclosure regulation. We recognize that there are no easy answers when it comes to the question of life insurance cost disclosure; there is room for discussion and disagreement. Undoubtedly, state regulators and others interested in cost disclosure will be able to suggest improvements on these materials.³

Our discussion of recommended modifications of the NAIC model regulation is divided into three sections:

1. The need to disclose the average annual rate of return for all cash value insurance and annuity products.
 2. The choice of an index number for comparing similar policies.
 3. Recommendations concerning other aspects of the NAIC model regulation.
- A. The Need to Disclose the Average Annual Rate of Return on All Cash Value Insurance and Annuity Products

Parts I and II demonstrate that many consumer problems in the life insurance industry stem directly from the extremely low rates of return offered on far too many cash value insurance products. The current lack of rate of return information is a major reason for the existence of these problems. The most important improvement that can be made in the NAIC model regula-

³ In this connection we note that the insurance departments of Wisconsin, North Carolina and Massachusetts proposed cost disclosure regulations which represent significant improvements over the NAIC model. Many of the recommendations in this report reflect the pioneering work done by these three departments. Unfortunately, none of the proposed regulations are currently in effect. The North Carolina regulation was overturned by the state legislature, the Wisconsin regulation is being challenged in court, and the Massachusetts proposal has not been finally adopted.

tion is to require disclosure of the average annual rate of return on cash value insurance and annuity products. Specifically, the NAIC model regulation does not provide consumers with the information necessary: (1) to evaluate cash value insurance as a savings vehicle, and (2) to compare dissimilar types of insurance policies. This section shows how rate of return is essential to consumers in making these decisions. It also discusses various industry objections to rate of return disclosure. Further, it sets out the appropriate method for computing rate of return, and the durations at which rates of return should be displayed.

1. Rate of Return Disclosure is Necessary to Evaluate Cash Value Insurance As A Savings Vehicle

Life insurance is often sold as a convenient way to save for retirement or other purposes. As shown in Part I, the life insurance industry is second only to savings and loan associations as a depository for personal savings. Yet it is the only savings medium that does not disclose the rate of return paid on consumer savings. Basic fairness dictates that consumers be given the rate of return they will receive on their savings through cash value insurance or annuities. The only information consumers currently receive concerning cash values, and all they would receive under the NAIC model regulation, is a ledger statement showing the cash value at selected years. Table IV-1 illustrates the type of information disclosed under the NAIC model regulation for a non-participating policy issued to a male at age 35.

Table IV-1

Policy Year	Premiums	Guaranteed Cash Value	Death Benefit
1	446.50	0.0	25,000
2	446.50	66.0	25,000
3	446.50	458.50	25,000
4	446.50	860.75	25,000
5	446.50	1,272.75	25,000
10	446.50	3,472.00	25,000
20	446.50	8,533.00	25,000
Age 60	446.50	10,807.75	25,000
Age 65	446.50	13,034.00	25,000

Although useful, the information contained in Table IV-1 does not tell the consumer much about the relative value of the policy as a savings vehicle. At the end of twenty years the policy will have a cash value of \$8,533. To many purchasers this sum might appear substantial for an annual expenditure of \$446.50 since they have also received \$25,000 worth of insurance. Because a portion of the premium provides death protection, the average consumer is unable to tell whether a whole life policy's cash value represents an adequate return on premiums paid. In fact, the policy in Table IV-1 has a 20-year rate of return of 2.09 percent. If the consumer had bought term insurance and invested the difference at 5 percent (after taxes), the side savings fund at the end of 20 years would be \$12,216, a difference of over 40 percent.⁴

This example demonstrates that the NAIC model does not provide sufficient information to enable the consumer to judge

⁴ For a description of this calculation see pages 55-56, supra. The actual calculation for the first twenty policy years is contained in the Hearings on Life Insurance Marketing and Cost Disclosure Before the Subcomm. on Oversight and Investigations of the House Comm. on Interstate and Foreign Commerce, 95th Cong., 2d Sess. 808 (1978) [hereinafter cited as Moss Subcommittee Hearings.]

the relative attractiveness of savings through cash value insurance compared with alternatives in the marketplace. It also shows the importance of making this comparison. Part II revealed that many policies in the marketplace have a 20-year rate of return of 3 percent or less. (See Tables II-7, II-8, supra). A person who saves \$1,000 each year at 3 percent will have, at the end of 30 years, approximately \$49,000. One who saves the same amount over the same period at 6 percent will have \$84,000.

2. Rate of Return Disclosure is Necessary to Compare Dissimilar Types of Insurance and Annuity Products

Rate of return disclosure on cash value products can also greatly assist consumers in making a choice between dissimilar policies. The NAIC model regulation does not attempt to deal with this problem.⁵ Yet this choice may be the most important decision a consumer has to make. The choice between dissimilar policies is often characterized as the choice between buying whole life insurance or buying term insurance and investing the difference. At this time there is a continuing, often emotional, debate within the life insurance industry concerning whether term or whole life is the superior product.⁶ We adopt

⁵ The indices provided in the NAIC model can only be used to compare the relative costs of similar policies.

⁶ See, e.g., Subcommittee on Oversight and Investigations of the House Comm. on Interstate and Foreign Commerce, Report on Life Insurance Marketing and Cost Disclosure, 95th Cong., 2d Sess. 9 (1978) [hereinafter cited as Moss Subcommittee Report].

a position of strict neutrality on this issue. Whole life insurance and term insurance plus a side fund are equally legitimate ways to protect against premature death while accumulating funds for retirement or other purposes.⁷ Either product can be a desirable purchase, depending upon an individual's circumstances. In deciding between an insurance program based primarily on term or whole life insurance, many factors should be considered including the individual's need for death protection, his tax bracket, and the rates of return available on other investments. But one of the most important factors that should be considered in choosing between term and whole life is the rate of return on the savings element of a cash value insurance policy.

The choice between dissimilar policies is much broader than deciding between term and whole life. The marketplace offers a multitude of policy types that combine insurance protection with savings in varying degrees--whole life, limited-pay life, deposit term, term plus annuity, economatic, modified whole life--to name just a few. Currently, consumers lack meaningful information to assist them in choosing among these dissimilar types of cash value policies. The information disclosed under the NAIC model regulation offers very little help in this regard. The following discussion illustrates the usefulness of rate of

⁷ Mathematically, term and whole life are very similar. Appendix III shows that a whole life policy can be viewed as a level premium term insurance policy that is renewable through age 100.

return in evaluating dissimilar cash value insurance policies, deposit term insurance and annuities.

a. Comparing Dissimilar Cash Value Policies

The difficulties facing the consumer in comparing dissimilar cash value policies, and the failure of the NAIC model to address this problem, are illustrated by looking at two \$50,000 policies issued to a 35-year old male--a whole life and a 30-year endowment.⁸ Table IV-2 shows the information concerning each of these policies that would be disclosed under the NAIC model regulation.⁹

Table IV-2

Endowment				
Policy Year	Premiums	Cash Value	Death Benefit	
1	1,349.50	0.0	50,000	
2	1,349.50	678.00	50,000	
3	1,349.50	1,877.00	50,000	
4	1,349.50	3,114.50	50,000	
5	1,349.50	4,386.50	50,000	
10	1,349.50	11,313.50	50,000	
20	1,349.50	28,628.00	50,000	
Age 60	1,349.50	38,210.50	50,000	
Age 65	1,349.50	50,000.00	50,000	

Whole Life				
Policy Year	Premiums	Illustrated Dividend	Cash Value	Death Benefit
1	1,117.50		70.50	50,000
2	1,117.50	102.50	872.50	50,000
3	1,117.50	136.50	1,693.00	50,000

⁸ In an endowment policy the cash value equals the policy's face amount at the end of a selected period, in this case 30 years.

⁹ Cost index numbers would also be displayed. However, these can only be used to compare similar policies. See page 127, infra.

4	1,117.50	171.50	2,530.50	50,000
5	1,117.50	208.00	3,384.50	50,000
10	1,117.50	405.50	8,595.50	50,000
20	1,117.50	819.00	18,591.50	50,000
Age 60	1,117.50	1,108.00	23,101.00	50,000
Age 65	1,117.50	1,268.00	27,521.50	50,000

Both of these policies will pay \$50,000 if the insured dies within the first 30 years of the policy and both provide savings accumulation in the event the insured lives. They differ in the size of the premium, how long the premiums must be paid, and the proportion of the premium dollar that goes to provide protection and savings. Looking at the information in Table IV-2, most consumers would be unable to determine which of the policies represents the better buy. The rate of return provides a simple answer to this question. The policies have the following rates of return:

	<u>Endowment</u>	<u>Whole Life</u>
5 years	-10.53%	-5.13%
10 years	- 1.04	3.38
20 years	1.86	5.01
30 years	1.99	5.32

Table IV-3 indicates what would happen over the first thirty policy years if the difference between the amount paid for the endowment policy and the whole life policy were invested in a savings fund at 5 percent (after taxes). At the end of thirty years, the endowment policy has a cash value of \$50,000. Under the "buy whole life and save the difference plan," the total savings are \$78,774 which is the sum of savings fund and the whole life policy's cash value. Thus, the difference in savings between the two plans is \$28,774. This example demonstrates

both the usefulness of rate of return in comparing dissimilar cash value policies and the importance to the consumer of being able to make this comparison.

b. Comparing Traditional Cash Value Insurance to Additional First-Year Premium Policies

The rate of return is also extremely useful in comparing traditional types of cash value insurance to "additional first year premium" policies. These policies require the payment of an additional premium in their first year or years, and provide for the return of the additional payment with interest at the end of a specified period. The most common of these policies is known as "deposit term." The recent introduction of deposit term has provoked spirited comments within the industry, ranging from highly exaggerated claims of its value to attempts by some industry members to get state regulators to ban its sale.¹⁰ Like most insurance products, however, it is neither inherently good nor bad. Whether it represents a desirable purchase depends upon the consumer's needs and the relative value of the benefit structure of the policy. It is, nonethe-

¹⁰ See, e.g., Sylvia Porter, "Is 'Deposit Term' For You?" New York Post (August 1, 1977); "Agents' Opposition to New Deposit Term. Life Plans Topic of Hearing in Texas," The National Underwriter, (Life/Health Ed.) at 1 (October 15, 1977); "Deposit Term-A Proponent Speaks," The National Underwriter, (Life/Health Ed.) at 13 (February 4, 1978); "Deposit Term Vs. Whole Life," The National Underwriter (Life/Health Ed.) at 8 (February 25, 1978); "Agent Exec. Join Deposit Term Debate," The National Underwriter (Life/Health Ed.) at 11 (March 18, 1978); and "Should 'Deposit' Policies Be Banned," The National Underwriter (Life/Health Ed.) at 11 (April 1, 1978).

Table IV-3

Year	(1) Endowment Premium	(2) Net Whole Life Premium	(3) Whole Life Cash Value	(4) Endowment Cash Value	(5) [1-2] Savings Deposit	(6) [5 + Interest] Side Acc. Fund 5%	(7) [3 + 6] Total Savings Component Whole Life Cash Value + Side Fund	(8) [(3-2) + 6] Savings Deposit Difference
1	1,349.50	1,117.50	70.50	0	232.00	243.50	314.00	314.00
2	1,349.50	1,015.00	872.50	678.00	334.50	607.00	1,479.50	801.00
3	1,349.50	981.00	1,693.00	1,879.00	368.50	1,024.50	2,717.50	838.50
4	1,349.50	946.00	2,530.50	3,114.50	403.50	1,499.50	4,030.00	915.50
5	1,349.50	909.50	3,384.50	4,386.50	440.00	2,036.50	5,421.00	1,034.50
6	1,349.50	872.00	4,396.00	5,694.50	477.50	2,639.50	7,035.50	1,341.00
7	1,349.50	833.50	5,423.00	7,040.00	576.00	3,313.50	8,736.50	1,696.50
8	1,349.50	793.00	6,465.50	8,424.00	556.50	4,063.50	10,529.00	2,105.00
9	1,349.50	752.50	7,523.00	9,848.00	597.00	4,893.50	12,416.50	2,568.50
10	1,349.50	712.00	8,595.50	11,313.50	637.50	5,807.50	14,403.00	3,089.50
11	1,349.50	671.00	9,540.00	12,821.50	678.50	6,810.50	16,350.50	3,528.50
12	1,349.50	628.50	10,498.50	14,374.00	721.00	7,908.00	18,406.50	4,032.50
13	1,349.50	586.50	11,470.50	15,971.50	763.00	9,104.50	20,575.00	4,603.50
14	1,349.50	544.40	12,454.50	17,616.50	805.00	10,405.00	22,859.50	5,243.00
15	1,349.50	501.50	13,451.00	19,311.00	848.00	11,815.50	25,266.50	5,955.50
16	1,349.50	460.00	14,458.50	21,057.00	889.50	13,340.50	27,799.00	6,742.00
17	1,349.50	417.00	15,476.50	22,858.00	932.50	14,986.50	30,463.00	7,605.00
18	1,349.50	372.00	16,505.00	24,717.50	977.50	16,762.00	33,267.00	8,549.50
19	1,349.50	335.00	17,543.00	26,189.00	1,014.50	18,665.50	36,208.50	10,019.50
20	1,349.50	298.50	18,591.00	28,628.00	1,051.00	20,702.50	39,293.50	10,665.50
21	1,349.50	260.50	19,492.50	30,420.50	1,089.00	22,881.00	42,373.50	11,953.00
22	1,349.50	109.00	20,395.50	32,269.50	1,240.50	25,327.50	45,723.00	13,454.00
23	1,349.50	75.50	21,299.00	34,179.00	1,274.00	27,931.50	49,230.50	15,051.50
24	1,349.50	42.00	22,201.00	36,157.00	1,307.50	30,701.00	52,902.00	16,745.00
25	1,349.50	9.50	23,101.00	38,210.50	1,340.00	33,643.00	56,744.00	18,533.50
26	1,349.50	- 23.00	23,997.50	40,348.50	1,372.50	36,766.50	60,764.00	20,415.50
27	1,349.50	- 55.00	24,889.00	42,582.00	1,404.50	40,079.50	64,968.50	22,386.50
28	1,349.50	- 86.50	25,774.50	44,924.00	1,436.00	43,591.50	69,366.00	24,442.00
29	1,349.50	- 118.00	26,652.50	47,390.50	1,467.50	47,312.00	73,964.50	26,574.00
30	1,349.50	- 150.50	27,521.50	50,000.00	1,500.00	51,252.50	78,774.00	28,774.00

less, a product for which meaningful rate of return disclosure is critical.¹¹

In deposit term, the consumer pays a first year premium that is substantially higher than subsequent premiums. This additional premium or "deposit" will be returned at the end of a specified period (usually 10 years) in an amount that is generally double the initial deposit. The representation is made that the "deposit" will thus earn interest at the rate of 7 to 10 percent. In most cases, this representation is misleading. A rate of return of 10 percent on the "deposit" means little if the consumer is paying an exorbitant rate for the term insurance component of the policy.¹² What is important is not the rate of return that is imputed on the "deposit" but the average annual rate of return on the gross premiums paid for the total package of insurance and savings.

In an article in the August 1978 Best's Review, Professor Harold Skipper of Georgia State University calculated the 10-year average annual rate of return of 21 deposit term policies

11 Our discussion of deposit term is applicable to the other additional first-year premium policies.

12 Deposit term can be viewed as a special type of endowment insurance. It differs from the traditional endowment in that the premiums are not level and the deposit term product does not mature for the full policy face amount. The traditional mathematical view of endowment insurance is that it is a combination of level term insurance and a pure endowment--each in the same amount. Similarly, deposit term is a combination of (usually) ten-year level term insurance and a pure endowment but in unequal amounts. See Skipper, "An Analysis of 'Deposit Term' Life Insurance," Best's Review, at 10 (August, 1978).

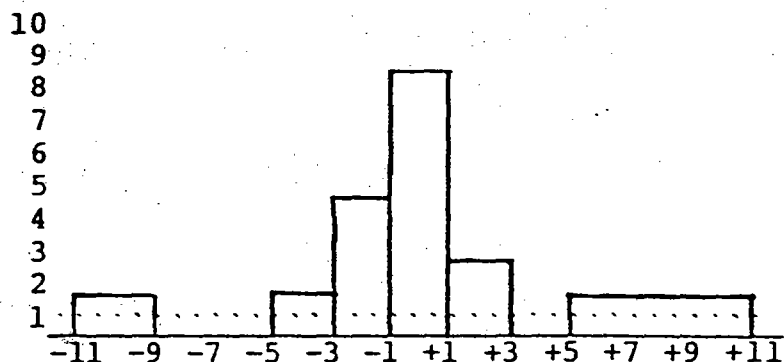
using the same low annual renewable term rates to calculate the return for each policy.¹³ He found that, while all the companies claimed an implicit rate of return of 7-10 percent on the deposit, the actual rate of return on the policy as a whole at issue age 25 varied from a high of plus 9.34 percent to a low of minus 9 percent. Table IV-4 shows the average rates of return for policies issued at ages 25 and 45 and the distribution of rates of return at age 25:

Table IV-4

Claimed Implicit Rate of Return	No. of Policies	Average Rates of Return	
		Age 25	Age 45
7-8%	13	-0.23%	-5.33%
9-10%	8	1.30%	-3.23%
Averages for all policies		0.32%	-4.65%

Distribution of Rates of Return - Age 25

Number of Policies



The Skipper study demonstrates two points: (1) there is an enormous variation in the quality of deposit term products on the market and (2) the only way consumers can evaluate whether this type of policy is a desirable purchase is if they are pro-

¹³ Id. at 12.

vided with the rate of return on gross premiums paid.

The preceding analysis of deposit term insurance illustrates a further need for mandatory, standardized rate of return disclosure. In some cases what purports to be rate of return information is given, but it is calculated and used in a misleading manner. An example of this is the representation that the "deposit" in deposit terms earns 7 to 10 percent annual interest.¹⁴ The most important area where this problem arises is in the sale of annuities which is discussed in the next section.

c. Using Rate of Return Disclosure to Evaluate Annuity Products

Annuities are contracts used to provide a policyholder with retirement income.¹⁵ Prior to retirement the contract is much like a savings account. The amount contributed minus sales and administrative charges earns interest. If a policyholder dies before retirement, he or she receives either the cash value of the contract or premiums paid, whichever is greater. Upon retiring, the policyholder usually can turn in the contract for its cash value or choose from annuity payment options which are set forth in the contract. These payment options guarantee to pay the annuitant a stipulated

14

In some whole life sales presentations an example is given comparing a whole life policy with buying term and investing the difference. The whole life policy is made to appear to be a better buy by using expensive term insurance rates in the comparison.

15

The number of annuities in force with domestic life insurance companies under individual and supplemental contracts totaled 4.3 million in 1977. Individual annuities accounted for nearly 3.7 million of the total. The amount paid into individual annuities in 1977 was \$4.4 billion. American Council of Life Insurance, Fact Book 36, (1978) [hereinafter cited as Fact Book].

income for a specified period--usually life.¹⁶

Two types of information are generally disclosed for annuities: (1) the annuity rate which is the number of dollars per \$1,000 accumulated that will be paid the annuitant monthly starting at retirement, and (2) the interest rate paid on the sums deposited into the annuity. The rate of interest will determine the amount of investment accumulation or cash value of the annuity.¹⁷ The actual amount of monthly income the annuitant will receive is called the annuity rent. The annuity rent is a function of both the annuity rate and the investment accumulation (or cash value) by which this rate is multiplied. As with life insurance, the cost of comparable annuities varies widely.¹⁸ This cost dispersion results, in part, from the current lack of meaningful standardized cost disclosure.

The NAIC has proposed a separate model cost disclosure regulation for annuities which requires disclosure of the guaranteed and current annuity payments at the scheduled commencement of the annuity. This information is important and should be disclosed. The NAIC model regulation, however, does not require disclosure of the interest rate (rate of return) that the annuity pays on the savings deposited in it. For reasons stated below, the staff recommendation would go

16 In addition to providing income for life, most annuities guarantee the payment for a fixed number of years, such as ten.

17 Both the annuity rate and interest rate are usually displayed on a guaranteed and current basis. The current rate is the rate that is being paid at the time the annuity is sold.

18 A study of annuity rents, annuity rates, and investment performance of 42 life insurers in the United States in 1975 found significant variability in all three areas. Greene, Neter, and Tenney, "Annuity Rents and Rates--Guaranteed vs. Current", 44 J. Risk & Insurance 383 (1977) [hereinafter cited as Greene, Neter, and Tenney.]

further than the NAIC regulation and require rate of return disclosure on annuity products.¹⁹

Two common types of advertisements used to promote the sale of annuities illustrate the possible deception when non-standardized rates of return are used. First, some advertisements guarantee a high rate of return, for example, 8 percent. They fail to explain that this figure does not represent the return on the gross premium paid. Rather it gives the return on the gross premium only after substantial administrative charges and sales commissions are deducted.²⁰ If the rate of return is expressed as a percentage of premiums paid, the return in some cases plummets to as low as 4 percent. For a description of the advertising of annuity interest rates see the Federal Trade Commission's Staff Report on Individual Retirement Accounts/Annuities (1978). That Report gives the following examples:

[O]ne flexible premium annuity advertised by Pacific Mutual at 8 1/4% has an actual rate of return of -.49% after 5 years, 2.82% after 10 years and 4.52% after thirty years. Thirty percent of the first year's payments to this flexible premium annuity will go for company costs. Valley Forge Life Insurance projects investment growth at 5% yet after 5 years its average annual rate of return was -10.36%, after 10, -1.11%, and after 30 years, 4.48%.²¹

¹⁹ The staff recommendation with regard to annuities is incorporated into the draft regulation, see Appendix X.

²⁰ Sometimes the advertisements do qualify the interest rate quoted by adding the words "with deduction of fees" after the quote. But usually neither the amount of these fees nor the effect they will have on the advertised rate of return is disclosed.

²¹ See Federal Trade Commission, Bureau of Consumer Protection Staff Report on Individual Retirement Accounts/Annuities (IRAs) submitted to the Subcommittee on Oversight, House Ways and Means Committee, at 64-67 (March 1978). In particular see page 4 of Appendix E of the IRA Report.

Second, some advertisements guarantee in large print a high rate of return. In minute print at the bottom of the ad, however, they limit the high rate guarantee to the policy's first three years and guarantee a much lower rate for succeeding years. In both cases, the method by which the rate of return for annuities is calculated should be standardized.

As previously mentioned, the monthly income an annuity will ultimately pay (the rent) is a function of both the annuity rate and the amount of cash accumulation to which the rate is applied. The cash accumulation is, in turn, determined by the rate of interest the annuity pays. One study of annuities found substantially less variation in annuity rates than in cash accumulations. It concluded that the investment accumulation is a more important factor than annuity rates in determining the amount the annuitant will ultimately receive (the rent).²² It is important to disclose the amount of the annuity payment that a consumer will receive. This information, however, will not allow consumers to compare savings through annuities with alternative savings media. To make this comparison, the annuity's rate of return (or interest rate) must also be disclosed. This can be accomplished by requiring disclosure of the average annual rate of return on gross premiums paid for all annuity products.

22 Greene, Neter, and Tenney, supra n.18, at 388-389. The coefficients of variation for annuity rates, investment accumulations and rents is set forth below:

	Guaranteed Basis	Current Basis
Rents	10.1%	13.6%
Rates	3.7%	5.7%
Investment Accumulation	7.4%	11.3%

3. Industry Arguments Against Rate of Return Disclosure

In our discussion of rate of return we have viewed cash value insurance, in part, as a savings medium. Many industry spokesmen object to rate of return disclosure on the ground that it requires what they allege is an improper separation of whole life insurance into savings and protection. In their view, life insurance is an inseparable contract and can only be viewed as a whole.²³ An example of this argument can be found in a paper prepared for the NAIC Life Insurance Cost Comparison Task Force by the Institute of Life Insurance (now ACLI). It states:

The whole life insurance contract is a contract of protection - an arrangement by which the insured person, upon regular payment of a level premium, is guaranteed that upon

²³ Another common way to view whole life insurance is to look at it as the purchase of insurance protection on the installment plan. Professor Robert Mehr has written, "What people want is the opportunity to buy their whole life insurance on the installment plan, just as they purchase their homes, automobiles, heavy appliances, and other large capital items. For example, instead of paying a single premium of \$3,000 for a \$10,000 whole life policy, the 25 year old buyer would normally prefer to pay a series of equal annual payments, either for life or for a limited number of years. . . . [T]he installment premium explanation of the level premium is the correct one because it is consistent with the method used to compute level premiums." Robert Mehr, "Development of Life Insurance in the Past Two Years in the United States," Pacific Insurance Conference, 2-4 (August 23-31, 1973).

his death his beneficiary will receive a stated amount.

While the central purpose of the contract is insurance protection, the contract also provides auxiliary rights which are available to the policyholder during his lifetime if he does not wish to continue the original arrangement. These stem from the level premium plan, the effect of which is to collect from the policyholder more than the cost of the pure risk in the early years to permit accumulation of a reserve against the rising risk of the later years, when the level premium alone would be insufficient.

A fair reading of the whole life contract, and an analysis of the history of its development, will demonstrate that the foregoing language accurately describes the true nature of the contract and points up the impropriety of definitions which would split the policy into two parts: i.e., protection and savings elements.²⁴

It is a matter of semantics whether a cash value insurance contract is described as an indivisible whole, insurance purchased on the installment plan, or a combination of death protection and savings. The debate should not focus on whether a particular definition is correct, but rather on whether the definitions are useful in helping to understand different aspects of the whole life contract. Each of these definitions can be useful for different purposes. The value of looking at the whole life contract from "complementary vantage points" has been expressed by Spencer L. Kimball and Mark S. Rapaport:

Their view [the actuaries] is not the

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The Nature of the Whole Life Contract 27 (NAIC 1974) [hereinafter cited as The Nature of the Whole Life Contract].

common sense view, but it is not nonsense. It is appropriate for an actuary to regard the savings element as an integral part of an insurance contract. The "savings element" is an indispensable feature of level premium life insurance without which the system would not work. The narrow actuarial perspective, however, does not represent ultimate truth and need not govern others who see the policy from a different and complementary vantage point. The savings element in life insurance is not exactly like a savings account. Nevertheless, the cash value is available to the policyholder. All he need do is either terminate the policy, pay interest on a policy loan, or assign the policy as collateral for a loan from a lender other than the insurer, and the cash value is available. For the planning of his personal finances it would be inane to advise a policyholder not to regard his cash value as an asset.²⁵

The view of cash value insurance as a combination of death protection and savings is commonly found in life insurance textbooks because it is a very useful and understandable way to

25 Kimball and Rapaport, "What Price Disclosure? The Trend to Consumer Protection Life Insurance", 1972 Wisc. L. Rev. 1025, 1028 [hereinafter cited as Kimball and Rapaport]. The authors give the following example of the usefulness of this approach:

The most striking illustration of the value of looking at phenomena from "complementary" viewpoints resulted from the development of quantum theory. As a result, it became useful to consider light sometimes as discrete particles instead of, as was traditional, waves. The choice depends on the purpose for which an inquiry is made and study techniques used. This notion of complementarity from the hard sciences ought to be readily understood by mathematically trained actuaries. Holton, "The Roots of Complementarity," 99 Daedalus 1015 (1970).

Id. at 1028 n. 14.

describe a complex financial instrument.²⁶ The industry admits that agents also often describe the contract in the same way for the same reason:

[E]ven the most dedicated agent can be hard put to explain the intricacies of a product to a client who is ill-equipped by education to grasp the details of the life insurance contract, and as experience shows, is not likely to study the policy very thoroughly. By dividing the contract into protection and savings elements, the agent, like many educators, may find it easier to describe the whole life policy in terms of this and rather than in technical language.²⁷

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...under the level-premium plan a \$1,000 policy does not provide \$1,000 of pure term insurance. Rather it provides a decreasing amount of term insurance and an increasing investment element which when combined are always just equal to the face amount of the policy. This analogy of the combination of protection and investment is found in all level-premium plans....

S. Huebner & K. Black, Life Insurance 11 (1972). A similar description is contained in Linton, How Life Insurance Can Serve You 63 (1958).

27

The Nature of the Whole Life Contract, supra n. 24, at 20.

Moreover, agents are often trained to refer to the whole life contract in this way. An Occidental Life agent training manual contains the following definition,

Permanent insurance is a combination of insurance protection and savings. As we said, permanent insurance has built-in savings values. A portion of each premium paid goes into a 'savings account' (represented by the policy's cash value) and these savings increase steadily, year by year.... As the cash value increases throughout the policy period, the insurance protection decreases proportionately.

Occidental Life Insurance Company of California (agent training manual) 10-11 (1970).

Kimball and Rapaport provide a succinct answer to the industry's opposition to rate of return disclosure on the "indivisible whole life contract" theory:

Thus the technically tenable actuarial point of view is, for disclosure purposes, irrelevant. The inseparable contract can be separated conceptually as easily as one can separate into two parts the purchase of a car with extra equipment for a single price. That the conceptual separation is not only possible, but an appropriate way to look at cash value life insurance, is shown not only by the fact that it is found in standard textbooks including those of the insurance saint, S.S. Huebner, but even more persuasively by the industry's own readiness to be recognized as a major savings institution when questions other than price disclosure are under discussion. Thus, the Life Insurance Association of America, in a scholarly monograph for the Commission on Money and Credit, published in 1962, had no qualms about a chapter entitled "Policyholders' Saving Through Life Insurance." The study talks of industry efforts to push whole-life and endowment as opposed to term, in the hope of "an augmented flow of savings into life insurance." They further expressed hope that the "declining trend in life insurance savings" would be transitory.

The readiness of the industry to make the conceptual separation whenever it suits industry purposes makes it impossible for us to take the actuaries' objections to the savings notion seriously enough to argue about it further.²⁸

The Moss Subcommittee reached a similar conclusion: "We regard the 'inseparable whole life policy' argument as a diversionary ploy. In our view, reliance on it in the future as a defense to rate of return disclosure will cross the line into irresponsi-

²⁸ Kimball and Rapaport, supra n. 25, at 1028-1029 (footnotes omitted).

bility."²⁹ We agree.

The industry also objects to rate of return disclosure because some features of a whole life policy are unique and cannot be duplicated by any program based on term insurance plus savings.³⁰ We agree whole life policies have unique characteristics that cannot be duplicated precisely by a program based on term insurance plus savings. As we have previously stated, supra, page 34, these advantages of the whole life contract may well lead consumers to accept a lower rate of return from a whole life

²⁹ Moss Subcommittee Report, supra n. 6, at 23 n. 55.

³⁰ This argument was presented in the testimony of the American Council of Life Insurance before the Moss Subcommittee:

Unlike a bank savings account, the cash value of a whole life policy may be used in many ways such as to purchase extended or paid-up insurance benefits, or to provide a life income to the insured or beneficiary, or as collateral for a relatively low cost policy loan. Moreover, since whole life insurance policies are not, in fact, bank accounts plus term insurance, income taxes are not payable on any interest that might be imputed to the policyholder. Further, at death, life insurance proceeds can be obtained quickly without passing through the estate of the insured and without having to be probated. Savings accounts do not provide any of these features, nor can banks provide the very long term investment guarantees which are inherent in whole life policies. Also, banks cannot enhance the insured's ability to continue his program of family protection by providing such benefits as the waiver of premiums in the event of disability. These advantages of permanent life insurance are ignored in the "buy term and invest the difference" comparison.

Id. at 21.

policy than they could receive elsewhere. The existence of these advantages is not, however, a valid argument for not disclosing the rate of return. Only if consumers know the rate of return received on a whole life policy, can they balance the unique characteristics of the whole life policy against the higher rates of return that may be available elsewhere.³¹ The buyer's guide should contain an explanation of the unique features of cash value insurance that distinguishes it from other forms of savings.

A further argument against rate of return disclosure is that it may cause many purchasers to select term rather than whole life insurance. Some argue that the only way many people can save for retirement or build an estate is to buy whole life insurance. It is contended that if people buy term insurance they will not save the difference between the term and whole life premium and will thus be left without funds in their later years. We see no evidence that consumers are only able to save through cash value insurance. Moreover, if consumers buy term and spend the difference, that is their choice. It is not an

³¹ A variant of this argument is that it may be difficult in practice to duplicate exactly a whole life policy by term insurance and a side fund because the marginal reductions in the amount of term insurance purchased implicit in the Linton Yield calculation may not be readily available in the marketplace. What the yield does is give a measure of the relative value of a cash value policy by comparing it to a hypothetical program of buying term insurance and investing the difference. The fact that a person may not be able to duplicate exactly the whole life policy does not detract from the usefulness of the information conveyed.

argument against rate of return disclosure. We agree with the Moss Subcommittee's analysis of this argument:

Even assuming that many people will "spend the difference" without remorse, it does not follow that the solution is to promote whole life sales by obscuring rate of return differentials. We simply reject the notion, implicit in this argument, that insurance companies should be allowed to fool people into saving for the future. If, from a social policy standpoint, we want people to save, and are afraid they will not do so voluntarily, the response has to be crafted on the floors of Congress, not in insurance company boardrooms.³²

Finally, the industry argues that the rate of return will vary somewhat depending upon the yearly renewable term rates used in the calculation.³³ A report by the Society of Actuaries on life insurance cost comparison index methods recommended that a low scale of term rates be used because "it would typically be assumed that one who seriously considers the two alternative programs upon which the method is based would attempt to obtain a low priced YRT (Yearly Renewable Term) policy."³⁴ We agree and think it is important that the rates used accurately reflect low cost term insurance available on the market.³⁵ If they do,

32 Moss Subcommittee Report, supra n. 6, at 25.

33 The rate of return can vary as much as 1 percent if high-cost rather than low-cost term rates are used in the calculation. Society of Actuaries, Analysis of Life Insurance Cost Comparison Index Methods 145 (1974) [hereinafter cited as Actuaries Report.]

34 Id. at 141.

35 It is important that all companies use the same YRT rates to calculate the Linton Yield. To insure that the rates used accurately reflect the low-cost term rates available
(Footnote Continued)

we do not think it is particularly relevant whether a different yield could be obtained by the use of high YRT rates.³⁶

4. Method Used for Rate of Return Disclosure

Parts IV.A.1 and 2 demonstrate the usefulness of rate of return disclosure. This section considers the method that should be used to calculate rate of return.

In this report we recommend what is known as the "Linton Yield" as the method for rate of return disclosure. The Linton Yield is a compound annual rate of return on gross premiums paid over a selected holding period. For example, if a policy has a 10-year Linton Yield of 3.5 percent it means that, if the policy is held for ten years, it will have earned an average of 3.5 percent per year compound interest. It is calculated by deducting from the whole life premium (less any dividend) the amount it would cost to buy as much term as is represented by the policy's pure insurance portion. The difference can be considered as a savings deposit. The rate of return, then, is the interest rate required to make these deposits, accumulated

35 (Footnote Continued)

in the market, it would be useful if an organization such as the Society of Actuaries or the NAIC survey market term rates on a yearly basis.

36 Because the rate of return is somewhat sensitive to the term rates assumed in the calculation, the Buyer's Guide should give examples of the term rates used for selected ages and face amounts. If this is done, consumers will be able to judge for themselves the appropriateness of a policy's rate of return for their particular situations. See Buyer's Guide in Appendix X.

at interest, equal the cash value of the policy at the end of the period of years chosen for the computation.³⁷

The Moss Subcommittee concluded that rate of return is an essential component of any meaningful disclosure system. While they stated that the Linton Yield was an acceptable method of disclosing rate of return, they preferred an alternative rate of return calculation known as the "cash accumulation method." The cash accumulation method compares a cash value insurance policy with a "buy term and invest the difference" alternative. It does this by comparing the funds available under an insurance policy with the fund available by allocating available premium dollars between term and a side investment fund that earns a specified interest rate.³⁸ The number disclosed to consumers is the dollar amount in the side fund at the end of selected years.

37 Moss Subcommittee Report, supra n. 6, at 13-14. A description of how the Linton Yield is calculated is set forth at pages 25-26, supra.

38 In the calculation, the cash outlay for each program is kept the same. In addition, the sum of the term face amount and the side fund is equal to the whole life face amount. Therefore, the beneficiary will always receive the same dollar amount under either program should the insured die. The only difference between the two programs is between the amount of the whole life policy's cash value and the side investment fund. The cash accumulation method is very similar to the Linton Yield except the interest rate is assumed rather than solved for. See Appendix VI for further details on this method as used by the FTC staff in this report. At various points in this report we have used the "cash accumulation method" of analysis, see e.g. page 337 supra. This method of comparing term and whole life was first described in Murray, "Analyzing the Investment Value of Cash Value Insurance," 43 J. Risk & Ins. 121 (1976).

The Subcommittee expressed its reasons for preferring the cash accumulation method over the Linton Yield as follows:

The cash accumulation method shows when the side fund exceeds the whole life face amount. This is important for purchasers who never intend to surrender their whole life policies. They are not especially interested in how the whole life cash value increases, and do not find a Linton Yield figure very useful because it merely reveals the side fund earnings rate that would be needed to exceed the cash value. This consideration convinces us, on balance, to prefer the cash accumulation method over the Linton Yield as a comparative method. However, we do not affirmatively oppose the Linton Yield, and regard both approaches as acceptable.³⁹

We recognize that the disclosure of the point when the side fund exceeds face amount of the insurance policy is an advantage of the cash accumulation method. This advantage, however, must be weighed against features of the Linton Yield which we think are clearly superior. There are two advantages of the Linton Yield. First, the Linton Yield gives a percentage figure for the rate of return. This concept is very familiar to consumers. The normal way that other forms of savings or investments are compared is through a percentage rate of return.⁴⁰ Therefore, the Linton Yield may well be more understandable than the dollar amounts of the side fund displayed under the cash

39 Moss Subcommittee Report, supra n. 3, at 20.

40 This is not to say the higher yielding investment should always be selected. The lower yielding investment may be subject to less risk, have different tax consequences, or have a variety of other characteristics that make it a desirable purchase. Nevertheless, the rate of return is an essential fact that is considered in most saving or investment decisions.

accumulation method. Second, the cash accumulation method is most useful in comparing term and whole life. The term/whole life choice is, however, only one aspect of the dissimilar policy comparison problem. It is also very important to be able to compare the quality of the wide range of products on the market that combine protection and savings in various degrees (see discussion, page 102 supra). The Linton Yield provides a standardized, easily understood method to do this. In contrast, the cash accumulation method is of limited use in comparing dissimilar types of cash value policies.⁴¹ For these two reasons we prefer the Linton Yield as the method to disclose rate of return information, although an effective disclosure system could be built around either method.

We recommend the rate of return be disclosed for the 5th, 10th, 20th and 30th years of the policy. In Part II it was seen that the early lapse of cash value policies is a major consumer problem. The 5th and 10th year rate of return will

⁴¹ The cash accumulation method shows the amount available in the side fund at age 65 for all cash value policies. The difference between a policy's cash accumulation and its cash value, can be compared to the differences for other similar policies to produce a ranking of policies consistent with a Linton Yield. The policy with the lowest difference would be the lowest cost policy. If the policies were different, like the example on page 104, supra (\$50,000 endowment versus \$50,000 whole life), the information generated by the cash accumulation method would be of little use in comparing costs. The method would disclose for each policy the amount in the side fund if the premium dollars were allocated between term insurance and the side fund. However, the difference between the cash accumulation and the cash value would tend to be greater for the endowment policy, even if it was a better buy. This is because endowment premiums tend to be substantially greater than whole life premiums, and their cash accumulations are thereby larger.

disclose to consumers the severe economic consequences of the early termination of many cash value insurance products. It will reinforce the message contained in the buyer's guide that a person should not buy a whole life policy unless one plans to keep it for at least ten years.⁴²

The 30-year rate of return is useful for two reasons. First, the annual rate of return on many insurance policies increases until a policy is held 15 or 20 years. At that point, it essentially levels off. (See Tables II-7, II-8, supra). The 30-year rate of return will disclose this leveling process and eliminate any inference that the early year pattern of a substantially increasing rate of return continues after the policy has been held for 20 years. Second, the 30-year rate of return will indicate to consumers

42 To deter early lapse of whole life policies, the Moss Subcommittee recommended that any cash value table displayed for a whole life policy print in red the policy year and the corresponding cash value figure for all years that have a negative Linton Yield. The cash value table would be accompanied by the following notice: "WARNING-Termination of this policy during the years printed in red will result in a loss to you. Do not purchase this policy unless you intend to keep it at least long enough to avoid loss. Ask your agent for further details." Moss Subcommittee Report, supra n. 6, at 27. This proposal has considerable merit and we would like to see it tried. We think however, that disclosure of the five- and ten-year Linton Yields would accomplish the same goal. Moreover, the approach we recommend has two advantages. First, disclosure of the yields could be done before sale, whereas the Subcommittee proposal would be contained in the Policy Summary delivered with the policy. Second, disclosure of the yield will indicate the magnitude of the loss in the case of a five-year lapse (where minus 25 percent rates of return are common) and the often low ten-year yield even if it is positive.

those policies whose dividends and cash value increases level off after the twentieth year. Traditionally, twenty years has been the period used for cost comparison purposes. As a result, some policies' benefits substantially decrease after the twentieth year.⁴³ Disclosure of the 30-year rate of return will alert consumers to the possible pitfalls in purchasing such a policy.

This section discussed the need to provide consumers with information to compare dissimilar insurance policies. It showed that the NAIC model regulation does not address this problem and demonstrated the usefulness of rate of return (Linton Yield) in comparing dissimilar policies.⁴⁴ The next section deals with the problem that the NAIC model does address--that of comparing similar policies.

43 An example of one such policy is contained in the Moss Subcommittee Hearings, supra n. 4, at 178. This policy had the following average annual rates of return: 5-year: -2.80%; 10-year: 2.36%; 20-year: 3.78%; 40-year: 2.71%.

44 As discussed later, the Linton Yield can also be used to compare similar cash value policies, see pages 157-158, infra.

B. Choice of an Index Number for Comparison of Similar Policies

Central to any cost disclosure system is an index number to provide a means to compare similar life insurance policies. As previously noted, a major problem facing consumers is the selection of a low-cost policy among an array of comparable policies. This problem is particularly acute in the case of cash value insurance. There, it is impossible to ascertain the true cost of a policy simply by looking at the premium, because, in addition to providing death benefits, whole life policies accumulate cash values and, in many cases, pay dividends. To compare the costs of two similar cash value policies, it is necessary to use an index that takes these factors, as well as the time value of money into account.⁴⁵ This section examines the current NAIC cost index system and recommends modifications of that proposal.

1. NAIC Cost Indices

The cost index system proposed by the NAIC stems largely from a recognition of the inherent failings of the traditional techniques used by agents to indicate life insurance costs. Traditionally, the life insurance industry employed the "net cost method" to explain life insurance costs. The agent would illustrate the cost of a particular policy by adding up the

⁴⁵ It is also necessary to use an index to compare the costs of two term policies because the first-year premium is often an unreliable guide to the policy's actual cost, since the renewal premiums for some term policies go up faster than others. In addition, many term policies pay dividends which may lower the cost of those policies.

premiums paid over a selected period (usually 20 years) and subtract from this sum the dividends received and the cash surrender value of the policy at the end of the twentieth year.⁴⁶ This result was then divided by the face amount of the policy to obtain a "cost" per thousand dollars of coverage which could be compared to "cost" of other policies.

The 20-year net cost figure was often negative. This gave rise to the totally misleading representation by many agents that over a twenty-year period, if a person bought a whole life policy, the insurance would not cost the individual anything. This representation illustrates the fundamental flaw in the traditional net cost method: it totally ignores the time value of money.⁴⁷ In representing that purchasers would receive essentially free insurance, the traditional net cost method failed to consider the cost to consumers of foregoing the use of their money over an extended period of time.⁴⁸

46 See, Moss Subcommittee Report, supra n. 6, at 33.

47 The time value of money simply means that, because of interest, \$100 available for use today is worth more than the same amount some time in the future.

48 As the traditional net cost method ignores the time value of money, it is also often an unreliable way to compare the relative costs of two similar cash value policies. This is because comparable insurance policies often have very different patterns of dividends. For example, two policies with the same premiums, dividends paid and cash value at the end of twenty years will have the same net cost. If one policy, however, pays very low dividends in the early years of the policy and high dividends in the policy years 15 to 20, if the time value of money is considered, it may be of substantially less value to a consumer than a policy that has a more level pattern of dividend accumulation.

Due in large measure to increasing criticism of the traditional net cost method of cost comparison, three major life insurance company associations in 1969 formed a Joint Special Committee on Life Insurance Costs.⁴⁹ This committee was asked "to consider the method or methods that a prospective buyer of life insurance may find most suitable for use in comparing the premiums, dividends and cash values of comparable policies offered by different life insurance companies."⁵⁰ The Joint Special Committee Report recommended that the industry abandon the use of the net cost method in favor of an interest-adjusted cost index (also known as the surrender index), a method of comparison that recognizes the time value of money.⁵¹

⁴⁹ The committee, chaired by Mr. E.J. Moorhead, the President-elect of the Society of Actuaries, was formed by the American Life Convention, the Institute of Life Insurance and the Life Insurance Association of America. See, Report of the Joint Special Committee on Life Insurance Costs (1970) (hereinafter cited as Special Committee Report.)

⁵⁰ The Life Insurance Industry, Hearings Before the Subcomm. on Antitrust and Monopoly of the Senate Judiciary Comm., 93d Cong., 2d Sess. 691 (1974). (testimony of E.J. Moorhead).

⁵¹ The interest-adjusted index differs from the traditional method in three respects:

1. Instead of merely adding the premiums for 20-years, they are accumulated with interest at a rate representative of what the purchaser could obtain in a personal investment of equivalent security and stability. The interest factor used in the 1970 Report was 4 percent. The rise of interest rates available in the market have resulted in a rise in the rate used in the calculation to 5 percent.
2. The dividends, instead of being added, are accumulated at the same interest rate as in 1;

(Footnote Continued)

In 1971, the NAIC embarked on an effort to develop "a useful life insurance consumer price disclosure method."⁵² In June, 1973, it adopted an interim model cost disclosure regulation that mirrored the cost comparison recommendations of the Joint Special Committee. This regulation (1) prohibited the use of any cost disclosure method that did not recognize the time value of money and (2) required the use of the interest-adjusted cost method (surrender index).⁵³ The final NAIC model regulation, adopted in May 1976, requires in addition to the surrender index, the disclosure of the payment index and the equivalent level annual dividend.⁵⁴ Furthermore, each of these indices must be displayed for the tenth and twentieth years. Thus, the NAIC recommendation would provide the consumer with two numbers for each of the following indices:

1. Surrender index - this index is a measure of the cost of an insurance policy if an individual

51 (Footnote Continued)

3. Instead of dividing by the number of years (for example 20) the net amount of accumulated premiums less accumulated dividends less the cash value is divided by the amount to which a dollar paid at the beginning of each year will accumulate, using the same interest rate as in (1) and (2),

52 Moss Subcommittee Hearings, supra n. 4, at 248 (statement of Herbert W. Anderson).

53 Actuaries Report, supra n. 33, at 5.

54 NAIC Model Life Insurance Solicitation Regulation, May 4, 1976, reprinted in Moss Subcommittee Report, supra n. 6, at 71, Appendix A.

surrenders it at a fixed point in time, either 10 or 20 years.⁵⁵

2. Payment index - this index measures the relative cost of a policy if death occurs in the tenth or twentieth year. In other words, this index assumes the policyholder will make no use of his policy's cash values during these time periods.⁵⁶
3. Equivalent level annual dividend - this number is intended to show the relative importance of illustrated dividends in calculating the surrender and payment indices. The purported purpose for this figure is to demonstrate the costs--for either the surrender or payment indices--of a participating policy if no dividends were paid.⁵⁷

In prohibiting the use of the traditional net cost method

55 To compute this index, the premiums are accumulated at interest for the stated period (10 or 20 years). From this total, the sum of the dividends accumulated at interest and the surrender value in the final year are subtracted.

56 The payment index is calculated by accumulating premiums at interest, subtracting this figure from the total of the dividends (also accumulated at interest). It is calculated in the same way as the surrender index except that cash values are not included in the calculation. For both the payment and surrender index, the lower the number the lower the cost on that index.

57 The equivalent annual dividend is calculated by accumulating dividends at interest and then converting the result to a present value on a level annual basis.

and requiring an index which recognizes the time value of money, the NAIC took an extremely significant step towards providing meaningful cost information for comparison shopping among similar policies. However, we have serious reservations regarding the utility of certain of the indices provided. Moreover, we are concerned that in requiring six index numbers for similar policy comparisons the NAIC model regulation may be unnecessarily complex and confusing to consumers. In the following section we discuss the drawbacks to the present NAIC cost index proposal in the context of (1) the payment index, (2) the equivalent level annual dividend (3) the duration for which the index numbers are displayed.

2. Deficiencies in the Present NAIC Proposal

Any workable and useful disclosure system must provide consumers with manageable amounts of relevant information, presented in a manner that will facilitate informed decision-making. In our view, the cost index system proposed by NAIC model regulation fails to meet this standard in several significant respects. As we detail below, the NAIC proposal presents the prospective purchaser with a "bewildering array" of index numbers, most of which are of doubtful relevance to the average insurance consumer.⁵⁸

⁵⁸ Hearings before the Senate Subcomm. on Housing, Insurance, and Cemeteries of the Comm. on Veteran's Affairs, 95th Cong., 1st sess. 150 (1977) Statement of Mr. E.J. Moorhead, [hereinafter cited as Veteran's Hearings]. The full text of this portion of Mr. Moorhead's statement reads:

(Footnote Continued)

a. Payment Index

The payment index purports to provide consumers with a gauge to measure costs of similar policies should the purchaser die in the tenth or twentieth year. Our concern with the payment index is that when used to compare whole life policies it fails to take into account the worth to policyholders of the cash value component of their policies. Thus, it implicitly assumes that cash values are of no value to the purchaser.⁵⁹ This assumption is inherently invalid.⁶⁰ As previously noted, significant amounts of whole life policy premiums

58 (Footnote Continued)

... the model bill of the National Association of Insurance Commissioners places before the buyer a potentially bewildering array of surrender cost indexes, net payment cost indexes, and equivalent level annual dividends. Very few life insurance buyers possess enough knowledge of life insurance intricacies to arrive at the right answer from so many indexes.

59 Mr. E.J. Moorhead stated in recent testimony before the Wisconsin Insurance Commission that it is both irrational and improbable "that [consumers] will never want to use the cash values in their policies . . ." Statement in Opposition to the Six-Index Comparison System of the NAIC Model Life Insurance Regulation, April 16, 1979 [hereinafter cited as Statement in Opposition]. Apparently, the assumption that cash values are of no worth to the purchaser is based on the conclusion that a person buying a policy knows how he or she plan to use that policy. We doubt that many people who are 25-35 (who buy the bulk of life insurance) are able to state conclusively how they intend to use the policy over a twenty to thirty year period.

60 The payment index assumes, for example, that access to the cash value and the opportunity to use it as collateral for loans has no value to policyholders who, at the time of purchase, fully intend to hold policies throughout their lifetimes.

go toward the accumulation of cash values. Indeed, this is one of the major attractions of whole life insurance.⁶¹ Moreover, policyholders are much more likely to make use of their policies' cash values than death benefits. Data submitted to the Moss Subcommittee indicate that for every 1000 whole life policies, 510 will have been surrendered or lapsed by the 15th policy year and only 16 will have resulted in a death claim.⁶² In addition, of the 474 policies that remain in force after 15 years, many policyholders will have utilized their cash values by taking out a policy loan.⁶³ Thus, we question whether the payment index is relevant for most consumers.

The use of this index can also present a distorted picture to purchasers who may subsequently decide to take advantage of their policy's cash value. The payment index often makes policies that have poor cash value scales appear to be relatively low-cost. An index taking cash values into consideration would show that many of these same policies are high cost.⁶⁴

61 If prospective purchasers are genuinely disinterested in the cash value component of a whole life policy, there are very few situations in which they would not be better off buying pure death protection, i.e. term insurance.

62 See, Moss Subcommittee Hearings, supra n. 4, at 774-76. This information further indicates that after 33 years, 626 policies will have been surrendered or lapsed, with 92 resulting in a death claim and 282 policies still in force.

63 Life insurance company policy loans to policyholders against the cash values of their insurance policies amounted to \$27.6 billion in 1977. Fact Book, supra n. 15, at 85.

64 The Actuaries Report found a high correlation in ranking
(Footnote Continued)

A comparison of two \$25,000 whole life policies available to a 35 year old male illustrates this phenomenon.⁶⁵ Policy A has a payment index of 14.67 and a surrender index of 5.63. Policy B has a payment index of 15.61 and a surrender index of 2.85. Based on the payment index, Policy A appears to be a better buy. However, if a person decided to make use of his cash value and the policy were surrendered in the twentieth year, the purchaser of Policy B would have saved approximately \$2,000.

Proponents of the payment index argue that it is useful for people who intend to hold their policies until they die and plan to make no use of the policies' cash values. They argue that for such people term insurance is not a viable option because term insurance premiums become very expensive after age 65.⁶⁶ This argument assumes that the only way individuals

64 (Footnote Continued)

among cost disclosure methods that include cash values such as the surrender index, company retention and Linton Yield. There is a much lower correlation between any of these indices and the net payment index. Actuaries Report, supra n. 33, at 100.

65 The indices for these two policies were taken from Best's Review (Life/Health Ed.): Policy A (February 1977), and Policy B (December 1976).

66 It should be noted that all forms of insurance are expensive after age 65. Although the premium for a whole life policy remains the same as long as the policy is in force, the actual amount of death protection bought by the level premium declines each year as the cash value increases. For example, a 35 year old man will pay approximately \$200 a year for a \$10,000 whole life policy. At age 70 this policy will have a cash value of approximately \$6,500. Thus, the person is actually only buying \$3,500 of insurance.

will be able to provide an estate for their survivors is through the proceeds of an in force whole life policy. What is needed, however, is a source of money for survivors if death occurs after age 65. Whole life insurance is only one of many ways to guarantee that such funds will be available. An equally valid way to build an estate is to buy term insurance and invest the difference. The staff analyzed 306 different \$25,000 whole life policies issued in 1973 to males aged 35. These policies were compared to an alternative program of term insurance plus a side fund accumulating at 5 percent after taxes. The mean age at which the side fund would equal the whole life face amount was 67. This means that even whole life purchasers who intend to keep their policies until death (and who are therefore not interested in cash values) could buy term instead and have the face amount of the whole life policy saved by age 67. Moreover, at that time, the number of dollars in the side fund will exceed the whole life surrender value (cash value) by an average of \$11,088.

In addition to providing information that is at best marginally relevant to most prospective purchasers, the payment index enhances the chances for consumer confusion. The industry's own Joint Special Committee on Life Insurance Costs recognized this in recommending against the use of the payment index. The Committee observed:

A second question has been whether the use of two methods might be desirable--one for persons desiring to appraise a life insurance policy in terms of its attractiveness if kept in force until maturity by death or endowment,

the other designed particularly for those who attach greater importance to the cash values it provides . . . Putting forward a choice of methods is tempting but unwise. To do so would inevitably complicate a subject that greatly needs to be kept straightforward.⁶⁷

The former chairman of this committee, Mr. E.J. Moorhead, has indicated that introduction of this confusion element was not purely accidental, noting that the committee specifically recommended against inclusion of the payment index that is required by the NAIC model regulation.⁶⁸ Mr. Moorhead further stated:

⁶⁷ Special Committee Report, supra n. 49, at 20. The possibility of consumer confusion in providing both the surrender and payment indices was also graphically demonstrated by the second Purdue Study (see page 159, infra). As part of the comprehension quiz, the subjects who were given the NAIC disclosure system were asked the following true/false question:

The Net Payment Cost Index helps you compare the cost of similar policies if at some future point in time you were to surrender each policy and take its cash value.

Only 36.6% of the subjects answered this true/false question correctly when they first took the quiz. The lowest percentage of correct answers for any of the other 20 questions was 73.2%. Even when the subjects retok the test with the Buyer's Guide before them only 67.6% of the subjects answered the question correctly.

⁶⁸ See, Statement in Opposition, supra n. 59, at 1. In a statement before the Senate Committee on Veterans Affairs, submitted in June 1977, Mr. Moorhead observed:

A company that sells an exorbitantly priced policy can continue to do so if it can display enough indexes so that at least one of that multitude can be stated to be competitively attractive.

Veteran's Hearings, supra n. 58, at 151.

The six-index system of the NAIC Model was never proposed by the Commissioners; it was adopted by them to satisfy companies desiring to sell non-participating whole life insurance. The pleas of those companies were, unwisely but understandably, supported by the American Council of Life Insurance.

Regardless of the merits of that controversy, we think that the NAIC model regulation would be substantially improved by the deletion of the payment index from the insurance cost comparison system.

b. Equivalent Level Annual Dividend

As noted above, the equivalent level annual dividend is a measure designed to demonstrate the role that illustrated dividends play in the calculation of the cost index of a participating policy. It is calculated by accumulating dividends at interest and then converting the result to a present value on a level annual basis. The resulting figure can then be added to the cost index for a participating policy to show how the cost index would increase if no dividends were paid.

Using the equivalent level annual dividend in this way highlights the fact that the values in a participating policy depend to some extent on the assumption that the illustrated dividends will in fact be paid. There is nothing conceptually wrong with this type of comparison. However, the difficulty with the equivalent level annual dividend as contained in the NAIC model is with the assumption made in the calculation that no dividends will in fact be paid. This is extremely unlikely to occur. To our knowledge there has never been a case where a participating policy which illustrated dividends has totally

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failed to pay any dividends. In fact, over the last twenty years the actual dividends paid on participating policies have been consistently higher than those illustrated at the time of issue.⁶⁹ While there are several reasons why actual dividends have exceeded illustrated dividends over the past twenty years, it is predominantly due to improvements in companies' investment earnings and mortality experience. Although investment earnings and mortality experience may not continue to improve in the future as they have in the past, there is also no reason to believe that, to any significant degree, companies will be unable to at least meet their current illustrated dividend scales. Further, there is certainly no reason to believe that companies will totally fail to pay any dividends. We agree with the Moss Subcommittee that the equivalent level annual dividend is potentially deceptive. As the Subcommittee's Report noted:

We think, however, that the "level annual dividend" is a profoundly inappropriate way of describing the risk differences between par and non-par policies. The figure is well suited only for painting a lurid picture of improbable par company catastrophe, and bears no worthwhile relevance to a reasonable analysis of actual risk. Providing this figure will put a tool highly conducive to misleading use directly into the hands of the agents who have a strong incentive to employ it deceptively.⁷⁰

⁶⁹ See, e.g., Best's Review 30 (December 1976).

⁷⁰ Moss Subcommittee Report, supra n. 6, at 45. A similar opinion was expressed by E.J. Moorhead in a statement to the Senate Committee on Veterans Affairs:

(Footnote Continued)

In rejecting the use of the equivalent level annual dividend we do not want to imply that the problems associated with the use of illustrated dividends in computing cost indices are not important or that consumers should not be aware of the advantage of guaranteed cost in non-participating policies.⁷¹ The uncertainty of illustrated dividends makes any cost index of a participating products only approximate. The potential for problems in the area of illustrated dividends is likely to increase.

70 (Footnote Continued)

I deplore the NAIC adoption (at industry request) of the equivalent level dividend. In my opinion it is sufficient if the display for a participating policy simply states, as has long been required, that dividends are not estimates or guarantees but reflect only the company's current dividend scale. The purpose of the equivalent level dividend is to help non-participating life insurance to compete successfully with participating.

Veteran's Hearings, supra n. 58, at 150.

71 The buyer's guide should contain a clear explanation that illustrated dividends are not guaranteed. See, Appendix X. If such an explanation is provided, we see no reason why consumers can't compare the cost indices of participating and non-participating policies. The Society of Actuaries found in their 1974 report that based upon the policies they analyzed, dividends actually paid would have to fall 30% below illustrations before participating policies would have generally lower 20-year comparison indices than guaranteed cost policies. Actuaries Report, supra n. 33, at 131-132. They concluded ". . . it would seem inappropriate to dismiss as a useless exercise the comparison of cost indices between otherwise comparable participating and guaranteed cost policies for fear that illustrative dividends may not be fully realized. There appears to be some room for actual dividends to fall short of those illustrated and still enable participating business to compete reasonably well with guaranteed cost." Id. at 132.

If meaningful cost disclosure becomes widespread there will be pressure on participating companies to increase their illustrated dividends to appear more favorable on a cost index.⁷² We recognize that this is a potential problem. However, we believe industry restraint and regulatory oversight are a more appropriate way to handle the problem of unrealistic illustrated dividends than inclusion of the potentially deceptive equivalent level annual dividend in a cost disclosure system.⁷³

c. Duration Displays for Similar Policy Comparison Index

The NAIC model regulation requires that each of the cost comparison indices be displayed for the tenth and twentieth policy years. In our view, the tenth year index figures provide little meaningful information and should be eliminated. Indeed,

72 In a 1975 report prepared by the Special Committee of the Society of Actuaries entitled "Dividend Illustration Philosophies" for the Life Insurance Cost Comparison (C3) Task Force of the NAIC, actuaries completed questionnaires relating to various aspects of illustrated dividends. A substantial majority (80%) of the actuaries who completed the questionnaire believe there will be increased company pressure on the actuary to produce more liberal dividend illustrations for new business if the consumer is to cost-shop and compare costs on some widely accepted basis mandated by law or regulation. Society of Actuaries Committee on Cost Comparison Methods and Related Issues, "Philosophies in the Computation and Dissemination of Dividend Illustrations" 52 (September 1974).

73 We note there is currently a considerable amount of interest within the actuarial profession and the NAIC with the problem of dividend illustrations. We hope this activity will continue and that the industry and regulatory authorities will be able to develop a standardized method of calculating illustrated dividends and adequately police their use to insure against abuse. See also discussion at pages 151-153, infra.

as the Moss Subcommittee Report stated, "We do not see much use for cost indexes [of duration less than 20 years] except to illustrate the folly of purchasing a whole life policy for a short duration."⁷⁴

The reasons for removal of the ten year displays are clear. The necessary holding period to make whole life a viable purchase almost always exceeds ten years. As shown in Part II the average ten year rate of return for \$25,000 participating policies issued in 1977 was between minus 1.30 and plus 1.25 percent, and for non-participating policies was between minus .61 and minus 3.86 percent. Accordingly, a person considering insurance for a ten year period is almost always better off buying term insurance.⁷⁵

⁷⁴ Moss Subcommittee Report, supra n. 6, at 46.

⁷⁵ A statement submitted by the Northwestern Mutual Life Insurance Company on a proposal by the Wisconsin Department of Insurance to require five-year index figures succinctly sums up the reason for not displaying index numbers of short duration. In remarks equally appropriate to a tenth year index, Northwestern Mutual stated:

[F]ive year figures could point a buyer in a unintended direction. One should not consider the purchase of permanent life insurance for a five year duration. Therefore, if a prospective buyer isn't considering surrender after five years, a purchase decision likewise should not be made based on five year index figures. The buyer should not be cautioned indirectly about the high cost of early surrender of cash value life insurance through cost indexes; this should be explained directly in the Buyer's Guide.

Statement Concerning Proposed Life Insurance Solicitation Regulation, The Northwestern Mutual Life Insurance Company, submitted to the Wisconsin Department of Insurance, June 27, 1978, at 2-3.

A related question is whether cost indices should be displayed for periods longer than 20 years. In rejecting later years displays, the NAIC task force concluded:

[T]wenty years was about as far as projections of future events could be made while retaining any validity for cost comparison purposes. The principal areas of uncertainty are the applicability of dividends according to dividend scales currently in use and the accuracy of interest rates at which future costs are discounted. Also of concern to the task force was the relatively small proportion of life insurance policies that remain in force after twenty years and the possibility of unwarranted emphasis placed on information at these later durations. An additional factor in favor of a twenty year or shorter period is uncertainty as to the course of inflation and the purchasing power of dollars projected for delivery into the future.⁷⁶

We agree with the NAIC that there is marginal value in displaying index numbers for greater than twenty years.⁷⁷

In sum, we believe that the goal of a cost disclosure system --to help consumers find attractively priced insurance products-- may be frustrated by the inclusion of the payment index, equivalent level annual dividend and the tenth year duration display. While these figures may be of some use to the sophisticated buyer of insurance, their potential for misuse, combined with the confusion they will inevitably cause the average consumer, leads us to conclude that the NAIC model regulation would be

⁷⁶ Moss Subcommittee Hearings, supra n. 4, at 304.

⁷⁷ As previously discussed, different considerations govern the years for which the average annual rate of return should be displayed. See, pages 125-126 supra.

substantially improved by the deletion of these index numbers. In our view, meaningful similar policy comparison can be achieved by the use of a single index number (which recognizes the time value of money) displayed for the twentieth policy year. We now turn to a discussion of what method should be employed to provide this index number.

3. Selection of an Appropriate Index Number

Over the past several years a variety of index methods have been proposed for making similar policy comparisons.⁷⁸ In this report we limit our discussion of the appropriate method to the surrender index and the company retention index because most cost disclosure proposals employ one or the other of these two indices and they are representative of the two basic approaches of presenting comparative cost information.

The surrender index is the best known of what is termed the "event specific" or "snapshot" approach to similar policy comparison. This technique looks at a particular point in time and assumes a specific event will occur. For example, the 20th year surrender index will show the relative cost of two policies based on the assumption that they are surrendered for their cash values after the policies have been held for twenty years.

The company retention index is an example of the "group average" approach. This method looks at each policy year and,

⁷⁸ A description of the more important of these indices and the mathematical formulas used in computing them is found in Actuaries Report, supra n. 33. See also Special Committee Report, supra n. 49, at 9-19.

through the use of average probabilities of lapse and surrender, determines the likelihood that any policy payment--premiums, dividends, cash value or death benefits--will be made. These "expected values" are combined into an index which can be described as a representation of the average cost of a policy to a group of similar policyholders. The most commonly used group average approach is the "company retention index" developed by Professor Joseph Belth of Indiana University.⁷⁹ The company retention index is essentially the present expected value⁸⁰ of all premiums, less the present expected value of all death benefits, policy dividends and cash values. To determine the "expected value" of the premiums, dividends, and death benefits, the amount paid is weighted by the probability that it will have to be paid; i.e., the probability that a person will not die during the year. Similarly, the "expected value" of the cash value in a given year is determined by the probability that a person will surrender or lapse a policy in that year.⁸¹ The index is called

79 Professor Belth describes the "company retention" method in, "The Relationship Between Benefits and Premiums in Life Insurance," 36 Journal of Risk and Insurance 19-39 (1969).

80 Present value refers to the fact that an interest rate is used to discount every future cash flow in the calculation (premiums, dividends, death benefits, and cash value) back to the present. For example, a \$1.00 dividend to be received at the end of the year has a "present" (beginning of the year) value of about 95 cents. Thus, the company retention index, like the surrender index, incorporates the time value of money into the calculation, see page 127, supra.

81 The mortality and lapse probabilities used in the calculation are industrywide averages. They are contained in Appendix VI, (Footnote Continued)

"company retention" because it measures how much (in present value terms) policyholders on the average can expect the company to retain out of their premium payments for expenses and profits.⁸²

We wish to stress at the outset our concurrence with the NAIC task force, which concluded that the choice between the surrender index and the company retention index should not be made solely on the basis of which index is technically the most accurate.⁸³ As previously discussed, the relative uncertainty of illustrated dividends makes any index applied to participating policies (the predominate form of ordinary life insurance), of necessity, only approximate. Moreover, all indices depend

81 (Footnote Continued)

together with the mathematical formula used to calculate the company retention index.

82 The retention figure does not measure the actual amount a given insurer will retain from a given policyholder over the period selected for the evaluation. This is because it is calculated using industrywide average mortality and lapse rates that may bear little relation to the insurer's actual experience. As an average measure, however, it provides a good indication of the relative attractiveness of similar insurance policies, see discussion, page 145, infra.

83 The NAIC task force concluded:

There is marked similarity of the messages conveyed by particular average and snapshot approaches. The conclusion is that the choice between these approaches should not be made on a hypothesis that one approach is more accurate than the other.

Report of the NAIC Life Insurance Cost Comparison Task Force, NAIC Proceedings - 1975, Vol. II at 426 (June 10, 1975).

upon assumptions made in their calculation.⁸⁴ Therefore, no cost index can be totally accurate. A cost index should reveal if a policy is generally high-cost and guide the consumer to a policy or group of policies that are attractively priced. Both the surrender index and company retention index do this rather well. It is significant that there is a high degree of correlation between the rankings of policies by cost under the two approaches.⁸⁵

We also share the NAIC's concern that, insofar as possible, a cost index be simple and understandable to consumers. In a statement submitted to the Moss Subcommittee, the NAIC gave the following reasons for basing its disclosure system on the interest-adjusted method:

In general, these particulars led to the selection of the interest adjusted disclosure because it is simple and relatively inexpensive to produce, provided cost rankings for policies that are consistent with more complex methods such as the company retention index, and it provides useful information regarding policy benefits assuming certain specified events which the policyholder can easily relate to.⁸⁶

We do not, however, find the fact that calculating the company

84 The surrender index assumes an interest rate and that the policyholder will surrender the policy in the twentieth year. The company retention calculation requires an assumed interest rate plus assumed mortality and lapse probabilities.

85 See, e.g., Moorhead, The Manipulation Issue: Research Project 2 (NAIC 1975) at 4; Actuaries Report, supra n. 33, at 74-79.

86 Moss Subcommittee Hearings, supra n. 4, at 262.

retention index is more complex than computing the surrender index to be a fatal flaw. As a practical matter both indices would be generated by company computers and supplied to agents.⁸⁷ We also note that it is not necessary for consumers to understand how cost indices are calculated in order to use them effectively.⁸⁸ As the Society of Actuaries observed:

Few would disagree that, as a minimum, it is important that the consumer understand the purpose of any cost comparison index method and that he accept its results, perhaps on faith, as a means whereby his purchase decision can be assisted. The question of whether a consumer need understand the mathematical basis behind the calculation of such an index is more subject to debate. Precedents do exist wherein the consumer seems to accept on faith an index whose mathematical basis is not specifically defined or generally understood. For example, the general public has an "understanding" of the meaning of such indices as the Consumer Price Index or the Dow-Jones Industrial Average, although it may lack specific knowledge of the details involved in the actual calculation of the results themselves. It is possible that similar "understanding" of a life insurance cost comparison index

87 We also do not see much difference in the cost of producing two indices. The necessary computer programming is relatively easy and the calculations are not complicated or costly.

88 It is perhaps also not crucial that agents understand the mathematical calculation behind the cost indices. See Actuaries Report, supra n. 33, at 39. Indeed, agents often express difficulty in fully understanding cost indices. For example, Mr. Joel Shapiro, an experienced life insurance agent and the chairman of the Committee of Federal Law and Legislation for the National Association of Life Underwriters, testified at the Subcommittee hearing: "I consider myself rather intelligent. I majored in insurance in college. I was a C.L.U. and I have a difficult time really understanding the various cost indices." Moss Subcommittee Hearings, supra n. 4, at 464.

method is achievable and is all that is necessary.⁸⁹

We agree with the Society of Actuaries that a general understanding of the meaning of the index and how it is used is all that is necessary. Applying this standard we see little to differentiate the surrender index from company retention in terms of understandability to the consumer.⁹⁰

However, in one area -- manipulation -- there appear to be significant differences between the surrender index and the company retention index.⁹¹ In the view of some experts, the surrender index is highly susceptible to manipulation.⁹²

⁸⁹ Actuaries Report, supra n. 33, at 40.

⁹⁰ Some have argued that company retention is actually easier to understand than the surrender index. The Canadian Institute of Actuaries recommended the use of the company retention index. Canadian Institute of Actuaries, Second Report of the Committee on Cost Comparisons of Industrial Life Insurance Policies (November, 1976). It stated at page 2, "While the mathematics of the Interest-Adjusted methods is easier to comprehend than that of the Retention method, the concept of the Retention method is actually easier to understand."

⁹¹ "Manipulation" can be defined as the structuring of a policy's benefits (cash values, dividends, etc) or its premium structure to make the policy appear more attractive on a particular cost index than it actually is. Thus a company may be able to change the cash flows in a policy in a manner that dramatically reduces its apparent cost on a particular index without offering any increased value to the policyholder.

⁹² For example, Professor William Scheel has written that "Perhaps the most overwhelming deficiency of the I-A index . . . [the surrender index] is that it is subject to manipulation in much the same manner as the traditional net cost index . . . The window dresser has not been put out of business--he merely changes styles." Scheel, "A Critique of the Interest-Adjusted Net Cost Index," 40 Journal of Risk & Insurance 257-58 (1973).

This is possible because the surrender index focuses on only one year -- the twentieth.⁹³ Thus a company can lower a policy's apparent cost on this index by either having a large increase in the twentieth year cash value or the twentieth year "terminal surrender dividend."⁹⁴ While such changes would increase the benefits a policyholder would receive if the policy was surrendered in the twentieth year, these increased benefits could be more than fully offset by reducing cash values or terminal dividends in some or all the years for which the index is not shown.⁹⁵

There appears to be much less potential for manipulating the company retention index by altering the patterns of cash values and terminal dividends. This is because in calculating the index all major cash flows of the policy are considered for each year over the duration of the index, and each cash item is discounted for the time it might be paid and the probability that it will be paid.⁹⁶ Thus the company retention

93 This argument applies with equal force to the NAIC proposal to include the tenth year index.

94 Terminal dividends are a special dividend paid only to surrendering policyholders.

95 See id. It should also be noted that since the average rate of return and the surrender index make use of the same data, the Linton Yield is subject to the same type of manipulation.

96 The Canadian Society of Actuaries, in recommending the company retention method as the single cost comparison index, noted that:

The Company Retention Method is less subject to manipulation than the other methods proposed. For example, a steepening of the

(Footnote Continued)

index effectively discourages highly selective increases in cash values and terminal dividends in the year the index is calculated which could falsely indicate that a non-competitive policy is competitive.⁹⁷

Neither the company retention nor the surrender index provides any protection against the manipulation of illustrated dividend scales.⁹⁸ As noted earlier, it is impossible to be totally precise in forecasting future dividends.⁹⁹ The use of illustrated dividends in cost indices would create few problems if the actual dividends paid by companies differed from illustrated dividends by the same percentage. Unfortunately, this has not been the

96 (Footnote Continued)

cash values scale in new issues by moving from a single to a dual interest assumption does not have the drastic effect on policy rankings that it has under the Traditional or Interest-Adjusted net cost methods.

See First Report to the Council of the Canadian Institute of Actuaries From the Committee on Cost Comparisons (Chairman: J. Bruce McDonald), page 11 (unpublished).

97 While the company retention index is significantly less vulnerable to manipulation, it is not totally immune. See Moss Subcommittee Report, supra n. 6, at 42 n. 154.

98 All cost indices include the dividends illustrated at the time of sale in their calculations.

99 The amount a company has available to pay in dividends depends on a variety of factors including its investment earnings and mortality and lapse experience. Of these, the most important factor is the income the company earns on its reserves. Over the past ten years company expenses and mortality have moved in opposite directions and have generally offset each other. See Palmer, "Illustrated and Realized Dividends: An Empirical Analysis," 43 Journal of Risk and Insurance, 673 (1976).

case in the past and is even less likely to be true in the future.¹⁰⁰ The basic problem is that more and more companies are computing dividends in a fashion that is both inconsistent with traditional practice and that make dividend illustrations inherently incomparable between companies employing these different "dividend philosophies." This problem was well expressed by Mr. James Reiskytl, an actuary for Northwestern Mutual, in a letter to the Chairman of the NAIC advisory committee on manipulation:

Now, at the very time when consumerist pressures are focusing increasing attention on comparison shopping for life insurance, the comparability of dividend illustrations issued by the several companies is (we fear) rather dramatically declining.¹⁰¹

In particular, many companies appear to be adopting dividend philosophies that have the effect of favoring newer policyholders at the expense of the old.¹⁰² The competitive advantage conferred on those companies might turn out to be specious from the new

¹⁰⁰ For example, Bruce Palmer has shown that over different 20-year periods the actual dividends paid by different companies have ranged between 70 percent and 160 percent of those illustrated at the time of sale. Id. at 673, 690.

¹⁰¹ Letter dated March 26, 1979 addressed to Mr. Julius Vogel, Senior Vice President and Chief Actuary, Prudential Life Insurance Company of America.

¹⁰² The major changes in dividend philosophies referred to above are the trend toward the use of "investment year" year methods to allocate dividends to particular classes of policyholders (as opposed to the more traditional "portfolio method") and the increasing use of terminal dividends. For a discussion of these and other aspects of dividend philosophies see J. Belth, "Distribution of Surplus to Individual Life Insurance Policy Owners," 45 J. Risk & Insurance 7-22 (1978).

policyholder point of view and will, in any case, come in part at the expense of the holders of old policies.

There are presently few restrictions designed to prevent manipulation.¹⁰³ Effective control of this type of conduct can occur only through active policing by state regulators willing to commit the resources necessary to review policies for manipulation and remove from the market those policies that have in fact been manipulated. Regulation of the type of manipulation that the company retention index discourages (cash value and terminal dividend) is relatively easy to detect and is correspondingly difficult for company actuaries to explain.

Despite these serious concerns, we recommend retention of the surrender index as presently contained in the NAIC model regulation.¹⁰⁴ The major basis for our recommendation is the fact that this index is currently in fairly widespread use. The American Council of Life Insurance estimates that companies that sell over 50 percent of the life insurance business in the United States either now deliver, or will soon deliver, policy summaries with their policies that contain the surrender index.¹⁰⁵ In addition, the surrender index has been used for

103 Minimum cash values are specified in every state by the minimum non-forfeiture laws. Since many companies provide cash values in excess of the minimum, however, the scope of cash value manipulation is only reduced, not eliminated, by the non-forfeiture laws.

104 As previously discussed, we urge that the tenth year duration be deleted.

105 Statement of Julius Vogel on behalf of the American Council
(Footnote Continued)

a number of years to rank similar policies by major industry publications such as the National Underwriter and Best's Review. There has undoubtedly developed a fair amount of agent and consumer comprehension of the interest-adjusted concept embodied in the surrender index and some acceptance of its usefulness in comparing the cost of similar policies. This growing comprehension should not be lightly disregarded. Further, there would be a certain expense involved in the widespread adoption of use of the company retention index, although, as we have earlier stated, this expense would not be prohibitively large. Cost disclosure regulations should not needlessly interrupt the progress that has been made in the past nor should they unnecessarily add to company expense. These factors militate in favor of the continued use of the twentieth year surrender index. However, we reiterate that the index's utility can only be maintained by concerted efforts on the part of state regulators to guard against manipulation.¹⁰⁶

¹⁰⁵ (Footnote Continued)

of Life Insurance, Moss Subcommittee Hearings, supra n. 4 , at 339.

¹⁰⁶ If a state insurance commission does not have the resources necessary to police policies for manipulation, it should seriously consider adoption of the company retention index.

4. The Need to Supply Comparative Cost Information

As noted in the preceding section, the surrender index provides a good way to compare the costs of similar life insurance policies. However, simply providing the twentieth year surrender index does not eliminate the difficulties facing the consumer searching for a low-cost policy. This is because the twentieth year surrender index, standing alone, has little intrinsic meaning.¹⁰⁷ For example, consumers may know that a particular policy has a surrender index of 6.21; but they have no way of knowing whether this means a policy is high or low cost relative to other policies on the market. Therefore, if the twentieth year surrender index is to be effective in comparison shopping, some form of gauge or "yardstick" is crucial. One way to provide this information is to include a range of surrender indices for a representative sample of different types of policies (of varying issue ages and face amounts) in the buyer's guide.¹⁰⁸ This range table will provide the prospective purchaser with a general basis for evaluating the cost of a particular policy relative to other similar policies. Although the tables will not contain every type of policy, issue age, and face amount of the policies on the market, it will--at the minimum--demonstrate the widely

¹⁰⁷ The company retention index suffers from this same problem.

¹⁰⁸ This basic approach to providing yardstick information is contained in the buyer's guide required by the State of Wisconsin, a copy of which is contained in Appendix X. The FTC draft buyer's guide in Appendix X also contains an example of this type of yardstick.

divergent cost of similar policies and the desirability of comparison shopping for life insurance.¹⁰⁹ The yardstick information in the buyer's guide should be supplemented with statements in the disclosure documents which emphasize the importance of comparing life insurance costs.

Another way of providing yardstick information that offers great promise is the recently implemented "Hotline" in the State of Wisconsin. This system provides a toll-free telephone service that consumers can call to find out whether the policy they are considering is high, average, or low cost compared to other similar policies offered for sale in that state.¹¹⁰

In the absence of a surrender index-yardstick approach, an alternative is the use of the Linton Yield to compare similar as well as dissimilar cash value insurance policies.¹¹¹ The advantage of the Linton Yield to compare similar cash value policies is that the rate of return it expresses has an indepen-

109 It is hoped that consumers who are considering policies not displayed in the range tables will be encouraged to seek comparative information from a number of companies and in essence prepare their own range table.

110 The Wisconsin Department of Insurance conducted a survey to determine the range of surrender cost indices for various policies sold in that state. This information was supplied to the Center for Public Representation, a public interest law firm connected with the University of Wisconsin, which actually runs the telephone service.

111 The rankings of policy costs as determined by the twentieth-year surrender index and the twentieth-year Linton Yield are highly correlated. This is to be expected because the same information is used in calculating both indices.

dent meaning to consumers.¹¹² The Massachusetts Division of Insurance has proposed a cost disclosure system that uses the Linton Yield to compare both similar and dissimilar policies.¹¹³ The only indices required under the Massachusetts proposal are the 5th, 10th and 20th year Linton Yields.¹¹⁴ Among the reasons for the choice of the Linton Yield was the fact that it has an independent meaning to consumers. Mr. James Hunt, who is head of the Massachusetts Rating Bureau, has compared the Linton Yield to the Annual Percentage Rate required under Truth-in-Lending:

A better example of a simple and understandable cost comparison index is the Annual Percentage Rate (APR) under the Truth-in-Lending Act. Although the calculation of an APR is often highly complex, the statement of the calculation's result is not only simple, but it has meaning in and of itself and therefore is understandable. There is no compelling need to issue the buyer a yardstick with the disclosed APR so that he or she may tell whether the rate is high or low. An APR is disclosed in an environment of considerable bank and other institutional advertising of interest rates on deposits and other investments and of loan

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- 112 Even if the Linton Yield were used, it would be useful to have yardstick information to point out what were the range of rates of return for that type of policy. It would not, however, be essential as is the case if the surrender index is used.
- 113 It should be noted that this is only a partial solution since the average annual rate of return (Linton Yield) cannot be used to compare the cost of similar term policies. Therefore, if this alternative were adopted, it would be necessary to use the surrender index to compare term policies.
- 114 The Massachusetts' proposal was outlined in an August 4, 1978 letter from the Department of Insurance to the principal industry trade association. A copy of this letter is included in Appendix X. The letter announced preliminary guidelines for policy form filing under Massachusetts' "Easy to Read" law that would have required rate of return disclosure. As of this time, this requirement has not been finally adopted.

rates, as well as prominent press attention to frequent movements of the prime rate. Disclosure of an APR, then, comes with its own yardstick, or frame of reference, for the buyer. We should prefer this type of disclosure tool to any others.¹¹⁵

As previously discussed, the surrender index is widely used and is generally accepted within the industry and by agents as a legitimate way to compare the costs of similar life insurance policies. For this reason we recommend the use of the surrender index for similar policy comparisons if meaningful yardstick data is provided. If yardstick information is not provided, however, we recommend that the Linton Yield be used to compare both similar and dissimilar policies.

C. Recommendations Concerning Other Aspects of the NAIC Model Regulation

The previous sections have discussed the index numbers that should be contained in a cost disclosure system. The index numbers provided are only one part of a cost disclosure regulation. This section contains our recommendations concerning the modifications of the other aspects of the NAIC model regulation. It is divided into six parts:

1. Consumer research concerning the understandability of the NAIC disclosure system.
2. The timing of disclosure.
3. The information that should be contained on the disclosure statements in addition to index numbers.
4. Information that should be contained in a life insurance buyer's guide.

¹¹⁵ J. Hunt, unpublished memorandum on cost disclosure, at 24-25.

5. Coverage of the regulation.
6. Enforcement provisions.
1. Consumer Research Concerning the Understandability of the NAIC Disclosure System

In 1976, New Jersey adopted the NAIC model regulation. In 1978, the Federal Trade Commission contracted with Professor Roger Formisano of the University of Wisconsin to conduct a study to attempt to assess the effectiveness of the NAIC disclosure system in New Jersey.¹¹⁶ This study, which was conducted with the cooperation of the New Jersey Department of Insurance, consisted of personal interviews with 194 people who had recently purchased insurance in New Jersey.¹¹⁷ The interviews took place between February

116 The Commission also contracted with Professor Jacob Jacoby of Purdue University to conduct two experimental studies designed to determine how a cost disclosure system can be made more understandable. The first Purdue study sought to determine what information consumers use when they purchase life insurance and the features that can be incorporated in a disclosure system to increase the use of cost information. The purpose of the second Purdue study was to compare the relative effectiveness, in an experimental setting, of several life insurance cost disclosure systems in helping consumers select appropriate life insurance policies. The disclosure systems tested were the NAIC model, a system developed by Professor Joseph Belth of Indiana University and several variants of a system prepared by the FTC staff for purposes of the experiment. These research studies will hereinafter be referred to as Purdue Study I and Purdue Study II. Some of the findings of these studies will be discussed in this section. A summary of the results is found in Appendix IX.

117 All of the subjects had purchased insurance from either Metropolitan Life Insurance Company or Prudential Insurance Company, the two largest insurance companies in the state of New Jersey.

and May 1979. The results of this study raise serious questions concerning the effectiveness of the NAIC model regulation. The New Jersey study found that the majority of people did not look at the disclosure materials that were provided. Fifty-eight percent of the subjects could not remember receiving the buyer's guide and 32 percent did not remember receiving the policy summary. Of those who did recall receiving the buyer's guide, only 15 percent said they either read the guide closely or read parts closely, while 15 percent said they skimmed the booklet and 11 percent said they didn't look at the guide. Eighty-six percent of the subjects said that the guide had no influence on their purchase decision.

As part of the study the subjects were asked a series of 15 questions relating to basic knowledge about life insurance and how to use the index numbers provided on the policy summary. The results for five of these questions are set forth below:¹¹⁸

1. True or False: The lower a policy's cost index, the better buy it is.

<input checked="" type="checkbox"/> True	7.2%
<input type="checkbox"/> False	39.7%
<input type="checkbox"/> Don't Know	53.1%

2. For a 35-year-old man, which policy will have a lower premium at first?

<input checked="" type="checkbox"/> \$25,000 renewable term policy	39.4%
<input type="checkbox"/> \$25,000 whole life policy	17.6%
<input type="checkbox"/> Don't Know	43.0%

3. True or False: The Net Payment Cost Index helps you compare

¹¹⁸ The correct answer is indicated by an X. Other results of the study will be discussed in later parts of this Section.

the cost of similar policies if at some future point in time you were to surrender each policy and take its cash value.

True	31.1%
X False	4.7%
Don't Know	64.2%

4. True or False: The best way to choose between a term policy and a whole life policy is to compare each policy's Surrender Cost Index and Net Payment Cost Index.

True	27.8%
X False	11.3%
Don't Know	60.8%

5. True or False: The dividends of a participating policy are usually guaranteed.

True	46.1%
X False	22.3%
Don't Know	31.6%

The New Jersey study showed that the test subjects who received the NAIC disclosure materials simply did not have the information essential to rational decision-making. The above questions and answers dramatically show, for example, that the test subjects who received these materials did not understand a basic distinction between a whole life and a renewable term policy and did not know a basic fact about participating policies. Even more significantly, the overwhelming majority of these subjects had fundamental misconceptions about the meaning of the cost indices that are the heart of the NAIC cost disclosure system.

The results of the New Jersey study are consistent with earlier studies that had been conducted concerning the comprehensibility of the NAIC buyer's guide. In March 1976, a survey research firm, Actionfacts, Inc., was commissioned by the Institute of Life Insurance (the predecessor of the American Council of

Life Insurance) to test market the NAIC buyer's guide. The Actionfacts report was presented to the NAIC in May 1978. The report was based on 320 interviews in eight metropolitan areas. Though the subjects tested gave the NAIC buyer's guide high subjective ratings for understandability, most of them did very poorly on an objective test of the guide's key cost information section. For example, after reading the NAIC buyer's guide only 31 percent of the respondents knew to check a policy's index numbers to compare the cost of life insurance policies. In addition, 61 percent admitted not knowing how to use the index numbers at all, while only 21 percent knew that the lower a policy's index number, the lower its cost.¹¹⁹ The report concluded, "The principal shortcoming of the booklet is the cost section, which was more the occasion of confusion than knowledge. It is clear that the cost section of the guide requires substantial revision."¹²⁰ The cost section of the guide has not been revised.

A study conducted by Prudential Insurance Company during the summer of 1976 produced even more disturbing results. In that study, Prudential distributed copies of the NAIC buyer's guide to its new policyholders in Georgia along with delivery of their policies, just as they are required to do under the

¹¹⁹ Actionfacts, A Report on a Study of Consumer Reaction to and Comprehension of a Life Insurance Buyer's Guide 6 (1976).

¹²⁰ Id. at 8.

NAIC model regulation. There were a total of 413 subjects in the study. Prudential's researchers interviewed the purchasers a short time after they had received the buyer's guide. They found that only 63 percent of the policyholders even remembered getting a copy of the buyer's guide, and of those, 60 percent could not recall any of the topics contained in it.¹²¹ Furthermore, 40 percent of those who did remember getting the guide did not look at it, while only 23 percent read all or most of it. Most disturbing of all, though 80 percent of those who read the guide claimed it was helpful, only 33 percent could explain the difference between term and whole life insurance and only 5 percent knew how to use the surrender index.¹²²

The New Jersey, Actionfacts and Prudential studies, taken together, raise fundamental questions concerning the capacity of the NAIC disclosure system to convey even the most basic information about life insurance to most life insurance purchasers. Set forth below are suggested modifications in the NAIC model which we think may increase understandability and use.

2. Timing of Disclosure

The information provided by a disclosure system should be easy for a consumer to understand and use, and should be provided at a time when a consumer is trying to decide which, if any, policy to buy--not after that decision has been made.

¹²¹ Public Affairs Department CORP, Impact Among Policyowners of the New Business Booklet 3, 13 (Prudential, 1976).

¹²² Id. at 11, 15, 21, 23.

Under the NAIC model regulation, purchasers usually receive the disclosure package when the policy is delivered. This is generally a week to 10 days after purchase. If cost disclosure is to be effective, it must take place before the purchase decision. Once that decision has been made, the buyer becomes psychologically committed to it and is, therefore, very unlikely to read and use a disclosure package provided 10 days after purchase.¹²³ The NAIC model regulation grants the life insurance purchasers a ten-day "cooling-off" period in which to rescind their purchase if they did not receive a disclosure package before they bought the policy. While the NAIC's "cooling-off" period is important, it is no substitute for full mandatory disclosure at the time of sale.

Existing industry data indicates that very few consumers are likely to avail themselves of the NAIC "cooling-off" period granted after policy delivery. In 1977, the American Council of Life Insurance (ACLI) surveyed 22 large life insurance companies that allow their customers a 10-day "cooling-off" period. It found that of the approximately 5,000,000 new policies sold by those companies only about 1.4 percent were returned.¹²⁴

123 Both the New Jersey and Prudential studies found that the majority of purchasers did not look at the disclosure materials that were provided. See pages 160, 162, 163, supra.

124 One reason more people did not use the cooling-off period is that they may not have known of its existence, see page 173, infra.

1.
7
In a slightly different context, that of policy replacement, the ACLI has recognized the inadequacy of post-sale disclosure combined with a "cooling-off" period. The NAIC model replacement regulation is designed to give the company whose policy is being replaced by another insurance policy the right to convince their policyholder not to replace the policy. The regulation requires that the insurer who is attempting to replace the existing policy either (1) delay issuance of the policy until 20 days after notice of replacement is sent to the existing insurer, or (2) issue the policy immediately, but grant the policyholder a 20-day "cooling-off" period that the company whose policy is being replaced can use to attempt to get the policyholder to retract his decision. In a June 13, 1978 letter to the NAIC, the ACLI opposed the 20-day "cooling-off" period option on the following ground:

ES
Once a replacement sale has been consumated and the existing policy, insurer or agent have been discredited in the eyes of the policyholder, a reversal of that action will be extremely difficult, even if replacement is shown to be disadvantageous to the policyholder.125

125

Reprinted in Moss Subcommittee Hearings, supra n. 4, at 409.

In testimony before the Moss Subcommittee, Mr. Julius Vogel, Vice President and Chief Actuary of Prudential Insurance Company, testifying on behalf of the ACLI, readily admitted that the industry has taken inconsistent positions on the timing of disclosure in initial sales and replacements.

als
Mr. SHAFFER (Subcommittee counsel): My obvious question is, isn't this inconsistent with your position on timing for the model solicitation rule?

Mr. VOGEL (ACLI): Yes, it is.

Id. at 410.

There are practical difficulties in disclosing all of the information required by the NAIC model prior to sale. The NAIC model regulation requires a policy summary that contains two different types of information: six indices that can be used for similar policy cost comparison and basic information about the policy such as premiums, death benefits, cash values and dividends for the first five policy years and representative years thereafter. The industry arguments against pre-sale disclosure are directly related to the amount of information disclosed. They contend that it would be impossible for agents to have with them during the sales presentation schedules of cash values and dividends for every issue age and face amount for all policies the company issues. They further argue that because the required disclosure calls for agents to fill in over 20 numbers there is a substantial likelihood that agents will make errors in filling out the disclosure statements. Currently, most companies comply with the NAIC regulation by producing the policy summary at the home office, generally by computer, and delivering it with the policy after sale.

We recognize there are legitimate practical problems connected with disclosure before sale of all of the information called for by the NAIC model regulation, problems which stem from the amount of information that must be disclosed. We therefore recommend modifying the NAIC model to require a

two-part disclosure.¹²⁶ The buyer's guide and a preliminary policy summary would be given prior to the time prospective purchasers are provided with an application for a policy. The preliminary policy summary would contain basic information such as policy type and size, premium, cost index and the rate of return. The preliminary policy summary contains only a limited amount of information essential to an informed purchase decision. It is not unreasonable to require agents to have all the information needed to fill out the preliminary policy summary with them during the sales presentation.

The second part of the disclosure would be a policy summary delivered with the policy. That summary requires, in addition to the information on the preliminary policy summary, detailed yearly information concerning the cash flow elements of the policy (premiums, illustrated dividends, death benefits and cash values). The basic information provided is essentially what is required by the NAIC model regulation.¹²⁷ This information is important and useful to the consumer. Because it is detailed, it may not be readily available to the agent during the sales presentation. It is appropriate, therefore, that the policy summary be delivered with the policy. The two-part

¹²⁶ A similar two-part disclosure is required by the cost disclosure regulation recently proposed by the Wisconsin Insurance Department. Wisc. Ins. Code, § 2.14. A copy of the Wisconsin cost disclosure regulation is contained in Appendix X.

¹²⁷ The exact information required for different types of policies is set forth in the draft regulation in Appendix X.

disclosure we recommend strikes an equitable balance between the consumer's right to have essential cost information prior to purchase and the burden on companies and agents to supply this information.¹²⁸

3. The Information That Should Be Contained on the Disclosure Statements In Addition to the Index Numbers

The next section describes in more detail the information that should be contained in the two disclosures statements we recommend.

a. Preliminary Policy Summary

Three features that can be incorporated into the preliminary policy summary may substantially increase consumer understanding and use of the information provided. First, the preliminary policy summary should contain information designed to make clear to the consumer the benefit of using cost information.

Judging from the results of the New Jersey and Prudential studies it is evident that many people simply

¹²⁸ The Moss Subcommittee recommended that a preliminary policy summary and buyer's guide be given prior to the time a prospect is asked to sign a policy application, and that the agent be prohibited from accepting a premium deposit when the application is signed. The agent would be required to prepare a "Final Policy Summary" that would be mailed to the consumer together with a premium billing notice. The notice would provide the customer with a minimum of 20 days to remit and would advise him that he is under no obligation to purchase the policy. Moss Subcommittee Report, supra n. 6, at 51. One concern with this approach is that it might unduly disrupt the sales process with few countervailing benefits to the consumer. We think consumers will have an adequate opportunity to comparison shop if they are given a preliminary policy summary prior to the application and are, in addition, granted a 10-day "cooling off" period after the delivery of the policy.

did not look at the information provided to them. The preliminary policy summary should tell the consumers the importance of the cost information they are being given. An example of how this can be done is contained in the Wisconsin regulation which requires each preliminary policy summary to begin with the following statement:

IMPORTANT: Many people think all life insurance policies cost about the same. They don't. The cost of similar policies varies sharply. You can save many hundreds or even thousands of dollars by choosing a low-cost policy. To find out how this particular policy ranks, compare its Cost Index (found below) to the range of cost indexes for similar policies. For further information on cost comparison and examples of the range of cost indexes for a number of policies, see pages 4-8 in the Wisconsin Buyer's Guide to Life Insurance which you should have received with this policy summary.¹²⁹

The second feature we recommend incorporating in the preliminary policy summary is a brief explanation of the cost information provided and how it can be used.¹³⁰ Without some explanation, the indices on the preliminary policy summary will mean little to most consumers. Putting explanatory material

¹²⁹ A similar statement is contained in our draft disclosure materials in Appendix X. Purdue Study I indicated that providing consumers with information that highlights the importance of cost information may substantially increase consumers' use of cost information. See Appendix IX

¹³⁰ The explanation of the surrender index should contain the statement "To find a low-cost policy, look at the policy's 20-year surrender index, not its premium." This warning is essential. As seen in Part III, many consumers equate cost with premium, yet premiums are a totally unreliable guide to the actual cost of a policy.

on the preliminary policy summary will not only make the summary itself more self-contained, it should also stimulate interest in reading the buyer's guide.

Third, the precise format of the preliminary policy summary should be specified in the regulation. Format is almost as important as the substantive information being conveyed. If too much information is disclosed, or if companies disclose the information in a confusing format, the whole purpose of disclosure can be defeated. Under the NAIC model regulation, companies are free to disclose the information in any way they choose subject only to the general requirement that "All information required to be disclosed must be set out in such a manner as to not minimize or render any portion thereof obscure."¹³¹ Most companies prepare the policy summary by computer. This often results in a presentation that is confusing and difficult for the consumer to use. An example of a typical computer-generated policy summary is set forth on the following page.

The draft regulation contains a standardized preliminary policy summary that can be used for both whole life and endowment policies and one that can be used for term insurance and term riders. If a cash value policy is sold with a term rider, a separate preliminary policy summary would be provided for the basic policy and each term rider.¹³² For annuities and

¹³¹ NAIC model regulation, Section 4(G)(11). See Appendix X.

¹³² See draft regulation, Appendix X.

CONNECTICUT GENERAL LIFE INSURANCE COMPANY

HARTFORD, CONNECTICUT 06152

STATEMENT OF POLICY COST AND BENEFIT INFORMATION

THIS EXHIBIT PROVIDES BASIC INFORMATION ABOUT THE COST AND COVERAGE OF THE INSURANCE SUMMARIZED BELOW. IT IS NOT AN OFFER TO CONTRACT FOR OR ALTER OR MODIFY ANY POLICY THAT MAY BE ISSUED

PREPARED FOR:

POLICY NUMBER:

0 AGE 35 SEX M

COVERAGE DESCRIPTION

BASIC POLICY: ORDINARY LIFE

FACE AMOUNT

25000 NON-PARTICIPATING

SUPPLEMENTARY BENEFITS (1)
(3)

(2)
(4)

POLICY YEAR	ANNUAL PREMIUM (INCLUDING POLICY FEE)			GUARANTEED DEATH BENEFIT (BEGINNING OF POLICY YEAR)			GUARANTEED CASH VALUE (END OF POLICY YEAR)			ILLUSTRATED DIVIDENDS* (END OF POLICY YEAR)
	BASIC POLICY	SUPPLEMENTARY BENEFITS (1) (2) (3)		BASIC POLICY	SUPPLEMENTARY BENEFITS (1) (2)		BASIC POLICY	SUPPLEMENTARY BENEFITS (1) (2)		BASIC POLICY
1	413	0	0	0	25000	0	0	0	0	0
2	413	0	0	0	25000	0	0	0	0	0
3	413	0	0	0	25000	0	0	325	0	0
4	413	0	0	0	25000	0	0	725	0	0
5	413	0	0	0	25000	0	0	1125	0	0
10	413	0	0	0	25000	0	0	3225	0	0
20	413	0	0	0	25000	0	0	8550	0	0
AGE 65	413	0	0	0	25000	0	0	13050	0	0

POLICY LOAN INTEREST RATE (APPLIED IN ARREARS): 4 %

*DIVIDENDS USED HEREIN ARE BASED ON PRESENT SCHEDULES AND ARE NOT GUARANTEES FOR THE FUTURE. THEY REPRESENT A RETURN OF PART OF THE PREMIUM PAID AND ARE DEPENDENT ON INVESTMENT EARNINGS, MORTALITY EXPERIENCE, AND EXPENSE EXPERIENCE

PREPARED FOR:

POLICY NUMBER: 0

LIFE INSURANCE COST INDEXES AND EQUIVALENT LEVEL ANNUAL DIVIDENDS

THE INDEXES SHOWN BELOW PROVIDE A MEANS OF COMPARING THE RELATIVE COSTS OF PROTECTION UNDER POLICIES WHICH ARE SIMILAR BOTH AS TO PLAN AND AMOUNT OF INSURANCE. IN SUCH COMPARISONS, IF EVERYTHING ELSE IS EQUAL, THE POLICY WITH THE LOWER INDEX USUALLY REPRESENTS A BETTER VALUE.

IT IS IMPORTANT TO NOTE THAT THESE INDEXES DO NOT TAKE INTO ACCOUNT (1) THE VALUE OF THE SERVICES OF AN AGENT OR COMPANY, (2) THE RELATIVE STRENGTH AND REPUTATION OF THE COMPANY, AND (3) DIFFERENCES IN POLICY PROVISIONS.

AN EXPLANATION OF THE PROPER USE OF THESE INDEXES AND THE EQUIVALENT LEVEL ANNUAL DIVIDEND IS INCLUDED IN THE LIFE INSURANCE BUYER'S GUIDE.

PER \$1,000 OF INSURANCE

	LIFE INSURANCE COST INDEXES @ 5.00 %				EQUIVALENT LEVEL ANNUAL DIVIDENDS @ 5.00 %		
	SURRENDER COST INDEX		NET PAYMENT COST INDEX		BASIC POLICY		
	BASIC POLICY	SUPPLEMENTARY BENEFITS (1) (2)	BASIC POLICY	SUPPLEMENTARY BENEFITS (1) (2)	BASIC POLICY		
10TH YEAR	4.73	0. 0.	14.52	0. 0.	0.		
20TH YEAR	4.47	0. 0.	14.52	0. 0.	0.		

EXCLUDING OPTIONAL RIDERS WHICH ARE LIMITED TO BENEFITS SUCH AS ACCIDENTAL DEATH, DISABILITY WAIVER OF PREMIUM, PRELIMINARY TERM LIFE INSURANCE COVERAGE OF LESS THAN 12 MONTHS, GUARANTEED INSURABILITY BENEFITS AND POLICIES AND RIDERS COVERING MORE THAN ONE LIFE.

*DIVIDENDS USED HEREIN ARE BASED ON PRESENT SCHEDULES AND ARE NOT GUARANTEES FOR THE FUTURE. THEY REPRESENT A RETURN OF PART OF THE PREMIUM PAID AND ARE DEPENDENT ON INVESTMENT EARNING, MORTALITY EXPERIENCE AND EXPENSE EXPERIENCE

NAME OF AGENT

DATE THIS STATEMENT WAS PREPARED 06/05/70

ADDRESS OF AGENT

additional first year premium policies, the draft regulation specifies the basic information that must be disclosed and provides that preliminary policy summary forms must be approved by the State Insurance Commissioner.¹³³ It is desirable to provide for prior approval of these products rather than providing a specified form because of the wide variation in the types of products.¹³⁴

b. Policy Summary

In addition to cost indices, the NAIC policy summary requires that premiums, death benefits, cash values and dividends be shown for the first five policy years and representative years thereafter. We agree with the NAIC that it is useful to provide this information.¹³⁵ There are two additional items of informa-

¹³³ See draft regulation, Appendix X.

¹³⁴ The Moss Subcommittee report notes that the problem caused by policies that combine elements of cash value and term insurance and states it would be desirable to develop a single format that will be applicable to any life insurance policy or annuity. Moss Subcommittee Report, supra n. 6, at 56. The potential problems caused by a combined policy are adequately handled by requiring a separate preliminary policy summary for the cash value and term elements of such a policy. We agree with the Moss Subcommittee that a single uniform format for all insurance related products would theoretically be desirable. However, we doubt if it is possible to have a single format because the information a consumer needs to shop for different types of products is quite different. For example, renewal rights and the amount of renewal premiums are very important for term insurance, but not for cash value insurance or annuities. Similarly, the rate of return is critical in cash value insurance and annuities but has no relevance when term insurance is being considered.

¹³⁵ The 1974 Society of Actuaries report stressed that ade-
(Footnote Continued)

tion we recommend including in the policy summary.

First, the interest rate assessed policyholders for paying premiums other than annually should be disclosed. In 1976, 81 percent of ordinary life policies purchased were paid for on other than an annual basis.¹³⁶ A survey of 15 companies prepared for the Moss Subcommittee by Professor Joseph Belth shows that the interest rates assessed for periodic payments are significant and vary widely from company to company. For example, he found that the added cost of paying premiums monthly rather than annually ranged from 4.9 to 29.3 percent on an annual percentage rate basis.¹³⁷ There are conveniences to the consumer and expenses to the company if premiums are paid more frequently than annually. If consumers want to pay premiums on other than an annual basis, they should be informed of the cost of this convenience.¹³⁸

135 (Footnote Continued)

quate information disclosure must consist of both a method for comparing costs of competing policies and a method for disclosing the cash flow elements and benefits of a particular life insurance contract as it relates to the individual purchaser. The cash flows of a policy are defined by the Society for this purpose as "the actual transfer of funds between the policyholder and the insurance company, in either direction, and includes premiums, dividends, cash values and death benefits." Actuaries Report, supra n. 33, at 6.

136 Moss Subcommittee, Report, supra n. 6, at 49.

137 Moss Subcommittee Hearings, supra n. 4, at 179.

138 On a \$50,000 policy with a premium of \$700 a year, if the company charges 15 percent for paying premiums monthly, the consumer will pay an additional \$48.80 a year. If the
(Footnote Continued)

Second, the policy summary should contain information concerning the existence of, and how to exercise, the 10-day "cooling-off" period.¹³⁹ The "cooling-off" period is an important component of the NAIC model regulation. If consumers are to make effective use of this right, they must know of its existence.¹⁴⁰

4. The Buyer's Guide

The NAIC model regulation requires that a standardized buyer's guide be given purchasers along with the policy summary. The NAIC buyer's guide is a short booklet describing the types of insurance available and how to use the cost indices provided on the policy summary. This section contains our recommendation concerning how to modify the NAIC buyer's guide.¹⁴¹

138 (Footnote Continued)

amount were invested each year at 5 percent (after taxes) it would amount to approximately \$1,680 at the end of 20 years.

139 This same information should be contained in the buyer's guide. See Appendix X.

140 The New Jersey study provided graphic evidence why this provision is needed. It was found that only 10 percent of purchasers knew that the New Jersey cost disclosure regulation granted a 10-day cooling-off period. Another 10 percent thought they had a 5-day cooling-off period, while 24 percent thought they had 30 days, 3 percent thought the period was 60 days and 55 percent answered they did not know what "cooling-off" rights they were granted under New Jersey law.

141 At various points in this report we have made recommendations concerning the information that should be contained in a buyer's guide, see page 121 n. 36, supra. These recommendations will not be repeated here.

One of the most important decisions consumers have to make is whether to base their insurance program on primarily term or whole life insurance. Other than providing a brief narrative description of the difference between term and whole life insurance, the NAIC buyer's guide contains little to help the consumer make this decision.¹⁴² We recommend the following changes to assist consumers in making the term/whole life decision.

1. The NAIC buyer's guide does not mention group insurance.

¹⁴² None of the NAIC index numbers are relevant to the term/whole life decision, see pages 99-106, supra. To help the consumer choose between term and whole life the NAIC system relies solely on the narrative information in the Buyer's Guide. Moss Subcommittee Report, supra n. 6, at 59. The Moss Subcommittee found this information to be inadequate:

The 'narrative explanation' referred to is a short, general description of the differences between term and whole life. It fails altogether to explain the significance of even the most fundamental aspects of the term-whole life choice. The NAIC rule neither provides rate of return data nor even mentions the concept. Instead, the NAIC adopts the position of non-disclosure that has been advanced by insurers for years to avoid revealing the information that would enable consumers to make a meaningful decision. The NAIC thus finds itself endorsing irrelevant and unpersuasive arguments devised by insurers to protect their economic position as financial intermediaries.

We would have expected to find the NAIC employing its influence to dissipate the wholly unnecessary confusion that surrounds the term-whole life controversy. Regrettably, we find the NAIC at the forefront of efforts to perpetuate it.

Id.

Almost one-half of the insurance currently in force is group insurance.¹⁴³ For many people, group insurance can provide a relatively inexpensive way to provide for their basic insurance needs.¹⁴⁴ Group insurance should be discussed in the buyer's guide.

2. The NAIC buyer's guide states that, "term insurance generally provides the largest immediate death protection for your premium dollar." The guide should point out that for many families, especially those with modest incomes and small children, the only way they can meet their basic insurance needs is by buying primarily term insurance. It would also be useful to give a specific illustration of how much more term insurance per premium dollar a person can buy at younger years.

3. The industry often distinguishes between term and whole life insurance on the grounds that term insurance is designed for temporary needs while whole life insurance is for the person who wants insurance for their entire life.¹⁴⁵ The buyer's

¹⁴³ See page 12, n. 29 supra.

¹⁴⁴ In addition to pointing out the potential advantages of group insurance, the buyer's guide should list the drawbacks, one of which is that the amount of coverage available under a group policy is often limited and a person may lose his group coverage if he changes employment.

¹⁴⁵ An example of this is contained in a recent brochure put out by the National Association of Life Underwriters (NALU). With regard to term insurance, they state, "term insurance has an important purpose. But, remember, a term policy gives temporary protection only. It's like renting instead of buying." This is in contrast to the description of whole life insurance, "chances are if you bought permanent life insurance, it was in answer to permanent needs. If
(Footnote Continued)

guide should point out that renewable term insurance can be used to meet long term insurance needs, at least through age 65. A 25-year old person who buys renewable term insurance and holds it until age 65 will have had protection for 40 years. It is hard to say this is temporary insurance coverage. The guide should also point out that term insurance premiums become very high after age 65, and if a person wants a life insurance policy in force after age 65 he should probably should buy whole life.¹⁴⁶

4. The NAIC buyer's guide describes three types of insurance--term, whole life, and endowment. For many people the best insurance program is a combination of term and cash value insurance. The buyer's guide should note this and discuss the ways these basic types of insurance can be combined (for example, through the purchase of a whole life policy with a term rider attached).

5. As discussed throughout the report, the savings element is an integral part of cash value insurance. The only mention of the savings feature of whole life insurance in the NAIC

145 (Footnote Continued)

those needs have not changed, then you still need the permanent protection. . . . Thus, if life insurance protection is required for relatively long periods, whole life insurance is the least expensive form of individual life insurance policy." This booklet is reprinted in Moss Subcommittee Hearings, supra n. 4, at 752-64.

146 We repeat the points made earlier that all insurance is expensive after age 65 and that whole life insurance and term insurance plus a side fund are equally legitimate ways to provide protection at any age. See pages 135-36, supra.

buyer's guide is a description of cash values and the fact a person can either borrow against them or receive them by surrendering the policy. We recommend that the explanation of the savings element of cash value insurance be expanded to include a statement that whole life insurance can be viewed as a combination of death protection and savings, with the size of the protection element decreasing over time as cash values increase. Additionally, it should include a description of how to use the rate of return.¹⁴⁷

5. Coverage of the Regulation

¹⁴⁷ This description should include i) a discussion of the unique characteristics of whole life that may make a relatively low yield acceptable (see page 120, supra), ii) the YRT rates used in the rate of return calculation (see page 121, supra), and iii) a description of the tax advantages of life insurance (see page 29, supra). The buyer's guide should also contain information on how to use the surrender index to compare similar policies. It should provide an example of how much a person can save by buying a low as opposed to a high-cost policy. It should also inform the consumer that small differences in the cost of similar policies may be offset by other policy features. See draft guide, Appendix X. The NAIC buyer's guide contains a statement that small differences in index numbers should be ignored and may be offset by other policy features. It does not, however, say what a small difference is. It would be extremely useful if the buyer's guide contained some concrete indication of what is a small difference. Mr. E. J. Moorhead has suggested that the figures be 50 cents per thousand. Statement before Senate Veterans Committee, supra n. 58, at 151. We think the use of this figure is appropriate and it is contained in the draft buyer's guide.

The NAIC model regulations totally exclude group insurance and group annuity products.¹⁴⁸ The regulation we propose only excludes these products if at least a portion of the cost is borne by a person other than the person insured or his beneficiaries.¹⁴⁹ It can be argued that cost disclosure is not necessary where employers who are paying part of the premium can be relied upon to search for an attractively priced product. In other group sales, however, this protection is not available. Therefore, it is appropriate to require cost disclosure for group products if the insured bears the total cost.

The NAIC model regulations do not apply to "life insurance policies issued in connection with pensions and welfare plans as defined by, and which are subject to, the Federal Employees Retirement Income Security Act of 1974 (ERISA).¹⁵⁰ We recommend dropping this exclusion. Individual life insurance and annuity products are often sold to fund Individual Retirement Accounts (IRAs), H.R. 10 (Keogh Plans) and small pension plans established under ERISA. The need to provide meaningful cost disclosure in this area is as great as in the individual market. The need to provide rate of return information is especially strong because the insurance and annuity products sold to plans under

148 NAIC model regulation, Section 3(b). See Appendix X.

149 This modification of the NAIC model regulation is contained in a cost disclosure regulation recently proposed by the Maryland Department of Insurance.

150 NAIC model regulation, Section 3(B)(4). See Appendix X.

cludes

ERISA are primarily designed to provide retirement income. Currently, neither the Department of Labor nor the Internal Revenue Service, the agencies having the responsibility to administer ERISA, require rate of return disclosure on insurance or annuity products.¹⁵¹

We also recommend that purchasers of small face amount policies, including industrial insurance, be given the same disclosure materials as purchasers of larger policies. Although the NAIC did not exempt small policies from the scope of its model,¹⁵² several states have excluded small policies from their disclosure requirements. There is little reason for exempting such policies. They are often purchased by lower income persons who may know even less about the true costs of an insurance policy than purchasers of larger policies. We note that substantial consumer problems peculiar to the small policy market, particularly for debit insurance, have been revealed in recent years. A principal criticism which has been leveled against many of these policies is that their cost is abnormally high compared to larger ordinary policies. Purchasers of small policies should have the right

¹⁵¹ ERISA preempts state insurance regulation in certain areas. The recent decision in Wadsworth v. Whaland, 562 F.2d 70 (1st Cir. 1977), indicates, however, that ERISA would not preempt a state cost disclosure regulation which applies to insurance company products sold to fund pension and welfare plans.

¹⁵² The NAIC Model Life Insurance Solicitation Regulation permits insurers to omit some information from the policy summary on policies whose Equivalent Level Death Benefit is less than \$5000. However, the cost indices must be provided. Our draft regulation contains no such exemption.

to find out how their insurance investments compare with other policies and other savings media.¹⁵³

6. Enforcement Provisions

The NAIC model regulation requires each company to maintain a file of one copy of each document authorized by the insurer for use pursuant to the model regulation.¹⁵⁴ This provision will be useful in determining whether authorized company forms comply with the regulation and is included in the draft regulation. This provision is of limited use, however, in determining whether an insurer and its agents are actually complying with the regulation. It will now show whether the forms actually used comply or whether the forms are correctly filled out.

The draft regulation contains an alternative provision that a state may wish to consider in lieu of NAIC, Section 6(A). This alternative provision requires insurers to maintain copies of the preliminary policy summary and policy summary for each policy they issue. This information will enable insurance departments to determine easily whether insurers and agents are fully complying with the regulation. This information will also enable companies to determine whether their agents are complying with the regulation. The preliminary policy summary will be filled out by the agent during the sales presentation. If the company has a copy of

¹⁵³ On the question of whether small policies should be exempt from disclosure, Spencer Kimball has concluded that the arguments favoring exemption are unpersuasive. He observed that, "...the low or moderate income consumer who purchases a small policy is the very person who most needs price disclosure information, to get the most from his limited resources." Kimball and Rapaport, supra n. 25, at 1047.

¹⁵⁴ NAIC model regulation, Section 6(A). See Appendix X.

the policy summary, it can easily check it against the policy summary it provides to the consumer and thus determine if the information on the preliminary policy summary is correct.

The drawback of the alternative provision is that it would, to an extent, increase company cost in complying the regulation. There would be a certain cost involved for companies to retain the required disclosure statement in the customer's file. This small additional cost should be weighed against the possibility of violations of the regulation and the saving in enforcement costs which would result from the adoption of the alternative enforcement provision.

Other enforcement mechanisms should also be considered that might make the regulation more self-enforcing. One method would be to permit the purchaser to return the policy and obtain a full refund within fourteen months after the policy is delivered if the disclosure requirements are not fully complied with. A provision of this type would give companies a substantial incentive to take all necessary steps to ensure that they fully comply with the regulation. It would substantially reduce the need for an insurance department to commit resources to enforce the regulation.

CONCLUSION

To summarize briefly. The life insurance industry is a major repository of consumer savings, holding over \$140 billion in 1977. Yet in 1977, the industry paid its policyholders less than 2% on their savings in a year when the rate of inflation was around 10% and in which all other savings institutions were paying higher rates. Life insurance companies paying 2% after 20 years compete successfully against companies paying 5%. Penalties for early withdrawals are remarkably severe but unannounced. We recommend that the life insurance industry be required to disclose the rate of return and several other items of information to their policyholders in a simple and effective manner. Price competition can only be effective when some significant fraction of the market is able to compare prices, and this is what the disclosure system is designed to do.

We note that the call for life insurance cost disclosure is not new. In 1908, the Wisconsin Commissioner of Insurance wrote:

There is a point where the benefits of insurance are outweighed by the expense. Either the policyholder should be enabled intelligently to determine for himself what that point is or the state should at least prescribe a maximum limit. The recent investigation committee recommended that every policy issued should state in dollars and cents for each year during the possible history of the policy, the amount provided for expenses, the amount provided for death claims, and the amount held to the credit of the policyholder as a reserve. With these facts before him, the proposed policyholder would have something on which to determine whether or not the contract was one he wanted.

He would also have something definite by which he could judge how the management afterward administered its trust as to his money.

When the recommendation was suggested in the hearings of the committee, it met with the answer that the prospective policyholder would not take the insurance if he knew what he was paying for expense. Company managements admitted that they were writing forms of policies which men ought not to take because the expense provisions far outweighed the benefits and which they would not take if they knew what the expense provisions really were. It would seem as if there could be no question that the present and prospective policyholder is entitled to have all the facts with regard to his policy in such form that he can understand them and be able to compare the expense and the insurance benefit. Yet so novel was the proposition to give the policyholder a chance to protect himself and so strenuous were the objections to the plan on the part of the companies, even during the hearings by the investigation committee, that the committee felt that it would be difficult to secure its immediate adoption. The opposition of the companies was continued in the hearings before the committees of the legislature at the session of 1907 and the recommendation was defeated." (1908 Annual Report, Wisconsin Commissioner of Insurance).

Due to inflation the need for meaningful cost disclosure has never been greater. We note with encouragement that the insurance departments of Massachusetts, North Carolina and Wisconsin have attempted to enact cost disclosure systems responsive to the problems addressed in this report and hope that other insurance commissions will follow the lead of these states. We think that the reaction of other state regulators to the problem of life insurance cost disclosure in the year ahead will be a very good measure of the adequacy of state regulation of insurance.

I. Introduction

This appendix describes the major features of the life insurance market and attempts to place ordinary insurance--the focus of the report--in context. The first part will discuss the size, concentration and profitability of the industry. The second part will compare ordinary insurance to group, industrial and credit insurance.

II. The Life Insurance Market

A. Size. The life insurance market is enormous by any measure. The average amount of life insurance in force per family increased from \$17,000 in 1967 to \$26,500 in 1974 and to \$32,400 in 1977.¹ In total, the amount of life insurance in force in 1977 exceeded \$2,582 billion.² In that same year, Americans purchased \$367 billion in new life insurance³ and received a total of \$26.5 billion in payments, including \$10.2 billion in death payments as shown in Table I-1 below.

¹ American Council of Life Insurance, Life Insurance Fact Book 24 (1978) [Hereinafter cited as Fact Book].

² Id. at 18.

³ Id. at 11.

Table I-14

**Life Insurance Benefit Payments
in the United States (000 Omitted)**

Year	Death Payments	Matured Endow- ments	Disability - Pay- ments	Annuity Pay- ments	Surrender Values	Policy Divi- dends	Total
1940	\$ 995,000	\$ 269,200	\$103,500	\$ 176,500	\$ 652,000	\$ 468,100	\$ 2,664,300
1945	1,279,600	406,700	87,600	216,400	210,900	466,100	2,667,300
1950	1,589,700	495,100	99,600	319,400	592,300	634,600	3,730,700
1955	2,240,700	613,900	110,000	462,300	895,900	1,059,900	5,382,700
1960	3,346,100	673,100	123,800	722,000	1,633,400	1,620,100	8,118,500
1965	4,831,400	931,100	163,000	1,038,900	1,932,300	2,519,900	11,416,600
1966	5,218,200	981,600	169,300	1,152,600	2,120,600	2,699,900	12,342,200
1967	5,665,300	1,017,100	174,600	1,261,300	2,243,100	2,932,200	13,293,600
1968	6,209,300	967,200	195,600	1,401,000	2,456,400	3,155,500	14,385,000
1969	6,758,100	952,600	204,700	1,558,600	2,721,600	3,328,900	15,524,500
1970	7,017,300	978,300	232,900	1,757,100	2,886,400	3,577,400	16,449,400
1971	7,423,300	990,200	256,800	1,944,400	2,881,600	3,680,900	17,177,200
1972	8,007,000	1,000,400	271,200	2,213,200	3,027,400	4,054,900	18,574,100
1973	8,572,000	1,025,600	316,600	2,597,900	3,417,800	4,382,900	20,312,800
1974	8,885,100	991,400	374,500	2,904,300	3,641,700	4,655,300	21,452,300
1975	9,192,100	946,300	426,000	3,176,800	3,763,200	5,031,800	22,536,200
1976	9,593,300	976,200	458,000	3,879,900	4,147,600	5,556,200	24,611,200
1977	10,195,700	931,700	495,000	4,617,500	4,308,900	5,913,200	26,462,000

Source: American Council of Life Insurance. Figures represent benefit payments under original policy contracts, including benefits that are left with the companies for future payment under supplementary contracts, but excluding payments from existing supplementary contracts. See page 47 for supplementary contract payments and page 48 for health insurance benefits paid by life companies.

The significance of the life insurance industry is also evident in the awesome size of its holdings. The assets of U.S. life insurance companies totaled \$351.7 billion at the end of 1977, an increase of 9.4 percent over the previous high of \$321.5 billion in 1976.⁵ Those assets, consisting largely of financial instruments, have been an important source of investment capital in the American economy, totalling \$29.2 billion of net investments in U.S. capital markets in 1977. In 1977, life insurance ranked 5th among the major domestic institutional sources of capital, providing 8 percent of the total monies flowing into U.S. financial markets.⁶

B. Concentration. An estimated 1,750 legal reserve life insurance companies were in business at the end of 1977.⁷ With the exception of Alaska, at least two insurance companies are domiciled in every state.⁸ This number has grown steadily from the early 1800's to the 1960's and since then has hovered at about 1,750:

5 Id. at 68, 69.

6 Id. at 68.

7 Id. at 89.

8 Id. at 89-90.

Number of U.S. Life Insurance Companies

Year	Number	Year	Number	Year	Number
1759	1	1900	84	1963	1,488
1760	1	1905	126	1964	1,547
1770	2	1910	284	1965	1,629
1780	2	1915	295	1966	1,704
1790	3	1920	335	1967	1,715
1800	4	1925	379	1968	1,763
1810	2	1930	438	1969	1,773
1820	6	1935	373	1970	1,780
1830	9	1940	444	1971	1,765
1840	15	1945	473	1972	1,753
1850	48	1950	649	1973	1,766
1860	43	1955	1,187	1974	1,757
1870	129	1960	1,441	1975	1,746
1880	59	1961	1,448	1976	1,742
1890	60	1962	1,469	1977	1,750

Note: The figure for 1976 is revised. The figure for 1977 is preliminary.

Sources: Marketing Life Insurance (J. Owen Stalson), American Council of Life Insurance, and Best's Review.

⁹ Id. at 90.

It should be noted, however, that this 1750 figure may be misleading because some of these reserve companies are wholly owned by one holding company. For example, American General of Houston, Texas wholly owns eleven insurance subsidiaries.¹⁰

Furthermore, although there are numerous legal reserve insurance companies, most of the assets and insurance in force are concentrated in a relatively few companies. The Hart Hearings found:

At the end of 1968, the two largest life insurance companies (by admitted assets) accounted for about 28% of the industry's admitted assets, the four largest about 40%, the eight largest (Prudential, Metropolitan Life, Equitable of New York, New York Life, John Hancock, Aetna Life, Northwestern Mutual, and Connecticut General) about 54%, the twenty-five largest about 74%, and the fifty largest [accounted for] about 84% [of the industry's admitted assets].¹¹

Likewise, a 1972 article in the Journal of Risk and Insurance stated that the top 20 life insurance companies in the United States, according to admitted assets, accounted for 70.69 percent of the total assets in the life insurance industry, while those 20 companies also held 58.05 percent of the industry's total surplus and dividends in 1969. In that group of top companies as of 1968, the top 4 companies had 34.20 percent of ordinary life insurance in force, the top 8 held 44.65 percent of ordinary

¹⁰ Best's Insurance Reports, Life & Health 98 (1978).

¹¹ J. Belth and W. Maxwell, "The State of Competition in the Life Insurance Industry," ¹⁵ Antitrust Bull. 213 (1970).

life insurance in force, and the top 20 together held 60.79 percent of all the ordinary life insurance in force.¹²

Table I-3

Base	Concentration ratios		
	4-Firm	8-Firm	20-Firm
Total premiums	28.9	43.2	58.2
Assets	36.9	50.3	68.2
Life insurance issued	25.9	36.7	54.8
Life insurance in force	31.2	44.1	59.5
Health insurance premiums*	27.2	42.7	61.4
Credit life insurance issued	23.8	33.3	50.8

* Excludes health insurance premium of property-liability insurance companies.

Sources: Universe data (except for credit life insurance) from

American Council of Life Insurance, Life Insurance Fact Book (1977), p.7. Company data from Best's Review, Life-Health Edition, August, 1977 (p. 35) June, 1977 (p.42), September, 1977 (p. 41) and October, 1977 (p. 39).

The concentration among the large firms may not, however, be cause for concern. First, when compared to other markets, the concentration ratio for the life and health insurance industries are low to moderate (Table I-3).

12

J. Cummins, H. Denenberg, and W. Scheel, "Concentration in the U.S. Life Insurance Industry," 34 J. of Risk and Insurance 177, 184 (June 1972).

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Second, entry restrictions are few. The only significant restrictions in the life-health insurance sector result from state regulation. New York, the state with the strictest standards, requires minimum paid-in capital of \$1 million, minimum surplus of \$2 million or twice the amount of paid-in capital (whichever is greater), and minimum reserves of \$1 million, minimum surplus of \$2 million or twice the amount of paid-in capital (whichever is greater), and minimum reserves of \$1 million.¹³ Similarly, recent studies of scale economies in the U.S. and Canadian life insurance industry show slight returns to scale. Firms with the lowest output levels had average costs about 25 percent above those of the largest firms. However, the small firms accounted for a small percentage of industry output and, at least in the Canadian industry, such firms are shielded by favorable tax treatments.¹⁴ In short, there appears to be a limited capital requirement entry barrier.

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The absence of significant barriers to entry is borne out by the existing evidence. Table I-4 shows the large number of legal reserve life insurance companies doing business in the United States from 1950 through 1977 and the frequency of entry and exit of such companies. The great majority of the companies added through the years were new firms (others had converted

¹³ U.S. Securities and Exchange Commission, Institutional Investor Study Report 509 (1971).

¹⁴ Randall Geehan, "Returns to Scale in the Life Insurance Industry," 8 Bell Journal of Economics 497 (1977).

from fraternal insurers or had been formed by consolidation of existing firms). Most companies that discontinued operations either merged with other insurers or had their outstanding business reinsured.¹⁵

¹⁵ Fact Book, supra n. 1, at 89.

Change in Number of U.S. Life Insurance Companies in Business in the United States

Year	In Business Start of Year			New Operations	Discontinued	In Business Year-End			Net Changes During Year
	Stock	Mutual	Total			Stock	Mutual	Total	
1950	478	133	611	44	6	507	142	649	+ 38
1951	507	142	649	50	20	531	148	679	+ 30
1952	531	148	679	62	11	567	163	730	+ 51
1953	567	163	730	117	15	661	171	832	+ 102
1954	661	171	832	115	30	753	164	917	+ 85
1955	753	164	917	216	26	942	165	1,107	+ 190
1956	942	165	1,107	133	49	1,035	156	1,191	+ 84
1957	1,035	156	1,191	120	38	1,119	154	1,273	+ 82
1958	1,119	154	1,273	142	50	1,212	153	1,365	+ 92
1959*	1,212	153	1,365	125	65	1,273	152	1,425	+ 60
1960	1,273	152	1,425	96	80	1,286	155	1,441	+ 16
1961	1,286	155	1,441	87	80	1,292	156	1,448	+ 7
1962	1,292	156	1,448	101	80	1,312	157	1,469	+ 21
1963	1,312	157	1,469	86	67	1,332	156	1,488	+ 19
1964	1,332	156	1,488	131	72	1,393	154	1,547	+ 59
1965	1,393	154	1,547	149	67	1,475	154	1,629	+ 82
1966	1,475	154	1,629	156	81	1,550	154	1,704	+ 75
1967	1,550	154	1,704	90	79	1,561	154	1,715	+ 11
1968	1,561	154	1,715	112	64	1,608	155	1,763	+ 48
1969	1,608	155	1,763	74	64	1,619	154	1,773	+ 10
1970	1,619	154	1,773	73	66	1,627	153	1,780	+ 7
1971	1,627	153	1,780	49	64	1,612	153	1,765	- 15
1972	1,612	153	1,765	76	88	1,603	150	1,753	- 12
1973	1,603	150	1,753	75	62	1,619	147	1,766	+ 13
1974	1,619	147	1,766	73	82	1,612	145	1,757	- 9
1975	1,612	145	1,757	63	74	1,603	143	1,746	- 11
1976	1,603	143	1,746	85	89	1,601	141	1,742	- 4
1977	1,601	141	1,742	N.A.	N.A.	N.A.	N.A.	1,750	N.A.

Note: Data for 1976 are revised. The figure for year-end 1977 is preliminary. A change in domicile is reflected in both new and discontinued operations.

N.A.—Not available.

*Includes seven companies domiciled in Alaska and Hawaii which were started in earlier years.

Source: American Council of Life Insurance.

C. Profitability. Current evidence does not permit any firm conclusions about profitability. Although there is an extensive literature on profitability in the property-liability insurance industry, little has been published on life insurance profitability. Profitability in the life insurance industry is more difficult to measure. Moreover, since its pricing is unregulated, there may have been less immediate need for profit studies. However, recent concern about the workability of competition in the life insurance industry and recent availability of financial statements for stock life insurance comparable to those of companies in other industries has prompted some research. 17/ At this point, the evidence does not indicate that life insurance companies are making massive profits. The companies did earn about 7 percent on their investments, before federal taxes, in 1977. The available facts do not support the conclusion that the differential between what the companies earn and pay out results in very high profits. Most of the differential is absorbed by high home office expenses, sales commissions to agents and federal and state taxes. Since entry into the life insurance industry appears to be easy, 18/ and there has been a

17/ See, e.g., Pritchett and Wilder, "A Comparative Study of Stock Life Insurer Profitability: Implications for Workable Competition," S.S. Huebner Foundation for Insurance Education, Wharton School, University of Pennsylvania. See Part I at n. 42.

18/ For example, the minimum capital requirement for life insurance company licensed in Arkansas was \$37,500, a sum that some people in the Washington, D.C. area would consider to be more like a down payment on a house than the capital upon which to found a life insurance company.

great deal of it, 19/ massive profits would likely be eroded.

While figures for 1977 are not available, we know that in 1975 the life insurance companies net investment income assets generated by their ordinary life business was about \$9.4 billion, which represented about a 7 percent before-tax rate of return. 20/ According to our calculations, they credited about \$1.1 billion in interest to policyholders, a rate of return of less than 1 percent (assuming a 66-2/3 percent loss ratio). The difference is a whopping \$8.3 billion for the year 1975 alone. If all of the companies' investment income had been credited to the policyholders, then the policyholders would have earned over 7 percent rather than 1 percent. However, the same statistics show that general expenses, sales commissions and taxes amounted to \$8.4 billion. With a loss ratio of 66-2/3 percent, only \$2.2 billion is available for covering expenses, an amount that was insufficient to cover sales commissions alone (\$2.5 billion). If all of the \$8.4 billion in expenses and taxes were allocated to the cost of insurance, the loss ratio would be about 35 percent or policyholders could expect to pay about \$2.89 in premiums to get back \$1 in death benefits. They would then be paying an extremely high price for their pure insurance protection, but earning over 7 percent on their savings. Since one can buy term

19/ There were 1750 life insurance firms in business in mid-1977, up from 1100 in 1955. Many of the new entrants appear to be in the credit life lines or in other than ordinary life insurance and are extremely small.

20/ These figures are taken from Appendix II, Table 2.

insurance with a 1.5 multiplier, it seems more appropriate to allocate only \$2.2 billion of expense to the pure insurance portion and the remaining expense shows up as a low rate of return.

On the other hand, the evidence does not demonstrate that the life insurance industry is unprofitable. The \$8.3 billion difference between what the companies earned and what they paid must be offset by the \$6.2 billion in expenses and taxes that would not be recovered at competitive term rates. This leaves about \$2.1 billion for profits (or contributions to surplus in the case of the nonprofit mutual companies). Without further information it is not possible to judge whether this figure is high or low. Although some companies are extremely profitable, many appear to be only of average profitability.

III. The Significance of the Different Types of Life Insurance

A. Types. Besides ordinary life insurance, there are three other types of life insurance: group, industrial and credit insurance. This section briefly explains the difference among these types of insurance.

Although not entirely exclusive, the four types of life insurance can be distinguished by differences in policy size and sales methods:

(1) Ordinary life insurance is generally sold to individuals in face amounts exceeding \$1,000.²¹ Most ordinary life insurance is sold through the agency system. However, mass-marketed wholesale insurance has come into wider use in recent years and, in

²¹ Report of the Subcomm. on Oversight and Investigations of the House Comm. on Interstate and Foreign Commerce, 95th Cong., 2d Sess. 5 (1978) [hereinafter cited as Moss Sub-committed Report.]

1977 new issues amounted to \$2.2 billion.²² Nonetheless, in 1967, the most recent year for which detailed data are available, of the 740,000 persons who worked in the life insurance industry, and about 220,000 persons derived from 50 percent to 100 percent of their income from the sale of life insurance.²³

(2) Group life insurance normally involves term insurance offered by employers (86.1%), unions (4.1%), professional societies and employee associations (4.8%).²⁴ Many group life plans provide for coverage on the lives of dependents of group members.

(3) Industrial life insurance is issued for small amounts, usually less than \$1,000 and premiums generally paid weekly

22 Fact Book, supra n. 1, at 28.

23 Id. at 92.

24 Id. at 30. Percents are based on a survey of group life in force at year-end 1973.

or monthly to an agent who calls at the policyholder's home.²⁵

(4) Credit insurance is term coverage to insure the life of a debtor.²⁶ It is issued through banks, finance companies, credit unions and retailers and is designed to satisfy the debt should the debtor die.²⁷ Accordingly, credit life generally decreases in amount as the loan is repaid. It is commonly a part of consumer credit contracts.²⁸

B. Relative Significance. Although there are signs of change, ordinary life insurance is the principal type of life insurance for most Americans. Of the total \$2,582 billion of life insurance in force in 1977, about \$1,289 billion was in ordinary life insurance, a 9.5 percent increase over the previous year. The remaining amounts of life insurance in force included \$1,115 billion of group insurance; \$139 billion of credit life insurance; and \$39 billion of industrial life insurance.²⁹ Therefore, at the end of 1977, ordinary insurance amounted to half of all life insurance in force. However, in recent years group insurance in force has grown rapidly, and at the end of 1977 it amounted to 43 percent of all life insurance in force. It should also be noted that in 1975, although group insurance

25 Id. at 31.

26 Id. at 33.

27 Moss Subcommittee Report, supra n. 21, at 5 n.6.

28 Fact Book, supra n. 1, at 33.

29 Id. at 7.

constituted only 20 cents of the premium dollar, it accounted for the distribution of 42 percent of all the death benefits. 30/

Within the area of ordinary life insurance, whole life policies account for the highest proportion of the amount in force although the percentage of whole life has declined from about 63.0 percent in 1974 to about 60.9 percent in 1977.

For a more precise picture of the relative size of the four types of insurance we rely on the following four tables. Tables 6 and 7 portray the aggregate size by type.

30/ Based on figures in the Annual Statement for 1975 of the U.S. Legal Reserve Life Insurance Companies.

Table I-6

Life Insurance Purchases in the United States
(Exclusive of Revivals, Increases, Dividend Additions and Reinsurance Acquired)

Year	Ordinary		Group		Industrial		Total	
	Policies (000 Omitted)	Amount (000,000 Omitted)	Certifi- cates (000 Omitted)	Amount (000,000 Omitted)	Policies (000 Omitted)	Amount (000,000 Omitted)	Number (000 Omitted)	Amount (000,000 Omitted)
1940	3,855	\$ 6,689	285	\$ 691	14,017	\$3,350	18,157	\$ 10,730
1945	4,343	9,859	681	1,265	11,869	3,430	16,893	14,554
1950	5,279	17,326	2,631	6,068	14,924	5,402	22,834	28,796
1955	7,572	30,827	2,217	11,258*	14,356	6,342	24,145	48,427*
1960	8,734	52,883	3,734	14,645	12,287	6,880	24,755	74,408
1961	8,735	55,016	3,971	17,019	12,327	7,000	25,033	79,035
1962	8,662	56,998	3,498	15,533	11,799	7,046	23,959	79,577
1963	9,046	64,267	3,534	18,152	11,407	7,154	23,987	89,573
1964	9,605	74,012	4,225	23,684	11,059	7,312	24,889	105,008
1965	9,937	83,485	7,007	51,385†	10,492	7,296	27,436	142,166†
1966	10,131	88,693	4,055	26,219	9,764	7,078	23,950	121,990
1967	10,192	94,694	4,353	39,118*	9,404	7,056	23,949	140,868*
1968	10,461	103,944	4,875	39,877*	8,417	6,674	23,753	150,495*
1969	10,588	113,500	5,156	39,329	7,916	6,454	23,660	159,283
1970	10,968	122,820	5,219	63,690†	7,582	6,612	23,769	193,122†
1971	11,291	132,130	5,403	49,407	8,326	7,274	25,010	188,811
1972	11,844	145,479	6,698	55,857	8,123	7,394	26,665	208,730
1973	12,198	162,506	7,065	64,461	7,506	7,224	26,769	234,191
1974	12,763	182,755	7,994	111,622†	6,747	6,680	27,504	301,057†
1975	12,549	188,003	8,146	95,190†	6,397	6,729	27,092	289,922†
1976	13,219	213,784	9,745	104,683	5,962	6,382	28,326	324,849
1977	13,485	242,842	10,170	117,960	5,800	6,533	29,455	367,335

*Includes Federal Employees' Group Life Insurance of \$1.9 billion in 1955, \$8.3 billion in 1967, and \$3.4 billion in 1968.

†Includes Servicemen's Group Life Insurance of \$27.8 billion in 1965, \$17.1 billion in 1970, \$29.2 billion in 1974 and \$1.7 billion in 1975.

Sources: Life Insurance Marketing and Research Association and American Council of Life Insurance. Figures from 1940-1973 exclude all credit life insurance. Beginning with 1974, data include long-term credit insurance (life insurance on loans of more than ten years' duration). Data for 1977 are preliminary.

Life Insurance In Force in the United States (000,000 Omitted)

Year	Ordinary		Group		Industrial		Credit		Total	
	No.	Amt.	Cert.	Amt.	No.	Amt.	No.†	Amt.	No.	Amt.
1900	3	\$ 6,124	—	—	11	\$ 1,449	—	—	14	\$ 7,573
1905	5	9,585	—	—	17	2,278	—	—	22	11,863
1910	6	11,783	—	—	23	3,125	—	—	29	14,908
1915	9	16,650	*	\$ 100	32	4,279	—	—	41	21,029
1920	16	32,018	2	1,570	48	6,948	*	\$ 4	66	40,540
1925	23	52,892	3	4,247	71	12,318	*	18	97	69,475
1930	32	78,576	6	9,801	86	17,963	*	73	124	106,413
1931	33	79,514	6	9,736	85	17,635	*	85	124	106,970
1932	32	75,898	5	8,923	79	16,669	*	69	116	101,559
1933	31	70,872	5	8,687	78	16,630	*	63	114	96,246
1934	32	70,094	6	9,472	79	17,036	*	75	117	96,677
1935	33	70,684	6	10,208	81	17,471	1	101	121	98,464
1936	33	72,361	7	11,291	83	18,863	1	138	124	102,653
1937	34	74,836	7	12,638	85	20,104	1	216	127	107,794
1938	35	75,772	7	12,503	85	20,396	2	256	129	108,927
1939	36	77,121	8	13,641	85	20,500	2	307	131	111,569
1940	37	79,346	9	14,938	85	20,866	3	380	134	115,530
1941	39	82,525	10	17,359	87	21,825	3	469	139	122,178
1942	41	85,139	11	19,316	90	22,911	2	355	144	127,721
1943	43	89,596	13	22,413	94	24,874	2	275	152	137,158
1944	46	95,085	13	23,922	98	26,474	2	290	159	145,771
1945	48	101,550	12	22,172	101	27,675	2	365	163	151,762
1946	53	112,818	13	27,206	104	29,313	3	729	173	170,066
1947	56	122,393	16	32,026	106	30,406	5	1,210	183	186,035
1948	58	131,158	16	37,068	106	31,253	6	1,729	186	201,208
1949	61	138,862	17	40,207	107	32,087	8	2,516	193	213,672
1950	64	149,116	19	47,793	108	33,415	11	3,844	202	234,168
1951	67	159,109	21	54,398	109	34,870	12	4,763	209	253,140
1952	70	170,875	24	62,913	111	36,448	14	6,355	219	276,591
1953	73	185,007	26	72,913	112	37,781	18	8,558	229	304,259
1954	76	198,599	29	86,410	111	38,664	21	10,046	237	333,719
1955	80	216,812	32	101,345	112	39,682	28	14,493	252	372,332
1956	83	238,348	35	117,399	110	40,109	32	16,774	260	412,630
1957	87	264,949	37	133,905	108	40,139	34	19,366	266	458,359
1958	89	288,607	39	144,772	104	39,646	35	20,536	267	493,561
1959	93	317,158	41	160,163	102	39,809	38	24,998	274	542,128
1960	95	341,881	44	175,903	100	39,563	43	29,101	282	586,448
1961	97	366,141	46	192,794	98	39,451	45	31,107	286	629,493
1962	99	391,048	49	209,950	95	39,638	47	35,341	290	675,977
1963	102	420,808	51	229,477	93	39,672	52	40,666	298	730,623
1964	104	457,868	55	253,620	92	39,833	58	46,487	309	797,808
1965	107	499,638	61	308,078	89	39,818	63	53,020	320	900,554
1966	109	541,022	65	345,945	88	39,663	69	58,059	331	984,689
1967	113	584,570	69	394,501	84	39,215	70	61,535	336	1,079,821
1968	116	633,392	73	442,778	81	38,827	75	68,357	345	1,183,354
1969	118	682,453	76	488,864	79	38,614	78	74,598	351	1,284,529
1970	120	734,730	80	551,357	77	38,644	78	77,392	355	1,402,123
1971	123	792,318	82	589,883	76	39,202	76	81,931	357	1,503,334
1972	126	853,911	85	640,689	76	39,975	78	93,410	365	1,627,985
1973	128	928,192	88	708,322	75	40,632	78	101,154	369	1,778,300
1974	131	1,009,038	94	827,018	71	39,441	84	109,623	380	1,985,120
1975	134	1,083,421	96	904,695	70	39,423	80	112,032	380	2,139,571
1976	137	1,177,672	100	1,002,647	67	39,175	78	123,569	382	2,343,063
1977	139	1,289,321	106	1,115,047	66	39,045	79	139,402	390	2,582,815

Note: "Credit" is limited to life insurance on loans of ten years' or less duration. "Ordinary" and "Group" include credit life insurance on loans of more than ten years' duration.

*Fewer than 500,000. †Includes group credit certificates.

Sources: Spectator Year Book and American Council of Life Insurance. Totals for "In The United States" represent all life insurance (net of reinsurance) on residents of the United States, whether issued by U.S. or foreign companies. Beginning with 1959, the data include Alaska and Hawaii.

The second two tables give figures for adults and households contracting agent-marketed and employee group insurance.

Table I-8 33

Ownership of Life Insurance by Adults 1976

Percent of Adults Insured by Type of Life Insurance

	All Types of Life Insurance		Agent-Marketed Individual Life Insurance		Employee Group Life Insurance	
	Male	Female	Male	Female	Male	Female
Total Adult	72%		54%		31%	
Men	80		59		42	
Women	65		50		21	
Age						
18-24	63%	57%	43%	39%	24%	21%
25-29	83	65	57	45	50	29
30-34	90	76	67	60	57	28
35-44	88	71	65	53	54	31
45-54	89	68	65	51	57	25
55-64	87	66	63	60	46	17
65 and Older	68	55	56	49	17	5
Total Life Insurance Coverage (All Adults)						
\$100,000 or More	2%		1%		+	
\$50,000-\$99,999	5		2		2%	
\$25,000-\$49,999	9		4		3	
\$15,000-\$24,999	8		5		4	
\$ 5,000-\$14,999	21		16		14	
Less than \$5,000	27		26		8	
	72%		54%		31%	
Average Amount of Coverage						
Total Adult	\$18,720		\$12,280		\$16,250	
Men	28,980		19,210		20,620	
Women	7,640		5,240		8,620	
Wives	8,470		5,980		8,900	
Children	2,630		2,450		2,310	

Ownership of Life Insurance by Households 1976

Percent of Households in Which at Least One Member Owns Life Insurance

	All Types of Life Insurance		Agent-Marketed Individual Life Insurance		Employee Group Life Insurance	
	Male	Female	Male	Female	Male	Female
All Households	83%		65%		46%	
Male Head	88		69		52	
Female Head	67		52		24	
All Families	88%		70%		51%	
Husband-Wife Families	90		71		55	
With Children Under 18	93		73		63	
Without Children Under 18	88		70		47	
Individual Heads	64%		46%		25%	
Percent of Households in Which Household Head Is Insured						
All Household Heads	80%		59%		42%	
Male Head	85		62		48	
Female Head	64		49		21	
Heads of All Husband-Wife Families	88%		65%		50%	
With Children Under 18	91		67		59	
Without Children Under 18	84		62		41	
Heads of All Families	85%		63%		46%	
Incomplete Families*	71		54		25	
Individual Heads**	63		44		24	

*Less than .5%.

*A family of two or more related individuals in which the family head does not have a spouse living in the household.

**Includes households of one person and households in which two or more unrelated adults live together.

Note: "All Types of Life Insurance" includes coverage with legal reserve life insurance companies, Veterans life insurance, and life insurance issued by savings banks, fraternal organizations, mutual aid and burial societies, and similar types of coverage. "Agent-Marketed Individual Life Insurance" comprises ordinary and/or industrial (but not group) life insurance individually purchased through an agent.

Source: A national consumer survey conducted in 1976 for the American Council of Life Insurance and the Life Insurance Marketing and Research Association.

In sum, this appendix illustrates the enormous size of the life insurance industry, but finds no conclusive evidence of undue concentration or profits. It explains the four different types of insurance and finds that ordinary insurance represents one half of all insurance in force.

APPENDIX II - STATISTICAL SOURCES FOR CALCULATING INDUSTRY-
WIDE RATES OF RETURN TO ORDINARY POLICYHOLDERS

The basic information from which the industry-wide rates of return (shown in table I-4 of this Report) were calculated comes from the "Gain and Loss Exhibit" of the Annual Statement filed by each life insurance company to the various State Insurance Commissions. The "Gain and Loss Exhibit" provides a wealth of detail on the sources of net gain from operations (after dividends to policyholders and federal income taxes) on some 11 "lines of business," of which one (column 3) is "ordinary life insurance." ^{1/} From time to time, the American Council of Life Insurance aggregates the individual company statements of virtually all the U.S. Legal Reserve Life Insurance Companies in the United States to produce tables such as 1 and 2 which are reproduced here. These tables, supplemented by the figures reported in the 1978 Fact Book formed the basis for the FTC staff's calculation of industry-wide rates of return. These tables were supplied to the FTC staff by the American Council of Life Insurance.

Since the aggregate figures were not available for the year 1977 by line of business, the FTC staff estimated them by assuming that the 1977 figures for the ordinary line bore the same relationship to the total figures reported in the Fact Book,

1/ The Annual Statement accounts are described in great detail in Joseph Noback, Life Insurance Accounting 5-6 (Irwin, 1969). See also the discussion of the "Gain and Loss Exhibit" by Robert Gaegler in Life Insurance Accounting ch. 4 (R. Strain, ed. 1977).

as did the corresponding figures in 1975. For example, the Fact Book reports that policy dividends (in all lines) amounted to \$5,031.8 million in 1975. 2/ Line 28 of table 2 shows that \$3,954.889 million was paid in dividends to holders of ordinary life insurance policies. In other words, about 78.6 percent of the total dividends paid in 1975 went to the holders of ordinary life insurance policies. We assume that of the total dividends paid in 1977 (\$5,913.2 million), 3/ 78.6 percent, or \$4,648 million, went to the holders of ordinary life policies. A similar procedure was followed for the other types of benefits paid. The ratios used were:

Dividends	78.6%
Surrender Values	91.9
Supplemental Contracts	78.8
Matured Endowments	95.6
Disability Payments	33.5
Annuity Payments	0.1

The basic formula for $1 + r_t$, where r_t is the industry-wide rate of return for year t , is:

$$1 + r_t = \frac{\text{Savings Account}_t}{\text{Savings Account}_{t-1} + \text{Deposit}_t - \text{Withdrawals}_t}$$

The savings account in year t consists of the sum of policyholder cash values and dividends left to accumulate with the companies. Cash Values were estimated by taking 90 percent of the ordinary life reserves as shown on page 67 of the 1978 Fact Book. 4/ Policy dividend accumulations were estimated by

2/ American Council of Life Insurance, Life Insurance Fact Book 39 (1978) [hereinafter cited as Fact Book].

3/ Id.

4/ Hearings Before the Subcomm. on Oversight and Investigations of the House Comm. on Interstate and Foreign Commerce, 95th Cong., 2d Sess. 397 (1978).

taking 78.6 percent of the total figure. ^{5/} The formulas for deposits and withdrawals are:

Deposit _t = Premiums (Fact Book at 57) minus the term multiplier (alternatively, 1.2658, 1.5 and 1.6667) times Death Benefits _t (Fact Book at 41).

Withdrawals _t = Dividends _t + Surrender Values _t + Supplemental Contracts _t + Matured Endowments _t + Disability Payments _t + Annuity Payments _t + (all from Fact Book, at 39, except supplemental contracts payments from at 47).

The rates of return shown in Table I-4 for 1970 and 1975 used the numbers that appear in Tables 1 and 2 in this appendix. The location of the numbers used to calculate the deposit and withdrawals are as follows:

Deposit = Premiums: (line 1 + line 2 + line 3 + line 3A, column 3) minus term multiplier (Alternatively, 1.2658, 1.5, & 1.6667) times death benefits (line 8, column 3)

Withdrawals = (line 9 + line 10 + line 11A + line 12 + line 14 + line 16, column 3)

Notice that considerations for supplementary contracts are included in premium income and payments on these under withdrawals. The savings figures were calculated in the same manner as the 1977 figures described above.

^{5/} See Fact Book, supra n.2, at 67.

Selection of the Term Multipliers or Loss Ratios

The multipliers used in the industry-wide rate of return calculations should be representative of those actually available on low cost term insurance policies in the market for that particular year. The precise figure will depend on the age composition, face amounts and issue ages of the entire group of ordinary policyholders (not just those that have purchased term insurance policies). Since such detailed information is not available on the 139 million policies in force in 1977, we are forced to use an average figure. The three multipliers used (see Table I-4 in the text) appear to cover the reasonable range available on low cost term insurance. The lowest multiplier (1.2658), or a loss ratio of 79 percent, is equal to the ratio of all benefits to premiums plus investment income for the life insurance as a whole (1978 Fact Book, p. 62). It is also about equal to the loss ratio on group life insurance (see Table 2, this appendix, column 8). The 79 percent loss ratio seems representative of the lowest cost term insurance available and it leaves a 21 percent margin for expenses and profits. The 1.5 multiplier, a loss ratio of 66 2/3 percent, is broadly consistent with the loss ratios implied by low yearly term rates contained in the proposed regulation (see Appendix X). The ratio of the present value of the premiums for a \$25,000 policy running from ages 35 to 54 to the present value (at 5 percent) of the death benefits, is 1.45. The ratio is higher at younger ages and for smaller face amounts. Given the uncertainty as to the precise number, ratios of 1.5 and 1.6667 were used in an attempt to cover the middle and high range of low cost loss ratios. The 1.6667 multiplier, a loss ratio of 60 percent, is similar to the minimum

loss ratio that have been set on certain types of life insurance policies, such as credit life. Retaining 40 percent for expenses and profits would appear ample for low cost life insurance.

Tables I-A and I-B

The total dollar figures shown in Table I-A are derived from the 1978 Fact Book. With the exception of death benefits, the benefit figures in the Fact Book include benefits paid under all types of life insurance contracts. Benefits paid to ordinary life insurance policyholders were estimated by using the ratios shown on p.II-2 in the same manner as for the rate of return calculations described there.

Table I-B was derived from I-A by dividing the totals shown there by 46 million, to get the average amount per household. The 46 million figure is a crude estimate, which was derived as follows: A 1976 survey (reported in the 1978 Fact Book, p.35) found that 70 percent of all households had "agent-marketed" life insurance coverage, that is, ordinary plus "industrial" coverage. There were about 79.6 million households in 1977, so if the survey results were extrapolated, about 55.7 million would have had either ordinary coverage, industrial coverage, or both. Since relatively few households have both kinds of coverage, we assume no overlap. There were 67 million industrial policies in force in 1977. Assuming an average of 7 industrial policies per household (see FTC Staff Report on Industrial Life Insurance), this would mean that 9.7 million households have industrial coverage. Subtracting 9.7 from 55.7 gives our ballpark figure of 46 million. Since there were 139 million ordinary life policies

in force in 1977, this would mean an average of about 3 policies per insured household.

ANNUAL STATEMENT FOR THE YEAR 1970 OF THE U.S. Legal Reserve Life Insurance Companies

ANALYSIS OF OPERATIONS BY LINES OF BUSINESS
(Gain and Loss Exhibit)

TABLE I - A

\$ Thousands

	Total (1)	INDUSTRIAL LIFE (Small Group Term and Industrial Accidental Death Benefits) (2)	ORDINARY				
			Life Insurance (3)	Total and Provisional Insurance (4)	Accidental Deaths with Benefits (5)	Investment Accounts (6)	Other Lines Including TFD (7)
1. Premiums and annuity considerations (Exhibit 1, Part 1)	36,706,641	1,311,377	15,089,687			959,872	572,877
2. Considerations for supplementary contracts with life contingencies	266,396	16	9,763	X X X	X X X	764	196,166
3. Considerations for supplementary contracts without life contingencies and dividend accumulations	1,573,501	1,370	974,859			4,312	610,028
4. Net investment income and capital gains and losses (Exhibit 2)	10,031,301	2,212	6,008,606			792,027	572,255
5. Other income	104,118	1,610	25,126			10,318	3,654
6. TOTALS	48,971,376	2,611,276	21,108,915			1,767,273	1,756,758
7. Death benefits	7,102,812	1,271	3,003,592	X X X		38	137,799
8. Matured endowments	1,004,796	114,573	878,087	X X X	X X X	27	58
9. Annuity benefits	1,235,680	56	1,089	X X X	X X X	471,918	- 6
10. Disability benefits	251,112	203	3,976		X X X	129	83,172
11. Surrender benefits	2,900,581	1,172	2,550,900	X X X	X X X	1,011	4,210
12A. Group conversions	4,010	310	20,538		X X X	292	- 603
12B. Transfers on account of group package policies and contracts	X X X		792	X X X	X X X		- 488
13. Benefits under accident and health policies	8,777,984	751	761	X X X	X X X		- 185
14. Interest on policy or contract funds	149,152	1,089	38,558			2,684	2,329
15. Payments on supplementary contracts with life contingencies	401,730	26	15,222	X X X	X X X	9	310,147
16. Payments on supplementary contracts without life contingencies and of dividend accumulations	1,712,758	1,156	799,837			3,656	761,099
16A. Amounts transferred between accounts	326,579					4,644	25,613
16B. Payments of withdrawal funds	65,756		2,785			616	- 2,933
17. Increase in aggregate reserves for policies and contracts with life contingencies	8,661,528	121,205	6,827,256			582,095	167,552
18. Increase in reserves for supplementary contracts without life contingencies and for dividend accumulations	180,008	1,905	387,051			1,649	- 272,609
19. Increase in reserves for accident and health policies	536,663	- 57	1,059			665	209
19A. Increase in reserves for accident and health policies	112,720	1,172	61,621			6,245	- 3,354
20. SUBTOTALS (Items 8 to 19A)	33,801,116	1,011,774	13,085,313			1,076,689	1,212,518
21. Commissions on premiums and annuity considerations	2,319,129	311,623	1,266,125			51,954	74,522
22. General insurance expenses (Exhibit 3, Cols. 1 and 2, Line 13)	4,750,051	309,551	2,609,256			80,196	128,872
23. Insurance taxes, licenses and fees, excluding federal income taxes (Exhibit 6, Cols. 1 and 2, Line 10)	807,204	60,920	364,607			7,556	15,591
24. Increase in loading on and cost of collection in excess of loading on deferred and uncollected premiums	65,066	- 810	69,771			3,607	3,131
25A. Adjustments between accounts							
25. TOTALS (Items 20 to 25)	42,813,151	1,684,390	17,908,600			1,227,916	1,633,898
26. Net gain from operations before dividends to policyholders and federal income taxes (Item 7 minus Item 27)	6,140,225	417,084	4,228,931			139,357	370,860
29. Dividends to life policyholders (Exhibit 7)			1,451,564				
30. Dividends on accident and health policies (Exhibit 7)		X X X	X X X	X X X	X X X	X X X	X X X
31. Increase in amounts provisionally held for deferred dividend policies							
32. TOTALS (Items 29 to 31)	3,762,668	191,261	2,776,067			91,569	62,537
33A. Net gain from operations after dividends to policyholders and before federal income taxes (Item 26 minus Item 32)	2,377,557	225,823	1,451,866			47,808	258,323
33B. Federal income taxes incurred	1,248,580	108,178	832,042			26,300	85,567
34. Net gain from operations after dividends to policyholders and federal income taxes (Item 33A minus Item 33B)	1,128,977	117,645	619,824			21,508	172,756

... and losses only.

ANNUAL STATEMENT FOR THE YEAR 1970 OF THE U.S. Legal Reserve Life Insurance Companies

TABLE I - A (cont'd)

ANALYSIS OF OPERATIONS BY LINES OF BUSINESS
(Gain and Loss Exhibit)

	INCOME		DEDUCTIONS		ACCIDENT AND DEATH	
	(A)	(B)	(C)	(D)	(E)	(F)
1. Premiums and annuity considerations (Exhibit 1, Part 1)	4,663,119	2,761,137	8,200,334	Y	Y	Y
2. Considerations for supplementary contracts with life continuation	6,096	15,115	922	Y	Y	Y
3. Considerations for supplementary contracts without life continuation, and dividend accumulations	117,618	1,536	316,511	Y	Y	Y
4. Net investment income and capital gains and losses (Exhibit 2)	759,373	1,687,796	3,451	Y	Y	Y
5. Net investment income and capital gains and losses (Exhibit 2)	12,263	251,666	3,451	Y	Y	Y
6. TOTALS	5,207,167	4,717,209	8,200,334	Y	Y	Y
7. Death benefits	3,057,609	3,655	3,061,264	Y	Y	Y
8. Matured endowments	8,051	1,349,739	1,357,790	Y	Y	Y
9. Annuity benefits	1,074	11,653	12,727	Y	Y	Y
10. Disability benefits	136,318	8,507	144,825	Y	Y	Y
11. Surrender benefits	65,523	2,542	68,065	Y	Y	Y
12. Group conversions	23,542	983	24,525	Y	Y	Y
13. Transfers on account of group purchase policies and contracts	169,925	98	170,023	Y	Y	Y
14. Benefits under accident and health policies	23,165	23,139	46,304	Y	Y	Y
15. Interest on policy or contract funds	30,837	49,476	70,313	Y	Y	Y
16. Payments on supplementary contracts with life contingencies, gains and dividend accumulations	130,632	13,602	144,234	Y	Y	Y
17. Amounts transferred between accounts	26,656	31,016	57,672	Y	Y	Y
18. Payments of withdrawal funds	3,102	61,837	64,939	Y	Y	Y
19. Increase in aggregate reserve for policies and contracts with life contingencies	320,681	2,363,723	3,010	Y	Y	Y
20. Increase in reserves for accident and health policies	1,232	58,591	59,823	Y	Y	Y
21. Increase in reserves for supplementary contracts without life contingencies and for dividend accumulations	11,113	3,278	14,391	Y	Y	Y
22. Increase in reserves for accident and health policies	8,776	26,532	35,308	Y	Y	Y
23. Surpluses (Items 8 to 19)	4,001,516	6,230,706	7,692,235	Y	Y	Y
24. Commitments on premiums and annuity considerations	216,436	19,860	236,296	Y	Y	Y
25. General insurance expenses (Exhibit 3, Cols. 1 and 2, Line 19)	270,696	108,530	379,226	Y	Y	Y
26. Insurance taxes, licenses and fees, excluding federal income taxes (Exhibit 4, Cols. 1 and 2, Line 10)	97,836	6,481	104,317	Y	Y	Y
27. Increase in holding cost and cost of collection in excess of holding on deferred and uncollected premiums	-9,275	-182	-9,457	Y	Y	Y
28. Adjustments between accounts	15,653	7,530	23,183	Y	Y	Y
29. Totals (Items 20 to 28)	616,762	335,892	952,654	Y	Y	Y
30. Net gain from operations before dividends to policyholders and federal income taxes (Item 20 minus Item 27)	253,754	57,265	311,019	Y	Y	Y
31. Dividends to life policyholders (Exhibit 7)	1,111,111	1,111,111	2,222,222	Y	Y	Y
32. Dividends on accident and health policies (Exhibit 7)	1,111,111	1,111,111	2,222,222	Y	Y	Y
33. Increase in amounts provisionally held for deferred dividend	1,111,111	1,111,111	2,222,222	Y	Y	Y
34. Totals (Items 29 to 31)	2,661,501	278,137	2,939,638	Y	Y	Y
35. Net gain from operations after dividends to policyholders and federal income taxes (Item 29 minus Item 31)	33,243	57,265	90,508	Y	Y	Y
36. Federal income taxes incurred	1,111,111	1,111,111	2,222,222	Y	Y	Y
37. Net gain from operations after dividends to policyholders and federal income taxes (Item 35 minus Item 36)	1,111,111	1,111,111	2,222,222	Y	Y	Y

23A. Net gain from operations after dividends to policyholders and before federal income taxes (Item 24 minus Item 29)	253,267	52,712	40,733	1,320
23B. Federal income taxes incurred	1,567	1,567		
24. Net gain from operations after dividends to policyholders and before federal income taxes (Item 23A minus Item 23B)	254,834	54,279	42,266	1,320

ANNUAL STATEMENT FOR THE YEAR 1975 OF THE U.S. Legal Reserve Life Insurance Companies
ANALYSIS OF OPERATIONS BY LINES OF BUSINESS
 \$ Thousands (Gain and Loss Exhibit) (Excluding Capital Gains and Losses) TABLE I - B

	Separate Account	Industrial Life	Life Insurance	Ordinary	
				Individual Annuities	Supplementary Contracts
1. Premiums and annuity considerations (Exhibit 1, Part II)	1,537,283	1,302,492	21,031,330	2,398,873	1,114
2. Considerations for supplementary contracts with life contingencies	1,322		XXX 10,163	XXX 743	215,222
3. Considerations for supplementary contracts without life contingencies and dividend and coupon accumulations	14	3,513	1,302,062	12,215	540,177
4. Net investment income (Exhibit 7)	483,990	853,164	9,431,530	781,136	457,490
5. Commissions and expense allowances on insurance ceded	97	156	100,141	- 46	108
5A. Reserve adjustments on reinsurance ceded	6	46	43,961	- 19,728	- 43
6.	877	6,523	103,142	- 37,974	1,868
7. Totals	2,023,549	2,165,945	32,026,349	2,135,219	1,214,834
8. Death benefits	57	672,634	4,433,746	1,111	55
9. Matured endowments (excluding guaranteed annual pure endowments)		61,998	904,303		
10. Annuity benefits	190,953	22	3,633	724,322	17
11. Disability benefits and benefits under accident and health policies	2,666	9,630	142,631	622	
11A. Corporate, guaranteed annual pure endowments and annuity benefits (Exhibit 7)		265	71,685	249	154
12. Surrender benefits (Excludes withdrawal of benefits)	233,367	253,769	3,458,803	14,980	203
13. Group conversions		223	- 36,600		1191
13A. Transfers on account of group package policies and contracts	111	111	XXX 2,814	XXX 2,176	111 531
14. Interest on policy or contract funds	7,419	2,309	66,778	7,630	2,6031
15. Payments on supplementary contracts with life contingencies	843	6	9,863	114	339,710
16. Payments on supplementary contracts without life contingencies and of dividend and coupon accumulations	127	4,967	999,113	7,068	651,301
17. Increase in aggregate reserves for life and accident and health policies and contracts	1,035,566	132,140	7,124,535	1,608,151	5,993
18. Increase in reserves for supplementary contracts without life contingencies and for dividend and coupon accumulations	117	1,161	633,715	4,588	51,138
19.	473,423	53	31,013	65,667	- 2,782
20. Totals (Items 8 to 19)	1,902,556	939,276	17,888,238	2,435,468	1,048,844
21. Commissions on premiums and annuity considerations (direct business only)	2,676	306,220	2,537,310	182,491	409
21A. Commissions and expense allowances on reinsurance assumed			75,408	2,418	
22. General insurance expenses (Exhibit 5, Col. 1 and 2, line 10)	10,462	302,832	3,893,346	201,032	25,267
23. Insurance taxes, licenses and fees, excluding federal income taxes (Exhibit 6, Col. 1 and 2, line 7)	388	45,844	543,318	19,976	1,120
24. Increase in loading on and cost of collection in excess of loading on deferred and uncollected premiums		- 659	131,942	10,051	**
25.	44,804	1,038	76,833	63,031	271
26. Totals (Items 20 to 25)	1,960,886	1,594,571	25,146,395	2,921,897	1,075,907
27. Net gain from operations before dividends to policyholders and federal income taxes (Item 7 minus Item 26)	62,663	571,374	6,877,754	213,322	138,927
28. Dividends to policyholders (Exhibit 7)	43	187,300	3,994,889	241,180	33,376
29. Net gain from operations after dividends to policyholders and before federal income taxes (Item 27 minus Item 28)	62,618	384,074	2,922,865	- 40,858	85,551
30. Federal income taxes incurred (including tax on capital gains)	2,985	153,818	1,452,660	19,701	42,388
31. Net gain from operations after dividends to policyholders and federal income taxes (Item 29 minus Item 30)	59,633	230,256	1,470,205	- 60,559	43,163

* Business not exceeding 120 months duration
 ** Not stated

ANNUAL STATEMENT FOR THE YEAR 1975 OF THE U.S. Legal Reserve Life Insurance Companies

ANALYSIS OF OPERATIONS BY LINES OF BUSINESS

TABLE I - B (Cont'd)

\$ Thousands (Gain and Loss Exhibit) (Excluding Capital Gains and Losses)

	6 Credit Life ^a (Group and Individual)	Group		Accident and Health		
		7 Life Insurance	8 Annuities	9 Group	10 Credit ^a (Group and Individual)	11 Other
1. Premiums and annuity considerations (Exhibit 1, Part 1)	1,208,870	5,792,381	6,229,718	13,948,045	629,451	4,496,906
2. Considerations for supplementary contracts with life contingencies		64,397	16,613	Y Y Y	Y Y Y	Y Y
3. Considerations for supplementary contracts without life contingencies and dividend and coupon ^b accumulations	41	147,678	26,183	1,057		459
4. Net investment income (Exhibit 2)	66,413	676,314	3,092,990	330,030	53,230	261,554
5. Commissions and expense allowances on reinsurance ceded	87,563	9,895	1,517	48,620	95,952	20,187
5A. Reserve adjustments on reinsurance ceded	2,806	- 347	4,354	1,753	7,904	6,740
6.	5,486	10,837	39,730	17,067	5,567	11,219
7. Totals	1,371,179	6,701,155	9,411,095	14,367,552	792,196	4,815,239
8. Death benefits	476,807	3,862,921	XXX 1,251	Y Y Y	Y Y Y	Y Y Y
9. Matured endowments (including guaranteed annual pure endowments)	11	7,143	Y Y Y	Y Y Y	Y Y Y	Y Y Y
10. January benefits	Y Y Y	XXX 1,267	2,332,795	Y Y Y	Y Y Y	Y Y Y
11. Disability benefits and benefits under accident and health policies	35,693	212,151	27,650	12,511,964	356,302	2,350,111
11A. Coupons, guaranteed annual pure endowments and similar benefits (Exhibit 7)						12
12. Surrender benefits (includes withdrawal of benefits)	- 96	--88,381	XXX 153,008	Y Y Y	Y Y Y	XXX 523
13. Group conversions	5	37,643	Y Y Y	2,322		- 2,286
13A. Transfers on account of group package policies and contracts	4,777	211,898	- 4,511	- 211,464	- 4,653	XX - 1,083
14. Interest on policy or contract funds	1,760	63,448	262,371	17,543	393	178
15. Payments on supplementary contracts with life contingencies	2	40,760	56,316	Y Y Y	Y Y Y	Y Y Y
16. Payments on supplementary contracts without life contingencies and of dividend and coupon ^b accumulations	51	150,533	21,061	1,586	3	177
17. Increase in aggregate reserves for life and accident and health policies and contracts	99,027	976,566	5,950,572	263,299	81,725	339,954
18. Increase in reserves for supplementary contracts without life contingencies and for dividend and coupon ^b accumulations	- 5	12,367	24,373	- 363	- 3	16
19.	- 10,144	130,139	51,717	- 8,376	16,109	9,893
20. Totals (Items 8 to 19)	563,430	5,391,217	8,876,603	12,576,611	442,720	2,697,303
21. Commissions on premiums and annuity considerations (direct business only)	351,421	136,537	55,359	335,364	198,547	844,275
21A. Commissions and expense allowances on reinsurance assumed	53,025	13,413	4,158	90,862	60,526	60,326
22. General insurance expenses (Exhibit 5, Columns 1 and 2, line 10)	119,862	339,199	230,479	1,058,610	75,374	1,066,670
23. Insurance taxes, licenses and fees, excluding federal income taxes (Exhibit 6, Columns 1 and 2, line 7)	35,840	120,121	15,508	308,891	16,105	136,667
24. Increase in loading on and cost of collection in excess of loading on deferred and uncollected premiums	- 832	- 18,177	889	275	38	- 372
25.	6,509	10,473	131,900	9,310	6,847	2,596
26. Totals (Items 20 to 25)	1,129,192	5,992,765	9,314,406	14,379,923	805,017	4,805,725
27. Net gain from operations before dividends to policyholders and federal income taxes (Item 7 minus Item 26)	- 241,987	708,370	96,599	- 12,371	- 12,821	9,514
28. Dividends to policyholders (Exhibit 7)	37,168	289,413	732,818	87,353	611	18,865
29. Net gain from operations after dividends to policyholders and before federal income taxes (Item 27 minus Item 28)	204,819	419,957	- 137,279	- 99,624	- 13,432	- 9,351
30. Federal income taxes incurred (including tax on capital gains)	31,193	107,043	18,255	73,484	2,552	5,500
31. Net gain from operations after dividends to policyholders and federal income taxes (including tax on capital gains) (Item 29 minus Item 30)	173,626	312,912	- 155,534	- 173,112	- 15,984	- 14,851

APPENDIX III: HOW THE WHOLE LIFE POLICY MAY BE VIEWED AS A COMBINATION OF INSURANCE AND BANKING SERVICES: THE GENERAL MATHEMATICS

A whole life policy can be defined or described in many equivalent ways. One of these ways is this: a whole life policy is a yearly premium term policy, renewable until age 100, with a level premium. In this appendix, we show mathematically (1) how this definition is equivalent to the common definition of whole life policies given in textbooks and (2) how a bank could "create" a whole life policy for its customers by creating an "installment" type plan for them to purchase one year renewable term insurance from their insurance company. The insurance company sells only one year term policies and a particularly simple kind of single payment annuity. The bank provides no "insurance" services whatsoever, nor does the insurance company provide any banking service whatsoever. Together these two "pure" operations combine to form a whole life insurance company which provides banking and insurance services.

This analysis shows how one can, in principle, use the books of an insurance company, or the annual reports of the whole industry, to estimate what rate of interest the company or the industry is paying its customers on the deposits they leave with it.

20 11/10/1984
21 All the items listed on this document are derived from the original document and are not to be used for any other purpose.
312,912
173,626
- 195,536
- 173,112
- 13,984
- 14,051

(10/7)

Textbooks define the whole life policy in two parts.¹

First, using a mortality table and a known rate of interest, one can derive an expression for a single premium, payable immediately, that provides coverage for the whole of life. Suppose there are l_x people alive of age x years and that we wish to provide each beneficiary with \$1 upon the death of the insured. It is assumed that death occurs at the end of the year and that any leftover funds are invested at an interest rate r . If d_x number of people die at the end of the first year, then we will need to deposit $\$d_x/(1+r)$ to pay \$1 to each of their beneficiaries. At the end of the second year, d_{x+1} people die and we need $\$d_{x+1}/(1+r)^2$ on deposit now to pay $\$d_{x+1}$ in two years. Proceeding in this fashion, one can show that the single premium (A_x) that l_x people must pay now to build a whole life fund is equal to,

$$l_x \cdot A_x = \frac{d_x}{(1+r)} + \frac{d_{x+1}}{(1+r)^2} + \dots + \frac{d_{T-1}}{(1+r)^{T-x}}$$

or,

$$(1) \quad A_x = \sum_{i=0}^{T-1-x} v^{i+1} \frac{d_{x+i}}{l_x}$$

where $v = 1/(1+r)$

¹ See, e.g., Walter Menge & Carl Fisher, The Mathematics of Life Insurance ch. 2 (2d ed. 1965). Note that, for simplicity, only the "actuarially fair" premium is discussed, that is, administrative selling costs and profits are ignored.

The second step is to find the level annual premium (P_x) that is equivalent (worth as much as) the single premium. To do this we must first define a life annuity.² Suppose that each of l_x people alive at age x agree to pay \$1, starting now, at the beginning of each year, providing that they are alive to pay it. What is the "present value" (a_x) of such a promise? I will receive \$1_x right away, and these have a present value of \$1_x. I receive \$1_{x+1} at the beginning of the second year, and these have a present value of $v \cdot 1_{x+1}$, since that sum now, would grow to \$1_{x+1} if left on deposit for a year. Proceeding similarly one finds that,

$$l_x \cdot \ddot{a}_x = v^0 1_x + v^1 1_{x+1} + \dots + v^{T-1-x} 1_{T-1}$$

or,

$$(2) \quad \ddot{a}_x = \sum_{i=0}^{T-1-x} v^i \frac{1_{x+i}}{l_x}$$

We can now easily find the level annual premium (P_x) due at the beginning of each year, that is equivalent to the single premium, A_x . Such a level annual premium is in fact a promise to pay $\$P_x$ at the beginning of each year if you are alive.

² More precisely, we derive a life annuity "due" which means that the first payment is due at the beginning of the year.

Therefore

$$P_x \cdot a_x = A_x$$

and the required expression for P_x is,

$$(3) \quad P_x = \frac{A_x}{a_x}$$

We now show that the level annual whole life premium P_x can be written as a weighted average of annual renewable term rates (TR_x), where the weights are particular fractions of the whole life annuity a_x . First, we need to define a "pure endowment," ${}_iE_x$. A pure endowment is a promise to pay \$1 to a person who is now age x , when and if that person attains age $x+i$. If the person dies before age $x+i$, nothing is paid. If l_x people pay $\$iE_x$ into a fund now, that fund must accumulate to $\$l_{x+i}$, i years from now. That is,

$$l_x \cdot {}_iE_x = v^i l_{x+i}$$

or

$$(4) \quad {}_iE_x = v^i \frac{l_{x+i}}{l_x}$$

Note that the whole life annuity (equation 3) is simply a sequence of pure endowments to the end of the mortality table, or that

$$(5) \quad a_x = \sum_{i=0}^{T-i-x} {}_iE_x$$

The actuarially "fair" premium for a one year term policy, issued at age $x+i$, is,

$$l_{x+i} \cdot TR_{x+i} = v d_{x+i}$$

or

$$(6) \quad TR_{x+i} = v \frac{d_{x+i}}{l_{x+i}}$$

Note that

$$({}_iE_x) (TR_{x+i}) = \left(v^i l_{x+i} / l_x \right) \left(\frac{v \cdot d_{x+i}}{l_{x+i}} \right)$$

or,

$$(7) \quad ({}_iE_x) (TR_{x+i}) = (v^{i+1} \cdot d_{x+i}) / l_x$$

But the right hand side is the same as the i th term in equation (1) defining a single premium whole life payment. Therefore, substituting equation 7 into equation 1, we get

$$A_x = \sum_{i=0}^{T-1-x} ({}_iE_x) \cdot TR_{x+i}$$

The level annual premium P_x is simply A_x divided by \ddot{a}_x .

But the latter is simply the sum of the pure endowments (see equation (5)). Hence, using equations 5 and 3, we get

or

$$A_x = \ddot{a}_x \cdot P_x = \left(\sum_{i=0}^{T-1-x} ({}_iE_x) \right) \cdot P_x = \sum_{i=0}^{T-1-x} ({}_iE_x) (TR_{x+i})$$

(TR_{x+i})

or,

$$(8) \quad P_x = \sum_{i=0}^{T-1-x} \left(\frac{{}_iE_x}{a_x} \right) \cdot TR_{x+i}, \text{ where}$$

$$\sum_{i=0}^{T-1-x} \frac{{}_iE_x}{a_x} = 1$$

Equation 8 says that the premium for a whole life policy is weighted average of the one year renewable term rates through the end of the mortality table. The weight for the i^{th} policy year is the i^{th} year pure endowment divided by the whole life annuity. In the next section, we give an intuitive explanation for the equivalence shown in equation 8.

The Pure Bank and The Pure Insurance Company

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To get a better understanding of equation 8, consider the following story. Our world consists of a life insurance company that issues only one year renewable term insurance policies and pure endowments (as defined above), a bank that pays a fixed rate of interest of r per year on all funds left on deposit with it, and a large number of policyholders/depositors. The bank's market research department finds that many of its customers would like to "levelize" their life insurance premium payments, just as they levelize their mortgage payments on their houses, rather than pay the constantly rising annual term insurance premiums. The financial department says that the bank may easily provide such a service, without engaging in any way in the insurance business (which would be against regulations). The financial department shows how such a contract should be priced, and the legal department draws up the contract.

The gist of the contract is this: In return for a level annual premium of $\$P_x$ (at issue age x) payable on the first day of every year, if the customer is alive, the bank agrees to pay the insurance company the term insurance premium (at the rate corresponding to the customers' attained age) on the agreed amount of coverage from the customer's "insurance savings fund." If and when the customer dies, with the contract in force, then the bank's obligation ends. The insurance company pays the customer's beneficiary the face amount of the term insurance

policy, and the bank has fully met its obligations under the contract. On the other hand, if the customer decides to cancel the contract while he or she is still living, then the bank agrees to "refund" the unspent portion of the insurance savings fund to the customer. The amount of the refund is specified in the contract for each year the contract is in force.

The chief of the financial department explains how to price the contract. For each individual customer of age x , the bank will receive $\$P_x$ right away, another $\$P_x$ one year later from each customer that survives one year, $\$P_x$ two years later from each survivor, etc. It is clear that $\$P_x$ delivered now from each customer is worth exactly $\$P_x$ to the bank, but what is the worth of $\$P_x$ delivered one year from now--if the customer survives? The answer, the chief points out, is $({}_1E_x) \cdot \$P_x$. Since ${}_1E_x$ is previously the present value of \$1 to be paid one year from now, should a person currently aged x years survive to age $x+1$. Similarly, the promise of $\$P_x$ two years from now contingent on survival is worth $({}_2E_x) \cdot \$P_x$. Thus the value of the contract to the bank is simply,³

$$\$P_x \cdot \sum_{i=0}^{T-1-x} {}_iE_x$$

³

Note that it is assumed that all deaths occur at the end of the year, and that no one survives past age T .

n- What is the cost of the contract to the bank? The bank must
 e pay $\$TR_x$ right away for insurance coverage for each customer.
 to One year from now it must pay the insurance company $\$TR_{x+1}$ for
 he each customer that has survived to reach age $x+1$. What is the
 t cost of this obligation? Simply $({}_1E_x) \cdot \$TR_{x+1}$. The com-
 pany must deliver to the insurance company $\$TR_{x+1}$ for each
 customer that survives to age $x+1$. But the present value of such
 an obligation (per dollar) is exactly given by the one year pure
 endowment, ${}_1E_{x+1}$. Similarly, the officer computes the costs for
 all future years and concludes that the cost to the bank is
 simply,

$$\sum_{i=0}^{T-1-X} ({}_iE_x) \cdot TR_{x+i}$$

ve Since the bank prices at cost, it equates the present value
 of revenues to the present value of cost and solves for the
 "price," P_x . The price so determined is given by equation 8,
 or simply the premium for a whole life policy.

The Bank's Income Statement

Since, elsewhere in this report, we will use insurance company income and balance sheet statements to estimate the rate of return the companies and the industry are paying savings depositors on the banking function they perform, it is worthwhile to examine in more detail the nature of such accounts.

For our simple example, let us follow the mathematics of the accounts for a single age cohort. Suppose the bank enters into whole life contracts with l_x number of people of age x . For simplicity, let the face amount of coverage under each contract be \$1. On the first of each year, the surviving customers pay $\$P_x$ to the bank. The bank in turn, on the same day, purchases term coverage for these customers from the insurance company and deposits any money left over in the insurance saving fund. The "deposit" can be negative, that is, the fund can be used to supplement the customers current payments, if these are insufficient to buy the term insurance coverage.

The account is shown on the next page.

The Bank's Income
and Insurance Saving
Fund Account Statement*

Year	Beginning of Year Savings Fund	Bank Income	Premium Payments to Insurance Company	Deposit to Savings Fund	End of Year Savings Fund
1	0	$l_x \cdot P_x$	$l_x \cdot TR_x$	$l_x(P_x - TR_x)$	$l_x(P_x - TR_x)(1+r)$
2	$l_x(P_x - TR_x)(1+r)$	$l_{x+1} \cdot P_x$	$l_{x+1} \cdot TR_{x+1}$	$l_{x+1}(P_x - TR_{x+1})$	$l_x(P_x - TR_x)(1+r)^2 +$ $l_{x+1}(P_x - TR_{x+1})(1+r)$
3					
.					
.					
.					
T-X	EF_{T-X-1}	$l_{T-1} \cdot P_x$	$l_{T-1} \cdot P_x$	$l_{T-1}(P_x - TR_{T-1})$	0

II-III

*NOTE: It is assumed that no one survives past age T (i.e., $l_T = 0$) and that death claims are paid at the end of the year.

The end of year savings fund (EF_{i+1}) is defined to be,

$$EF_{i+1} = l_{x+i} \cdot (P_x - TR_{x+i}) (1+r) + EF_{i-1} (1+r)$$

(NOTE: This is the fund at the end of the $(i+1)^{st}$ policy year).

Substituting for EF_{i-1} , we can solve for EF_i in terms of all of the preceding deposits.

$$EF_{i+1} = \sum_{j=0}^i l_{x+j} \cdot (P_x - TR_{x+j}) (1+r)^{i-j+1}$$

In particular, the savings fund at the end of the final year (the $(T-x)^{st}$ or at age $T-1$) is,

$$EF_{T-x} = \sum_{j=0}^{T-x-1} l_{x+j} \cdot (P_x - TR_{x+j}) (1+r)^{T-x-j}$$

We now show that the savings fund is exhausted in the $(T-x)^{st}$ year, that is, the level premium P_x paid by the survivors (l_{T-1} in number) when added to the beginning year savings account (EF_{T-x-1}) is just enough to pay that year's term premiums for the survivors.

To show this, multiply equation 9 above by $\frac{l_x}{(1+r)^T}$

$$\frac{(1+r)^T}{l_x},$$

$$EF_{T-x} = \sum_{j=0}^{T-x-1} \left[l_{x+j} (P_x - TR_{x+j}) (1+r)^{-(x+j)} \right].$$

$$[P_x (1+r)^T]$$

$$\text{but } \frac{l_{x+j}}{l_x} (1+r)^{-(x+j)} = v^j \frac{l_{x+j}}{l_x} = jE_x$$

So,

$$EF_{T-x} = \left[\sum_{j=0}^{T-x-1} j E_x (P_x - TR_{x+j}) \right] \left[l_x (1+r)^T \right]$$

Now the first bracketed term on the right hand side is simply our basic pricing equation 8, which shows that the bracketed term is equal to zero. Since the second bracketed term is positive, the whole expression is equal to zero.

Refunds, Cash Values and Policy Loans

If the customer cancels the contract, he or she is entitled to the return of the unspent portion of the contract. How much does the customer get back? Consider a customer who wants to cancel at the end of the i^{th} year. The insurance saving fund is equal to EF_i and there are now l_{x+i} of the original customers left alive. Therefore, the equitable refund is just EF_i/l_{x+i} . This refund can be shown to be exactly equal to the theoretical terminal reserve held on a whole life policy, which, in turn, would be equal to the policy's cash value if the policy were being supplied at its "actuarial cost."

Suppose a surviving customer wants to borrow from "his" portion of the saving fund. Can he just withdraw his funds, as he would, on any normal savings account? The answer is no. The bank will point out to the customer that their contract requires the bank to purchase term insurance for the customer, using the accumulated fund. If the customer wants to borrow from his fund then, he must promise to repay the "loan" with interest, in order for the bank to meet its commitments under the contract. Policy loan provisions in cash value contracts, of course, work exactly like this. If the customer dies, before repaying the loan, the bank will, of course, recover its money from the term insurance proceeds, that is, the beneficiary will receive the face amount of the term policy minus any indebtedness to the bank. This example shows clearly the fallacy of the argument that some critics of cash value insurance have made, namely, that the company unfairly charges you interest for borrowing your own money and "steals" your cash value if you die. The treatment of policy loans clearly makes sense, once it is recognized that the insurance company is performing a banking service for the customer and is not simply paying interest on an ordinary savings account.

If the bank did not disclose the rate of interest it was paying to its customers, could we use the statement above to calculate it? Clearly the answer is yes. We know how much

the savings fund was at the beginning of year i , namely, EF_{i-1} . To that we add the deposit (call it d_i). If we divide the end of the year fund amount (EF_i) by the sum $EF_{i-1} + d_i$, we get $1+r$. It is the same calculation we would do for any savings account.

But the example tells us more. If we want to find out what rate of interest an insurance company is paying its customers on their savings funds accumulating through cash value policies, we perform basically the same simple analysis. From the premium flows going into the insurance company, we need to subtract out the cost of the year's term insurance, as well as any dividends or funds withdrawn due to contract cancellation.⁴ The remainder is treated as a deposit, added to the beginning period savings account and divided into the end of year account. The result is one plus the rate of interest.

⁴ Policy loans, however, should not be reflected either in the size of the account itself, or in the flows between the company and its customers.

Relation Between the "Bank Rate" and the "Linton Yield"

Suppose an individual is trying to decide between the bank's constant payment contract and paying the rising annual renewable term insurance premiums each year. To help in making the decision, he computes the Linton yield on the bank's level premium contract. Will the Linton Yield, for each duration, equal the bank rate? We show here that, still assuming that insurance premiums are "actuarially fair" (no expenses or profits), that the answer to the question is yes. Under these conditions, the bank rate and the Linton Yield for every holding period are one and the same. We caution that this result may not hold when premiums are not assumed to be actuarially fair.

The bank's total insurance fund at the end of the $(i + 1)$ st policy year, or the year in which each member of our cohort is $x + 1$ years old, is given by:

$$EF_{i+1} = \left[\sum_{j=0}^i (P_x - TR_{x+j}) \cdot jE_x \right] \cdot \left[l_x (i+r)^{i+1} \right]$$

The fund, per surviving policyholder, at the end of year is simply $\frac{EF_{i+1}}{l_{x+i+1}}$

or

$$(A) \quad \frac{EF_{i+1}}{l_{x+i+1}} = \frac{1}{i+1E_x} \cdot \sum_{j=0}^i (P_x - TR_{x+j}) \cdot jE_x$$

How does this compare to a fund built up under the Linton Yield assumptions? As we did for the bank example, let's assume that amount of coverage (the death estate) is \$1 and that death is assumed to occur at the end of the year. The latter requires that a minor change be made in the usual Linton formulation, to hold the death estate constant at the end of the year rather than at the beginning. The individual is x years old and can buy the bank's level contract at $\$P_x$ per year, or buy renewable term insurance and invest the difference.

The conditions are:

- (1) the death estate must be the same under either alternative or; ${}_i\text{Prot}_x$ (Protection at age $x + i$) must be equal to \$1 minus the side fund accumulated at the end of the $(i + 1)$ th policy year (SF_{i+1}).

$${}_i\text{Prot}_x = 1 - \text{SF}_{i+1}, \quad i=0, 1 \dots T-x-1$$

- (2) The cash outlay under the two alternatives must be the same, that is

$$P_x = \text{TR}_{x+i} \cdot {}_i\text{Prot}_x + d_{i+1}$$

where d_{i+1} is defined to be the "deposit" made to the side fund at the beginning of the $(i + 1)$ th policy year.

- (3) The side fund at the end of the $(i + 1)$ th policy year is equal to the sum of the deposit made at the beginning of the year and the preceding year's side fund times one plus the rate of interest.

$$SF_{i+1} = (SF_i + d_{i+1})(1+r^*)$$

- (4) Let the terminal year for the yield calculation be the $(t + 1)$ st policy year. The Linton Yield is defined to be that rate of interest, r^* , that makes the side fund accumulation (SF_{t+1}) equal to the "cash value" or "refund" under the bank's contract.

$$SF_{t+1} = \frac{EF_{t+1}}{l_{x+t+1}} = ({}_{t+1}CV_x)$$

Rearranging equation 2 and substituting for ${}_i\text{Prot}_x$ from equation 1, we get

$$\begin{aligned} (4) \quad d_{i+1} &= P_x - TR_{x+i} \cdot {}_i\text{Prot}_x \\ &= P_x - TR_{x+i} + TR_{x+i} \cdot SF_{i+1} \end{aligned}$$

Now substitute (4) into (3)

$$SF_{i+1} = (SF_i + P_x - TR_{x+i} + TR_{x+i} \cdot SF_{i+1})(1+r^*)$$

Group terms involving SF_{i+1} on the left side and simplify.

$$(5) \quad SF_{i+1} = \frac{1+r^*}{1-TR_{x+i}(1+r^*)} \cdot (SF_i + P_x - TR_{x+i})$$

Equation 5 is a linear first order difference equation and may be solved recursively to eliminate the "SF" terms on the right hand side. To simplify the exposition, let us introduce two auxiliary variables.

$$a_i = P_x - TR_{x+i}, \quad i = 0, 1, \dots, t$$

$$b_i = 1 - (TR_{x+i})(1+r^*), \quad i = 0, 1, \dots, t$$

Equation 5 can now be rewritten as

$$(5) \quad SF_{i+1} = \left(\frac{SF_i}{b_i} + \frac{a_i}{b_i} \right) (1+r^*)$$

But (5) holds for $i = 0, 1 \dots t$

So

$$\begin{aligned} SF_{i+1} &= \left[\frac{1}{b_i} \left(\frac{SF_{i-1}}{b_{i-1}} + \frac{a_{i-1}}{b_{i-1}} \right) (1+r^*) + \frac{a_i}{b_i} \right] (1+r^*) \\ &= \frac{SF_{i-1}}{b_i \cdot b_{i-1}} (1+r^*)^2 + \frac{a_{i-1}}{b_i \cdot b_{i-1}} (1+r^*)^2 + \\ &\quad \frac{a_i}{b_i} (1+r^*) \end{aligned}$$

Continuing this process back to the first policy year we get,

$$SF_{i+1} = \frac{a_0 (1+r^*)^{i-1}}{b_0 \cdot b_1 \cdot \dots \cdot b_i} + \frac{a_1 (1+r^*)^i}{b_1 \cdot b_2 \cdot \dots \cdot b_i} + \dots$$

or,

$$(6) \quad SF_{i+1} = \sum_{j=0}^i \frac{a_j (1+r^*)^{i+1-j}}{\prod_{s=j} b_s}$$

Now the a_j in equation 6 is also contained in the equation for the bank fund, but in the latter it is multiplied by the pure endowments $j E_x$. Is there any relationship between the product of the b_j 's in the denominator and these pure endowments? In our particular case, the surprising answer is yes. Suppose for the moment that $r^* = r$, that the Linton Yield for duration $t + 1$ is equal to the bank rate. Then

$$TR_{x+s} = \frac{1}{(1+r^*)} \frac{d_{x+s}}{l_{x+s}}$$

and

$$b_s = 1 - TR_{x+s} (1+r^*) = 1 - \frac{d_{x+s}}{l_{x+s}} = \frac{l_{x+s+1}}{l_{x+s}}$$

Therefore

$$\prod_{s=j}^i b_s = \frac{l_{x+j+1}}{l_{x+j}} \cdot \frac{l_{x+j+2}}{l_{x+j+1}} \cdot \dots \cdot \frac{l_{x+i+1}}{l_{x+i}} = \frac{l_{x+i+1}}{l_{x+j}}$$

The complicated product in the denominator of the term involving a_j reduces to the simple ratio of the number of survivors of age $x + i + 1$ to the number of survivors at the younger age $x + j$. Now simplify equation 6.

$$SF_{i+1} = \left[\sum_{j=0}^i (P_x - TR_{x+j}) \cdot \frac{l_{x+j}}{(1+r^*)^j} \right] \times \left[\frac{(1+r^*)^{i+1}}{l_{x+i+1}} \right] \times \left[\frac{l_x}{l_x} \right]$$

But

$${}_jE_x = (1+r^*)^j \frac{l_{x+j}}{l_x}$$

so

$$(8) \quad SF_{i+1} = \left[\sum_{j=0}^i (P_x - TR_{x+j}) \cdot {}_jE_x \right] \cdot \left[\frac{l_x}{l_{x+i+1}} \right]$$

But the right hand side of 8 is exactly the same as the r.h.s. of equation (A) or

$$SF_{i+1} = \frac{EF_{i+1}}{l_{x+i+1}}$$

Thus, when term insurance is available on an "actuarially fair" basis, the Linton Yield and the bank rate are the same for all durations.

The Interest Adjusted Surrender Index: Biased Against
Term Insurance--Why It Should Not Be Used to Compare
Dissimilar Policies

While the NAIC Buyer's Guide advises that the IAC index should not be used to compare "dissimilar" policies, it is nowhere explained why one should not, nor is it said whether the index is biased in such comparisons and, if so, which way. Using the equivalent whole life and term policies we have developed here, we show that a straightforward comparison of interest-adjusted surrender costs is strongly and always biased against term insurance.

The observed similarity in cost between term and whole life policies in such publications as the New York State Shopper's Guide should not be taken as an indication that the two types cost about the same.

Proof:

$${}_t\text{IAC}_x = \frac{\sum_{s=1}^t {}_sP_x (1+r)^{t-s+1} - {}_t\text{CV}_x}{S_n i}$$

But

$${}_t\text{CV}_x = {}_{t+1}E_x \left(\sum_{s=1}^t (P_x - TR_{x+s}) \cdot {}_sE_x \right)$$

(See Appendix II for a derivation of this equation.)

For a whole life policy, $sP_x = P_x$, that is, the premium is level. For term policies, $sP_x = TR_{x+s}$ and ${}_tCV_x = 0$. Subtract the whole life interest adjusted cost from the term cost.

$${}_tIAC_x (\text{Term}) - {}_tIAC_x (\text{whole life}) =$$

$$1/\overline{s_n}|i \left[\sum_{s=1}^t TR_{x+s} (1+r)^{t-s+1} - \sum_{s=1}^t P_x (1+r)^{t-s+1} + {}_tCV_x \right]$$

rearranging and substituting for ${}_tCV_x$ from the equation above, we have [within the brackets].

$$\left[\sum_{s=1}^t (P_x - TR_{x+s}) \cdot \frac{{}_sE_x}{{}_{t+1}E_x} - \sum_{s=1}^t (P_x - TR_{x+s}) (1+r)^{t-s+1} \right]$$

or

$$\sum_{s=1}^t (P_x - TR_{x+s}) \frac{{}_sE_x}{{}_{t+1}E_x} - (1+r)^{t-s+1}$$

But

$$\frac{{}_sE_x}{{}_{t+1}E_x} = \frac{(1+r)^{-s}}{(1+r)^{-(t+1)}} \frac{l_{x+s}}{l_{x+t+1}} = (1+r)^{t-s+1} \frac{l_{x+s}}{l_{x+t+1}}$$

So the term in brackets now becomes

$$\left[\sum_{s=1}^t (P_x - TR_{x+s}) \cdot (1+r)^{t-s+1} \left(\frac{l_{x+s}}{l_{x+t+1}} - 1 \right) \right]$$

Since $s < t + 1$ for all $s = 1, 2, \dots, t$, $l_{x+t} > l_{x+t-1}$ and the last term in parenthesis will be positive in every term. Since initially, and then for long periods of time (15 to 20 years), the differences between P_x and TR_{x+s} are positive, the whole expression will be positive. Thus the comparison (falsely!) suggests that whole life is less costly than term--when they are constructed to be exactly equivalent.

The bias against term insurance arises primarily because the amount of protection declines steadily in the whole life contract, but not in the term contract. Thus, comparing policies of the same face amount produces a bias against the term insurance contract. That this bias is likely to be large, can be seen from the following example. Compare two equivalent policies; a whole life policy constructed from the 1958 CSO mortality table using an interest rate of 3-1/2% and a term policy whose rates are equal to the mortality rates in this table and with the difference in the whole life and term premiums invested at 3-1/2%. The level premium for the whole life policy issued to a man aged 25 would be \$10.16 per \$1000 of face amount,⁵ whereas the term premium would start at \$1.93 and increase steadily thereafter. The cash value (assuming the latter equal to the "net level reserve" for each year) at the end of the 20th year is \$245.41 per \$1000 of face amount. The 20-year interest adjusted surrender cost for the whole life policy can be shown to be \$3.53 per \$1000 as compared to \$5.30 for the term policy. Thus, the whole life policy appears to be 33% cheaper (!) than the equivalent term policy. At higher interest rates, the bias would be even larger.

⁵ See table 3-4, p. 52 in R. Mehr, Life Insurance: Theory and Practice (revised edition 1977). The same table shows the "cash values" or net level reserves for this policy in column 8.

APPENDIX IV: THE RELATIONSHIP BETWEEN POLICY COST AND SALES, AND PREMIUMS AND COST

This Appendix provides additional information concerning two subjects discussed in the report: (1) the relationship between policy cost and sales; and (2) the relationship between premiums and cost.

The relationship between cost and sales

To test the relationship between cost and market share a unique size classification was assigned to each of 349 whole life policies in Senator Hart's 1973 survey.¹ All policies of a given size classification and type were then ranked by their 20-year Company Retention index values.² Policies were grouped by cost deciles. The least costly policies were assigned to the first decile, and the most costly to the tenth decile. Table 1 shows total sales by face amount by decile for \$10,000 whole life policies issued to males age thirty-five.³

1 This was done by dividing total number of new issues for each ordinary policy into total face value of sales for 1973. Since data was collected for sizes 5,000, 10,000, 25,000 and 100,000, each policy was assigned the size category that came closest to the above quotient. For example, if a company sold 2,000 "Executive Specials," with an aggregate face value of \$30,000,000, then the average policy had a face value of \$15,000. This is closer to \$10,000 than \$25,000, so it was assumed that all "Executive Special" sales had face value equal to \$10,000.

2 For example, among the 193 nonparticipating policies in this sample, 70 were classified as "size 10,000." The most costly policy had a Company Retention value of \$132.46 and was ranked "70." The next most costly had a value of \$71.31 and was ranked "69." The least costly policy had a value of \$45.82, and was ranked "1." Company Retention values were computed for a 20-year period, assuming male issue age 35, a 5 percent rate of interest, and Moorhead's "Table S" lapse rates.

3 A similar table for \$25,000 policies is contained in the report at pages 61-62.

Table 1

Sales by Cost Decile Ranked by Company Retention,
Size 10,000

Nonparticipating Policies

Decile	Face Value of Sales (000)	No. of Policies in Decile	Median Index Value
1	\$ 71,946	7	\$52.73
2	379,235	7	55.89
3	151,340	7	57.91
4	135,713	7	59.37
5	113,376	7	60.60
6	179,852	7	62.30
7	320,164	7	62.97
8	131,378	7	63.94
9	153,477	7	67.76
10	73,745	7	70.64
Total	\$1,710,217	70	

Participating Policies

1	\$1,300,059	7	38.75
2	616,636	7	42.14
3	4,158,364	7	46.04
4	670,248	7	49.61
5	393,138	7	52.16
6	122,263	7	55.71
7	105,957	7	59.42
8	78,862	7	61.51
9	565,789	7	66.11
10	101,557	8	71.05
Total	\$8,112,873	71	

Table 2 shows the Pearson correlation coefficient between sales and various measures of cost. The Pearson correlation coefficient measures the degree to which two variables behave in a similar way. For example, if the differences in sales among the 70 non-participating policies were perfectly mirrored by differences in the Company Retention Index, the Pearson coefficient would be 1. If the two variables behaved exactly opposite, then the coefficient would be -1. If there was no systematic relationship between sales and Company Retention, then the coefficient would be near zero. Table 2 shows that there is a weak, but positive relationship between high sales and low cost.

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Table 2

Pearson Coefficients for \$10,000 Whole Life Policies⁴Nonparticipating Policies

Correlated Variables	Pearson Coefficient
Sales vs. Company Retention	-.055
Sales vs. Savings Yield	.083
Sales vs. Interest Adjusted Cost	-.056
Sales vs. Premiums	-.059

Participating Policies

Sales vs. Company Retention	-.175
Sales vs. Savings Yield	.172
Sales vs. Interest Adjusted Cost	-.173
Sales vs. Premiums	-.024

Pearson Coefficients for \$25,000 Whole Life PoliciesNonparticipating Policies

Correlated Variables	Pearson Coefficient
Sales vs. Company Retention	-.368 ⁵
Sales vs. Savings Yield	.401
Sales vs. Interest Adjusted Cost	-.366
Sales vs. Premiums	-.301

Participating Policies

Sales vs. Company Retention	-.101
Sales vs. Savings Yield	.200
Sales vs. Interest Adjusted Cost	-.232
Sales vs. Premiums	-.016

⁴ A rate of interest of 4 percent was used for Interest Adjusted Cost calculations. All indices were calculated on a 20-year basis from issue age 35. The Savings Yield calculations employ the term rates used by Massachusetts Mutual in analyzing the Hart data.

⁵ A negative coefficient for Company Retention, Interest Adjusted Cost and Premiums means that there is a positive relationship between the variables because the lower the index the lower the cost of the policy. The opposite is true for Savings Yield since the higher the yield the lower the cost of the policy.

The relationship between premium and cost

Part III.B. (page 70) discussed the relationship between premium and cost. As stated in the report, premiums are a fairly good measure of cost when looking solely at non-participating policies and are a much less reliable guide for participating policies. This is confirmed by Table 3 which shows the Pearson correlation coefficients between premiums and various cost indices.

Table 3

Pearson Correlation Coefficients Between Premiums and Various Cost Indices

<u>Type Policy</u>	<u>Premiums Correlated With</u>		
	Savings Yield	Interest-Adjusted Cost	Company Retention
Non Par, 10,000	.746	.820	.836
Par, 10,000	.321	.289	.363
Non Par, 25,000	.664	.652	.594
Par, 25,000	.55	.260	.310

Part III.B. (page 50) shows that when both participating and nonparticipating policies are compared, premiums are a totally unreliable measure of cost. This is demonstrated by Table 4 which shows correlation coefficients between premium and cost for all 307 \$25,000 whole life policies in the Hart data base that were available to males, age 35, making no distinction between participating and nonparticipating policies.

Table 4

Correlation Coefficients Relating Premiums and Cost for All Whole Life Policies in Size 25,000¹

Correlated Variables	Pearson Coefficient	Kendall Coefficient
Premiums vs. Company Retention	.066	.063
Premiums vs. Savings Yield	.254	.146
Premiums vs. Interest Adjusted Cost	-.125	-.054

Table 4 shows that when both participating and nonparticipating policies are being compared picking a policy with a low premium will often lead to the purchase of a high cost policy. The Kendall coefficient presented in Table 4 can be used to determine the probability that two policies will be ranked in a similar way using two different measures of cost. Technically, it is the difference between the probability that they will rank in the same way and the probability that they will rank differently. Therefore, the Kendall coefficient of .146 between premiums and savings yield can be expressed as $.573 - .427$. If policies A and B are selected randomly from our sample, and if policy A has a lower premium, then 57% of the time it will also have a lower savings yield.

APPENDIX V: CONSUMER LOSS DUE TO EARLY LAPSATION

ly. Consumers lost an estimated \$212 million from first-year lapse of ordinary permanent policies purchased in 1977. Since a permanent policy which lapses in the first year (before cash values accrue) buys only an equivalent amount of term insurance, the loss to the lapsing policyholder is the difference between the premiums paid on the permanent policy and the value of the death protection which was received while the policy was in force.

Several calculations and assumptions were made to estimate this loss. First, the staff determined how much of the \$3.314 billion in first year ordinary premiums was paid for permanent insurance and how much for term insurance.¹ Then, to calculate the amount of premiums on lapsed permanent policies, a lapse rate of 20 percent and a 5.6 month duration was assumed.² Next, the value of the death protection provided by the lapsed policies while they remained in force was estimated by using representative

¹ Actually the \$3.314 billion figure refers to receipts by U.S. life companies on first year business. American Council of Life Insurance, Life Insurance Fact Book 59 (1978). Technically, it is slightly different than first-year premiums paid by U.S. citizens.

² The duration figure is based on data submitted to the Hart Subcommittee by 18 companies. Each gave a mean duration for ordinary permanent policies lapsed in the first year. The unweighted mean for all companies was 5.6 months.

term rates. Finally, this value was subtracted from the amount of premiums paid on lapsed permanent policies to determine the total consumer loss from first-year lapse.

The staff used data from LIMRA's 1975 Buyer Study to estimate the first-year premium payments spent on term insurance:

Table 1³

Premium Expenditures on Term Products

Percentage of Ordinary Premiums Paid on Term Products by Sex					Percentage of All Ordinary Premiums Paid by Sex	Percentage of All Term Premiums Paid by Sex
Level Term	Decreasing Term	Term Portion of Permanent Policies	Total			
(a)	(b)	(c)	(d)	(e)	(f)	(e)x(f)
Male	7%	5%	4.4%	16.4%	79%	12.9%
Female	4%	3%	3.9%	10.9%	17%	1.9%
Juvenile	.3%	0	2.4%	2.7%	4%	0.1%
Total						14.9%

Table 1 indicates that 14.9 percent of first-year ordinary premiums was spent for term products. The staff next assumed that the remainder of first-year ordinary premiums (85.1) percent was spent for permanent insurance.

³ Data for this table were compiled from LIMRA, The 1975 Buyer Study, 8, 19, 22, 26 and 32. The figures for the term portion of permanent policies are not directly available in the text. However, we used the data on page 22 to calculate that 66.7 percent of the volume of these policies was term volume. Using this figure, and assuming that all term portions are level, we derived the figures in column (d) of Table 1.

Assuming the same proportion of first-year premium dollars was spent in 1977 for term insurance, \$2.817 billion (\$3.314 billion x 85.1 percent) was for first-year ordinary permanent insurance in 1977. Assuming the lapse rate was 20 percent⁴ and the duration of the lapsed policies was 5.6 months, approximately \$295 million was spent on lapsed policies in 1977.⁵

This \$295 million does not represent a total loss because buyers received the equivalent of term insurance protection while their policies remained in force. To estimate the value of this term coverage, the staff analyzed the lapse data submitted to the Hart Subcommittee by 16 companies. Each company had provided data on annualized premiums for lapsed and non-lapsed permanent business, average duration of permanent ordinary policies lapsed in the first year, and age and size breakdowns of these lapses.

The staff calculated a loss ratio for each company of the value of term protection received to the annualized premiums on permanent policies lapsed in the first year. A sample calculation for one company and one age group follows:

⁴ Other estimates of first-year lapse rates on permanent ordinary business range from 14.2 percent (LIMRA figure based on the 1972-73 experience of nine companies) to 22.4 percent (unweighted mean of 24 companies submitting data to the Hart Subcommittee).

⁵ Let NL represent premiums on non-lapsed policies and L represent annualized premiums on lapsed policies. Then $\$2.817B = NL + \frac{5.6L}{12}$. If the lapse rate is 20 percent, then $NL = 4 \times L$. Solving, we get: $NL = \$2.522B$ and $\$2.817B - \$2.522B = \$295$ million = amount spent on permanent ordinary lapsed policies.

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Table 2

Value of Term Protection for Lapsed Policies

<u>Size</u> (a)	<u>Average</u> ⁶ <u>Size</u> (b)	<u>Term</u> ⁷ <u>Rate</u> (c)	<u>No. of Poli</u> ⁸ <u>cies Lapsed</u> (d)	<u>Value of</u> <u>Term Protection</u> <u>((b) (c) (d))</u>
\$0-4,999	\$ 2,500	\$8.57	1,010	\$ 21,639.25
5,000	5,000	5.57	3,814	106,219.90
5,001-9,999	7,500	5.57	313	13,075.58
10,000	10,000	4.57	5,645	257,976.50
10,000-24,999	17,500	4.57	1,371	109,645.73
25,000	25,000	3.57	83	7,407.75
Over 25,000	25,000	3.57	33	<u>2,945.25</u>
			Total	\$518,909.96

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FTC figures.

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Rates used by Massachusetts Mutual in calculating Linton Yield figures using the Hart data. These rates are similar to the "Average Yearly Renewable" rates prepared by E.J. Moorhead. See The Society of Actuaries, Analysis of Life Insurance Cost Comparison Methods 192 (1974).

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Data for one age group (15-24) submitted by one company (Allstate). Age categories used were: 15-24; 25-34; 35-44; 45-54; and 55 and over.

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For all age groups, purchasers of permanent ordinary life insurance which lapsed in the first year received annualized benefits of \$1,196,971.77. This represents 32.2 percent of annualized premiums received by this company for permanent ordinary policies lapsed in the first year. The average for all 16 companies was 28 percent. Since only 28 percent of the premium on the lapsed policies purchased the equivalent of term protection, the remaining 72 percent was lost. Thus, the loss from first-year lapse of permanent ordinary policies purchased in 1977 is \$212 million (\$295 million x 72 percent).⁹

The only other comparable loss calculation of which the staff is aware is Dean Sharp's estimate made during the Hart Subcommittee hearings. He estimated a \$505 million loss due to lapse of policies sold in 1970 and lapsed within two years.¹⁰ Sharp had limited data at his disposal.¹¹ Aside from the different lapse period used, Sharp's calculations differed from the staff's method in a number of ways. Most significantly, he assumed that all policies which lapsed within two years

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In an effort to determine how sensitive this estimate is to the choice of lapse rate, the staff performed similar calculations using lapse rates of 15 and 25 percent. These loss figures were \$156 million and \$275 million respectively.

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The "one-year" data is actually for policies not renewed within 13 months.

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Details of Sharp's calculation can be found in The Life Insurance Industry: Hearings Before the Senate Subcommittee on Antitrust and Monopoly, 93rd Cong., 1st Sess. 211 (1973).

remained in force for the full two year period before they were dropped, and that cash values at the end of two years were zero.¹² The staff has been able to use the data assembled by Sharp for the Hart Subcommittee to estimate the duration of lapsed policies to be 5.6 months. Therefore, the staff's estimate is much smaller than his.¹³

¹² Sharp's calculations differed in other ways as well. He employed average data for all ordinary insurance. He did not distinguish between lapse of term and lapse of permanent business, or take into account different lapse behavior for different policy size groups, and age groups. He used an average premium per \$1,000 figure without distinguishing between term and permanent business. Finally, he assumed a term value of \$4 per \$1,000 regardless of policy size or age of the insured.

¹³ The staff calculation, based on \$1.869 billion first-year premiums paid on ordinary business in 1970, would be a loss of \$120 million in that year. If the lapse period was expanded to two years, and a 5 percent lapse rate was assumed in the second year, the loss calculation for 1970 would be about \$255 million.

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APPENDIX VI:
TECHNICAL NOTES ON THE DIFFERENT COST
MEASURES USED IN THIS REPORT

The purpose of this Appendix is to provide, for the financially and/or actuarially sophisticated reader, a more complete explanation of the company retention index, the premium breakdown that can be derived using the company retention index, the average annual rate of return (Linton Yield), and the cash accumulation method that we described in the report. For each of these major financial disclosures the Appendix provides (a) a brief technical explanation of the measure; (b) references to published works concerning the measure; (c) the mathematical formulas for these measures; and (d) the actual interest rate, mortality, lapse and term premium rate assumptions used in computing these measures in this report. The computer program that was used to calculate the Linton Yields in this report is also included.

A. The Company Retention Index

(1) The "company retention index" is essentially the present expected value of all premiums, less the present expected value of all death benefits, policy dividends and cash values, over a given period of time, say 20 years. It is a "present" value because an interest rate is used to discount every future cash flow back to the present. For example, a \$1 dividend to be received at the end of the year has "present" (beginning of the year) value of about 95 cents. It is an "expected" value because each future premium, dividend, cash value, death benefit, etc., is weighed by the probability that it will actually be paid.

Each cash flow is weighed by a probability that reflects the fact that payments are contingent on whether the insured lives or dies and whether the insured "surrenders" or allows his policy to "lapse."

The actual mortality and lapse probabilities used are industrywide averages and will not necessarily be good predictors of any individual company's future mortality and lapse experience. For the sake of comparing the cost of one policy to another, however, it is important to use the same interest, mortality and lapse assumptions. Finally, the company retention index is expressed on a level annual basis, as is the premium for a whole life policy.

(2) References on the Company Retention Index

The "Company Retention" method is described and illustrated in Joseph Belth, "The Relationship Between Benefits and Premiums in Life Insurance," 36 J. of Risk and Insurance 19-39 (1969).

Much useful information about this and other methods is contained in Analysis of Life Insurance Cost Comparison Methods, prepared by the Society of Actuaries Committee on Cost Comparison Methods and Related Issues (Special), September 1974.

(3) Mortality: The "1957-60 Ultimate Basic Mortality for Males" table (Transactions of the Society of Actuaries, 1962) was adjusted by Mr. E.J. Moorhead to reflect the recent decline in mortality and "selection" factors were employed. The tables used are set forth later in the appendix.

Lapse: Moorhead's table "S".

Interest Rate: 5%

Duration: 20 years from issue.

Timing of Cash Flows: It is assumed that premiums are paid at the beginning of the year and that any dividends, cash values or face amounts are paid at the end of the year. Terminal dividends are assumed payable on death or surrender.

B. The Premium Breakdown

(1) The premium breakdown figures are simply the components of the company retention index shown separately. They are the expected present value of premiums, protection, dividends, savings and company retention, all expressed on a level annual basis as explained in section one above. "Protection" for any given year is defined to be the face amount of the policy plus any terminal dividend, less the cash value for that year. "Savings" in any given year are defined to be the difference between the cash value at the end of the year and the previous year's cash value augmented by one year's interest.

(2) Same as A. (2).

(3) Same as A. (3).

C. The Average Annual Rate of Return (Linton Yield)

(1) In the insurance literature this rate of return is known as the "Linton Yield." It is one example of what economists and financial analysts call an "internal rate of return." In essence, the method consists of subtracting a "cost of protection" from each year's premium (net of dividends) and treating the remainder as a "saving deposit." The 20-year

average annual rate of return is then that rate of interest which would make the balance in the "savings account" at the end of 20 years equal to the cash value of the whole life policy at the end of 20 years. The "cost of protection" depends on the yearly renewable term premiums used and the amount of protection purchased. The term rates assumed are given in the appendix and the amount of protection purchased is calculated in such a way that the sum of the saving account and the face amount of the term insurance policy is equal to the face amount of the whole life policy.

The Society of Actuaries has described the "Linton Yield" as follows: "The method solves for a level, effective, annually compounded interest rate or yield. This yield is determined by equating the cash available at the end of n years from two different protection/savings programs, each with identical yearly death benefits, and then solving for the annual yield that must be achieved on the separate savings fund of the second program in order to produce the cash equivalency with the first program. The two programs compared are:

- (a) A life insurance policy on, normally but not necessarily, some permanent plan. The cash used at the end of the nth year is the policy's guaranteed cash value.
- (b) A combination of a savings fund and Yearly Renewable Term (YRT) insurance. The amount deposited in the savings fund each year is assumed to be equal to the annual premium

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payable under the alternate program for the permanent life insurance policy (less any dividend payable at the end of the preceeding year) less any assumed premium payable for YRT insurance. The amount of YRT purchased each year is that which would be adequate to bring the combined death benefit from the saving plan and the YRT to the same as that payable under the permanent life insurance policy. The cash used for comparison with the permanent policy is the amount accumulated in the savings fund at the end of the nth year. See Analysis of Life Insurance Cost Comparison Methods, pp. 28-29.

(2) References:

Belth, Joseph. "The Rate of Return on the Savings Element in Cash-Value Life Insurance," The Journal of Risk and Insurance, Vol. 35, #4 (December 1968), pp. 569-81.

(3) Term Insurance Rates.

In the report, the term insurance rates used were computed by using the Society of Actuaries mathematical formula for low yearly renewable term rates (Actuaries Report, p. 187) together with the mortality rates (adjusted for selection, id. p. 188). This mortality table is reproduced in this appendix as Table 1. The term insurance rates produced by this process are somewhat lower than the rates used in the Actuaries Report.

This is because the FTC staff used the mortality table that reflects the improved mortality experience that companies achieve through selective underwriting, whereas the Actuaries Report used the same mortality table, but without adjustments for selection. We think it is appropriate to use these somewhat lower term rates for two reasons. First, the Actuaries Report was published in 1974 and the low term rates used reflected prices available for individual policies in 1973. Since that time, however, term rates have declined. Therefore the rates used in the Actuaries Report are no longer representative of low cost term rates available in the market. Second, the rates used in the Actuaries Report were chosen to be representative of low cost individual term insurance alone. Since about half of all insurance in force is group term and much more than half of all term insurance premiums are paid for group term policies, we think it is necessary, in selecting term rates for Linton Yield calculations, to reflect the relatively lower rates for group term policies as well as for individual term policies. When group term rates are considered, the rates used in the Actuaries Report simply do not reflect low cost term insurance rates available in the market in 1977. In contrast, the rates used in this report better reflect low cost term insurance rates available in that year. For completeness, however, we have also calculated rates of return using term rates identical to those used in the Actuaries Report. These appear in Appendix VI Tables 1-3.

The draft regulation (Appendix X) contains the mortality table without the selection adjustment and, in conjunction with the formula, will produce the term rates used in the Actuaries Report. The "select" table could not be used, since selection factors were only available for four issue ages (25, 35, 45 and 55), whereas rates of return must be computed for any issue age. As previously discussed, we believe the term rates so produced are no longer representative of low cost term insurance. Therefore the term rates implicit in the draft regulation are more for illustrative purposes than for actual use. We recommend that any state, considering adoption of rate of return disclosure regulations, conduct a study to determine rates representative of low cost individual and group term insurance policies in that state and use those in their regulation.

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Table 1

Average Rates of Return (Tax Free) on Whole Life Insurance Policies
1973 and 1977

Age at Issue	Face Amt of Policy	If Policy is Held For	1973		1977	
			Dividend Paying	Nondividend Paying	Dividend Paying	Nondividend Paying
25	\$10,000	5 years	-11.17%	-16.68%	-11.34%	-18.10%
		10 years	1.03	- 0.29	2.60	- 0.41
		20 years	3.94	2.68	4.94	2.82
	25,000	5 years	-10.85%	-17.08%	-11.25%	-16.30%
		10 years	0.34	- 0.87	1.77	0.07
		20 years	3.50	2.41	4.46	2.98
	100,000	5 years	-11.74	-17.24	-11.52	-15.68
		10 years	- 0.18	- 1.13	1.47	0.28
		20 years	3.26	2.29	4.32	3.11
35	10,000	5 years	- 8.87	-12.31	- 7.59	-13.06
		10 years	0.79	- 0.49	2.23	- 0.57
		20 years	3.61	2.29	4.66	2.44
	25,000	5 years	- 8.57	-12.21	- 7.76	-11.11
		10 years	0.40	- 0.67	1.79	0.21
		20 years	3.35	2.22	4.37	2.77
	100,000	5 years	- 9.19	-12.24	- 7.93	-10.52
		10 years	0.04	- 0.78	1.63	0.48
		20 years	3.19	2.18	4.31	2.94
45	10,000	5 years	- 7.60	-10.43	- 7.18	-11.19
		10 years	0.80	- 0.56	2.22	- 0.67
		20 years	3.33	1.88	4.42	1.99
	25,000	5 years	- 7.11	-10.01	- 6.63	- 8.81
		10 years	0.65	- 0.50	2.16	0.40
		20 years	3.22	1.94	4.36	2.49
	100,000	5 years	- 7.57	- 9.93	- 6.61	- 8.09
		10 years	0.39	- 0.51	2.09	0.75
		20 years	3.12	1.94	4.34	2.71

NOTE: Term rates used for calculation of rates of return include no selection factors.

Variation in Rates of Return on \$25,000 Whole Life
Insurance Policies Issued in 1973 and 1977

Dividend Paying Policies

<u>Age at Issue</u>	<u>Year of Issue</u>	<u>Duration of Holding Period</u>	<u>Average Rate</u>	<u>Lowest Rate</u>	<u>Highest Rate</u>	<u>Standard Deviation</u>	<u>Coefficient of Variation</u>
25	1973 N= (139)	5 years	-10.85%	-28.06%	1.70%	7.53%	69%
		10 years	0.34	- 6.02	4.22	2.11	-
		20 years	3.50	- 0.02	5.02	0.76	22
		30 years	3.87	1.00	5.05	0.65	17
	1977 N= (94)	5 years	-11.16	-46.40	1.93	8.66	77
		10 years	1.78	- 2.58	6.71	1.95	111
		20 years	4.45	1.01	7.78	0.93	21
		30 years	4.77	2.28	7.98	0.78	16
35	1973 N= (145)	5 years	- 8.57	-21.87	1.35	5.60	65
		10 years	0.40	- 6.02	3.60	1.84	-
		20 years	3.35	- 0.32	4.68	0.74	22
		30 years	3.71	0.67	4.81	0.65	18
	1977 N= (129)	5 years	- 7.76	-28.40	1.54	4.81	62
		10 years	1.79	- 2.72	6.30	1.68	94
		20 years	4.37	1.25	8.07	0.89	20
		30 years	4.72	1.95	8.15	0.71	15
45	1973 N= (145)	5 years	- 7.11	-19.62	1.78	4.87	68
		10 years	0.65	- 5.99	3.46	1.79	-
		20 years	3.22	- 0.93	4.66	0.82	25
		30 years	3.49	- 0.01	4.84	0.72	21
	1977 N= (92)	5 years	- 6.63	-69.77	9.30	8.15	123
		10 years	2.16	- 3.63	7.89	1.84	85
		20 years	4.36	0.31	8.76	1.07	25
		30 years	4.55	0.54	8.70	0.99	22

NOTE: In those instances when the average rate of return was close to zero, a coefficient of variation was not computed. Turn rates used for calculation of rates of return include no selection factors.

include no selection factors.

Variation in Rates of Return on \$25,000 Whole Life
Insurance Policies Issued in 1973 and 1977

Non-Dividend Paying Policies

<u>Age at Issue</u>	<u>Year of Issue</u>	<u>Duration of Holding Period</u>	<u>Average Rate</u>	<u>Lowest Rate</u>	<u>Highest Rate</u>	<u>Standard Deviation</u>	<u>Coefficient of Variation</u>
25	1973 N= (162)	5 years	-17.08%	-56.06%	2.85%	8.79%	5%
		10 years	- 0.87	-20.80	6.10	2.80	-
		20 years	2.41	- 2.90	4.65	0.99	41
		30 years	2.64	- 0.36	6.33	0.68	26
	1977 N= (57)	5 years	-16.30	-38.06	4.59	9.59	59
		10 years	0.07	- 8.95	4.91	2.71	-
		20 years	2.98	- 0.86	5.00	1.22	41
		30 years	3.11	1.03	4.61	0.80	26
35	1973 N= (162)	5 years	-12.21	-44.53	1.27	5.83	48
		10 years	- 0.67	-19.65	5.68	2.27	-
		20 years	2.22	- 3.54	4.64	0.87	39
		30 years	2.44	- 1.01	4.23	0.57	23
	1977 N= (59)	5 years	-11.11	-26.95	2.98	5.94	53
		10 years	+ 0.21	- 6.68	3.52	2.05	-
		20 years	2.77	- 1.05	4.33	1.11	40
		30 years	2.94	0.33	4.66	0.86	29
45	1973 N= (161)	5 years	-10.01	-41.55	1.17	4.89	49
		10 years	- 0.50	-21.11	4.97	2.38	-
		20 years	1.94	- 5.26	4.18	1.05	54
		30 years	2.11	- 3.70	3.88	0.78	37
	1977 N= (57)	5 years	- 8.81	-19.60	1.69	4.82	55
		10 years	0.40	- 4.92	3.69	1.92	-
		20 years	2.49	- 1.50	5.18	1.30	52
		30 years	2.52	- 1.07	4.74	1.07	42

Table 3

NOTE: In those instances when the average rate of return was close to zero, a coefficient of variation was not computed. Term rates used for calculation of rates of return include no selection factors.

D. The Cash Accumulation Method

(1) The cash accumulation method is a variant of the Linton Yield method. As previously discussed, the Linton Yield method involves constructing a term insurance plus side fund alternative to a particular cash value policy that is in some sense, equivalent to the cash value policy.

By "equivalent" is meant that the death estate (at the beginning of the year) and the cash outlay are the same, regardless of whether the cash value policy or the term plus side fund package is purchased. Any method that holds death benefits and cash outlay constant, can be referred to as a "Linton type" method. The Linton yield itself is simply the rate of interest that equates the accumulated deposits (uniquely defined by holding 1 and 2 constant) with the cash value of the whole life policy at the end of the terminal year. If the rate of interest by which to discount the flows over time is assumed, then it is possible to compute how much money there would be in the side fund at the end of each year and compare it to the cash value specified in the alternative policy. The amounts in the two savings accounts are the only significant items that can differ between the two alternatives and so a comparison limited to the "savings" element alone is valid. This is what the cash accumulation does.

(2) References:

The cash accumulation method is described in Murray, "Analyzing the Investment Value of Cash Value Life Insurance," 43 J. Risk & Ins. 121 (1976).

It is also discussed in the Moss Subcommittee Report,
Subcommittee on Oversight and Investigations: Report on
Life Insurance Marketing and Cost Disclosure, 95th Cong.,
2d Sess. 13-14 (1978).

(3) The term rates used in the calculation are the
same as those used for the Linton Yield.

Mathematical Formulas

1. Company Retention Index and the Premium Breakdown.

$$\text{Consumer Cost Index} = CC_x = \left(\frac{nCR_x}{PREM} \right) \cdot \left({}_tP_x \right)$$

$$\text{Protection} = \frac{PROT}{PREM} \cdot ({}_tP_x)$$

$$\text{Savings} = \frac{SAV}{PREM} \cdot ({}_tP_x)$$

$$\text{Dividends} = \frac{DIV}{PREM} \cdot ({}_tP_x)$$

$$\begin{aligned} \text{Company Expenses} \\ \text{and Profit} \end{aligned} = CC_x$$

where, $nCR_x = PREM - PROT - SAV - DIV$

$$PREM = \sum_{t=1}^n ({}_tP_x) (v)^{t-1} z_x$$

$$PROT = \sum_{t=1}^n \left(F + {}_tTD_x - {}_tCV_x \right) (v^t) ({}_{t-1}z_x) (q_{x+t-1})$$

$$SAV = \sum_{t=1}^n [{}_tCV_x - ({}_{t-1}CV_x)(1+i)] (v^t) ({}_{t-1}z_x)$$

$$DIV = \sum_{t=1}^n [{}_tD_x + ({}_{t-1}TD_x) (q_{x+t-1})] (v^t) ({}_{t-1}z_x)$$

and, n = duration of index, here 20 years from date of issue.

x = issue age.

${}_tF_x$ = annual premium at beginning of year t for issue age x .

${}_tCV_x$ = cash value at end of year t for issue age x , excluding any terminal dividend payable upon surrender.

${}_tD_x$ = annual dividend at end of year t for issue age x .

${}_{t-1}TD_x$ = terminal dividend payable on surrender at the end of year t for issue age x

${}_tTD_x$ = terminal dividend payable on death in year t for issue age x .

F = amount payable on death, excluding terminal dividend (assumed constant).

i = assumed rate of interest (here 5 percent).

d
 $q_{x+t-1} =$ probability a person age $x+t-1$ will die before age $x+t$

$$v^t = \frac{1}{(1+i)^t}$$

${}_t-1p_x =$ probability of surviving and persisting from age x to age $x+t-1$

$$= \prod_{s=1}^{t-1} (1 - q_{x+s-1} - w_{x+s-1})$$

where, $q_{x+s-1} =$ probability a person age $x+s-1$ will lapse or surrender before age $x+s$.

and $\prod_{s=1}^{t-1} f(s) =$ the product of some function of s , where $s=1,2,3, \dots$

and ${}_0p_x = 1$.

2. The n th year Average Annual Rate of Return (Linton Yield).

This rate of return is calculated by recursively solving the following system of simultaneous equations.

(a) ${}_tBFUND_x = {}_{t-1}EFUND_x + {}_tP_x - {}_{t-1}D_x$

(b) ${}_tPROT_x = {}_tF_x - {}_tBFUND_x$

(c) ${}_tEFUND_x = ({}_tBFUND_x - {}_tTCHG_x) (1+r)$

(d) ${}_tTCHG_x = \frac{({}_tPROT_x) ({}_tYRT_x) (.001)}{1 - [({}_tYRT_x)(.001)]}$

(e) ${}_nEFUND_x = {}_nCV_x$

The last equation (e) is solved for that rate of return (r) that makes the quality (e) hold. These five equations may be combined to produce the following polynomial, which will be familiar to those who use internal rates of return.

$${}_nCV_x = \frac{\sum_{t=1}^n (1+r)^t [{}_n-t+1P_x - {}_n-tD_x - (F)({}_n-t+1YRT_x)(.001)]}{\prod_{j=1}^n [1 - ({}_n-j+1YTR_x)(.001)]}$$

where

${}_tP_x$, ${}_{t-1}D_x$ and ${}_nCV_x$ are as defined in (1) above, and

${}_tBFUND_x =$ savings fund at the beginning of year t

${}_tEFUND_x =$ savings fund at the end of year t

${}_tPROT_x =$ insurance protection needed in year t

${}_tTCHG_x$ = term insurance charge for insurance protection
in year t

${}_tYRT_x$ = yearly renewable term premium per \$1000 at
attained age $x+t-1$

r = the rate of return to be solved for.

3. Cash accumulation method

1. Death benefits are to be the same at the beginning of each year whether one buys the whole life policy or the term plus saving fund package.

$$F_t = PROT_t + E_{t-1} + d_t$$

where F_t = face amount of the whole life policy in year t (in
dollars)

$PROT_t$ = face amount of annual renewable term insurance bought at
beginning of year t (in dollars)

E_t = the amount of dollars in the side fund at the end of
year t .

d_t = the "deposit" in the side fund made at the beginning
of year t (in dollars).

Equation can be solved for the protection amount,

$$(1') \quad \text{PROT}_t = \begin{cases} F_t - (E_{t-1} + d_t), & \text{if } F_t > E_{t-1} + d_t \\ 0, & \text{if } F_t \leq E_{t-1} + d_t \end{cases}$$

The above form takes explicit account of the fact that one buys no further term insurance once the savings fund equals or exceeds the face amount of the whole life policy. Beyond this point, one of the fundamental conditions mentioned above is violated, namely, the death benefits under the term plus side fund option exceed those under the whole life option.

2. Cash outlays are the same for both options.

$$(2) \quad (P_t - D_{t-1}) \cdot F_t = \text{TR}_t \cdot \text{PROT}_t + d_t$$

where P_t = the premium on the whole life policy in year t in dollars per dollar of face amount.

D_t = dividend paid at the end of year t on the whole life policy, in dollars per dollar of face amount.

TR_t = the premium rate for annual renewable term insurance in year t , in dollars per dollar of face amount.

3. Side fund accumulation.

$$(3) \quad E_t = (E_{t-1} + d_t) (1 + r)$$

where r = the assumed rate of interest.

The above equations can be solved simultaneously to obtain a single expression for E_t in terms of the basic policy parameters.

i. Using equation 1', substitute for PROT_t in equation (2).

$$d_t = (P_t - D_{t-1}) \cdot F_t - \text{TR}_t \cdot (F_t - E_{t-1} - d_t)$$

or,

$$(4) \quad d_t = \frac{(P_t - D_{t-1} - \text{TR}_t) \cdot F + \text{TR}_t \cdot E_{t-1}}{1 - \text{TR}_t}$$

ii. Now substitute d_t from equation (4) into equation (3).

$$E_t = \frac{(P_t - D_{t-1} - TR_t) \cdot F_t + TR_t \cdot E_{t-1} + E_{t-1} - TR_t E_{t-1}}{1 - TR_t} \\ \times (1 + r)$$

or,

$$(6) \quad E_t = \frac{E_{t-1} (1 + r)}{1 - TR_t} + \frac{(P_t - D_{t-1} - TR_t) \cdot F (1 + r)}{1 - TR_t}$$

Note that (6) is in a very convenient recursive form for computer computation.

iii. Using (6), you can solve for E_{t-1} in terms of E_{t-2} and the basic parameters. Continuing the process, you obtain an expression for E_t in terms of E_1 and the basic parameters. Now solve for E_1 :

$$E_1 = d_1 (1 + r) \quad \text{since } E_0 = 0$$

from equation (4),

$$d_1 = \frac{(P_1 - TR_1) \cdot F_1}{1 - TR_1} \quad \text{since } D_0 = 0$$

hence,

$$E_t = \frac{(P_t - TR_t - D_{t-1}) \cdot F_t (1 + r)}{1 - TR_t} \\ + \frac{(P_{t-1} - TR_{t-1} - D_{t-2}) \cdot F_{t-1} (1 + r)^2}{(1 - TR_t) (1 - TR_{t-1})} \\ + \dots \\ + \frac{(P_1 - TR_1) \cdot F_1 (1 + r)^t}{(1 - TR_t) (1 - TR_{t-1}) \dots (1 - TR_2) (1 - TR_1)}$$

or more compactly,

$$(7) \quad E_t = \sum_{j=1}^t \frac{a_j \cdot (1+r)^{t-j+1}}{\prod_{i=j}^t (1-TR_i)} \quad \text{where } a_j = (P_j - D_{j-1} - TR_j)$$

where $\prod_{i=j}^t f(i)$ = the product of some function of i ,
 where $i=j, j+1, \dots, t$

4. E_t from equation (7) should be compared to $(CV_t + TD_t + D_t)$
 F_t for the whole life policy, where

CV_t = cash value of whole life policy at end of year t , in dollars per dollar of face amount.

TD_t = terminal surrender dividend of whole life policy at end of year t , in dollars per dollar of face amount.

MORTALITY RATES (PER 1,000) USED IN COST COMPARISON METHODS

<u>Policy Year</u>	<u>Issue Age 25</u>	<u>Issue Age 35</u>	<u>Issue Age 45</u>	<u>Issue Age 55</u>
1	.53	.71	1.81	3.72
2	.63	.89	2.48	5.37
3	.77	1.16	3.11	7.32
4	.80	1.32	3.69	8.67
5	.80	1.48	4.17	9.47
6	.81	1.70	4.85	11.22
7	.85	1.99	5.49	13.13
8	.88	2.26	6.10	14.34
9	.96	2.59	6.70	15.58
10	1.05	2.98	7.50	17.41
11	1.17	3.37	8.38	19.08
12	1.27	3.91	9.66	22.55
13	1.40	4.47	11.11	26.44
14	1.57	5.04	12.65	30.72
15	1.72	5.71	14.45	35.34
16	1.91	6.25	15.92	38.61
17	2.12	6.80	17.60	41.80
18	2.39	7.49	19.45	44.96
19	2.72	8.28	21.38	48.35
20	3.10	9.08	23.25	52.34
21	3.56	9.90	25.19	
22	4.06	10.85	27.31	
23	4.58	11.93	29.74	
24	5.14	13.14	32.33	
25	5.71	14.45	35.34	
26	6.25	15.92	38.61	
27	6.80	17.60	41.80	
28	7.49	19.45	44.96	
29	8.28	21.38	48.35	
30	9.08	23.25	52.34	
31	9.90	25.19		
32	10.85	27.31		
33	11.93	29.74		
34	13.14	32.33		
35	14.45	35.34		
36	15.92	38.61		
37	17.60	41.80		
38	19.45	44.96		
39	21.38	48.35		
40	23.25	52.34		
41	25.19			
42	27.31			
43	29.74			
44	32.33			
45	35.34			
46	38.61			
47	41.80			
48	44.96			
49	48.35			
50	52.34			

MODIFIED MOORHEAD TABLE 5 LAPSE RATES USED IN COST COMPARISON METHODS

<u>Policy Year</u>	<u>Issue Age 25</u>	<u>Issue Age 35</u>	<u>Issue Age 45</u>	<u>Issue Age 55</u>
1	.2250	.2250	.2250	.2250
2	.0450	.0450	.0450	.0450
3	.0350	.0350	.0350	.0350
4	.0300	.0300	.0300	.0300
5	.0275	.0275	.0275	.0275
6	.0260	.0260	.0260	.0260
7	.0250	.0250	.0250	.0250
8	.0245	.0245	.0245	.0245
9	.0240	.0240	.0240	.0240
10	.0235	.0235	.0235	.0235
11	.0230	.0230	.0230	.0230
12	.0225	.0225	.0225	.0225
13	.0220	.0220	.0220	.0220
14	.0215	.0215	.0215	.0215
15	.0210	.0210	.0210	.0210
16	.0205	.0205	.0205	.0205
17	.0200	.0200	.0200	.0200
18	.0190	.0190	.0190	.0190
19	.0180	.0180	.0180	.0180
20	.0170	.0170	.0170	.0170
21	.0160	.0160	.0214	
22	.0150	.0150	.0248	
23	.0150	.0150	.0282	
24	.0150	.0150	.0316	
25	.0154	.0150	.0350	
26	.0174	.0180	.0380	
27	.0193	.0210	.0410	
28	.0212	.0240	.0440	
29	.0230	.0270	.0470	
30	.0250	.0300	.0500	
31	.0260	.0320		
32	.0270	.0340		
33	.0280	.0360		
34	.0290	.0380		
35	.0300	.0400		
36	.0300	.0420		
37	.0300	.0440		
38	.0300	.0460		
39	.0300	.0480		
40	.0300	.0500		
41	.0320			
42	.0340			
43	.0360			
44	.0380			
45	.0400			
46	.0420			
47	.0440			
48	.0460			
49	.0480			
50	.0500			

YEARLY RENEWABLE TERM PREMIUMS PER \$1000 FOR \$25,000 POLICY (INCLUDING POLICY FEE)*

<u>Age</u>	<u>Low Scale</u>	<u>Average Scale</u>	<u>High Scale</u>
25**	\$ 2.97	\$ 3.39	\$ 3.80
26**	2.97	3.39	3.80
27**	2.97	3.39	3.80
28**	2.97	3.39	3.80
29	2.97	3.39	3.80
30	2.99	3.41	3.82
31	3.06	3.48	3.90
32	3.12	3.54	3.97
33	3.15	3.59	4.02
34	3.17	3.61	4.04
35	3.23	3.67	4.11
36	3.32	3.76	4.21
37	3.42	3.88	4.34
38	3.56	4.04	4.51
39	3.71	4.21	4.70
40	3.91	4.43	4.94
41	4.14	4.68	5.21
42	4.43	4.99	5.56
43	4.77	5.37	5.97
44	5.18	5.82	6.47
45	5.66	6.36	7.05
46	6.18	6.94	7.69
47	6.74	7.54	8.35
48	7.32	8.20	9.07
49	7.92	8.86	9.79
50	8.49	9.49	10.48
51	9.08	10.14	11.19
52	9.80	10.94	12.07
53	10.64	11.86	13.08
54	11.49	12.79	14.10
55	12.35	13.75	15.15
56	13.36	14.86	16.37
57	14.50	16.12	17.75
58	15.77	17.53	19.29
59	17.16	19.06	20.97
60	18.71	20.77	22.84
61	20.47	22.73	24.98
62	22.43	24.89	27.35
63	24.46	27.14	29.81
64	26.44	29.32	32.20
65	28.49	31.59	34.69
66	30.72	34.06	37.39
67	33.29	36.89	40.50
68	36.02	39.92	43.81
69	39.21	43.43	47.66
70	42.66	47.25	51.84
71	46.03	50.97	55.92
72	49.36	54.66	59.95
73	52.93	58.61	64.28
74	57.15	63.27	69.38

* To obtain per \$1000 premiums for \$5,000 policy add \$4;
for \$10,000 policy add \$1.50; for \$100,000 policy
deduct \$.75.

** Premiums for x < 29 equal premium for x = 29.

PROGRAM: LINTON

(Linton Yield Program)

1. Introduction

The funds used to purchase a whole life insurance policy are used instead to purchase term insurance with the remainder deposited in a savings account, such that the total of term insurance plus savings fund at the beginning of year equals the face amount of the whole life insurance policy. The Linton yield is the rate of interest which would have to be paid on the savings deposits to equate the savings balance at the end of the N^{th} year to the N^{th} year cash value of the whole life policy.

Mathematically, the following recursive equation is solved for r :

$$E_t = (E_{t-1} + (P_t - D_t - Y_t)F_t)(1+r)/(1-.001Y_t)$$

$t = 1, \dots, N$

subject to $(C_N + D_N + T_N)F_N = E_N$

where r is the Linton yield and

E_t is the value in dollars of the savings account in time t ,

and $E_0 = 0$,

P_t is the whole life insurance premium in time t , expressed in cost per thousand dollars of face value

D_t is the dividend per thousand dollars of face value in time t , and $D_0 = 0$

Y_t is the term insurance premium in time t , expressed in cost per thousand dollars of face value.

F_t is the face value of the policy in time t , expressed in thousands of dollars.

N is the time period for which the yield is computed

C_N is the cash value of the whole life policy in year N , per thousand dollars of face value

T_N is the terminal dividend in year N , per thousand dollars of face value

The Linton yield program calculates r using the Mueller iteration method, given user-supplied policy issue age, whole life premium, dividends, face value and cash value. The last variable includes any terminal dividends. Optionally, the user may supply term rates, the time periods for which the returns are to be computed, upper and lower bounds for the Linton yield, a tolerance level of the estimate, the number of iterations, and if more than one set of data is used, whether these options change for subsequent data sets. In addition, the option cards may be on a separate file from the data sets.

At least one option card must be supplied. If a field on the option card is blank, default values are assumed. If the same options are to apply to all data sets in the job, only one option card need be supplied.

OPTION CARD FORMAT

<u>COLS</u>	<u>VARIABLE</u>	<u>DESCRIPTION</u>	<u>DEFAULT VALUE</u>
1-2	IYR	Number of years of data in the data set(s)	20
3-4 5-6 7-8	IPER	The period(s) for which the yield(s) is (are) to be computed. Up to 3 periods may be selected (but see note on cash value on DATA SET FORMAT). If fewer than 3 periods are selected, enter the periods in the leftmost fields. For example, if returns are to be computed for 15 and 20 years, enter '15' in cols 3-4, '20' in cols 5-6 and nothing in cols 7-8	5 10 20
9-16	XLI*	Leftmost bound of yield	-1.0 (-100%)
17-24	XRI*	Rightmost bound of yield	.10 (+10%)
25-32	EPS*	Tolerance level of the estimate (i.e., $ (C_N + D_N + T_N)F_N - E_N < EPS$)	.001
33-35	IEND	Number of iterations	20
36	IART	If zero or blank, term rates are calculated for issue age 25, 35, 45 or 55 from mortality tables in core using the following formula: $Y_t = .95M_{t,a} + .90 + 25000/F_t$ where $M_{t,a}$ is the entry in the mortality table for year t, age a If 1, a mortality table is to be read in following this option card, and term rates are to be calculated as above If 2, term rates are to be read in with the data set, and there is no age restriction.	See default mortality

OPTION CARD FORMAT (cont'd)

<u>COLS</u>	<u>VARIABLE</u>	<u>DESCRIPTION</u>	<u>DEFAULT VALUE</u>
37	IFV	If zero or blank, face value is fixed over time If 1, face value changes over time	
38	IPREM	If zero or blank, premium is level over time If 1, premium changes over time	
39	IOPT	If zero or blank, no more option cards are to be read If 1, an option card is to be read for the subsequent data set	
40	IT	This is used only if the data sets are not on the same file as the option cards If zero or blank, yields are to be computed for all years for which data are available If 1, yields are to be computed for periods determined by IPER	

* If any of these fields are overridden, the decimal point must be keyed in explicitly.

DEFAULT MORTALITY RATES USED WHEN IART=0

Policy Year	Issue Age 25	Issue Age 35	Issue Age 45	Issue Age 55
1	.53	.71	1.81	3.72
2	.63	.89	2.48	5.37
3	.77	1.16	3.11	7.32
4	.80	1.32	3.69	8.67
5	.80	1.48	4.17	9.47
6	.81	1.70	4.85	11.22
7	.85	1.99	5.49	13.13
8	.88	2.26	6.10	14.34
9	.96	2.59	6.70	15.58
10	1.05	2.98	7.50	17.41
11	1.17	3.37	8.38	19.08
12	1.27	3.91	9.66	22.55
13	1.40	4.47	11.11	26.44
14	1.57	5.04	12.65	30.72
15	1.72	5.71	14.45	35.34
16	1.91	6.25	15.92	38.61
17	2.12	6.80	17.60	41.80
18	2.39	7.49	19.45	44.96
19	2.72	8.28	21.38	48.35
20	3.10	9.08	23.25	52.34
21	3.56	9.90	25.19	
22	4.06	10.85	27.31	
23	4.58	11.93	29.74	
24	5.14	13.14	32.33	
25	5.71	14.45	35.34	
26	6.25	15.92	38.61	
27	6.80	17.60	41.80	
28	7.49	19.45	44.96	
29	8.28	21.38	48.35	
30	9.08	23.25	52.34	
31	9.90	25.19		
32	10.85	27.31		
33	11.93	29.74		
34	13.14	32.33		
35	14.45	35.34		

DEFAULT MORTALITY RATES (cont'd)

Policy Year	Issue Age 25	Issue Age 35	Issue Age 45	Issue Age 55
36	15.92	38.61		
37	17.60	41.80		
38	19.45	44.96		
39	21.38	48.35		
40	23.25	52.34		
41	25.19			
42	27.31			
43	29.74			
44	32.33			
45	35.34			
46	38.61			
47	41.80			
48	44.96			
49	48.35			
50	52.34			

OPTIONAL MORTALITY TABLE FORMAT (used when IART=1)

If an optional mortality table is to be read in, the data for an age is read with one FORTRAN read statement using a format of 11X,17F4.2. The number of observations read in for an age is the minimum of the number of years specified in IYR (see OPTION CARD FORMAT, above) and 75 minus the age, for example, if IYR is 30, then 30 observations would be read for ages 25, 35 and 45 and 20 observations for age 55. All data is assumed to be available.

Example of optional mortality table data for IYR = 30:

EXAMPLE

COLS. 1-11

COLS. 12-79

ANYTHING	50 60 80 80 80 80 90 90 100 110 120 130 140 160 170 190 210
YOU WANT	240 270 310 360 410 460 510 570 630 680 750 830 910
MAY APPEAR	70 90 120 130 150 170 200 230 260 300 340 390 450 500 570 630 680
IN THESE	750 830 910109011901310145015901760195021402330
COLUMNS	180 250 310 370 420 490 550 610 670 750 840 97011101270145015901760
THEY ARE	1950214023302520273029703230353038704180450048405730
NOT READ	370 540 730 880 950112013101430156017401910226025403070353038604180
BY PROGRAM	450048405230

The optional mortality table follows the option card which specified that the table is to be read.

<u>COLS.</u>	<u>VARIABLE</u>	<u>DESCRIPTION</u>
1-11		These columns are not read and may contain comments, if desired.
12-15	ART(Year, Age)	For each age, 25, 35, 45 and 55, use as many cards as needed to contain mortality data. The decimal point is assumed to be between the second and third column of each field. Each age starts on a new card.
16-19		
20-23		
24-27		
28-31		
32-35		
36-39		
40-43		
44-47		
48-51		
52-55		
56-59		
60-63		
64-67		
68-71		
72-75		
76-79		
80		blank

DATA SET FORMAT

If the data sets are to be read from the same file as the option cards, the following formats apply:

The first card contains a company number, form number of the policy, kind of policy, issue age, and up to three cash values, which correspond to the last year(s) of the period(s) for the Linton yield calculation(s). The FORTRAN format statement is I3,A4,A2,I2,3F8.2. If the three cash values are blank or zero, then it is assumed that the Linton yield calculations are to be performed for each year from year 1 through IYR, and the next set of cards following the first card contains the cash values from years 1 to IYR. The FORTRAN format statement which reads this data is 11X,8F8.2.

The next set of cards contain the face value. If the face value is constant (IFV=0 or blank on the option card) only the one face value is keyed in columns 12-19, otherwise this set of cards contains the face values from years 1 through IYR. The FORTRAN format statement which reads the face values is 11X,8F8.0.

Following the face value is the set of premiums. If the premium payment is level (IPREM=0 or blank on the option card), only one premium is keyed in columns 12-15, otherwise this set contains the premiums from years 1 through IYR. The FORTRAN format statement which reads the premiums is 11X,17F4.2

Following premiums is the set of dividends for years 1 through IYR. The FORTRAN format statement which reads the dividends is 11X,17F4.2.

IDENTIFICATION RECORD

COLS	VARIABLE	DESCRIPTION
1-3	ICO	Company number (numeric)
4-7	IFORM	Policy form number (alphameric)
8-9	IKIND	Kind of policy (alphameric)
10-11	IAGE	Issue age (numeric)
12-19	CV(1) --	Cash values per thousand
20-27	CV(2) --	dollars of face value corresponding
28-35	CV(3) --	to the last year(s) of the periods for the Linton Yield calculations. The decimal point is assumed between the 6th and 7th column of each field. If columns 12-35 are blank or zero, it is assumed that cash values for all years follow this card.

CASH VALUES

COLS	VARIABLE	DESCRIPTION
1-11		These columns are not read and may contain comments if desired.
12-19	CV(year)	Cash values per thousand dollars of face value. Use as many cards as needed to contain the data. The decimal point is assumed between the 6th and 7th column of each field.
20-27	"	
28-35	"	
36-43	"	
44-51	"	
52-59	"	
60-67	"	
68-75	"	
76-80	blank	

FACE VALUES

COLS	VARIABLE	DESCRIPTION
1-11		These columns are not read and may contain comments if desired
12-19	FV(1) or FV(year)	Face values in dollars. Use as many cards as needed to contain the data. No decimal point is assumed.
20-27	blank or FV(year)	
28-35	"	
36-43	"	
44-51	"	
52-59	"	
60-67	"	
68-75	"	
76-80	blank	

PREMIUMS

COLS	VARIABLE	DESCRIPTION
1-11		These columns are not read and may contain comments if desired
12-15	PREM(1) or PREM(year)	Premiums per thousand dollars of face value. Use as many cards as needed to contain the data. The decimal point is assumed between the second and third column of each field.
16-19	"	
20-23	"	
24-27	"	
28-31	"	
32-35	"	
36-39	"	
40-43	"	
44-47	"	
48-51	"	
52-55	"	
56-59	"	
60-63	"	
64-67	"	
68-71	"	
72-75	"	
76-79	"	
80	blank	

DIVIDENDS

COLS	VARIABLE	DESCRIPTION
1-11		These columns are not read and may contain comments if desired
12-15	DIV(year)	Dividends per thousand dollars of face value. Use as many cards as needed to contain the data. The decimal point is assumed between the second and third column of each field.
16-19	"	
20-23	"	
24-27	"	
28-31	"	
32-35	"	
36-39	"	
40-43	"	
44-47	"	
48-51	"	
52-55	"	
56-59	"	
60-63	"	
64-67	"	
68-71	"	
72-75	"	
76-69	"	
80		blank

TERM PREMIUMS

COLS	VARIABLE	DESCRIPTION
1-11		These columns are not read and may contain comments if desired
12-15	ART2(year)	Term premiums per thousand dollars of face value. Use as many cards as needed to contain the data. The decimal point is assumed between the second and third column of each field.
16-19	"	
20-23	"	
24-27	"	
28-31	"	
32-35	"	
36-39	"	
40-43	"	
44-47	"	
48-51	"	
52-55	"	
56-59	"	
60-63	"	
64-67	"	
68-71	"	
72-75	"	
76-79	"	
80		blank

If the option cards are read from a separate file from the data sets, then a subroutine called READT must be supplied which reads input from unit 10. The subroutine must supply values for the same variables listed above and must have two returns, one a RETURN and the other a RETURN 1 which indicates end of file on the data set.

Each call to the subroutine returns a new data set; these values are transmitted in labelled common blocks. The form of the subroutine is

```
SUBROUTINE READT(*)  
COMMON/COM1/PREM(50),DIV(51),FV(50),CV(50)  
COMMON/COM4/IYR,IPER(3),XLI,XRI,EPS,IEND,IART,IOPT,IFV,IPREM  
COMMON/COM5/ITEMP(50),IPIND,NPER,XNA,IYIND,IY,IREPT  
COMMON/COM7/ICO,IFORM,IAGE,IKIND  
REAL*8 PREM,DIV,FV,CV,XLI,XRI,XNA,ART2
```

Subroutine

.

.

RETURN

end of file routine

RETURN 1

Note that dividends are dimensioned 51. This is because the dividends lag the other variables by one period. The dividends for years 1 through IYR are stored in DIV(2) through DV(IYR+1). DIV(1) is set to zero in a block common subroutine.

IYIND and IY are used to convey to the main program the number of years to use. If IYIND is zero, the number of years is taken from IYR (specified on option card), otherwise the number of years is given by IY.

ITEMP, NPER and IPIND convey the time periods to the main program. If IT (specified on option card) is not zero, then NPER is set to 3 and ITEMP (1), (2) and (3) as determined by the option card.

If IT is zero, then NPER=IY and ITEMP(I)=(I) for I from 1 through IY.

If IPIND is not zero, this indicates that these values have been set by the subroutine and that they are not to be changed in the main program.

The subroutine READT that exists in program LINTON reads the HART insurance file. The subroutine READT in program LINTON77 reads the FTC insurance files.

APPENDIX VII: LIFE INSURANCE AGENTS

Part III of the report discusses the impact of the agent and the importance of the two-tier commission structure. This Appendix provides additional information concerning the number of agents, their incomes, and commission structures.

LIMRA statistics indicate that there were approximately 287,000 full time life insurance agents in the United States in 1975. These can be broken down as follows:

Table 1

Full-Time Life Insurance Agents, 1975¹

Full-time Career Ordinary Agents	145,000
Personal Producing General Agents	16,000
Multiple Line Exclusive Agents	39,000
Combination Agents	<u>87,000</u>
Total	287,000

In addition, there were approximately 42,000 part-time agents and 48,000 district heads, managers and supervisors. Women accounted for 4 percent of the sales force in 1975.

¹ Table assimilated from data in LIMRA publications, Census of Life Insurance Sales Personnel 2, 6 (1976), and Census of Life Insurance Sales and Support Personnel 2 (1975). The latter publication indicates that companies define such terms as "full time" and "life insurance agent" in different ways. Id. at 6. No attempt was made to standardize different definitions for purposes of this table.

Table 2

1973 Total Personal Income of Full-Time Ordinary
U.S. Agents 2

Time in Business	Less than \$10,000	\$10,000- 14,999	\$15,000- 19,999	\$20,000- 24,999	25,000+
1 - 3 years	39%	35%	14%	6%	6%
3 - 5 years	24	17	30	8	21
5 years +	4	12	20	13	51

Additional data comes from a study of agent income made by a relatively large mutual company located in the Northeast in 1974. Table 3 gives average incomes for this company's agents by number of years in the business. The data is generally consistent with data from Table 2.

2

First Report of the Industry Advisory Council Committee to the Agents' Compensation Systems Task Force of the NAIC C-3 Life Insurance Subcommittee, 34 (1976) (hereinafter cited as Agents Report]. This table refers to agents with 75-100 percent of their income from the sale of individual life insurance and/or annuities. It is based on the Survey of Agent Opinion conducted by the NALU and LIMRA in 1974. Approximately 1,300 among 5,500 randomly selected agents elected to respond to the survey.

Table 3

1974 Income of Agents of One Large Mutual³

<u>Number of Years in Business</u>	<u>Average Total Income from all Insurance Sources</u>
1 but less than 3 years	\$11,344
3 but less than 5 years	14,934
5 but less than 10 years	25,115
10 but less than 20 years	32,188
20 years or more	46,611

Due to inflation agents' incomes have probably increased substantially since 1973 and 1974.⁴ On the other hand, the data in Table 2 and 3 represent gross income. Approximately 30 percent of this income must be used to meet business expenses.⁵ Therefore, the data in Tables 2 and 3 representing agents' gross incomes in 1973 and 1974 probably come reasonably close to approximating their net incomes in 1979.

³ Agent's Report, supra n. 2 at 36.

⁴ The Consumer Price Index increased 52 percent from 1973 to November 1978, and 37 percent from 1974 to November 1978. Economic Report of the President 239 (1979).

⁵ Agent's Report, supra n. 2 at 38. A million dollar round table survey showed that expenses accounted for approximately 36 percent of earnings for agents earning less than \$25,000 and 32 percent of earnings for agents earning more. The company providing data for Table 3 estimated expenses to be between 20 and 30 percent of earnings for its agents.

As noted in Part III.E.2 there is an extremely high turnover rate among agents. LIMRA research indicates that in 1975 28 percent of the agent sales force "turned over" from the beginning of the year to its end, 39 percent of agents were in their first year, and only 14 percent of agents who had entered the profession four years earlier were still in it.⁶ Therefore, a large majority of agents are relatively inexperienced and most must struggle to earn a living. As discussed in Part III these facts exacerbate the impact of the two-tier commission structure.

The remainder of this Appendix consists of an analysis of agent contracts submitted to Hart's Subcommittee in 1974. There is a great deal of variance among companies with regard to both commission schedules and vesting policy.

First year commissions on one, five and ten year term policies range from 15 to 60 percent, with most companies falling in the 30 to 45 percent range. Renewal commissions are generally 4 to 7 percent for the first ten years. However, some companies pay high second-year commission (10 to 15 percent), others pay higher commissions on specific renewals (such as the 6th and 11th years of renewable term policies), and others pay first year rates on renewals, based on the increase in premiums.

6

LIMRA, The Manpower and Production Survey 10 (1975).

First year commissions on whole life policies are generally in the 35 to 75 percent range, with 55 percent most common. First year commissions tend to be higher for companies not licensed in New York State. The most common renewal schedule is 5 percent in years two through ten. However, most companies deviate from this pattern in one way or another. Many pay larger commissions in years two and three, smaller in later years.

Companies vary substantially in their vesting policies. Some companies vest commissions immediately. Others require 20 years of service before renewal commissions are fully vested. Often conditions for vesting are tied to sales performance. All companies make some kind of exception for death or retirement if commissions would not otherwise be fully vested.

Table 4 provides a detailed company-by-company breakdown of commission schedules and vesting policy for whole life and term policies in 1973.

Table 4 - Company-by-Company Breakdown of Commission Schedules and Vesting Policy in 1973
Term Policies

COMPANY	NO.	POLICY	FIRST YEAR	RENEWAL COMMISSIONS											
				2	3	4	5	6	7	8	9	10			
Aetna Life Insurance Co.	002	5-Yr. Renewable & Convertible Policy	40%				5%		25%		5%				
All American Life & Casualty Co.	005	1-Yr. Renewable Term to Age 70	30 to 50%				5%				5%				
American General Life Ins. Co.	011	1-, 5-, 10-, 15-Year Term & Term to 30	45%				35%		10%		5%		35%		5%
American Heritage Life Ins. Co.	012	1-Yr. Renewable & Convertible Term	15%				4%				4%				
American National Insurance Co.	015	5, 10, 15-Yr. policies & riders	32%				8%								
American United Life Ins. Co.	019	5-Yr. Renewable Term	25%				5%				2%				Additional commission of 15% on renewal premium of 6th & 11th yr.
Bankers Life & Casualty Co.	020	5-Yr. Level Renewable & Convertible Term	35%				10%	2%		20%		2%			
Bankers Life Company	021	5 & 10 Yr. Convertible & 5-Yr. Renewable & Convertible Age 45 Age 45	40%				6%	4%		4%					
Bankers National Life Ins. Co.	023	5-Yr. Renewable & Convertible Term	37%				5%				5%				
Central Life Assurance Company	032	Yearly Renewable Term Policy	40%				7%				7%				No. of renewal commissions is a function of 1st yr. commissions paid in contract yr.

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L-III-7

COMPANY	NO.	POLICY	FIRST YEAR	RENEWAL COMMISSIONS											
				2	3	4	5	6	7	8	9	10			
Coastal States Life Ins. Co.	036	5-Yr. Term Renewable & Convertible	35%	15%	7½%					7½%					No renewal commissions on Term plans for less than \$5000.
Combine Insurance Co. of Am.	043	Little Giant Life Ins. Policies	\$7 for each \$2400 face value policy, plus 20% of the first semi-annual premium collected by agent.												Renewals: 10% of all premiums collected by the representative
Commercial Union Life Ins. Co. of America	045	5-Yr. Convertible & Renewable	40%	5%	5%			20%		5%					
Connecticut General Life Insurance Company	048	5-Yr. Renewable & Convertible Term Age 50 Age 50	31%	9%	6%	4%	4%	see box at rt.		2%					Commission in a renewal yr. will = ½ the 1st yr. rate applicable at insured's age.
Connecticut Mutual Life Ins. Co.	049	5-Yr. Renewable Term	30%	8%	4%			4% Fees on 1st & subsequent renewable premiums		2%					
Covenant Life Insurance Co.	Not On List	5-Yr. Renewable & Exchangeable Term	45%		5%					5%					A non-vested service fee = to 45% of the 1st renewal premium will be paid in 6th renewal yr.
Equitable Life Assurance Society of the United States	054	5-Yr. Renewable Term	17½%		5%				10%	5%					1th & later policy yr. 2%
Farmers New World Life Ins. Group	059	5-10-Yr. Renewable & Convertible Term	50%		10%	5%				50%					

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COMPANY	NO.	POLICY	FIRST YEAR	RENEWAL COMMISSIONS															
				2	3	4	5	6	7	8	9	10							
Fidelity Life Association &/or Federal Kemper Life Ins. Co.	Not On List	5-Yr. Renewable & Convertible Term	50%	10%	5%														
Franklin Life Ins. Co. of Springfield	063	Term Policies	15 to 50%																No renewal commission on policies of 5-yrs. or less
General Services Life Ins. Co.	065	Decreasing Term 15, 20, 25 Yr.	40%																Monthly Income & Pro- duction Bonuses Provided
General United Life Insurance Co	066	5-Yr. Renewable & Convertible Term	25%	10%	5%														
Georgia International Life Ins. Company	068	10-Yr. Convertible Level Term	40%	10%	5%														
Globe Life & Accident Ins. Co.	069	Convertible & Renewable Term	40 to 50%		5%														
Hamilton National Life Ins. Co.	079	Level Term Life	15 to 80%		7%														Premiums payable: 1) pre- miums payable
Home Life Insurance Co.	082	5-Yr. Renewable Term (\$5000 min)	35%		35%*														*On increase in premium
International Life Insurance Company of Buffalo	Not On List	Term*	35 to 50%		5%														Commission on 5-yr. re- newable & convertible term in 6th yr. is same as 1st yr. On 4yr. rec. & convt., it will be same as 1st yr. in the 5th.

COMPANY	NO.	POLICY	FIRST YEAR	RENEWAL COMMISSIONS												
				2	3	4	5	6	7	8	9	10				
Jefferson National Life Ins. Co.	094	5-Yr. Renewable & Convertible Term	30%													1st yr. 1% payable on each 5th yr. renewal
Jefferson Standard Life Ins. Co.	095	5-Yr. Renewable & Convertible Term	40%	* 4%	4%	2%	2%									
John Hancock Mutual Life Ins. Co.	096	5-Yr. & 5-Yr. Renewable Term	35%	7%	5%											See sect. 21 in spec. agent's commission agreement
LaFayette Life Ins. Co.	101	5-Yr. Convertible Term	45%	6%	4.5%	4.5%										
The Lahar Life Ins. Co.	102	5-Yr. Renewable & Convertible Term	60%	41*												Additional commissions of 36% in the 6th policy yr.

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VII-10

COMPANY	NO.	POLICY	FIRST YEAR	RENEWAL COMMISSIONS										
				2	3	4	5	6	7	8	9	10		
Liberty National Life Ins. Co.	104	5 & 10 Yr. Convertible Term	45%				5%					5%		
Lincoln National Life Ins. Co.	115	5, 10 & 15 Yr. Convertible Term & 5-Yr. Renewable Term	30 to 35%				5%	5%				5%		
Minnesota Mutual Life Ins. Co.	125	1-Yr. Renewable & Convertible Term	10%				10%							
Mutual Benefit Life Ins. Co.	129	1 & 5 Yr. Renewable Term Ins.												See contract for renew commission & formula in in Tables 3 & 4. No 1st yr. rates given.
Mutual Life Insurance Company of New York	130	5-Yr. renewable term	35%*				5%	5%				5%		*Renewal commission at the 1st yr. commission rate applies to increase in premium & rate of re- newable commission
National Investors Life Ins. Co.	134	5-Yr. renewable & convertible Term	30%				5%	3%				3%		
National Life Insurance Co.	137	Term Policies	30%				5%					50%		
National Old Line	138	5-Yr. Term, renewable convertible	40%				4%					4%		
Nationwide Life Ins. Co.	142	5-Yr. Term	35%				3%					3%		
New England Mutual Life Ins. Co.	143	Renewable & Convertible Term at issue & subject to increase in premium at renewal	35%				5%					5%		See Commission schedule for more information
Massachusetts Mutual Life Ins. Co.	119	Term Policies	31.5%				5%					5%		In yrs. of renewal, the 1st yr. commission rate applies only to the in- crease in premium. Renew al rates apply to balance

COMPANY	NO.	POLICY	FIRST YEAR	RENEWAL COMMISSIONS										
				2	3	4	5	6	7	8	9	10		
Metropolitan Life Insurance Co.	120	Level-Term-Renewable, Convertible Other than 1-yr. Term	25 to 45%	10%					10%					
Northwestern National Life Ins. Co.	148	5-Yr. Renewable & Convertible Term	40%	15%	5%	2%								
North Atlantic Investors Life Insurance Company	Not On List	5-Yr. Convertible Term	60%	5%					0%					
New York Life Insurance Co.	144	5-Yr. Renewable Term	40%	5%					5%					Age of issuer determines the number of renewals allowed.
Occidental Life Insurance Co. of California	149	5-Yr. Convertible & Renewable Term Policy	50%	5%										See section on commission modification.
Ohio State Life Insurance Co.	152	5-Yr. Convertible - Renewable	*	10%	3%	3%								All renewable term poli- cies are considered as
Pacific Mutual Life Insurance Company	157	Annual Renewable & Convertible Term	30%	8%	6%	4%	2%	2%						
Penn Mutual Life Ins. Co.	159	5-Yr. Renewable Term (Initial Period)	35%	15%	1%	7%	3%							
Phoenix Mutual Life Ins. Co.	164	5-Yr. Term	30%	5%	5%	5%								A 5% renewal commission will be paid on subse- quent premiums including automatic renewal of the policy contract (A6)
Provident Life & Accident Ins. Co.	169	5-Yr. renewable & convertible Term	30%	3%										

VII-12

COMPANY	NO.	POLICY	FIRST YEAR	RENEWAL COMMISSIONS											
				2	3	4	5	6	7	8	9	10			
Provident Mutual Life Ins. Co.	169	Renewable Level 5-Yr. Term (on initial issue)	35%	6½%	6%			6%							
Republic National Life Ins. Co.	175	5-Yr. Term Renewable & Convertible	40%	20%	10%	5%			5%						From Form A-3039-173 (75%)
Security Life & Accident Co.	181	1, 5, & 10 Yr. Renewable & Convertible Term	40%			5%			5%						1st commission paid only once
Southwestern Life Insurance Co.	187	Term policies & Renewable & Convertible Term to Age 60	40%	10%	5%				5%						
State Farm Life Insurance Co.	191	5-Yr. Term - 10-Yr. Term	30%	Scale A 8%	Scale A 4%				Scale B 4%	Scale B 2%					
State Life Insurance Co.	192	Term Policies	30 to 40%	15%	10%	5%			Service Fees						
State Mutual Life Assurance Co. of America	193	Term: 2 Premium & over	35%			5%			5%						
Travelers Insurance Company	201	Select 5-Yr. Term Renewable to Age 70 Convertible to Age 65	40%	6%	3%			2%							
Union Central Life Ins. Co.	202	All Term Plans	40%			5%			5%*						*except increase in 6th yr. premium only on which 10% is payable.
United Benefit Life Ins. Co.	205	Term Insurance (Except 10-Yr. Term	40%			5%			5%						

COMPANY	NO.	POLICY	FIRST YEAR	RENEWAL COMMISSIONS																
				2	3	4	5	6	7	8	9	10								
United Founders Life Insurance Co.	208	5-Yr. Renewable & Convertible	50%																	
United Investors Life Ins. Co.	Not On List	All Term Policies	50%																	

Table 4- Whole Life Policies

Company	No.	Policy	Commissions										All Full Vested	Conditions for Full Vesting
			1	2	3	4	5	6	7	8	9	10		
Aetna Life Insurance Co.	002	Wholelife	50%*	10-10-3		3%							After 15 yrs or death or disability	1st year - fully vested 2 - 4 - vested if with co. 4 years before termination 5 - 10 - vested if with co. 15 years before termination (all fully vested if termination by death or total disability)
All American Life & Casualty Co.	005	Non-part. Ordinary Life	55%	5%		5%							After 3 yrs.	1st year - fully vested No renewal comm'n if terminates during year in which agent's life, accident & sickness comm's'n are \$200. If less than 3 yrs, agent can get 1 yr's renewal for each full contract year of service. If > than 3 yrs - commission for 2-10 vest. All vested upon death, or total, permanent disability after 3 yrs.
		Participating Ord. Life	60%	5%		5%								
American Heritage Life Insurance Co.	012	"Citadel" Whole Life	65%	5%		5%							After 2 yrs (conditions attached)	1 yrs - fully vested 2-10 - vested after 2 consecutive yrs under the contract.
		LPU at 90	65%	5%		5%								
American General Life Insurance Company	011	Whole Life Series (10 - 20 more premiums)	55 to 75%	45 to 55% (10 - 5%)		45 to 55% (5%)							Termination	All commissions vested with death or disability. If terminated for other reasons, comm'n vested if averaging > \$10 per month.

* 5% additional will be paid for each policy of \$5,000 or more written up to and including age 60.

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Company	No.	Policy	Commissions										All Full Vested	Conditions for Full Vesting
			1	2	3	4	5	6	7	8	9	10		
American National Insurance Company	015	Non-part. Whole Life	35 57½	8½		--					.	All 1st yr commsns cease upon termination All renewal commsns cease upon termination of service " " "		
		Part. Continuous Premium Whole Life	47½	8½		--								
American United Life Insurance Company	019	Ordinary Life, Shielder (less than 60 yrs)	65½	15-10-49		4½						All vested with death or disability. Otherwise, for each full year of continuous service, commsns will be paid as follows: <u>Yrs. of Service</u> <u>Vesting</u> 1 1 policy 2 2 " 3 3 " 4 4 " 5 or more 9 "		
		Ord. Life, over 60 yrs.	35- 65½	5 5 60 60 4 4½ 15 10	4½									
Bankers Life & Casualty Co.	020	Whole Life	65- 70½	25 - 2½		2½					After 10 yrs, or age 65 or death or disability	1st yr. premiums - fully vested 2-10 yrs: vested after 10 yrs, or at age 65 or upon death or disability if > \$200 per year.		
		LPU at 95	60½	15 - 2½		2½								
Bankers Life Company of Iowa	021	Ordinary & Whole Lives	50 to 55½	7½		7½ to eighth policy year					All vested at 9 yrs.	1st yr. vested < 3 yrs service, no commsns 2nd yr commsn vested at 3 y 3rd " " " " 4 4th " " " " 5 5th " " " " 6 6th " " " " 7 7th " " " " 8 8th " " " " 9		

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Company	No.	Policy	Commissions										All Full Vested	Conditions for Full Vesting	
			1	2	3	4	5	6	7	8	9	10			
Bankers National Life Insurance Company	023	Ordinary & Modified "10" Whole Life	60%			5%			5%						1st yr. vested 2-10 yr. vested if due to death, disability, or termination of General Agent's agreement. 2-10 yr. lost if terminated for any other reason.
Central Life Assur. Co.	032	Whole Life Graded Premium Life LPU at 95: < \$25,000 ≥ \$25,000	55% 45 55 40			7 14 <u>2</u> 7 10 <u>3</u>									
Coastal States Life Ins. Co.	036	Whole Life Forms	4 to 80%	0 to 27½	0 to 7½				0 to 7½				After 5 years	No renewal commissions unless Agent has in force policies of >\$100,000. If contract outstanding for 1 yr & has produced new business each month, then 2nd renewal vests renewal thru 4th yr. 3 to 5 yrs sixth renewal 5 yr. vests the last renewal.	
Combined Ins. Co of America	043	Little Giant Life Insurance Policies	\$3.50 of each \$1,200 face value policy, plus 20% of 1st semi-annual premium. Renewals: 10% of all premiums collected by the Representative							No rts. at termination.			No commissions vest.		

* Number of Renewal commission determined by amount of coverage.

2 7½ after 5th year.

3 ≥ \$25,000 drops to 7½.

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Company	No.	Policy	Commissions										All Full Vested	Conditions for Full Vesting																		
			1	2	3	4	5	6	7	8	9	10																				
Commercial Union Life Ins. Co. of America	045	Whole Life & LPU at 95	40 to 60%	10%	5%		5%						At termination	Commissions vest at termination.																		
Conn. General Life Ins. Co.	048	Ordinary & Whole Lives	45	15	10	5	5	5	5	6	2	2	After 20 years	a. Termination <table border="1"> <thead> <tr> <th>Yrs of Service</th> <th>Policy Yrs</th> </tr> </thead> <tbody> <tr> <td>0-1</td> <td>1</td> </tr> <tr> <td>2-4</td> <td>2</td> </tr> <tr> <td>5 or more</td> <td>3</td> </tr> </tbody> </table> b. Death <table border="1"> <thead> <tr> <th>Yrs of Service</th> <th>Policy Yrs</th> </tr> </thead> <tbody> <tr> <td>0-9</td> <td>4</td> </tr> <tr> <td>10-14</td> <td>6</td> </tr> <tr> <td>15-19</td> <td>8</td> </tr> <tr> <td>20-more</td> <td>10</td> </tr> </tbody> </table>	Yrs of Service	Policy Yrs	0-1	1	2-4	2	5 or more	3	Yrs of Service	Policy Yrs	0-9	4	10-14	6	15-19	8	20-more	10
Yrs of Service	Policy Yrs																															
0-1	1																															
2-4	2																															
5 or more	3																															
Yrs of Service	Policy Yrs																															
0-9	4																															
10-14	6																															
15-19	8																															
20-more	10																															
Conn. Mutual Life Ins. Co.	049	LP Life Whole Life LPE 95 Econo Live Under 61	50%	10	10	5	5	5	5	2%				1st vests in any event 2nd & 3rd vest in any event 4th - 7th vest as provided by contract Remainder are non vested																		
Covenant Life Ins. Co.	Not on List	Covenant 25 - Full Life Paid at 95	55%	5%			5%					At any time	All commssn's vest except where agent performs a criminal act against the company.																			
Equitable Life Assurance Society of the U. S.	054	Adjustable Whole-Life ≤ 55 yrs. ≥ 56 yrs.	55 52	15	10	5	5	5	2	2	2	2	After 15 years.	All vest at death <table border="1"> <thead> <tr> <th>Period of Yrs</th> <th>Vested as to</th> </tr> </thead> <tbody> <tr> <td>5</td> <td>2nd policy or or contract year subj. to collection</td> </tr> <tr> <td>5</td> <td>2nd & 3rd " " "</td> </tr> <tr> <td>15 or retirement</td> <td>2nd to 10th " " "</td> </tr> </tbody> </table>	Period of Yrs	Vested as to	5	2nd policy or or contract year subj. to collection	5	2nd & 3rd " " "	15 or retirement	2nd to 10th " " "										
Period of Yrs	Vested as to																															
5	2nd policy or or contract year subj. to collection																															
5	2nd & 3rd " " "																															
15 or retirement	2nd to 10th " " "																															

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Company	No.	Policy	Commissions										All Full Vested	Conditions for Full Vesting
			1	2	3	4	5	6	7	8	9	10		
General American Life Ins. Co.	064	Double Protection to Age 70	60				5%					5%*	See next box	At termination renews vest only so long as agent has \$100,000 of individual life insurance business remains in force on a premium paying basis. At death or disability, commissions will vest with certain stipulations
		Joint Ordinary Life (2 lives)	50				5%					5%*		
General Services Life Insurance Co.	065	Preferred Risk and Juvenile Whole Life	60%											No renewal commissions. Company has a system of semi-annual production bonuses.
General United Life Insurance Co.	066	Various Whole Life Plans	30 to 65%	5 to 10%	2 1/2 to 5%						2 1/2 to 5%	Upon contingencies	All renewals vest upon termination if 1) agent has completed 1 yr under the contract and 2) the total in commissions for 12 consecutive months exceeds \$240.	
Georgia International Life Insurance Co.	068	Non-part. Whole Life Plans	60 to 100%	10	5%						5%	At 9 years	1st year fully vested then no renewals if < 2 yrs continuous service, then renewal commission vest equal to number of full yrs of service. Ex: 5 yrs service entitles agent to 5th yr renewal.	
		Participating Ordinary Life	55	5	5%						5%			

* 2 1/2 for 11th & subsequent years upon contingencies.

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Company	No.	Policy	Commissions										All Full Vested	Conditions for Full Vesting	
			1	2	3	4	5	6	7	8	9	10			
Globe Life & Accident Insurance Co.	069	Ordinary Life	70%			5%			5%					No Commsn's Survive Termination	Termination cancels agents right to receive commission
Hamilton National Life Insurance Company	079	Ordinary Life	50 to 90%			10%			10%					Upon Contingencies	After termination, renewal commissions are payable only if Personal Net Annualized Premium in force is not less than \$10,000 or if Agency net Annualized Premium in force is \geq \$20,000.
Home Life Insurance Co.	082	Whole Life*	45 to 50%	2-4	10%									After 1 yr & \$1500 in 1st yr.	Renewals vest at death or disability. Otherwise, renewal commissions vest after 1 yr. of service & \$1500 in 1st yr. commsn's.
International Life Insurance Co. of Buffalo	Not on List	Modified Whole Life	50%			10%			10%					At any time	All commissions are vested subject to three divesting clauses; commission lost at death
Jefferson National Life Insurance Co.	094	Life Paid Up at 90 - Non Pan & Other Whole Life Plans	50 45 to 60			10%		10	2%					After 5 years	At death or disability, renewals vest if agent has \geq \$10,000 in premiums in force. If termination is before 5 yrs, only 1st comsn vest. After 5 yrs, agent's commissions become vested.

* Figures are for a field underwriter.

VII-20

Company	No.	Policy	Commissions										All Full Vested	Conditions for Full Vesting
			1	2	3	4	5	6	7	8	9	10		
Jefferson Standard Life Insurance Co.	095	Part. Whole Life & LPU at 85 Non-Part: Whole & LPU at 90, 95	50 to 55½ 55 to 60½	.15½ 12 to 15½	10½	2½	2½						After seven years	After 5 yrs, 1st year 2 1 renewal are vested. After 6 yrs, 2 renewals are vested After 7 yrs, all renewals are vested.
John Hancock Mutual Life Insurance Co.	096	Life Paid Up at Age 85 Policies	20 to 45½		4½			4½						No vesting until 2 consecutive years Conditions attached.
John Hancock Mutual Life Insurance Co.	096	Life Paid Up at 85 & Limited Payment Life Policies Excluding Signature 25 Policies	25 to 55½		5½			5½						No vesting until 2 consecutive years. Conditions.
Lafayette Life Insurance Co.	101	Whole Life Plans	40 to 60½		$\frac{2-4}{6}$ to 8½		$\frac{5}{4.5}$ to 6½	$\frac{6-7}{4.5}$ to 6½		$\frac{8-10}{4}$ to 5½				At death all renewal commissions are vested so long as the total for any year is \geq \$120. Termination for reasons: will vest according to specific contingencies as to gross volume of premiums & total amount due exceeds \$120.

Company	No.	Policy	Commissions										All Full Vested	Conditions for Full Vesting
			1	2	3	4	5	6	7	8	9	10		
Lamar Life Insurance Co.	102	Ordinary Life & Life Paid, Up at 95 Plans, Par & Non-Par	50 to 70%		5%			5%					After 10 yrs.	If terminated with cause, only first year commissions vest. If less than 2 yrs, & w/o cause, on 1st yr. commissions vest. If more than 2 yrs, right to renewal based on length of service. E.g., 5 yrs service = 5 renewals.
Liberty National Insurance Co.	104	Whole Life	70%		5%			5%					After 2 yrs.	After 2 full years, at termination by death or otherwise, company will continue to pay renewal commissions until such amount to \leq \$10 for 4 consecutive mos.
Lincoln National Life Insurance Co.	115	Ordinary Life Plans Par & Non-Par LPU at 95 (Par) (Non Par)	30 to 50% 35 to 55% 25% 55%		5%			5%					After 9 yrs.	Renewal Commissions vest according to # of yrs. worked. E.g. 7 yrs. completed makes agent eligible for 5 renewals at termination.
Minnesota Mutual Life Insurance Co.	125	LPU at Age 90 Whole Life & Adjustable Life	40 to 50%		3 1/2 to 5%			3 1/2 to 5%					After 5 yrs.	1st yr. commissions fully vested. Renewal Commissions become vested only after 5 yrs. & may be extinguished after falling below \$120 for a 1 yr. period.

* Subject to some contingencies.

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VII-22

Company	No.	Policy	Commissions										All Full Vested	Conditions for Full Vesting	
			1	2	3	4	5	6	7	8	9	10			
Mutual Benefit Life Insurance Co.	129	Ordinary Life & Life Paid Up at 70 Plans	31 to 50%	Determined by Formula. See Agent's contract.										at 15 years.	If terminated < 2 yrs. - no renewals ≥ 2 yrs & < 11, 4 renewals ≥ 11 yrs & < 12, 5 renewals ≥ 12 yrs & < 13, 6 renewals ≥ 13 yrs & < 4, 9 renewals ≤ 14 yrs, 8th yr renewal ≥ 15 yrs, 9th yr renewal.
Mutual Life Ins. Co. of New York	130	Whole Life Plans	50 to 55%	2-3 5 to 8%	3-4 4 to 5%			4 to 5%					After 20 yrs.	1st year commissions are fully vested. 1st & 2nd renewals are vested after three years. 3rd - 9th renewals are vested after 20 years.	
National Investors Life Insurance Co.	134	Whole Life - Premiums Payable	30 to 75%	7 1/2 to 20%	5 to 20%	3%		3%					See next box.	If, at termination, the annualized life insurance premium in force, with some exclusions, is ≥ \$10,000, renewal commission will be paid until this amount drops to < \$5,000.	
National Life Insurance Co.	137	Life Plans	30 to 45%		2-4 5%	2%		2%					After 17 yrs.	At 12 yrs. of service, 5th policy vests At 13 yrs. " " 6th At 14 yrs. " " 7th At 15 Yrs. " " 8th At 16 yrs. " " 9th At 17 yrs. " " 10th	

Company	No.	Policy	Commissions										All Full Vested	Conditions for Full Vesting
			1	2	3	4	5	6	7	8	9	10		
National Old Line Insurance Co.	138	Various Whole Lives	60 to 70%		4%		4%						After 1 yr.	1st year commission is vested. < 1 yr service, renewal commissions are extinguished. > 1 yr service renewals vest with charges and contingencies.
Nationwide Life Insurance Co.	142	Whole Life & Modified 3-10 Whole Life	55%	2-3 10%	3%		3%						Vesting only under contract.	No vesting after termination.
New England Mutual Life Ins Co.	143	Ordinary Life & Life Paid Up at 85	55%		5%									See questionnaire for details. Apparently years 1-5 are fully vested with subsequent renewals depending upon years of service & total production produced.
Massachusetts Mutual Life Insurance Co.	119	No Whole Life Listed												At death, all commissions are vested. Termination for other reason with < 1 yr service: No renewal commissions. Termination after 1 yr.: Basic vested renewal 1 commissions plus earned vested commission determined by years service.

VII-24

Company	No.	Policy	Commissions										All Full Vested	Conditions for Full Vesting																
			1	2	3	4	5	6	7	8	9	10																		
Metropolitan Life Insurance Co.	120	Whole Life Plans	35 to 55%	2-4 11%										Upon retirement only.	No vesting whether active or terminated. But if agent belongs to the Retired Metropolitan Field Force, 3 11% renewals for 2nd - 4th yrs., are vested.															
Northwestern National Life Insurance Co.	148	Various Whole Life Plans	30 to 55%	2 25%	5 to 10%					2%			After 7 yrs.	If terminated before 7 yrs. For other than death or disability, no further commissions will be paid. If terminated after 7 yrs., then 1st commissns are payable in full; 2nd - 5th yrs. will be paid at 80% of value; later commissions will not vest unless due to retirement.																
Northwestern Mutual Life Insurance Co.	147	Whole Life & E.O.L	41 to 50%	2 10% to 20%	3 10% to 15%	4-5 10%							After 9 yrs,	1st year commissions are fully vested. <table border="1"> <thead> <tr> <th>Renewal Yr.</th> <th>Years of Service Required for vesting</th> </tr> </thead> <tbody> <tr><td>1-3</td><td>None</td></tr> <tr><td>4</td><td>10</td></tr> <tr><td>5</td><td>11</td></tr> <tr><td>6</td><td>12</td></tr> <tr><td>7</td><td>13</td></tr> <tr><td>8</td><td>14</td></tr> <tr><td>9</td><td>15</td></tr> </tbody> </table> All renewals vest if termination is due to death, disability or agent become employee.	Renewal Yr.	Years of Service Required for vesting	1-3	None	4	10	5	11	6	12	7	13	8	14	9	15
Renewal Yr.	Years of Service Required for vesting																													
1-3	None																													
4	10																													
5	11																													
6	12																													
7	13																													
8	14																													
9	15																													

Company	No.	Policy	Commissions										All Full Vested	Conditions for Full Vesting
			1	2	3	4	5	6	7	8	9	10		
North Atlantic Investors Life Insurance Co.	Not on List	LPU at 90 & Executive Whole Life	50 to 75%	2 5%		5%		6 5%			1%		After 10 yrs.	1st yr. commissions fully vested. No renewals vest if terminated within 36 months. After three years, will be vested for # of actual yrs of service. E.g., 5 yrs. service entitles agent to the 5th renewal. No vesting after 10th renewal.
New York Life Insurance Co.	144	Various Whole Lives*	40 to 55%	2 15%	3 5% Conditional								At any time.	Commissions on permanent plans of life insurance and endowment policies ... for policy years 1 & 2 are generally fully vested. However, any conditional third year renewal commissions payable on such policies are not generally vested.
Occidental Life Insurance Co. of California	149	Guaranteed & Decreasing Whole Life	65%	2 25%	3 15%					10%			After 5 yrs.	If terminated for other than specified reasons in P 3, 17, renewal commissions for yrs. 2-5 will be paid to agent, after 5 yrs service the service requirement as to disability or death is 3 yrs.

* From the field Underwriter's contract.

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Company	No.	Policy	Commissions										All Full Vested	Conditions for Full Vesting																	
			1	2	3	4	5	6	7	8	9	10																			
The Ohio State Life Insurance Company	152	Various Ordinary Lives & LPU at 95	50%	20%	31*			31*				After 9 yrs.	No renewals when terminated for cause all vest at death or disability. <table border="1"> <tr> <th>Yrs. Under K</th> <th>Completed Policy yrs.</th> </tr> <tr> <td>2</td> <td>None</td> </tr> <tr> <td>3 but 4</td> <td>4</td> </tr> <tr> <td>4 but 5</td> <td>5</td> </tr> <tr> <td>5 but 6</td> <td>6</td> </tr> <tr> <td>6 but 7</td> <td>7</td> </tr> <tr> <td>7 but 8</td> <td>8</td> </tr> <tr> <td>8 but 9</td> <td>9</td> </tr> <tr> <td>9</td> <td>12</td> </tr> </table>	Yrs. Under K	Completed Policy yrs.	2	None	3 but 4	4	4 but 5	5	5 but 6	6	6 but 7	7	7 but 8	8	8 but 9	9	9	12
Yrs. Under K	Completed Policy yrs.																														
2	None																														
3 but 4	4																														
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5 but 6	6																														
6 but 7	7																														
7 but 8	8																														
8 but 9	9																														
9	12																														
Pacific Mutual Life Insurance Company	157	Whole Life	60%	20%	30%	40%	50%	20				After 15 yrs.	1st yr. commissions are vested. Commissions for yrs. 2-4 are vested if termination is due to death, disability, or comes after 15 yrs. service.																		
The Penn Mutual Life Insurance Company	159	Whole Life	50%	15%	10%	7%			3%					If terminated within the first two years, no renewal commissions paid. If terminated for cause, no 1st yr. or renewals will be paid. After 2 yrs, renewal commissions appear to vest.																	

* 8% of 3rd year premium.

Company	No.	Policy	Commissions										All Full Vested	Conditions for Full Vesting
			1	2	3	4	5	6	7	8	9	10		
Phoenix Mutual Life Insurance Company	164	Ordinary Life Plans	40 to 55%	$\frac{2-4}{8}$ to 10%	$\frac{5}{4}$ to 10%	$\frac{6-7}{4}$ to 10%	$\frac{8-10}{4}$ to 10%						After 15 years.	The 1st-3rd renewals vest after 3 yrs service. The 4th-6th renewals vest after 9 yrs service. The 7th-9th renewals vest after 15 yrs service. There are production requirements which can alter the above.
Provident Life & Accident Insurance Co.	168	Whole Life Plans	65%		5%		5%						Contingent upon amount produced.	Termination by death or disability vest renewal commissions thru 8th yr. If terminates for another reason & leaves in force \geq \$500,000 (with some exclusions) the commissions continue through year 8, subj. to a fee. Otherwise, no renewals vest
Provident Mutual Life Insurance Company	169	Whole Life Plans	35 to 55%	$\frac{2-3}{10\%}$	5%		5%						After 20 yrs, 1-5 vest.	All vest upon death or retirement. Termination for other reasons: $<$ 10 yrs - 1st yr. commission only \geq 10 yrs but 15 - yrs 1 & 2 \geq 15 yrs but 20 - yrs 1 - 3 \geq 20 - yrs 1-5.

* Number of renewals is determined by amount of coverage. For \geq \$3,000, there are 9 renewals.

Company	No.	Policy	Commission										All Full Vested	Conditions for Full Vesting	
			1	2	3	4	5	6	7	8	9	10			
Republic National Life Insurance Company	175	Whole Life Plans	90%	15%		7%		7%							If terminated within 1 yr. only 1st commission will vest. Death or disability through yr. 10. Otherwise, after 1 yr, all renewals vest as long as > \$500 yearly.
Security Life & Accident Co.	181	Whole Life Plans	35 to 65%			5%		5%					After 5 yrs & \$12,000	Death or disability; all commissions vest. Termination for cause; no commissions. Termination for other reasons; first yr. commission vest & if after 5 yrs of service & at least \$12,000 in premiums, renewal commissions also vest, subj. to min. amount stipulation.	
Southwestern Life Insurance Company	187	Whole Life	75%	10%	5%	5%		5%					After 3 yrs.	Death or disability; all commissions vest. If less than 3 yrs, no commissions; If more than 3 yrs, then 1 commission per year worked. e.g. 5 yrs, then 5 commissions. There must be \$100,000 premiums outstanding.	

* For general agent.

Company	No.	Policy	Commissions										All Full Vested	Conditions for Full Vesting
			1	2	3	4	5	6	7	8	9	10		
State Farm Life Insurance Co.	191	Life Paid Up at 85	30 to 50%	$\frac{2-3}{4}$ to 10%	$\frac{4-5}{2}$ to 5%								Do not vest.	Termination by death or otherwise; any unpaid compensation then due will be paid. All other commissions are extinguished.
State Life Insurance Co.	192	Whole Life	55 to 65%	$\frac{2}{10\%}$	$\frac{3-4}{10\%}$	$\frac{5}{5\%}$	Service Fees computed 2%						After 3 yrs.	If less than 3 yrs, compensation will be paid that falls due within 1 yr. of termination. After 3 yrs, all renewals will be paid. No renewals if termination for fraud, etc.
State Mutual Life Assurance Co. of America	193	Whole Life	50 to 55%		5%		5%						After 12 or more years..	Death or disability; all companies vest. If no provisions are breached, then the # of commissions is determined by years of service in accordance with schedules A & B. See contract.
The Travelers Insurance Co.	201	Ordinary Life Plans	40 to 55%	$\frac{2-3}{10\%}$	$\frac{4}{7}$	$\frac{5}{5\%}$	$\frac{6}{5\%}$						See next box	1st yr. & first 2 renewals are vested. Remainder are vested if agent produced no less than \$1500 in new life premium including single premium in the year the policy was sold.

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Company	No.	Policy	Commissions										All Full Vested	Conditions for Full Vesting
			1	2	3	4	5	6	7	8	9	10		
Union Central Life Insurance Company	202	Ordinary Life Plans	25 to 65%		5 to 10%			5 to 10%					After 3 years	All commissions vest after three years. If less than 3 years, commission will vest if agent has in force \$1,000,000 or more of ordinary life business at termination.
United Benefits Life Insurance Company	205	Whole Life Plans	60%		5%			5%					After 3 years	After 3 yrs, renewals will be paid if 1. policy was sold in a year when agent produced at least \$150,000 of issued & paid for business. 2. At the specified rates.
United Founders Life Insurance Company	208	Ordinary Life	65%	² 7.5%	5%			5%						Renewals shall be paid to agent provided 1. annualized premiums are \geq \$20,000 at termination; & 2. that a minimum persistency of 80% is maintained each year.
United Investors Life Insurance Company	Not on List	Ordinary Life	60%		5%			5%					All vested subj to a min. total	After termination, if the total 1st yr. & 1st renewal commission is $<$ \$100, then all subsequent commissions are lost.

APPENDIX VIII: STATE REGULATIONS WHICH MAY BE ANTICOMPETITIVE

In explaining why the life insurance industry is beset with consumer problems, Section III focuses on the lack of consumer information and on conflicts of interest built into the current agency system. This appendix outlines other, possibly very important reasons for the problems detailed in Section II. Most involve state regulations or laws which may curtail vigorous competition. While we are unaware of any detailed examination of the impact of state regulation, serious questions are raised by some aspects of regulation designed: (1) to discourage replacing old life insurance policies with new ones; (2) to insure company solvency; (3) to prohibit agents from rebating any part of their commission to a client; and (4) to limit agent compensation. Although this appendix does not attempt to assess the precise importance of these regulations, we believe they deserve further study.

1. Regulation Designed to Discourage Replacing Old Insurance Policies

Virtually all states have "replacement" regulations that are intended to provide the policyholder with sufficient information to make an informed decision as to whether to drop one policy in favor of another. While laudable in spirit, many of these laws may not benefit consumers. These laws are premised on the assumption that "replacement" will generally not be in the policyholder's interest: that is, he will have to pay the heavy "front end" load again, he will be subject to a new period of "contestability" and so on. This premise is now under question. Professors Scheel

and Van Derhei, in the most comprehensive study of replacement activity to date, found that the majority of replacements were "acceptable," that is, represented a cost saving for the policyholder.¹ In those cases (22 out of the 70 studied) where a term insurance policy replaced a cash value policy, all of the replacements were cost saving to the policyholders. The authors conclude that "the data offer no support for the caveats approved by insurance departments that replacements generally are undesirable," but they caution that "the data may not be representative of a general cross-section of existing insurance."²

Scheel and Van Derhei are also highly critical of present replacement regulations and of the NAIC model regulation. They state that, "The failure of the present NAIC Model Replacement to present clear and concise information that is relevant and easily used is exceeded only by its failure to provide the right kind of information," and that, "The

¹ Scheel and Derhei, "Replacement of Life Insurance: Its Regulation and Current Activity," 45 Journal of Risk and Insurance (1978). Their research is discussed in Coyle, "How to Save \$7000 on Your Life Insurance," Money Magazine 75-82 (July 1978).

²

Id. at 205.

overwhelming omission in the present replacement regulations is guidelines for the manner in which the data are to be used, integrated and interpreted. There is little argument that the most important reasons that can be given for policy replacement hinge on cost considerations. The argument that cost is unimportant is indefensible for a replacement situation. Yet, no replacement regulation in effect today provides for disclosure of cost or offers a methodology by which costs can be compared validly. Cost disclosure is as important for policy replacement situation as for original issues."³ Their final appraisal of the present system of replacement regulations is a harsh one. They write, "Until meaningful cost disclosure is embodied into replacement regulations, one could conclude with justification that they are a facade instigated and perpetuated by the distribution system of life insurance and designed for the self-interest of insurance agents who are more concerned with the preservation of their commissions than a dispassionate, professional assessment of the merits of individual policy replacement situations."⁴

2. Regulations Designed to Insure Company Solvency

Almost every state sets minimum cash value guarantees and certain other solvency requirements through a statute known as the "Standard Nonforfeiture Law."⁵ This statute was generally

³ Id. at 206.

⁴ Id. at 207.

⁵ See C.F.B. Richardson, "Expense Formulas for Minimum Non-Forfeiture Values" 29 Transactions of the Society of Actuaries 33-34 (1977).

enacted in response to the Guertin Committee's Report to the National Association of Insurance Commissioners in 1941. A new committee has recently recommended various revisions in this statute that could have very important implications for life insurance pricing.⁶ As part of the effort to revise this statute, the NAIC asked Mr. Charles Richardson to make new estimates of expense allowances that would be used in computing minimum cash values. Commenting on the changes that have taken place in the business since 1940, Mr. Richardson writes:

The consumer movement has become a powerful force in many sectors of private business, and neither the life insurance industry nor the regulators can safely ignore it. Today it does not seem politically feasible to base minimum values on expense factors that would accommodate the expense rates incurred by marginal or high-cost companies, as was the objective of the formulas in the Guertin laws.⁷

While such regulations do not result in uniformly high costs for consumers, they may well set a "floor" below which prices cannot fall. For example, some states have interpreted the law to make it impossible for companies to charge premium rates as low as they might want to on renewable term insurance policies. To do so, the company would have to put up the capital to cover a so-called "deficiency reserve" that may run as high as 2000 per-

⁶ Id. at 35-36.

⁷ The "Unruh Committee" Report can be found in 27 Transactions of the Society of Actuaries 549-633 (1975).

cent of the first year premium.⁸ Also, the impact of solvency/ cash value regulations appears to be extremely important in determining premiums charged and cash values offered by the life insurance industry. Proposed changes in the solvency laws allowing companies to use higher interest rates in calculating reserves and minimum cash values would drastically change the way deficiency reserves are calculated.⁹ According to some industry experts, these changes will enable the life insurance industry to:

- Sell very competitively priced permanent insurance at lower rates than any companies have used in the past.
- Sell permanent insurance to policyholders who otherwise would have been receptive only to term insurance.
- Provide commission revenues to agents exceeding that which can be realized from conventional term policies.¹⁰

These experts give some figures to show the possible impact of these changes on whole life premium rates. For example, under the new regulations, they show that a \$15,000 (non-par) whole life policy could generate a reasonably healthy 13 percent

⁸ See Holland, "NAIC Actuarial Guidelines," Best's Review (Life/Health Ed.) 26 (September 1978).

⁹ The NAIC adopted a set of revisions to the Standard Valuation and Nonforfeiture Laws at its December 1976 meeting. For a discussion of the proposed changes and their probable impact, see Curlee and Collett, "New Standard Valuation and Nonforfeiture Laws," 78 Best's Review (Life/Health Ed.) 22 (September 1977), and Hill and Greenberg, "Permanent Insurance Beckons--Should the Industry Respond?," 78 Best's Review (Life/Health Ed.) 10 (November 1977).

¹⁰ Hill and Greenberg, supra n. 7, at 10.

profit margin with a premium rate of about \$13.50 per thousand at age 35.¹¹ Current premiums for such policies average about \$17.50 per thousand. A premium rate of \$13.50 would represent a reduction of over 20 percent. Because the first year premiums in 1977 exceeded \$3 billion, the proposed changes in the solvency laws could save consumers hundreds of millions of dollars each year. Additionally, they might permit more agents to be hired, higher commission to be paid or higher profits for the companies. This is an area that needs to be examined from the consumer's point of view.

3. Regulation Designed to Prohibit Agents from Rebating Any Part of Their Commission

Most states have "anti-rebate" statutes that prohibit agents from rebating any part of their commission to the policyholder, although it is legal to rebate to another agent. These laws inhibit agents from competing on a "price" basis with one another. Indeed, they appear to be similar in impact to the so-called "fair trade" laws which inhibit price competition among retailers. In particular, they make it illegal for an agent to try to decrease the price for his service in the hope of increasing volume. When the average agent is making less than one sale per week, any law which appears to inhibit productivity increases ought to be very carefully examined.

4. Regulations Designed to Limit Agent Compensation

A few states have set limits on the percent of the first

¹¹ Id. at 54 (Table).

year premium that an agent can receive in commissions. For example, section 213 of the New York insurance law sets the maximum rates at roughly 55 percent for whole life and 37 percent for term insurance. Significantly, this law affects the operations in all states of those companies licensed to do business in New York and many companies have elected not to operate in New York or only through a subsidiary.¹² As to those companies operating in New York the law is thought by some industry observers to create a bias in favor of whole life.

The actual effect of the New York law on whole life and term commission rates is unclear. In comparing the first year commission rates of those companies licensed to operate in New York with those not licensed to operate in New York, the latter pay higher first year commissions on whole life.¹³ The New York licensed companies, however, may circumvent the law by paying more of their agents' expenses. In fact, under a recent clarification of the New York regulation, the companies can give an agent 96 percent of the first year's premium in first year commissions and total expense reimbursements.¹⁴ Also, the New York companies may pay

12 Rappaport, "Consumerism and Agent's Compensation" 26 Transactions of the Society of Actuaries 560 (1974) [hereinafter cited as Rappaport].

13 See, e.g., id. at 561.

14 Id. at 562.

their agents larger renewal commissions.¹⁵ Thus, Rappaport hypothesizes that companies not licensed in New York may not have higher total agency costs.¹⁶ Moreover, it seems unlikely that the New York licensed companies, which include many of the larger and better known firms,¹⁷ would remain licensed in New York if doing so placed them at a competitive disadvantage in their whole life operations in all other states.

Similarly, the effect of the New York law on term commission rates appears negligible or small. An independent analyst found that the average "New York" term rate was only 3 percent lower than the "non-New York" figure.¹⁸ (In contrast, he found an almost 10 percent spread between the two groups of companies for whole life).¹⁹ Likewise the Hart Committee found no difference in average term rates:

The effect of Section 213 is not apparent in term commissions as it was in whole life. New York companies pay about the same com-

15 Id. at 540.

16 Id. at 560.

17 Dorfman, "Reformation in Life Insurance Agent Compensation," 43 Journal of Risk and Insurance 449 (1976).

18 Id. at 450.

19 Id.

Agent Commission (5-year renewable) Term Insurance:			
	New York Operations,	mean =	36%
No	"	"	= 39%
Agent Commission Whole Life Insurance			
	New York Operations,	mean =	54%
No	"	"	= 62%

Overall, there appears to be little difference in total commission rates paid between New York licensed companies and non-New York licensed companies. This does not necessarily mean, however, that the New York law has had little effect on the average commission rates paid on cash value policies and on term policies. Companies licensed in New York account for roughly 56 percent of the total volume of sales in the entire United States.²¹ Since, outside of New York State, both sets of companies are competing with each other to attract agents, it is not surprising that, on average, commission rates are similar. Nonetheless, non-New York licensed companies may be able to attract agents by paying commission rates only marginally higher than those being paid by the other companies. If it were true that non-New York licensed companies were able to pay even slightly higher commission rates, they would be able to attract more agents and thus grow more rapidly than the New York licensed companies. Eventually, the New York companies would lose their dominant market shares and then the New York expense "cap" would cease to affect non-New York commission rates. This scenario is consistent with the observed facts for cash value insurance, but not for term insurance. As noted above, term commission rates do not differ between the

²⁰ The Life Insurance Industry, Hearings Before the Subcomm. on Antitrust and Monopoly of the Senate Judiciary Comm. 93d. Cong., 2d Sess. 2859 (1974) [hereinafter cited as Hart Subcommittee Hearings].

²¹ See S. Weisbart, Extraterritorial Regulation of Life Insurance 8 (1975).

two classes of companies.²² Thus, given the available evidence, we cannot conclude that the operation of the New York expense limitation law explains the wide disparity in cash value and term commission rates, but this question deserves further study.²³

22 It is possible that the average figures conceal some important differences between the two groups. For example, it may well be that only a relatively few companies are actively interested in selling term insurance, that these have much higher commission rates on term products, and that none are licensed in New York State. These few companies could be writing a large portion of the new "term" business and their share of this market could be expanding. Their high term commission rates would be submerged in an average dominated by more traditional companies whose low term commission rates reflect a lack of interest in the market, rather than the expense limitation law.

23 Three other factors may account for the substantial difference in commission rates paid on cash value policies relative to term policies. First, because the companies face reduced price competition from other savings media, they might structure the commission system to encourage sales of cash value insurance.

Second, another explanation for the relatively low term commission rates, offered by Senate Antitrust Subcommittee staff, is that "nobody seems to be competing to pay agents to sell term insurance." Hart Subcommittee Hearings, supra n. 18, at 2859. While this may be true of many companies, there are several large companies (such as Federal Kemper, Occidental Life of California and the Old Line Life Insurance Company of America) that write much more term than cash value insurance. None of these are licensed in New York and all pay much higher than industry average commission rates on term sales. It is not known, however, what share of the term market such companies have captured, nor whether their share is expanding.

Third, an explanation somewhat contradictory to the preceding has been offered by an actuary, Mr. Peter Hutchings. In commenting on Ms. Rappaport's paper, supra n.10, at 580, he wrote:

One of the many valuable insights in this paper is the relating of field compensation practices to the lack of

(Footnote Continued)

23 (Footnote Continued)

effective price competition in life insurance. Today's agent has an excellent understanding of his commission agreement; today's customer has, at best, an imperfect understanding of his insurance product. Companies compete for agents and let the agents compete for customers. In the past this imbalance led to abuse, and abuse led to section 213. As the paper suggests, no such regulation would be needed if the product were less confusing.

- Consider those products which, by their nature, are "self-disclosing." These products are so simple that any informed consumer can understand their price without needing an advanced degree. Three examples are yearly renewable term, immediate annuities, and mutual funds. By and large, these kinds of products have the following characteristics: (1) very low commission for agents, (2) very low (and/or negative) profits for companies, and (3) very low spread between cheapest and most expensive product.

For an interesting example of the relationship of price disclosure to commission level, compare the treatment of flat extras for substandard cases with class extras. The easiest life insurance price to understand is an extra of \$5 per thousand—ask any private pilot! On the other hand, substandard class 2 whole life is at least as confusing as regular old whole life. It is not uncommon for flat extras to carry low marginal commissions while class 2 extras are on a full-commission basis.

Very few New York companies would run a section 213 risk by selling their yearly renewable term with a 50 percent commission (since this test is aggre-

(Footnote Continued)

explain the problems staff sees in the life insurance market. At this point, we can only recommend that they receive further examination.

23 (Footnote Continued)

gate in nature). Excellent arguments can be made for adopting such an approach to partially equalize the agent's incentive. However, relatively few companies have taken this approach, presumably because the market will not tolerate such a load.

Mr. Hutchings' explanation does not appear to be consistent with the fact that the three companies mentioned above (as well as others) seem to sell a lot of term insurance even though two of the three provide first-year commissions of at least 50% on such products. One reason is that in spite of higher commission rates, these companies often market term products at premium rates lower than those offered by the more traditional companies.

To summarize, several explanations for the observed wide disparity in commission rates between the two types of insurance have been offered, but none are well documented.

APPENDIX IX: THE PURDUE STUDIES

Introduction

To determine which of several disclosure systems--including the NAIC model--is most understandable to consumers and most likely to be used by them, the Commission in 1977 contracted with Purdue University to conduct two consumer research studies.¹

The first attempted to determine what information consumers actually use when they purchase life insurance and how they can be motivated to make greater use of cost information. The second study compared the relative effectiveness of several life insurance cost disclosure systems in helping consumers select appropriate life insurance policies. It tested the following systems: the NAIC model, a system developed by Professor Joseph Belth of Indiana University and several variants of a system prepared by the FTC staff for purposes of the experiment. The study employed disclosure packages which had two parts: a buyer's guide and a policy summary from one of the above disclosure systems. Some packages contained only a policy summary.²

It is necessary to emphasize three points before discussing the results of the Purdue research studies: first, the research

¹ Dr. Jacob Jacoby of Purdue University directed the research studies. He is an experienced researcher in measuring consumers' ability to use information, and with the problem of confusing consumers with too much information, and is well respected throughout the research community.

² A buyer's guide is a booklet which addresses various questions that consumers face in buying life insurance. A policy summary is a sheet which contains basic financial and cost information concerning the policy.

studies were experimental studies conducted in a controlled environment with a limited number of subjects. Many factors present in an actual sales situation were not incorporated into the experimental design. The most important of these factors was the impact of the agent. Consequently, we recognize that the findings of the studies cannot be directly translated to actual sales presentations in the marketplace. These limitations are common to most social science research, and are not critical here since the studies were designed primarily to isolate those elements of a cost disclosure system which affect its understandability and use.³

Second, although understandability is extremely important, it is only one factor that must be considered in determining what information should be contained in a cost disclosure system. It is equally important to find out what information the consumer needs to make an informed purchase decision and the feasibility and cost of providing this information.

Third, the materials prepared by the FTC were developed solely to test the understandability and effectiveness of and various alternatives to the NAIC disclosure system. Partially as a result of the Purdue studies, the draft disclosure materials

³ The FTC, in cooperation with the New Jersey Department of Insurance, conducted a study of the effectiveness of the NAIC disclosure system in New Jersey. This study consisted of personal interviews with approximately 200 recent purchasers of insurance in New Jersey who received the NAIC disclosure materials. For further discussion of this New Jersey study see Part 4.C.

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in Appendix 10 differ in several ways from those tested in the studies. We do not think the fact that the disclosure system recommended in this report differs from that tested is particularly important because, as previously mentioned, the purpose of the studies was not to judge disclosure systems but rather to use what was learned from the studies to prepare disclosure materials that may be more effective than the NAIC, FTC or other systems that were tested.

This appendix summarizes the methodology and major findings of the two studies that pertain to our recommendations; it does not review all the findings. The major findings are:

1. cost-related factors were accessed less frequently than other factors but received significant weight in the simulated purchase decisions;
2. the Savings Yield was the cost dimension accessed most frequently and many subjects appear to have used it to comparison shop;
3. buyer's guides and trigger statements caused greater use of cost-related factors;
4. the FTC experimental disclosures increased the selection of lower cost policies compared to the NAIC disclosure;
5. the simple single page policy summary is almost as effective in enabling consumers to select low-cost policies as more elaborate disclosure systems.
6. It is possible to have a buyer's guide that is more comprehensible to consumers than the NAIC guide.

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I. The First Purdue Study

A. Purpose and Design of the First Study The first Purdue study sought to find out what types of information were most

useful to consumers.⁴ Using a simulated purchase decision experiment, this study attempted to measure to what extent:

- (1) consumers use cost indices, premiums and other related information;
- (2) written motivational or "trigger" statements increase consumer use of cost information; and
- (3) use of cost information leads to greater selection of lower cost policies.

To answer these questions, the study drew a sample of over 200 individuals between the ages of 25 and 45 from in and around Lafayette, Indiana. Furthermore, each participant had at least one dependent under 15 years old to assure an insurable interest. The proportion of individuals in the sample who had life insurance in force and contacts with agents was similar to the national average.⁵

Next, this sample was divided into six groups. After a brief introduction to the experiment, each group was given a different set of disclosure materials to review prior to the simulated insurance purchase decision. One group received an NAIC buyer's guide; one group received an experimental FTC

⁴ The second part of the first study attempted to evaluate the effectiveness of five different yardstick formats. Study I at 52. Some of the formats were in color, some were black and white, some were open-ended, and others provided the answers. Although significant differences were found in completion times, this study found no overall statistically significant differences across these five formats in the ability of participants to rank policies in terms of increasing costs. Id. at 56-60.

⁵ Study I, 6. The basic sociodemographic characteristics of the sample are set out at p. 7.

ment, buyer's guide; one group received an NAIC buyer guide plus a trigger statement; one group received the FTC buyer's guide plus a trigger statement;⁶ one group received only a trigger statement; and one group received no additional material. For an illustration see table below.

GROUP	1	2	3	4	5	6
Buyer's Guide	None	NAIC	FTC	None	NAIC	FTC
Trigger	Absent	Absent	Absent	Present	Present	Present
Number	40	40	39	40	41	38

ce
After reviewing these disclosure materials, each participant was asked to pick from among three \$10,000 policies:⁷ half of each group chose from three whole life policies and half chose from two whole life policies and one term policy.⁸ To assist them in making their decisions, participants were given a list of 37 types of information about life insurance policies. From the list, participants could then request access to the

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⁶ A "trigger" is a brief statement alerting the consumer to the facts that he (she) might be able to save appreciable amounts of money by shopping around.

⁷ Study I, 14.

⁸ Id. at 12.

information on each of the three policies. In total, these facts summarize most of the relevant information needed to evaluate these policies. Out of the 37 types of information available, ten are directly cost related, that is, examination of one of these factors gives an accurate picture of cost. They are savings yields, company retention index, surrender cost index, net payment cost index, company retention yardstick, breakdown of premiums, year-by-year payments and benefits, surrender cost yardstick, year-by-year cost of protection and rate of return, and the net payment cost yardstick. Three types of information are indirectly cost related: premium, cash values, and illustrated dividends. They are only indirect cost factors because they must be considered together to estimate net cost.

The participants were able to acquire (at no cost) as much or as little of this information as they wished prior to making their purchase decision. By determining which of the types of information participants requested access to, the study was designed to measure the factors that may be relevant to the life insurance purchase decision. Since the participants were given different disclosure materials, the study also provides data on the impact particular disclosure materials had on consumers' understanding of what factors are most relevant. The average total number of facts considered or "accessed" did not differ significantly with the type of disclosure.⁹ The average

⁹ Id. at 18.

for all participants was 17.85.¹⁰

ate B. Results of the First Study We believe three salient conclusions can be safely drawn from the results of this experiment: (1) the participants accessed cost related factors less frequently than other factors but placed more weight on them when purchasing insurance; (2) the buyer's guides and trigger statements improved participants' use or "access" ranking of cost related factors; and (3) the NAIC written statements should in certain respects be improved so as to effect better disclosure.

1. Consumer Use of Cost Related Factors

ys
it The accessing results indicate that fewer participants chose to find out what the cost indices were than chose to find out about other policy characteristics, but that those who did pick them used the indices effectively. Many participants did not use the factors most directly related to the cost of a policy. For example, savings yields received the highest access ranking of the ten facts considered to be directly cost related --tenth.¹¹ The other nine such facts were ranked 16, 17, 21, 25, 29, 31, 32, 34 and 35.¹² The median rank of the cost related facts was 27.5. These figures are particularly troublesome if one remembers

10. Id. It should be noted, however, that in terms of unique items acquired, the researchers found that these participants accessed considerably more items than were accessed by comparable groups of consumers making breakfast cereals, margarine, and analgesic decisions. Id.

11 Study I, 24.

12 Id. at 20 (Table 5a).

that there are only 37 facts and the average number of facts accessed for all participants was 17.85.¹³

In contrast, the ranks for those facts indirectly related to cost are 1, 3, and 23.¹⁴ Although these facts are important to consumers in deciding whether they can meet premium payments or in choosing savings goals, they are of limited utility to most consumers when they attempt to measure actual costs. Indeed, focusing on one or two of these facts can in some instances lead to poor selections.¹⁵

Therefore, it appears that the participants tended to turn first to those factors which offer only limited guidance and turn last if at all to those factors specifically designed to rank similar policies by costs. The following table presents the rankings for all 37 facts by the percent of participants who accessed the information.

Accessing Rates for Different Types of Life Insurance Information

<u>Rank</u>	<u>Dimension Name</u>	<u>% of Participants That Accessed.</u>
1.	Premiums	86
2.	Name of Company	85
3.	Cash Value	74
4.	Accidental Death	73
5.	Financial Rating	71
6.	Guaranteed Insurability	66
7.	Waiver of Premium	66
8.	Policy Loan Interest Rate	63
9.	Passing Physical Exam Required	58

13 Id. at 18.

14 Id. at 20 (Table 5a).

15 See § III of Report.

10. Savings Yield	58
11. Settlement Options	57
12. In Business Since	56
13. Mutual or Stock Company	55
14. New York License	55
15. Dividend Payment	55
16. Company Retention Index	54
17. Surrender Cost Index	47
18. Other Kinds of Insurance Sold	46
19. Monthly, Quarterly, Semi-Ann'l Premium	46
20. Conditions for Reinstatement	45
21. Net Payment Cost Index	44
22. Convertability	43
23. Illustrated Dividends	43
24. Nat'l Rank in Assets	42
25. Co. Retention Yardstick	37
26. Assets	36
27. Agent's Commission	35
28. Investment Portfolio	34
29. Yr-by-Yr Payments & Benefits	34
30. Renewability	34
31. Breakdown of Premiums	33
32. Yr-by-Yr Cost of Protect'n & Rate of Return	27
33. Premium for Renewal	27
34. Surrender Cost Yardstick	26
35. Net Payment Cost Yardstick	24
36. Sales Volume	23
37. Nat. Rank in Sales Volume	23

The cost related factors, however, were important to the participants in the actual decision making process. When asked "why did you choose the policy you did?", cost dimensions tended to be among the 6th-10th reasons given.¹⁶

<u>Dimension Chosen as Reason</u>	<u>Number of Respondents</u>	<u>% (N = 238)</u>
Premium	95	40
Financial Rating	88	37
Cash Value	78	33
Accidental Death Provision	59	25
Dividend Payment History	53	22
Company Retention Index	52	22

¹⁶ This was question 9 of Study I. These results are not tabulated in the report.

Mutual or Stock	51	21
Savings Yield	46	19
Surrender Index	36	15
Illustrated Dividends	36	15

Also, it appears that many subjects used cost indices as a convenient means to comparison shop. This is evidenced by the large percentage of subjects who accessed a particular cost dimension for all three policies they examined.

Comparison Shopping Rates for Four Cost Dimensions

Group Source	1 Control	2 NAIC	3 FTC	4 FTC	5 NAIC	6 FTC
Trigger	Absent	Absent	Absent	Present	Present	Present
Buyer's Guide	Absent	Present	Present	Absent	Present	Present
N	40	40	39	40	41	38
Company Retention	10.3%	20.0%	30.8%	52.5%	12.2%	39.2%
Savings Yield	28.2	30.0	30.8	25.0	22.0	28.9
Surrender Cost	10.3	32.5	12.8	20.0	29.3	18.4
Net Payment	10.3	30.0	12.8	25.0	29.3	5.3

The FTC subjects in groups 3, 4 and 6 received literature highlighting the Company Retention Index, 41.0% of these subjects used Company Retention to comparison shop. Similarly, 30.9% of the NAIC subjects used the Surrender Cost Index for comparison shopping and 29.6% used the Net Payment Index.

Of particular interest is the fact that 27.4% of all subjects used the Savings Yield to comparison shop. This percentage held steady across all six test groups, despite the fact that Savings Yield was never mentioned in any NAIC literature, and discussed only briefly in the FTC Buyer's Guide. The control group used the Savings Yield for comparison shopping almost three times as frequently as any other cost dimension. The implication is that subjects in all groups considered the savings

feature of life insurance to be very important in choosing among policies.

2. The Effect of Disclosure This study shows that buyer's guides and trigger statements increased participants' accessing of those items considered directly cost related. Table 7 illustrates the change in rankings between those receiving the written statements--trigger statements and buyer's guides--and those receiving none. Looking at only those items which changed rank by five or more places, the groups receiving the written statements devoted less attention to the following facts: settlement options, conditions for reinstatements, year-by-year cost of protection and rate of return, and sales volume.¹⁷ Conversely, these groups gave more attention to the following facts: company retention index, surrender cost index, company retention yardstick, and surrender cost yardstick.¹⁸ In other words, the written statements tended to shift participants' attention from non-cost facts to cost related facts.

Table 7. Comparing Rank Orders of Information Assessed by Groups Receiving no Written Statements (N=40) vs. the Remaining Subjects (n=198).

Dimension Name	Net Change
Financial Rating	-7
Monthly, Quarterly, Semi-Ann'l Premium	-10
Conditions for Reinstatement	-5

¹⁷ Study I, 25-27.

¹⁸ A yardstick is a representation of the range of values a given index may assume. Thus a yardstick can enable a person to determine whether a policy is low, high, or average cost relative to other similar policies.

6
FTC
Present
Present
38

39.2%
28.9
18.4
5.3

ing

Mutual or Stock Company?	+6
Yr-by-Yr Cost of Protect'n & Rate of Return	-14
Yr-by-Yr Payments & Benefits	-7
Company Retention Index	+15
Surrender Cost Index	+9
Sales Volume	-6
Company Retention Yardstick	+8
Surrender Cost Yardstick	+5

An analysis of the relationship between direct cost information accessed by participants and selection of low cost policies also provides some support that cost disclosure is useful. The table below sets forth the policy choices broken out by 16 possible combinations of the four indices chosen by the 115 participants who were presented with three whole life policies to choose from. The data in this table show whether participants who accessed one or more of the four indices picked the lower cost policies more often than the other participants.

Table 12. The Association Between Cost Indices Accessed and Cost of Policy Selected.

COST INDICES ACCESSED		COST OF POLICY			Total
		Low	Medium	High	
		(B)	(E)	(C)	
1. None	N	8	2	1	11
	%	72.7	18.2	9.1	9.6
2. Company Retention	N	8	0	2	10
	%	80.0	0	20.0	8.7
3. Savings Yield	N	7	1	2	10
	%	70.0	10.0	20.0	8.7
4. Surrender Cost	N	5	1	0	6
	%	83.3	16.7	0	5.2
5. Net Payment	N	1	0	0	1
	%	100.0	0	0	.9
6. Company Retention & Savings Yield	N	7	2	1	10
	%	70.0	20.0	10.0	8.7

7. Company Retention & Surrender Cost	N %	3 75.3	0 0	1 25.0	4 3.5
8. Company Retention & Net Payment	N %	9 100.0	0 0	0 0	9 7.8
9. Savings Yield & Surrender Cost	N %	1 50.0	1 50.0	0 0	2 1.7
10. Savings Yield & Net Payment	N %	6 75.0	1 12.5	1 12.5	8 7.0
11. Surrender Cost & Net Payment	N %	6 100.0	0 0	0 0	6 5.2
12. Company Retention & Savings Yield Surrender Cost	N %	9 100.0	0 0	0 0	9 7.8
13. Company Retention & Net Payment & Savings Yield	N %	5 83.3	0 0	1 16.7	6 5.2
14. Company Retention & Surrender Cost & Net Payment	N %	1 100.0	0 0	0 0	1 .9
15. Savings Yield & Surrender Cost & Net Payment	N %	5 71.4	2 28.6	0 0	7 6.1
16. All 4 Indices	N %	12 80.0	1 6.7	2 13.3	15 13.0
	Ns %	93 80.9	11 9.6	11 9.6	115 100.0

The low cost policy was selected 81% of the time and even those participants who did not access any cost index information selected the lowest cost policy in 8 out of

11 cases.¹⁹ We do not believe, however, that this figure should be construed as demonstrating that there is no need for cost index disclosure. First, these results are based on a small number of participants. The group that accessed no cost index included only 11 participants. This small number does not provide a basis for any statistically significant conclusions. But more importantly the study was designed primarily to examine whether information accessing behavior, not policy selection behavior, varied by disclosure format.²⁰ Consequently, the three whole life policies from which the participants could choose differed in important respects besides cost. Although the low cost policy had the highest annual premium, it also was the only policy offered by a mutual company, the only participating policy, the issuing company had the highest financial rating, and the policy had the highest 20-year cash value.²¹ Cash values, financial rating, mutual or stock company, and dividend payment were each accessed by more than half of all the participants.²²

19 Id. at 36.

20 Id.

21 See Appendix B of Study I. Another possible explanation for the high absolute scores is that the participants did not treat the experiment as a real purchase decision. In other words, when asked to choose or decide on one of three policies, they chose the most expensive product. In this case, if they equated high premium with high quality they would select the lowest cost policy. Furthermore, some participants may have avoided one of the high cost policies because it was offered by Business Men's Assurance Company.

22 Study I, 20 (Table 5a).

Furthermore, as noted above, the participants stated that premium, financial rating, and cash value were the three most important dimensions explaining their purchase decisions. Therefore, the fact that 82 percent of those accessing cost indices chose the lowest cost policy may in large part be explained by these other policy differences. Therefore, the high selection rates of the lowest cost policy do not support an inference that consumers do not need cost information.²³

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II. The Second Purdue Study

²³ Id. at 35 (Table 12).

A. Purpose of the Second Study The second study was designed to compare the effectiveness of several life insurance disclosure systems in aiding consumers when purchasing insurance. Gathering a comparable sample from the same area as the first study,²⁴ the second study also employed the simulated purchase technique. The participants were tested on how well they succeeded in selecting lower cost policies from a representative sample of whole life policies. Subsequently, they were asked and tested on how well they understood the various disclosure formats.

It should be noted at the outset that we do not attempt to summarize all of the second study's findings. Some findings are beyond the scope of the present discussion. Other findings are not statistically significant and do not warrant discussion. The role playing scenarios, for example, did not result in statistically significant differences among disclosure formats.²⁵ We highlight only those findings that bear directly on the suf-

24 See Study II at 4-10 for this sample's general demographic characteristics and page 5 for its insurance related characteristics.

25 In the role playing segment, the participants were given four written scenarios depicting hypothetical characters confronted with life insurance purchase decisions. Asked to assume the role of the hypothetical person, each participant selected the "best" of three policies offered. As constructed by the FTC staff, each scenario had only one correct answer. Of the participants exposed to the FTC buyer's guide, 72.8 percent selected the best policy. Only 66.2 percent of the participants using the Belth buyer's guide made the "best" choice and 61.1 percent of those exposed to the NAIC buyer's guide made the correct choice Study II, 84-85. These results, however, miss (barely) being statistically significant and we do not discuss them in the text. Id. at 84.

iciency of the NAIC disclosure format vis a vis other possible disclosures.

19 B. The Simulated Shopping Decision The first segment of the study measured the relative impact of six different disclosure systems on the ability of participants to make good purchase decisions. The participants were divided into six groups, each receiving a different disclosure package:

- Group 1: no buyer's guide, no yardstick;
- Group 2: no buyer's guide, FTC yardstick;
- Group 3: FTC buyer's guide, no yardstick;
- Group 4: FTC buyer's guide, FTC yardstick;
- Group 5: NAIC buyer's guide, no yardstick, and
- Group 6: Belth buyer's guide, no yardstick.

After receiving directions, each group was given an unlimited amount of time to read the disclosure package. Then each participant had an opportunity to examine up to eight different \$25,000 whole life policies, one at a time, with a search fee charged for each policy examined.²⁶ In the case of the first four groups (even group 1), each policy was accompanied by an FTC designed consumer cost statement which had considerable instructional content. Unbeknownst to the participants, the policies were pre-arranged to allow the researchers to control the order in which each participant received the different policies.²⁷ Within each of the six groups, the policies were arranged in three structured sequences:

Sequence 1: 8, 7, 4, 3, 6, 5, 1, 2;

²⁶ Id. 17-18. Subjects were informed that different policies had different payoffs, the payoffs for the best being \$27 (minus search fees) and the payoff for the worst being \$7 (minus search fees). Id. at Appendix B, pages 3-6.

²⁷ Id. at 17-20.

Sequence 2: 7, 8, 4, 3, 6, 5, 1, 2; and
Sequence 3: 1, 2, 4, 3, 6, 5, 8, 7.

where 1 is the lowest cost policy and 8 is the highest cost policy.²⁸ One third of the group using the NAIC model buyer's guide, for example, received the policies in one of each of these three sequences. An identical approach was used in testing the participants who received the FTC and other disclosure packages. The relative impact of the different systems was measured by comparing disparities in the selection rates of the lowest cost policy. The lowest cost policy was defined in different ways: (1) the least expensive policy, (2) the least expensive policy from those examined, and (3) the least expensive policy factoring in search fees.²⁹

1. The Least Expensive Policy 47.2% of the participants who received the FTC buyer's guide and yardstick selected the least expensive policy among the eight available. The next best were those participants receiving no buyer's guide or yardstick (44.4%),³⁰

28 Id. at 15.

29 Id. at 23-24.

30 The relatively good performance of this group is the most significant finding of this study. This group only received a document that is very similar to the Preliminary Policy Summary recommended in Part IV of this report. As the researchers note this statement conspicuously provided average annual rate of return data as well as:

[T]he Consumer Cost Index and premium, and contain[s] several paragraphs which emphasize the benefits of using the Consumer Cost Index. Each policy [summary] instructs the subject regarding what to look for and how to make the policy purchase decision. Thus, the 'control' subjects (i.e., those who saw neither a buyers guide
(Footnote Continued)

those receiving the FTC yardstick without buyer's guide (42.6%), and those receiving the FTC buyer's guide without a yardstick (38.9%). The groups receiving the NAIC buyer's guide and the Belth buyer's guide only selected the least expensive policy 33.3 and 27.8 percent of the time, respectively.³¹

2. The Least Expensive Policy Among Those Examined. In terms of selecting the least expensive policy from among those examined, the groups receiving the FTC disclosures (groups 2-4) made the fewest errors. The next lowest error rate was in the group receiving no buyer's guide or yardstick.³² The highest error rates were in the NAIC and Belth groups. The differences in error rates between

Group	1	2	3	4	5	6
Buyer's Guide	None	None	FTC	FTC	NAIC	Belth
Yardstick	None	FTC	None	FTC	None	None
Average Error Rate (%)	7.4	3.7	1.9	5.7	26.4	24.1

³⁰ (Footnote Continued)

nor a yardstick) still had considerable assistance in making their decision. Id. at 54-55.

This finding indicates the potential effectiveness of the Preliminary Policy Summary.

³¹ See id., 27 and Table 8, at 30. The study also considers choice of policy by sequence (Table 9, p. 31)), and breaks down the data on educational attainment (Table 10, p. 33).

³² Id. at 35.

groups 1-4 and groups 5-6 are statistically significant.³³ Indeed, the average error rate for those receiving the FTC disclosures (groups 1-4) is 5 percent or approximately one-fifth of the error rates for those receiving the NAIC and Belth disclosures.

3. The Least Expensive Policy Factoring in Search Fees

The selection rate of the least expensive policy factoring in search fees demonstrates the importance of yardsticks in comparison shopping. Given the specified payoff differences among the policies and a one dollar search fee, the only six participants making the "optimal" purchase decision were in the groups using the FTC yardstick.³⁴ Likewise when the search fee assessed was raised to two dollars, these two groups still outperformed the other groups.³⁵

Still considering the influence of search fees on the optimal choice, the researchers standardized the results to create a common scale, a "payoff maximization statistic." This measure attempts to eliminate the effect of different sequences and search fees. For example, for the group receiving a two dollar search fee and sequence three, the maximum payoff is 25 dollars. By dividing all net payoffs (for this sequence and search fee combination) by 25, a standard scale having 1.0 as the maximum

33 These figures were compiled from Table 11, id. at 35.

34 Id. at 45 (Table 18a).

35 Id. at 46 (Table 18b).

score is created.³⁶ Similar calculations were performed for the other possible combinations of sequences and search fees. The following table presents the average payoff maximization statistic by disclosure format.³⁷ The best scores were achieved by the

Group	1	2	3	4	5	6
Buyer's Guide	None	None	FTC	FTC	NAIC	Belth
Yardstick	None	FTC	None	FTC	None	None
Payoff Statistic	.804	.817	.823	.834	.703	.729

three FTC related groups.³⁸ Further, the groups using the NAIC and Belth buyer's guides did less well than the baseline provided by the group receiving no buyer's guide.³⁹ Indeed, given the average number of policies examined, the NAIC payoff statistic is not substantially higher than it would have been if policies were picked by random. That is, random choice among policies might yield a payoff maximization statistic as high as .659.⁴⁰ In this light, the NAIC figure (.703) is even

³⁶ Id. at 47.

³⁷ This table is compiled from Table 19, id. at 48.

³⁸ Id. at 47.

³⁹ Id. at 50.

⁴⁰ To illustrate, assume 56 persons select at random from among the possibilities after three searches and 44 persons select from among the possibilities after four searches (the reason
(Footnote Continued)

more troublesome.

4. Conclusions The groups receiving the experimental FTC disclosure packages outperformed the other groups--particularly the NAIC group--on the basis of all three definitions of best choice. Particularly significant is the fact that those subjects who received only the one page summary performed almost as well as those persons who received the more extensive disclosure.

C. Post Decision Reactions After the purchase decisions, the participants were requested to give their reactions. First, in answer to an open-ended question, participants gave general reasons for deciding on the policy selected. Of those groups receiving FTC disclosures (groups 1-4), over 25 percent of the participants said their choices of policies were based upon

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(Footnote Continued)

for choosing 56 and 44 is that the average number of policies searched by for all participants was 3.44). In this case, the random payoff statistic by sequence would be:

SEQUENCE	8-7	.454
	7-8	.454
	1-2	.666
AVERAGE		.525

On the other hand, if these 100 persons copy the search behavior of the participants in their sequence (rather than that of all other participants, regardless of sequence) then the payoff statistic by sequence would be:

SEQUENCE	8-7	.614
	7-8	.614
	1-2	.749
AVERAGE		.659

In sum, the NAIC payoff statistic of .703 is not substantially higher than the result if policies are picked by random.

the Consumer Cost Index either alone or in combination with one or more cost-related indices. Fifteen percent of the FTC participants based their choice on the highest average annual rate of return. In contrast, about six percent of the NAIC participants referred to surrender cost data discussed in the NAIC buyer's guide. An additional twenty-two percent of the NAIC participants did refer to an index which they could not name.⁴¹

Next, the participants were queried on the buyer's guides. They were asked for their general reactions to their respective buyer's guides⁴² and how well they understood specific sections.⁴³ In general, most participants stated that their buyer's guide was helpful and understandable. But as the researchers state: "it is clear that subjects using the FTC buyers guide (groups 3 and 4) reported it to be significantly easier to comprehend than did subjects exposed to either the NAIC or Belth buyers guides."⁴⁴

In the same vein, the only section of any buyer's guide that a substantial number of participants said they found hard to understand was the section in the NAIC buyer's guide on how cost indices are computed and used. Out of a total of 72 responses,

⁴¹ Id. at 58 (Table 23).

⁴² Id. at 62.

⁴³ Id. at 71.

⁴⁴ Id.

41 persons (56.9%) said they had difficulty understanding the cost index section of the NAIC buyer's guide.⁴⁵ Only 3.8 percent and 3.7 percent respectively, had difficulty understanding the cost index sections of the FTC and Belth buyer's guides.⁴⁶

In sum, it appears that it is possible to develop a buyer's guide that is more comprehensible than the NAIC guide.

D. Comprehension Quiz In the final phase of testing, each participant completed a 21-item comprehension quiz. The quiz included true-false and multiple choice questions about life insurance. Three quizzes were used, corresponding to the three buyer's guides (NAIC, FTC and Belth). Fifteen of the 21 questions, however, were common to all three quizzes.⁴⁷ The participants were not allowed to refer to their buyer's guides during the first administration of the comprehension quiz. Subsequently, the quiz was re-administered and then participants were permitted to refer to their buyer's guides for help in answering the quiz questions. Participants not receiving any buyer's guide up to that time were allowed to use the FTC's buyers guide for help in taking the quiz.

Comparing the quiz results by buyer's guide, the table below shows that the NAIC groups in both quizzes scored significantly

45 Id. at 75 (Table 34).

46 Id.

47 Id. at 91.

lower.⁴⁸ Assuming no difference in intelligence⁴⁹ between the "NAIC" and other participants, these data suggest either that the six unique items on the NAIC quiz were more difficult or the NAIC buyer's guide was the least explanatory.⁵⁰

Group	1	2	3	4	5	6
Buyer's Guide	None	None	FTC	FTC	NAIC	Belth
Yardstick	None	FTC	None	FTC	None	None
Quiz I						
(% Correct)	84.3	82.9	91.9	91.0	84.8	87.6
Quiz II						
(% Correct)	94.3	92.4	95.2	92.4	89.0	91.0

In contrast, the groups receiving the FTC buyer's guide in both quizzes did better than all other groups. This was true even for groups 1 and 2 who received no buyer's guides for the first quiz and the FTC buyer's guide in the second quiz.⁵¹

In particular, the researchers found that in quiz I the participants receiving no buyer's guide and the NAIC buyer's guide scored significantly lower than those receiving the FTC buyer's guide.

⁴⁸ Id. at 92. The table was compiled from Table 44, id. at 93.

⁴⁹ Id. at 92.

⁵⁰ Id. at 96.

⁵¹ Id.

It should also be noted that the group receiving no buyer's guide did virtually as well as those groups receiving the NAIC and Belth buyer's guides. In Quiz II group (1) and FTC-No yardstick group (3) both were significantly higher than the NAIC group mean. (No other pairs of means differ significantly).⁵² Again, the results indicate that it is possible to develop a buyer's guide that is more comprehensible than the NAIC model guide.

III. Conclusions Drawn from the Two Purdue Studies

The major conclusions drawn in this appendix are:

⁵² In the closing section of Study II, the authors wrote:

In conclusion, while some of the data suggest that subjects exposed to a disclosure system (particularly the FTC buyers guide) will fare better than those not exposed to such a system, the differences were not as striking nor as conclusive as expected. (Study II, 114)

This statement might well be interpreted to mean that none of the disclosure systems tested make much difference in the subjects' performance in choosing low-cost policies. This interpretation is not correct. As shown earlier in this Appendix, all four of the groups who received the FTC material had higher payoff maximization statistics (from 80% to 83%) than the Belth or NAIC groups (73% and 70% respectively).

A letter from Professor Jacoby (to Michael Lynch, FTC, March 1, 1979) clarified what he and his colleagues meant in the paragraph quoted above. There he writes that the surprising finding was that the FTC groups 1 and 2, which did not receive a buyer's guide. Groups 1 and 2 did have the one-page "consumer cost statements," however, and these apparently proved almost as effective as the buyer's guide plus yardstick plus cost statement. We regard this finding as one of the most important and hopeful results of the Purdue studies. In our view, it underlines the importance and potential effectiveness of providing the "preliminary policy summary."

Study 1

1. Although cost dimensions are accessed much less frequently than other policy dimensions, they play a significant role in the final choice among policies.
2. Exposure to written statements (triggers and buyers guides) increased access to the targeted cost information for all subject groups.
3. The Savings Yield was the cost dimension accessed most frequently and many subjects appear to have used it to comparison shop.

Study 2

1. The participants receiving the FTC disclosure materials appear to have engaged in more intelligent search behavior than their counterparts.
2. Very few (5%) of FTC participants failed to choose the least costly policy among those they examined. A substantial portion (25%) of the NAIC and Belth subjects failed to choose the least costly policy.
3. A simple one sheet disclosure statement like the Preliminary Policy Summary recommended in Part IV of this report offers good promise in achieving meaningful disclosures.
4. It appears possible to develop a buyer's guide that is more comprehensible than the NAIC model guide.

APPENDIX X: BUYER'S GUIDE,
SUGGESTED STATE REGULATION,
AND NAIC AND STATE REGULATIONS

BUYER'S GUIDE TO LIFE INSURANCE

The purpose of this booklet is to give you general information that will help you select a satisfactory life insurance policy for your needs. It is not intended to be an endorsement of any policy or insurance company.

Since the information is general, if you have unusual insurance problems, you should seek professional advice. The Guide is not designed to assist in the evaluation of your existing policies.

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Buyer's Guide to Life Insurance

IMPORTANT: Many people think all similar life insurance policies cost about the same. They don't. Reading this Buyer's Guide may save you many hundreds or thousands of dollars over a twenty-year period by helping you find a low-cost policy that best fits your needs.

The main purpose of life insurance is to provide financial security after your death for those who depend on you. Life insurance can also be used to pay off your mortgage or provide for other large debts, pay education expenses, provide savings and retirement income. It can also be used to pay for funeral and last illness expenses. In addition, life insurance can be valuable protection against the premature death of a spouse who raises the children and maintains the household.

This guide will help you to determine the amount of protection your family needs. It will also help you learn which kind of policy best provides that protection. You'll learn how to select a policy that gives you the most coverage at the lowest cost.

Read the guide carefully and never forget that when buying insurance, being a careful shopper can give you the most protection at the least expense.

WHAT IS LIFE INSURANCE

Every life insurance policy is a contract. In return for your paying premiums, an insurance company promises to pay a specified amount of money when you die to a person you name in the policy. The person who is to receive the money is called the beneficiary.

The money to be paid is called the proceeds or death benefits, and its amount is often referred to as the face amount of the policy.

BASIC TYPES OF LIFE INSURANCE

All life insurance policies promise to pay a stated amount of money when you die. There are two basic types of life insurance: term and whole life. While they may go by different names, most life insurance policies are either one of these types or a combination of both. However, all policies of the same type do not necessarily cost the same or provide the same kind of protection. In fact, buying a policy that fits your needs and your budget can save you hundreds or even thousands of dollars over your lifetime.

TERM INSURANCE

Term insurance insures your life for a fixed period of time or term such as 1, 5, or more years. Death benefits are payable only if you die within the term, provided, of course, the policy is still in effect. At the time of purchase, term insurance generally provides the largest death protection for your premium dollar. You can usually renew term insurance policies for one or more terms without having to pass a medical examination to get the renewal. But be careful: not all term policies are renewable. You should be sure about this feature before buying. If the policy is renewed for another term, the premium will be increased because you will be older during the additional term. Some term policies may be renewed through age 100. However, the premiums on term insurance are very expensive after age 65.

You can also buy term policies whose premiums stay level but whose death benefit declines each year. These are called decreasing term policies. A decreasing term policy may be useful if you are young and currently responsible for a mortgage or other large debt.

Before you consider buying an individual life insurance policy check with your employer, labor union, or professional association on your eligibility for group term insurance. Group insurance often costs much less than either individual term or individual whole life, especially if your employer pays part of the premiums. In addition, you can usually buy group insurance without passing a medical exam. There are, however, some things to watch for. Like individual term insurance, group insurance is usually renewable only through age 65 or 70. Also, there may be a limit on the amount of group insurance you'll be able to buy. And if you switch employers or drop your union or professional association membership, your group coverage may end. If that happens, you're usually guaranteed the right to convert that coverage to an individual whole life policy--but at a higher premium. Still, all things considered, group insurance may provide a solid, relatively inexpensive foundation for your personal insurance program.

WHOLE LIFE INSURANCE

Whole life insurance is also referred to as "ordinary life" or "straight life" insurance. It differs from term insurance in two important ways. First, although the premiums start out at a

higher level than term insurance for the same amount of insurance protection, they remain level and do not increase with age. Second, whole life policies develop cash values that increase every year.

You should understand that if you buy a whole life policy, a substantial portion of your premiums will go into the savings element (cash value) of the policy. During the early years of a whole life policy, the premiums are much more than the amount needed to buy term insurance for a person of the same age. The insurance company puts most of the extra dollars into a fund, called the policy's cash value. This cash value grows steadily over the years, and as it grows, it reduces the amount of actual death protection the company must provide to pay the face amount. In fact, you can think of whole life insurance as a combination of an increasing savings element (cash value) and a decreasing amount of pure life insurance protection.

You can get the cash value if you cancel your policy. However, if you keep the policy, the insurance company will pay only the face amount of the policy if you die, not the face amount plus the cash value. For example, if you bought a \$25,000 whole life policy at age 35, it might have a cash value of \$10,000 by the time you're 65. Yet, if you die at age 65, your beneficiary will get only \$25,000, no matter how large or small the cash value.

Besides making it possible to have affordable life insurance beyond age 65, cash values can be useful to you in other ways. Many people find buying a whole life policy a convenient way to save for retirement or other purposes. Each time you pay your premium, a part of the premium automatically goes to build up the policy's cash value. You can get the full amount of the cash value by simply canceling your policy. But if you do, you'll, of course, lose your death protection. You can also borrow up to the full amount of the cash value in the form of a policy loan. You will have to pay interest on this loan at the annual percentage rate fixed in the policy, but this rate is often lower than other rates available. If the loan is still outstanding when the policyholder dies, the policy loan amount will be deducted from the payment made to beneficiaries.

OTHER TYPES OF POLICIES

In addition to whole life policies, there are many other policies on the market with savings elements. "Life paid up at age 65" is just what the name implies: after age 65 no more premiums are due. "Twenty-pay life" is a policy with 20 annual premiums after which time the policy stays in force without additional payments. An "endowment policy" is one in which the cash value equals the policy's face amount at the end of a limited period, usually 20 or 30 years. Endowment insurance has a greater savings component than whole life policies, but it gives you less death protection for your premium dollar. Although the premium on all of these types is higher than simple whole life, they may be useful for certain special needs. But most people's insurance needs can be met by either term or whole life or a combination of the two.

TERM OR WHOLE LIFE INSURANCE

In deciding whether to buy term or whole life insurance, you ought to consider these three questions: (1) How much insurance coverage does my family need against my premature death; (2) How long do I want to keep my insurance in force; and (3) Do I want to use my insurance policy as a way to save?

HOW MUCH INSURANCE TO BUY

You should remember: THE MAIN PURPOSE OF LIFE INSURANCE IS TO PROVIDE FINANCIAL SECURITY FOR DEPENDENTS WHEN A WAGE-EARNER OR SERVICE-PROVIDER DIES PREMATURELY.

It is important to establish the amount of money your dependents will need if certain income or services are no longer available because of premature death. Life insurance is a source of cash for paying a family's living expenses, education costs, mortgages, and other debts. A comprehensive life insurance program should come as close as you can afford toward providing the funds your family and dependents would need over and above the assets you have acquired and can leave to them and what would be available to them through social security or other protection.

When you're young and your insurance needs are generally greatest, term insurance gives you three to five times more protection for your premium dollar than whole life. For example, a 25-year old person who can afford to spend \$300 a year on life insurance could buy either \$20,000 worth of whole life or \$100,000 worth of term insurance. Many people--especially those with young children--can get the amount of insurance they need only by buying a term policy. On the other hand, if you expect to carry that amount of insurance no matter how old you become, term insurance will become expensive after age 65.

HOW LONG TO KEEP YOUR POLICY IN FORCE

Remember that the main purpose of life insurance is to replace income lost when a family's breadwinner dies prematurely. This suggests that when a person approaches retirement, the need for life insurance may diminish. Whole life insurance can, of course, be used to meet a person's long-term insurance needs through age 65. But so can renewable term insurance. Though the term policy's

premium will go up with each renewal, the process is slow. For example, if you buy a renewable term policy at age 35, it will take about 20 years for the premium of your renewable term policy to become larger than the level premium you would have had paid if you had bought a whole life policy. By that time, however, you may need less insurance and can reduce the insurance you carry.

On the other hand, whole life policies kept in force even after retirement can be used to pay for funeral expenses, medical bills, and death taxes. They can also provide money for the surviving members of the family. Though some term policies are renewable through age 100, remember that their premiums become very expensive after age 65.

COMBINING TERM AND WHOLE LIFE

If you think you'll want some insurance after age 65 but you can't afford enough whole life insurance to give your family adequate protection while you're young, there are several things you can do. One is to buy a renewable term policy that is also "convertible." This means that any time before the end of the conversion period, you can trade the policy in for a whole life policy of the same or lesser face amount without having to pass a medical exam. Premiums for the new policy, however, will be higher than you have been paying for the term insurance.

People with young children often find this type of insurance program attractive because it lets them buy a larger amount of death protection when they're young at a price they can afford. At the same time they preserve their option to buy a whole life policy if they decide they want some insurance in force after age 65. You can also buy a combination of term and whole life

insurance by purchasing either separate policies or a whole life policy with a term policy attached to it (this is called a "term rider"). In either case you'll have insurance that will remain in force after you turn 66 plus you will have some additional death protection during your younger years when you need it most.

Because your income and the number and needs of your dependents may change, it is important to review your life insurance program periodically. As a part of this process you should consider the effect of inflation on your assets and on your family's future needs.

SAVING THROUGH LIFE INSURANCE

If you want protection for your family while you're young and a source of money as you grow older, there are two things you can do. You can buy a whole life policy with its built-in savings program. Or you can buy a term policy and each year invest the difference between the whole life premium and the term premium in a savings account, U.S. savings bonds, or some other safe investment. If you buy a term policy and you're the kind of person who can save regularly, and many people are, you'll build up a sizeable sum of money by the time you're 65. You can then use this sum for the same purposes as the cash value of a whole life policy. This could reduce your need for life insurance in your later years.

Consider the Annual Rate of Return. If you are considering whole life as a way of saving, you should compare its features with other types of savings programs, especially savings accounts. The best way to make a comparison is to look at a policy's average

annual rate of return. The average annual rate of return will, to a large extent, depend on how long you keep a policy in effect. It is calculated by breaking down the cost of the premium according to where the premium dollar goes. Part of the premium goes for relatively inexpensive death protection. The rest can be considered a "savings deposit". The rate of return is expressed as a percentage and is equal to the interest rate that will make the "savings deposit" grow into an amount equal to the policy's cash value. For example, a policy with a rate of return of 3.2 percent means that the savings element of your premium, if deposited in a bank, would need to earn 3.2 percent after taxes for the depositor to be as well off with either alternative.

You'll find a policy's average annual rate of return for 5, 10, 20 and 30 years on the PRELIMINARY POLICY SUMMARY an insurance agent must give you before asking you to sign a policy application. Remember though that the average annual rate of return is based on estimates of how much it will cost you to purchase term insurance. The chart below shows term insurance rates used in making the rate of return calculations.

Average Yearly Renewable Term Rates per \$1,000

<u>Age</u>	<u>Amount of Insurance</u>		
	<u>\$10,000</u>	<u>\$25,000</u>	<u>\$100,000</u>
25	\$ 4.47	\$ 2.97	\$ 2.22
35	4.73	3.23	2.48
45	7.16	5.66	4.91
55	13.85	12.35	11.60

If you can find term insurance that costs less than what is on the chart, the actual average annual rate of return on a whole life policy you are considering will be somewhat lower than the rate disclosed on the PRELIMINARY POLICY SUMMARY. In any case, whether you are merely comparing term and whole life or considering setting up an insurance package made up mainly of term insurance, you should be able to find a term policy that costs as little as the one in the chart. Don't forget that the annual rates shown are per \$1,000 of coverage. Multiply these rates by the number of thousands of dollars of coverage you want to get. For example, at age 25 multiply \$4.47 times 10 to get the total annual cost for a \$10,000 insurance policy.

A little difference means a lot. If your reaction to all this talk of rates of return is to say "What difference can a percent or so make?" the answer is--a lot! A difference of only 1 percent in a rate of return is extremely significant. When compounded over 30 years (which can be how long a whole life policy lasts), this seemingly small difference can amount to a lot of money. The chart below illustrates this by showing how many pre-tax dollars you would have, at the end of 30 years, if you deposited \$500 each year in bank accounts paying various interest rates:

Impact of Different Interest Rates on a \$500 Per

Year Investment for a 30-Year Period

<u>Rate of Interest</u>	<u>Value After 30 Years</u>
2%	\$20,284
3%	23,788
4%	28,042
5%	33,219
6%	39,529
7%	47,230

TAX CONSIDERATIONS

You may also want to consider the possible tax advantage of saving with a whole life policy. Interest earnings credited to the "savings deposit" feature of a whole life policy are not taxed until you surrender the policy; even then, the taxable amount may be zero or quite small. It is important to compare rates of return with the after-tax return that you could get from other savings or investment programs. For example, if you are in a 20 percent tax bracket, a 4 percent rate of return from the "savings deposit" feature of the whole life policy is equal to a 5 percent return on fully taxable investments. Here's why--on a \$100 fully taxed investment paying 5 percent, you would get \$5.00. But 20 percent of that--\$1.00--would go for taxes. This means you would end up with the same \$4.00 you would get from a policy with a 4 percent rate of return.

OTHER BENEFITS OF WHOLE LIFE

Finally, many whole life policies offer benefits (other than cash values) that are not found in term insurance combined with a savings or investment program. These include the right to stop

paying premiums and use the accumulated cash value to purchase paid up insurance or extended term insurance. Whole life policies also contain guarantees with respect to annuity purchase rights. Additionally, you can borrow against your cash value at a favorable interest rate. These other benefits of a whole life policy might make it a desirable purchase even if its rate of return is lower than you could receive elsewhere.

A WORD OF CAUTION ABOUT WHOLE LIFE

It's a costly mistake to buy a whole life policy only to drop it after a year or two. If you do, you'll usually get next to nothing back. It's true that few people plan to drop a whole life policy soon after buying it. Yet about one in five new policyholders actually does just that. Moreover, because of the cost elements involved, the cash value of a whole life policy builds up very slowly during the policy's early years, making whole life insurance a very uneconomical way to save for short-term needs. Therefore, you shouldn't buy a whole life policy unless you plan to keep it at least 10 years.

"PAR" OR "NON-PAR" POLICIES

Some term and whole life policies pay dividends (participating or "par" policies), while others do not (non-participating or "non-par" policies). Dividend-paying policies generally have higher premiums than nondividend-paying policies, but often cost less in the long run, especially if their dividends are paid each year. The amount a company expects to pay each year are known as "illustrated" dividends. These "illustrated" dividends are not

guaranteed. The exact amount a company actually decides to pay in dividends each year depends upon a number of factors, including the company's investment income for that year. These factors simply can't be predicted with complete accuracy several years in advance. In recent years, however, the actual dividends paid on most "par" policies have been higher than those illustrated at the time the policies were sold.

HOW TO FIND A LOW-COST POLICY

Once you've decided on the type and size of policy you want, use the Surrender Index to find a low-cost policy. This index is found on the PRELIMINARY POLICY SUMMARY. Don't pick a policy just because it has a low premium. Premiums only measure what you pay for a policy. They don't measure a policy's benefits. Those benefits, which may include cash values and dividends as well as death protection, vary by large amounts among policies with similar premiums sold by different companies. The Surrender Index takes premiums, cash values, dividends, and interest into consideration. It is called the Surrender Index because it compares cost as if at some future point in time you were to surrender the policy and take its cash value. THE MOST IMPORTANT THING TO REMEMBER WHEN USING THE SURRENDER INDEX IS THAT A SMALL NUMBER IS GENERALLY A BETTER BUY THAN A COMPARABLE POLICY WITH A LARGER INDEX NUMBER.

The table below illustrates the range of 20-year Surrender Indices for four commonly sold participating policies sold to males at the ages indicated. One-fourth of all policies are at or below the "Low Cost" figure. The "Average Cost" figure is in the middle of the range--half of all policies of that type are cheaper and half are more expensive. One-fourth of all policies are more expensive than the "High Cost" figure.

Policy Type	Size	Range of Costs	Surrender Index		
			Age 25	Age 35	Age 45
Whole Life	\$10,000	Low Cost	\$3.69	\$5.39	\$ 9.95
		Average Cost	4.50	6.43	11.51
		High Cost	5.54	7.59	13.05
Whole Life	\$25,000	Low Cost	2.76	4.56	8.82
		Average Cost	3.53	5.39	10.10
		High Cost	4.20	6.35	11.39
Term	\$25,000	Low Cost	3.42	5.62	12.38
		Average Cost	3.64	5.86	12.93
		High Cost	4.19	6.71	13.91
5 Year Renewable & Convertible Term	\$50,000	Low Cost	3.49	6.00	12.90
		Average Cost	3.87	6.31	13.71
		High Cost	4.36	6.94	14.54

As this table shows, the cost for similar policies varies widely. These differences in cost can be very important to you. For example, if a person were to buy a \$25,000 whole life policy with a Surrender Index of \$3 per \$1,000 instead of one with a Surrender Index of \$6 per \$1,000, the saving would be about \$75 per year on the average ($\$6 - \$3 \times 25 = \$75$). If a person were then to deposit this \$75 per year in a bank account at 5 percent interest, the balance at the end of the 20 years would be almost \$2,500.

The range of Surrender Indices given on the table only apply to the particular policies and ages given. To find out if the cost of a particular policy is high or low you should call up a number of competing companies and ask for the 20-year Surrender Index (at your current age) for their comparable policies.

When using the Surrender Index to look for a low-cost policy, remember the following:

1. The index is only approximate. Rather than search for

the lowest-cost policy on the market, use the index to find a group of relatively low-cost policies from which to make your final choice. Differences of less than 50 cents per \$1,000 can usually be ignored and may be offset by other policy features or by differences in the quality of service you may expect from the company or its agent.

2. The Surrender Index is only useful in comparing the costs of similar policies, those which provide essentially the same basic benefits and require payments for approximately the same period of time. The more similar the policies, the more reliable the cost comparison will be. For example, don't use the Surrender Index to compare the cost of a term policy to that of a whole life policy; instead, base your choice of term versus whole life on factors mentioned earlier in this Buyer's Guide.

3. The Surrender Index for a dividend-paying policy assumes that dividends on the policy will be paid exactly as illustrated at the time the policy was issued. This, however, rarely happens. Since the exact amount of a "par" policy's dividends isn't guaranteed, the policy's actual cost may turn out to be higher or lower than that indicated by the Surrender Index. Remember, however, in recent years the actual dividends paid on most "par" policies have been higher than those illustrated at the time the policies were sold. As long as you recognize that "par" policies' dividends are not guaranteed, you can use the Surrender Index to compare the costs of dividend-paying and nondividend-paying policies.

POINTS TO REMEMBER

1. KNOW YOUR RIGHTS. The laws of this state provide that anyone who buys a life insurance policy from an agent can return the policy to the company for any reason within 10 days after the policy is delivered and receive a full return of all money paid. If the policy was bought through the mail, you have 30 days after delivery to return it and receive a refund.
2. BUY ONLY WHAT YOU CAN AFFORD. If you drop your whole life policy within the first 10 years because the premiums turn out to be more than you can afford, you may lose a substantial portion of the money you have paid in.
3. GROUP INSURANCE. If you are eligible for such coverage, check it out carefully. It may be the easiest and least costly way to meet your basic life insurance needs.
4. TRY NOT TO LEAVE YOURSELF UNDERINSURED. Remember: during your younger years, when your insurance needs are generally greatest, term insurance will provide you with several times more insurance protection than whole life for the same premium dollar.
5. SHOP AROUND. Many people think that all similar policies cost about the same. They don't. Before you buy a life insurance policy, check to see if it has a low Surrender Index.
6. CHECK THE RATE OF RETURN. If you are thinking about using whole life insurance as a way to save, be sure to check its rate of return and compare it with other policies and alternative savings or investment programs.

7. SHOP FOR A GOOD AGENT AS WELL AS A GOOD POLICY. You can't overestimate the value of a well-informed agent. Inexperienced agents often lack detailed knowledge about their company's policies. They may not even realize that the costs of similar policies differ greatly from company to company. In addition, because agent commissions are tied to premium size, there may be an incentive for some agents to sell costlier policies that may not fit your needs. So shop around. Talk to two or three agents, including agents who represent several companies. Compare the advice each one gives you and the Surrender Indices and rates of return of the policies each one recommends.

Preliminary Policy Summary

For
Whole Life and
Endowment Insurance

Important

Many people think all similar life insurance policies cost about the same. *They don't.* The cost of similar policies varies sharply. You can save many hundreds or even thousands of dollars by choosing a low-cost policy. To find out how this particular policy ranks, compare its Cost Index (found below) to the

range of cost indexes for similar policies. For further information on cost comparison and examples of the range of cost indexes for a number of policies, see pages 00-00 in the *Buyer's Guide to Life Insurance* which you should have received with this policy summary.

Company	Yearly Premium \$	(\$	per \$1,000 of Face Amount)
Type of Policy	20-Year Surrender Index (per \$1,000 of Face Amount)\$		
Name of Policy	The Average Annual Rate of Return if you keep this policy		
Face Amount \$	5 years is	10 years is	
Policyholder's Sex	and Age at Issue	20 years is	30 years is

How to Use This Preliminary Policy Summary

Surrender Index

To find a low-cost policy, look at the policy's 20-year surrender index, *not* its premium. Premiums only measure what you pay for a policy. The benefits you receive from policies with similar premiums vary widely. The Surrender Index takes premiums, cash values, and dividends into consideration. In doing so, it provides a much more complete measure of the cost of similar life insurance policies than premiums. A policy with a *low* Surrender Index is generally a better buy than a similar policy with a higher index number. The Surrender Index should only be used to compare the cost of similar policies. Don't use it to compare the cost of a term policy to that of a whole life policy.

Average Annual Rate of Return

Part of each premium you pay buys you death protection and part can be viewed as a deposit which builds up the savings (or cash value) portion of your policy. The Average Annual Rate of Return shows you approximately what rate of return you'll get on the savings portion of this policy if you keep it for 5, 10, 20 or 30 years. The rate of return is one factor you should consider in deciding whether to buy term or whole life insurance. There are other benefits in a whole life contract that are not generally available in term insurance contracts. Therefore a whole life policy may be a desirable purchase even if its rate of return is lower than you could receive elsewhere. For a discussion of this and other factors, see pages 00-00 of your Buyer's Guide.

Signature of Agent

Date

Preliminary Policy Summary

For
Term Insurance
and Term Riders

Important

Many people think all similar life insurance policies cost about the same. *They don't.* The cost of similar policies varies sharply. You can save many hundreds or even thousands of dollars by choosing a low-cost policy. To find out how this particular policy ranks, compare its Cost Index (found below) to the

range of cost indexes for similar policies. For further information on cost comparison and examples of the range of cost indexes for a number of policies, see pages 00-00 in the *Buyer's Guide to Life Insurance* which you should have received with this policy summary.

Company

Companies (or intermediaries) should enter in this space the appropriate information for representative policy years.

Type of Policy

Initial Face Amount \$

Policy Years	Annual Premium	Premium per \$1,000 of Face Amount	Face Amount	Dividends
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Policyholder's Sex and Age at Issue

Length of Term

Renewable* Yes No If Yes, through what age?

Convertible Yes No If Yes, through what age?

20-Year Surrender Index (per \$1,000 of Face Amount)\$

How to Use This Preliminary Policy Summary

Surrender Index

To find a low-cost term policy, look at the policy's 20-year Surrender Index, not just its first-year premium. That's because the premiums for some term policies go up faster than others. In addition, many term policies pay dividends. When they do, that lowers the cost of those policies. The Surrender Index takes both dividends and later-year premiums into consideration and thus gives a better measure of a term policy's cost than the first-year premium alone. A policy with a *low* Surrender Index is generally a better buy than a similar policy with a higher index number.

The Surrender Index should only be used to compare the cost of similar policies. *Don't* use it to compare the cost of a term policy to that of a whole life policy.

*Renewability

If you're buying term insurance for long-term needs, make sure your policy is guaranteed renewable through at least age 65. Check above for the age through which this policy can be renewed. For more information on how to shop for life insurance, read your Buyer's Guide.

Signature of Agent

Date

DRAFT REGULATION

(1) AUTHORITY. (Insert applicable state authority)

(2) PURPOSE. The purpose of this regulation is to require insurers to deliver to prospective purchasers of life insurance information which will improve the buyer's ability to select the most appropriate plan of life insurance for his or her needs, improve the buyer's understanding of the basic features of the policy which has been purchased or which is under consideration, improve the ability of the buyer to evaluate the relative costs of similar plans of life insurance and improve the buyer's ability to chose between dissimilar plans of insurance. This rule does not prohibit the use of additional material which is not in violation of this rule or any other [state] statute or rule.

(3) SCOPE. (a) Except as hereafter exempted, this rule shall apply to any solicitation, negotiation or procurement of life insurance or annuities occurring within this state. This rule shall apply to any issuer of life insurance contracts including fraternal benefit societies.

(b) For purposes of this regulation the term "life insurance" includes annuities except where the context indicates otherwise.

(c) Unless otherwise specifically included, this rule shall not apply to:

1. Credit life insurance.
2. Group life insurance provided at least a portion of the cost is borne by a person other than the persons insured or their beneficiaries.

3. Variable life insurance under which the death benefits and cash values vary in accordance with unit values of investments held in a separate account.
4. Group annuities provided at least a portion of the cost is borne by a person other than the annuitants or their beneficiaries.

(4) DEFINITIONS. For the purposes of this rule, the following definitions shall apply:

(a) [state] Buyer's Guide to Life Insurance. The [state] Buyer's Guide to Life Insurance is a document which contains, and is limited to, the language within the current edition of "The [state] Buyer's Guide to Life Insurance" put out by the Insurance Commissioner of the State of []. A copy of which is attached hereto as Appendix 1. Insurers may purchase the Buyer's Guide at cost from the Office of the Commissioner of Insurance, or they may reproduce it themselves (subject to reasonable standards of style, size, and layout).

(b) Cash Dividend. A Cash Dividend is the current illustrated dividend which can be applied toward payment of the gross premium.

(c) Additional First Year Premium Policies. A policy requiring an additional premium payment for the first policy year, or for the first several policy years, that is substantially larger than the premium for the remainder of the policy years and providing a fixed payment at the end of a fixed term period coupled with a term insurance policy or a whole life insurance

policy. There are several variations in the forms of such policies and are more commonly known as "deposit term", "deposit whole life," or "modified whole life" policies.

(d) Equivalent Level Death Benefit. The Equivalent Level Death Benefit of a policy or term life insurance rider is an amount calculated as follows:

1. Accumulate the guaranteed amount payable upon death, regardless of the cause of death, at the beginning of each policy year for twenty years at five percent interest compounded annually to the end of the twentieth policy year.
2. Divide each accumulation of step 1 by an interest factor that converts it into one equivalent level annual amount that, if paid at the beginning of each year, would accrue to the value in step 1. The twenty year interest factor is 34.719.

(e) Generic Name. Generic Name means a short title which is descriptive of the premium and benefit patterns of a policy or rider.

(f) Life Insurance Indices

1. Surrender Index. The Surrender Index is calculated by applying the following steps:
 - a. Determine the guaranteed cash surrender value, if any, available at the end of the twentieth policy year.

- b. For participating policies, add the terminal dividend payable upon surrender, if any, to the accumulation of the annual Cash Dividends at five percent interest compounded annually to the end of the twenty years and add this sum to the amount determined in step a.
- c. Divide the result of step b (step a for guaranteed-cost policies) by the interest factor that converts it into an equivalent level annual amount that if paid at the beginning of each year, would accrue to the value in step b (step a for guaranteed-cost policies) over the respective period stipulated in step a. The twenty year interest factor is 34.719.
- d. Determine the equivalent level premium by accumulating each annual premium payable for the basic policy or rider (if the premium includes supplemental benefits without separate identifiable charge, a reasonable adjustment may be made) at five percent interest compounded annually to the end of twenty years and dividing the result by the factor stated in step c. (This amount is the annual premium payable for a level premium plan).

- e. Subtract the result of step c from step d.
 - f. Divide the result of step e by the number of thousands of the Equivalent Level Death Benefit to arrive at the Surrender Index.
2. Average Annual Rate of Return Index. This index is calculated on cash value policies using the Linton Yield method.
- a. The Linton Yield method solves for a level, effective, annually compounded interest rate, or yield. This yield is determined by equating the cash available at the end of a specified number of years from two different protection/savings programs, and then solving for the annual yield that must be achieved on the separate savings fund of the second program in order to produce the cash equivalency with the first program. The two programs compared are:
 - i. A life insurance policy on, normally but not necessarily, some permanent plan. The cash used at the end of the specified year is the policy's guaranteed cash surrender value plus the terminal dividend payable upon surrender and the dividend payable at the end of the specified year.

ii. A combination of a savings fund and yearly renewable term (YRT) insurance. The amount deposited in the savings fund each year is assumed to be equal to the annual premium payable under the alternative program for the permanent life insurance policy (less any dividend payable at the end of the preceding year) less an assumed premium payable for YRT insurance. The amount of YRT purchased each year is that which would be adequate to bring the combined death benefit from the savings plan and the YRT to the same as that payable under the permanent life insurance policy. The cash used for comparison with the permanent policy is the amount accumulated in the savings fund at the end of the specified year.

b. Average Annual Rate of Return index figures given out in [state] by insurers or intermediaries shall be calculated separately for males and females and shall be based upon the following assumptions:

i. As to YRT premium rates:

YRT premiums = $(1,000 q) (K) + \$0.90 + \$25/S$ where K equals 1.00 for ages 0 through 14 and 0.95 for ages 15 and above, S equals policy size in thousands and $1,000q$ equals the mortality rate for age x shown in subsection (9);

ii. As to elements entering into the calculation: Gross premiums shall include the total premiums charged for all life insurance benefits; dividends shall be total illustrated dividends excluding any separately identifiable dividends payable for benefits other than life insurance.

c. Average Annual Rate of Return index figures for additional first year premium policies defined in Section 4(c) shall be calculated in the same manner as for cash value policies. For purposes of the calculation gross premiums shall include all payments made to the company under the contract and cash values for each year shall be the total amount to which the policyholder is entitled under the contract for that year.

- d. Average Annual Rate of Return index figures for annuities shall be the annually compounded interest rate, or yield, on gross premiums paid over the selected holding period.

Note: A discussion of the Linton Yield method may be found on pages 28-30 in the Analysis of Life Insurance Cost Comparison Index Methods, prepared by the Society of Actuaries Committee on Cost Comparison Methods and Related Issues (Special), September, 1974. Further discussion on the "low" YRT rates to be used in computing the Linton Yield, which are the rates specified in this rule, may be found in Appendix E, pp. 187-192 of that same publication.

(g) Preliminary Policy Summary. For the purposes of this rule, Preliminary Policy Summary means a document provided to the buyer of a life insurance policy which contains necessary consumer cost disclosure information, in substantially the same format for all companies, as specified by the Commissioner. Appendix 2 to this rule contains a Preliminary Policy Summary form for Whole Life and Endowment Policies. Appendix 3 contains a Preliminary Policy Summary form for Term Policies and Term Riders.

(h) Preliminary Policy Summary for Additional First Year Premium Policies. For the purposes of this rule the Preliminary Policy Summary for additional first year premium policies means a document provided to the buyer of these products which contains the following information:

1. The name of the company and Generic Name of the policy.
2. The policyholder's age and sex at issue.
3. The annual premiums and guaranteed amount payable upon death for representative policy years.
4. The average annual rate of return for five, ten, twenty and thirty years.
5. A statement warning that early termination of the policy will result in the loss of the additional premium, if such is the case.
6. Language substantially similar to the notice located at the top of the Preliminary Policy Summaries in Appendices 2 and 3.
7. The signature of the soliciting agent and the date on which the summary was prepared.
8. Such other information that the Commissioner may determine is necessary to fully inform the purchaser of the basic features of the policy.

(i) Preliminary Policy Summary for Annuities. For the purposes of this rule the Preliminary Policy Summary for annuities means a document provided to the buyer of an annuity which contains the following information:

1. The name of the company and Generic Name of the policy.
2. The policyholder's age and sex at issue.
3. The annual premium for the policy.

4. The average annual rate of return on gross premiums paid for five, ten, twenty and thirty years.
5. If the annuity contains both a guaranteed and current rate the average annual rate of return shall be shown for both.
6. Language substantially similar to the notice located at the top of the Preliminary Policy Summaries in Appendixes 2 and 3.
7. The signature of the soliciting agent and the date on which the summary was prepared.
8. In the case of flexible premium annuity contracts the information on the Preliminary Policy Summary shall be determined on the assumption that consideration payments will be made at the rate of \$1,000 per year.

(j) Policy Summary. 1. For the purposes of this rule, Policy Summary means a written statement in substantially the same format for all companies and describing the elements of the policy including but not limited to:

- a. A prominently placed title as follows:
STATEMENT OF POLICY COST AND BENEFIT
INFORMATION.
- b. The name and address of the insurance intermediary, or, if no intermediary is involved, a statement of the procedure to be followed

in order to receive responses to inquiries regarding the Policy Summary.

c. The full name and home office or administrative office address of the company in which the life insurance policy is to be or has been written.

d. The Generic Name of the basic policy and each rider.

e. The following amounts, where applicable, for the first five policy years and representative policy years thereafter sufficient to clearly illustrate the premium and benefit patterns, including but not necessarily limited to, the year for which the Surrender Index is displayed and at least one age from sixty through sixty-five or maturity whichever is earlier:

i. The annual premium for the basic policy.

ii. The annual premium for each optional rider.

iii. Guaranteed amount payable upon death, at the beginning of the policy year regardless of the cause of death other than suicide, or other specifically enumerated exclusions, which is provided by the basic policy and each optional rider, with benefits provided

under the basic policy and each rider shown separately.

- iv. Total guaranteed cash surrender values at the end of the year with values shown separately for the basic policy and each rider.
- v. Cash Dividends payable at the end of the year with values shown separately for the basic policy and each rider. (Dividends need not be displayed beyond the twentieth policy year).
- vi. Guaranteed endowment amounts payable under the policy which are not included under guaranteed cash surrender values above.
- f. The effective policy loan annual percentage interest rate, if the policy contains this provision, specifying whether this rate is applied in advance or in arrears. If the policy loan interest is variable, the Policy Summary shall include the maximum annual percentage rate.
- g. The annual percentage rate of interest if the premiums are paid more often than once a year.
- h. Surrender Cost Index at the twentieth year. Separate indices are displayed for the

basic policy and for each optional term life insurance rider. Such indices need not be included for optional riders which are limited to benefits such as accidental death benefits, disability waiver of premium, preliminary term life insurance coverage of less than 12 months and guaranteed insurability benefits nor for the basic policies or optional riders covering more than one life.

- i. For cash value insurance policies, annuities, and additional first year premium policies, the average annual rate of return if the policy is held for five, ten, twenty and thirty years.
- j. A statement that the purchaser can return the policy within 10 days after receipt of the policy and receive a full refund of all premiums paid.
- k. A Policy Summary which includes dividends shall also include a statement that dividends are based on the company's current dividend scale and are not guaranteed.
- l. A statement in close proximity to the Surrender Index and average annual rate of return as follows: A further explanation

of the intended use of these indices is provided in the Life Insurance Buyer's Guide.

m. The date on which the Policy Summary is prepared.

2. The Policy Summary must consist of a separate document. All information required to be disclosed must be set out in a manner as to not minimize or render any portion thereof obscure. Any amounts which remain level for two or more years of the policy may be represented by a single number if it is clearly indicated what amounts are applicable for each policy year. Amounts in subdivision 1.a. above shall be listed in total, not on a per thousand nor per unit basis. If more than one insured is covered under one policy or rider, guaranteed death benefits shall be displayed separately for each insured or for each class of insureds if death benefits do not differ within the class. Zero amounts shall be displayed as zero and shall not be displayed as a blank space.
3. If the Policy Summary is for an annuity contract, in addition to the information listed above which may be applicable, the policy summary shall also show:

- i. The amount of the guaranteed annuity payments at the scheduled commencement of the annuity, based on the assumption that all scheduled considerations are paid and there are no prior withdrawals from or partial surrenders of the contract and no indebtedness to the insurer on the contract.
- ii. On the same basis as for item i. except for guarantees, illustrative annuity payments not greater in amount than those based on (1) the current dividend scale and the interest rate currently used to accumulate dividends under such contracts, or the current excess interest rate credited by the insurer, and (2) current annuity purchase rates. A dividend scale or excess interest rate which has been publicly declared by the insurer with an effective date not more than two months subsequent to the date of declaration shall be considered a current dividend scale or current excess interest rate.

iii. In the case of a flexible premium annuity contract, the information on the policy summary shall be determined on the assumption that consideration payments will be made at the rate of \$1,000 per year.

(5) DISCLOSURE REQUIREMENTS. (a) The insurer will provide, to all prospective purchasers of any policy subject to this rule, a copy of the current edition of the [state] Buyer's Guide to Life Insurance at the beginning of any sales presentation. A properly filled out Preliminary Policy Summary for a life policy, first year premium policy or annuity, as appropriate, must be provided to all prospective purchasers prior to the time they are provided an application for a policy. If a whole life or endowment policy has a term insurance rider, a separate Preliminary Policy Summary must be provided for the basic policy and any term riders.

(b) Insurers that do not market policies through an intermediary may provide the Preliminary Policy Summary and the [state] Buyer's Guide to Life Insurance at the time of policy delivery, provided they:

1. Guarantee to the policyholder a 30-day right to return the policy for a full refund of premium, and
2. Alert the prospective policyholder, in advertisements or direct mail solicitations, of his or her right to obtain a copy of the [state] Buyer's Guide to Life Insurance and a Preliminary Policy Summary prior to sale.

(c) The insurer shall provide a Policy Summary upon delivery of the policy.

(d) The insurer shall provide a [state] Buyer's Guide to Life Insurance and a Preliminary Policy Summary to individual prospective purchasers upon reasonable request.

(e) For policies already issued and paying premiums on the effective date of this rule, policyholders shall have the right to obtain a Policy Summary at cost. The company may charge a reasonable fee for preparing this summary, not to exceed \$5.00, and may utilize reasonable assumptions in providing the cost disclosure information, so long as they are clearly disclosed.

(f) If the provisions of Sections 5(a) and (c) are fully complied with the purchaser shall have the right to return the policy and obtain a full refund of all monies paid at any time within ten days after the policy is delivered.

(6) GENERAL RULES. (a) Each insurer shall maintain at its home office or principal office, a complete file containing one copy of each document authorized by the insurer for use pursuant to this regulation. Such file shall contain one copy of each authorized form for a period of three years following the date of its last authorized use.

[Alternative Paragraph 6(a)] Each insurer shall maintain at its home office or principal office, a complete file containing one copy of the Preliminary Policy Summary and Policy Summary for each policy that it issues. Such documents shall be maintained for a period of three years after the policy is issued.

(b) An intermediary shall inform the prospective purchaser, prior to commencing a life insurance sales presentation, that he or she is acting as a life insurance intermediary and inform the prospective purchaser of the full name of the insurance company which he or she is representing to the buyer. In sales situations in which an intermediary is not involved, the insurer shall identify its full name.

(c) Terms such as financial planner, investment advisor, financial consultant, or financial counseling shall not be used in such a way as to imply that the insurance intermediary is generally engaged in an advisory business in which compensation is unrelated to sales unless such is actually the case.

(d) Any reference to policy dividends must include a statement that dividends are not guaranteed.

(e) A system or presentation which does not recognize the time value of money through the use of appropriate interest adjustments shall not be used for comparing the cost of two or more life insurance policies.

(f) A presentation of benefits shall not display guaranteed and nonguaranteed benefits as a single sum unless they are shown separately in close proximity thereto.

(g) A statement regarding the use of the Surrender Index shall include an explanation to the effect that the index is useful only for the comparison of the relative costs of two or more similar policies.

(h) For the purposes of this rule, the annual premium for a basic policy or rider, for which the company reserves the right to change the premium, shall be the maximum annual premium.

(7) EFFECTIVE DATE. This rule shall apply to all solicitations of life insurance which commence on or after

(8) UNUSUAL CIRCUMSTANCES. Insurers with unique difficulties in implementing sections of this rule may petition the Commissioner for allowance to meet the requirements of the rule through alternative approaches.

(9) YEARLY RENEWABLE TERM INSURANCE MORTALITY RATES. The following mortality rates are to be used in determining YRT premiums for calculating Average Annual Rate of Return Index figures.

MORTALITY RATES PER 1,000

<u>Attained Age (x)</u>	<u>Male Lives</u>	<u>Female Lives</u>	<u>Attained Age (x)</u>	<u>Male Lives</u>	<u>Female Lives</u>
0	5.80	4.80	48	5.71	3.20
1	1.33	1.22	49	6.34	3.52
2	0.84	0.72	50	6.94	3.84
3	0.65	0.55	51	7.56	4.15
4	0.53	0.48	52	8.32	4.48
5	0.48	0.42	53	9.20	4.84
6	0.42	0.37	54	10.09	5.23
7	0.39	0.33	55	11.00	5.67
8	0.35	0.29	56	12.06	6.16
9	0.32	0.22	57	13.26	6.70
10	0.31	0.25	58	14.60	7.27
11	0.31	0.26	59	16.06	7.87
12	0.33	0.27	60	17.69	8.52
13	0.42	0.29	61	19.55	9.21
14	0.52	0.31	62	21.61	10.00
15	0.73	0.36	63	23.75	10.83
16	0.87	0.36	64	25.83	11.81
17	1.02	0.37	65	27.99	13.07
18	1.18	0.38	66	30.34	13.72
19	1.29	0.40	67	33.04	16.80
20	1.37	0.41	68	35.92	19.28
21	1.46	0.44	69	39.27	22.28
22	1.52	0.48	70	42.90	25.69
23	1.47	0.53	71	46.45	29.43
24	1.32	0.60	72	49.96	33.43
25	1.25	0.66	73	53.72	37.30
26	1.22	0.70	74	58.16	40.72
27	1.19	0.70	75	63.36	43.59
28	1.17	0.70	76	69.04	46.36
29	1.13	0.71	77	75.09	49.38
30	1.15	0.75	78	81.98	53.45
31	1.22	0.83	79	89.68	59.01
32	1.28	0.93	80	96.68	66.03
33	1.32	1.04	81	105.42	73.80
34	1.34	1.14	82	113.40	79.38
35	1.40	1.21	83	122.90	86.03
36	1.49	1.23	84	135.00	94.50
37	1.60	1.25	85	149.17	107.40
38	1.75	1.29	86	165.94	122.80
39	1.91	1.37	87	182.12	138.41
40	2.12	1.47	88	196.71	153.43
41	2.36	1.59	89	213.16	170.61
42	2.66	1.74	90	229.66	188.32
43	3.02	1.91	91	246.98	207.47
44	3.45	2.10	92	262.03	225.34
45	3.96	2.32	93	276.79	243.58
46	4.51	2.58	94	302.02	271.82
47	5.09	2.88	95	338.33	311.26

NOTE: The mortality rates for ages 0 through 14 are from the 1965-1970 Select Basic Tables published on pages 202 and 203 of the Transactions of the Society of Actuaries Publication Year 1974, Number 3, 1973 Reports of Mortality and Morbidity Experience. The mortality rates for ages 15 and above are from the Ultimate Basic Tables, Males Lives (1957-1960 Experience), Female Lives (1957-1960 Experience) published on page 48 of the Transactions of the Society of Actuaries, Publication Year 1963, Number 2, 1962 Reports of Mortality and Morbidity Experience.

(10) PENALTY. Violations of this rule shall subject the violator to (Insert applicable state statute or regulation).

(11) SEPARABILITY. If any provision of this rule shall be held invalid, the remainder of the rule shall not be affected thereby.

APPENDIX 18



The Commonwealth of Massachusetts

Division of Insurance

100 Cambridge Street, Boston 02202

JAMES M. STONE
COMMISSIONER OF INSURANCE

August 4, 1978

Life Insurance Association of Massachusetts
11 Beacon Street
Boston, Massachusetts 02108

American Council of Life Insurance
1730 Pennsylvania Ave., N.W.
Washington, D. C. 20006

Chapter 801 of the Acts of 1977 (Section 2B. of Chapter 175, M.G.L.) specifies certain standards of readability for most life insurance policy forms filed in Massachusetts after June 30, 1978. Policy forms approved or deemed approved prior to July 1 of this year may not be used after June 30 of next year, unless they conform to the new law.

It is the purpose of this letter to give advance indication of the procedures the Division of Insurance intends to use in reviewing life insurance policy forms subject to the new law. It is expected that our standards for review will include the following:

- (1) All policy forms must conform to the objective standards of the law with respect to readability and format.
- (2) A policy summary satisfactory to the Division of Insurance must be a part of all policy contracts issued after July 1, 1979.
- (3) An actuarial memorandum must accompany each submission. We expect to require in such memoranda Yearly Information and Summary Information similar to that proposed by Professor Joseph M. Belth in the December 1975 Drake Law Review Insurance Law Annual.

Attached to this letter is a draft of a whole life policy summary we believe is "conducive to understandability of the form." (Section 2B.(f) of Chapter 175). An analogous summary would apply to endowments. A different summary would be necessary for term policies. No summary can be accepted if it is

less informative than the enclosed example.

We feel the most important contribution to understandability that can be made by a whole life summary is the disclosure of meaningful cost information. For that reason, the policy summary includes rates of return on the savings portions of whole life policies calculated by the well-known Linton Yield Method. It will be recalled that on June 7, 1978, Commissioner Stone indicated an intention to follow this format during a meeting attended by representatives of your respective associations; he invited comments at that time.

We realize that a Rate-of-Return (ROR) disclosure system differs from the NAIC Interest-Adjusted Method (IAM) currently being urged upon the states by the life insurance industry. We believe ROR to be superior in understandability for these principal reasons:

- (1) ROR may be used in comparing dissimilar policy forms; IAM may not be.
- (2) ROR produces indices which have a convenient frame of reference for the public. A 4.5% return, for example, has an independent meaning to the average buyer, while \$4.00 per \$1,000 per year, for example, is meaningful only in the context of a range of costs for a particular plan of insurance, a particular age at issue and a particular policy size.
- (3) Both methods depend on assumptions. IAM requires the assumption of an interest rate; 5% is the current standard. ROR requires the assumption of a schedule of term insurance rates. If term insurance rates are more stable in the future than interest rates, ROR will in this sense be more consistent over time than IAM.

We continue to welcome your comments on the proposed policy summary. It is likely the policy summary can be improved upon scrutiny by actuaries, insurance lawyers and marketing experts. My staff and I are available to meet with you in Boston at your convenience.

We would appreciate your communicating the sense of this letter to your respective memberships.

Very truly yours,

James H. Hunt

James H. Hunt
Director, State Rating Bureau

JHH:bw

Massachusetts Whole Life Policy Summary

This is a summary of your life insurance policy. A life insurance policy is a legal contract between you as the owner and the company as the insurer. Its purpose is to provide an amount of money upon your death, or the insured's death if you are not the insured, to the person you designate. In exchange for that benefit, you agree to pay premiums when due. Check the last page of this policy summary to make sure the type of policy and amount of insurance you requested are correct.

In this policy summary, some of the basic concepts of your life insurance policy are explained. All life insurance policies, however, are complex. Not everything can be explained here. Massachusetts law requires that most personal insurance policies be written in clear, readable English. If you have any questions about your policy that are not answered in this summary, the policy itself may contain the answers. If not, ask the agent or the company. They are available to help you.

You have ten days after receipt of this policy to review it. If you decide you don't want to keep it, return it to the agent or the company within the ten-day period and you will receive a refund of all premiums paid.

Understanding Whole Life Insurance

This particular policy is a whole life policy. That means it insures you throughout your lifetime as long as you pay premiums when due. The most popular form of whole life insurance is called Ordinary Life. Premiums for an Ordinary Life policy remain the same from year to year and are payable as long as you live.

The other major form of life insurance is called term insurance. It insures you for a term of one or more years. Death benefits are paid only if you die within that period of time. Term insurance in its simplest form -- annual renewable term insurance -- gives you the right each year to renew the policy for one more year, but at a higher premium. A more common form of term insurance is five year renewable term insurance, on which premiums increase only once every five years.

All whole life policies have this in common: you buy less life insurance for your premium dollar initially than with a term policy, but the premium does not increase when you get older as the term policy premiums would. For example, if you buy a \$10,000 policy at age 35, the whole life premium might be \$200 and the term premium \$60. By the time you are 55, however, the term premium would have increased to about \$200; by 65 it might be \$450.

Whole life insurance policies are sometimes known as cash value insurance. This is because, during the early years, the premium is much higher than the amount needed to pay death claims. Most of the excess goes to develop a fund, called the cash value, which grows over the years. Interest earnings on this fund help pay for the cost of death protection each year. If you die, the company will use the cash value to pay a part of the policy's death benefit. For example, if you buy a \$10,000 policy at age 35, by age 65 the policy might have a cash value of about \$5,000. The company then needs only an additional \$5,000 from its own funds to make up the \$10,000 face amount. If you keep the policy beyond age 65, the cash value continues to increase and the additional amount the company will need to pay a death claim continues to decrease.

Whole life policies, then, can be viewed as a combination of an increasing savings element and a decreasing amount of pure life insurance protection. This is the main reason why the premium does not increase as one grows older.

Although premiums on a whole life policy are usually payable for life, they may instead be paid in higher amounts over any term of years. A policy whose premiums are payable until age 65 is called Life Paid Up at 65; if premiums are payable for 20 years, the policy is called Twenty Payment Life. In either case, coverage continues after

the policy is paid up. Cash values under these forms build up faster than under Ordinary Life, so the amount of the pure life insurance protection is correspondingly less. For example, after fifteen years of payments on a \$10,000 Ordinary Life policy issued at age 35, the cash value would be about \$2,200, but, under a Twenty Payment Life policy, it would be about \$3,600. The last page of this summary shows the payment period for this policy.

Although whole life policies are designed to provide insurance protection for life, many policyholders surrender their policies when they reach retirement age in order to use the cash value to purchase a monthly income during retirement. One of the features of a whole life policy is that the company guarantees a minimum monthly income in the settlement option section of the policy. This guarantee also applies to the proceeds of a death claim.

Amount of Insurance

Most life insurance policies provide a level face amount of insurance from year to year; many policies, however, are designed so that the face amount varies. There are endless variations.

On the last page of this summary, the face amount of insurance is shown. If the face amount varies in any way, this will also be shown. If you have agreed to add any kind of term insurance rider to the policy, the total death benefit will be shown, including any year by year variation.

Premiums

The yearly premium on your policy is shown on the last page of this summary. Any year-by-year variation in premiums is also shown. If you were charged an extra premium due to a health problem or for any other reason, that too is shown. You usually have the right to pay premiums more often than once a year -- monthly, quarterly or semi-annually. There are extra charges for this right because expenses are higher and because the company cannot earn as much interest as it would if it received the full premium at the beginning of the year. If the cost for this right exceeds an Annual Percentage Rate of 12%, the rate is shown on the last page of this summary.

Although premiums are due on a particular date or dates during the year, the law allows you to pay any premium without penalty during a grace period of thirty days after the due date. Most companies allow thirty-one days. If you forget to pay the premiums within the grace period, your policy will lapse unless any accumulated dividends are sufficient to pay the premium or you have elected the Automatic Premium Loan provision. If the policy lapses, you have the right to reinstate the policy -- put it back in full force. Most companies allow reinstatement without a health statement and without charge except for premiums due for a period of time -- usually a month -- after the end of the grace period, if the insured is alive. An explanation of these provisions is contained in the policy.

Policy Loans

All whole life policies have a policy loan feature. This means that after the policy has a cash value you may borrow on your policy for any purpose you wish. The maximum amount that can be borrowed is generally the amount of the cash value on the next premium due date less interest payable on that date. The policy loan interest rate is shown on the last page of this summary. This rate may be compared with Annual Percentage Rates required by the Federal Truth-in-Lending Act to be disclosed on consumer credit transactions. Interest is charged only for the actual number of days the loan is outstanding. There are no hidden loan charges. There is no requirement that the loan be repaid but interest is due annually.

The amount of any outstanding loan and interest on it will be deducted from the policy proceeds if you die or surrender the policy.

Dividends

More than eighty percent of policies sold in Massachusetts pay dividends. Such policies are called participating. Check the last page of this summary to see if this is a participating policy.

In calculating premium rates for a policy, the company's actuary must make assumptions about future mortality rates, interest rates and costs of doing business. It is, of course, impossible to predict the future accurately so companies selling participating policies make assumptions they know are quite safe and use dividends to adjust premiums in accordance with actual experience in the future.

Dividends can be paid in cash or they can be used in a number of other ways, such as the purchase of additional insurance. The choices you have are outlined in the policy.

Life insurance policy dividends, unlike dividends received from credit unions and savings and loan associations or from corporations, are not taxable when received. Instead they are considered premium refunds.

Exclusions

There are certain situations in which the company can refuse to pay the death benefit under this policy. Suicide within two years of the date of issue of the policy is generally not covered. If you gave a material false statement when you applied for this policy and die within two years from its date of issue, the company may contest the validity of the policy. These are the two principal exclusions under a whole life policy. Occasionally, a company may add a rider to the policy excluding certain causes of death. The last page of this summary tells you if any such riders apply to you.

Rates of Return

Whole life policies differ from one another in how much they cost. Sometimes the differences are very large. Because whole life policies include widely varying mixtures of pure life insurance protection and savings, comparing relative costs between policies and among companies is difficult. By making an assumption about what the pure life insurance portion of a whole life policy would cost if purchased as a separate policy, however, it is possible to compute Rates of Return on the savings portion of a whole life policy. The technique is to deduct from the whole life premium each year (less any dividend) the amount it would cost to buy as much term insurance as is represented by the policy's pure insurance portion. The difference can be considered as a savings deposit. The Rate of Return, then, is the interest rate required to accumulate these deposits to the cash value of the policy at the end of the period of years chosen for the computation.

On the last page of this summary are shown Rates of Return for this policy over periods of five, ten and twenty years.

The Rates of Return shown are intended to assist you in two ways: to determine whether to purchase a whole life policy rather than term insurance; and to decide which of two or more companies is lowest in cost. If the Rates

of Return shown for this policy are high in comparison to another investment alternative, this policy may be considered more favorable in that respect. If they are higher than another company's policy you may be considering, this policy is probably going to be lower in cost over the years.

In comparing Rates of Return with the interest rate you could earn on a savings account or other safe investment, you should remember that interest earnings credited to the savings element of a whole life insurance policy are not taxed until you surrender the policy; even then, the taxable amount may be zero or quite small. For this reason, you may wish to compare the Rates of Return shown with after-tax returns on other investments. For example, if you are in a 20% tax bracket, a 4% Rate of Return under a whole life policy is about the same as a 5% return that is fully taxable.

Quite often, the Rate of Return for the early years of a policy is negative. This is a reflection of the company's costs in selling and issuing the policy. Whole life insurance is not meant for short term needs. A negative Rate of Return suggests you should not buy a whole life policy unless you intend to keep it for at least 10 and probably 20 years.

It is also important to understand that the Rates of Return shown depend on assumptions about what it would cost to buy term insurance. Term rates from a study by the Society of Actuaries were used to make this estimate. Samples of these rates are shown below. If you have access to term insurance that costs less, the Rates of Return on the whole life policy you are considering would be decreased somewhat.

Average Yearly Renewable Term Rates per \$1,000

<u>Age</u>	<u>Amount of Insurance</u>		
	<u>\$10,000</u>	<u>\$25,000</u>	<u>\$100,000</u>
25	\$ 4.47	\$ 2.97	\$ 2.22
35	4.73	3.23	2.48
45	7.16	5.66	4.91
55	13.85	12.35	11.60

If this is a participating policy, the company used its current dividend schedule in figuring Rates of Return. Such dividends are not guaranteed. You should keep this in mind in comparing Rates of Return on participating policies with the guarantees offered by non-participating policies.

LIFE INSURANCE SOLICITATION MODEL REGULATION

May 4, 1976

(As Adopted by the NAIC)

Section 1. Authority.

This rule is adopted and promulgated by (title of supervisory authority) pursuant to sections [4(1) (a) of the Unfair and Deceptive Acts and Practices in the Business of Insurance Act] of the insurance code.

Section 2. Purpose.

- (A) The purpose of this regulation is to require insurers to deliver to purchasers of life insurance, information which will improve the buyer's ability to select the most appropriate plan of life insurance for his needs, improve the buyer's understanding of the basic features of the policy which has been purchased or which is under consideration and improve the ability of the buyer to evaluate the relative costs of similar plans of life insurance.
- (B) This regulation does not prohibit the use of additional material which is not in violation of this regulation or any other (state) statute or regulation.

Section 3. Scope.

- (A) Except as hereafter exempted, this regulation shall apply to any solicitation, negotiation or procurement of life insurance occurring within this state. This regulation shall apply to any issuer of life insurance contracts including fraternal benefit societies.
- (B) Unless otherwise specifically included, this regulation shall not apply to:
1. Annuities.
 2. Credit life insurance.
 3. Group life insurance.
 4. Life insurance policies issued in connection with pension and welfare plans as defined by and which are subject to the federal Employee Retirement Income Security Act of 1974 (ERISA).
 5. Variable life insurance under which the death benefits and cash values vary in accordance with unit values of investments held in a separate account.

Section 4. Definitions.

For the purposes of this regulation, the following definitions shall apply:

- (A) Buyer's Guide. A Buyer's Guide is a document which contains, and is limited to, the language contained in the Appendix to this regulation or language approved by (title of supervisory authority).
- (B) Cash Dividend. A Cash Dividend is the current illustrated dividend which can be applied toward payment of the gross premium.
- (C) Equivalent Level Annual Dividend. The Equivalent Level Annual Dividend is calculated by applying the following steps:
1. Accumulate the annual cash dividends at five percent interest compounded annually to the end of the tenth and twentieth policy years.
 2. Divide each accumulation of Step 1. by an interest factor that converts it into one equivalent level annual amount that, if paid at the beginning of each year, would accrue to the values in Step 1. over the respective

periods stipulated in Step 1. If the period is ten years, the factor is 13.207 and if the period is twenty years, the factor is 34.719.

3. Divide the results of Step 2. by the number of thousands of the Equivalent Level Death Benefit to arrive at the Equivalent Level Annual Dividend.

(D) Equivalent Level Death Benefit. The Equivalent Level Death Benefit of a policy or term life insurance rider is an amount calculated as follows:

1. Accumulate the guaranteed amount payable upon death, regardless of the cause of death, at the beginning of each policy year for ten and twenty years at five per cent interest compounded annually to the end of the tenth and twentieth policy years respectively.
2. Divide each accumulation of step 1. by an interest factor that converts it into one equivalent level annual amount that, if paid at the beginning of each year, would accrue to the value in step 1. over the respective periods stipulated in step 1. If the period is ten years, the factor is 13.207 and if the period is twenty years, the factor is 34.719.

(E) Generic Name. Generic Name means a short title which is descriptive of the premium and benefit patterns of a policy or a rider.

(F) Life Insurance Cost Indexes

1. Life Insurance Surrender Cost Index. The Life Insurance Surrender Cost Index is calculated by applying the following steps:
 - a. Determine the guaranteed cash surrender value, if any, available at the end of the tenth and twentieth policy years.
 - b. For participating policies, add the terminal dividend payable upon surrender, if any, to the accumulation of the annual Cash Dividends at five percent interest compounded annually to the end of the period selected and add this sum to the amount determined in step a.
 - c. Divide the result of step b. (step a. for guaranteed-cost policies) by an interest factor that converts it into an equivalent level annual amount that, if paid at the beginning of each year, would accrue to the value in step b. (step a. for guaranteed cost policies) over the respective periods stipulated in step a. If the period is ten years, the factor is 13.207 and if the period is twenty years, the factor is 34.719.
 - d. Determine the equivalent level premium by accumulating each annual premium payable for the basic policy or rider at five percent interest compounded annually to the end of the period stipulated in step a. and dividing the result by the respective factors stated in step c. (this amount is the annual premium payable for a level premium plan).
 - e. Subtract the result of step c. from step d.
 - f. Divide the result of step e. by the number of thousands of the Equivalent Level Death Benefit to arrive at the Life Insurance Surrender Cost Index.
2. Life Insurance Net Payment Cost Index. The Life Insurance Net Payment Cost Index is calculated in the same manner as the comparable Life Insurance Cost Index except that the cash surrender value and any terminal dividend are set at zero.

- (G) Policy Summary. For the purposes of this regulation, Policy Summary means a written statement describing the elements of the policy including but not limited to:
1. A prominently placed title as follows: STATEMENT OF POLICY COST AND BENEFIT INFORMATION.
 2. The name and address of the insurance agent, or, if no agent is involved, a statement of the procedure to be followed in order to receive responses to inquiries regarding the Policy Summary.
 3. The full name and home office or administrative office address of the company in which the life insurance policy is to be or has been written.
 4. The Generic Name of the basic policy and each rider.
 5. The following amounts, where applicable, for the first five policy years and representative policy years thereafter sufficient to clearly illustrate the premium and benefit patterns, including, but not necessarily limited to, the years for which Life Insurance Cost Indexes are displayed and at least one age from sixty through sixty-five or maturity whichever is earlier:
 - a. The annual premium for the basic policy.
 - b. The annual premium for each optional rider.
 - c. Guaranteed amount payable upon death, at the beginning of the policy year regardless of the cause of death other than suicide, or other specifically enumerated exclusions, which is provided by the basic policy and each optional rider, with benefits provided under the basic policy and each rider shown separately.
 - d. Total guaranteed cash surrender values at the end of the year with values shown separately for the basic policy and each rider.
 - e. Cash Dividends payable at the end of the year with values shown separately for the basic policy and each rider. (Dividends need not be displayed beyond the twentieth policy year.)
 - f. Guaranteed endowment amounts payable under the policy which are not included under guaranteed cash surrender values above.
 6. The effective policy loan annual percentage interest rate, if the policy contains this provision, specifying whether this rate is applied in advance or in arrears. If the policy loan interest rate is variable, the Policy Summary includes the maximum annual percentage rate.
 7. Life Insurance Cost Indexes for ten and twenty years but in no case beyond the premium paying period. Separate indexes are displayed for the basic policy and for each optional term life insurance rider. Such indexes need not be included for optional riders which are limited to benefits such as accidental death benefits, disability waiver of premium, preliminary term life insurance coverage of less than 12 months and guaranteed insurability benefits nor for basic policies or optional riders covering more than one life.
 8. The Equivalent Level Annual Dividend, in the case of participating policies and participating optional term life insurance riders, under the same circumstances and for the same durations at which Life Insurance Cost Indexes are displayed.
 9. A Policy Summary which includes dividends shall also include a statement that dividends are based on the company's current dividend scale and are not guaranteed in addition to a statement in close proximity to the Equivalent Level Annual Dividend as follows: An explanation of the intended use of the Equivalent Level Annual Dividend is included in the Life Insurance Buyer's Guide.

10. A statement in close proximity to the Life Insurance Cost Indexes as follows: An explanation of the intended use of these indexes is provided in the Life Insurance Buyer's Guide.
11. The date on which the Policy Summary is prepared.

The Policy Summary must consist of a separate document. All information required to be disclosed must be set out in such a manner as to not minimize or render any portion thereof obscure. Any amounts which remain level for two or more years of the policy may be represented by a single number if it is clearly indicated what amounts are applicable for each policy year. Amounts in item 5 of this section shall be listed in total, not on a per thousand nor per unit basis. If more than one insured is covered under one policy or rider, guaranteed death benefits shall be displayed separately for each insured or for each class of insureds if death benefits do not differ within the class. Zero amounts shall be displayed as zero and shall not be displayed as a blank space.

Section 5. Disclosure Requirements.

- (A) The insurer shall provide, to all prospective purchasers, a Buyer's Guide and a Policy Summary prior to accepting the applicant's initial premium or premium deposit, unless the policy for which application is made contains an unconditional refund provision of at least ten days or unless the Policy Summary contains such an unconditional refund offer, in which event the Buyer's Guide and Policy Summary must be delivered with the policy or prior to delivery of the policy.
- (B) The insurer shall provide a Buyer's Guide and a Policy Summary to any prospective purchaser upon request.
- (C) In the case of policies whose Equivalent Level Death Benefit does not exceed \$5,000, the requirement for providing a Policy Summary will be satisfied by delivery of a written statement containing the information described in Section 4(C), items 2, 3, 4, 5a, 5b, 5c, 6, 7, 10, 11.

Section 6. General Rules.

- (A) Each insurer shall maintain at its home office or principal office, a complete file containing one copy of each document authorized by the insurer for use pursuant to this regulation. Such file shall contain one copy of each authorized form for a period of three years following the date of its last authorized use.
- (B) An agent shall inform the prospective purchaser, prior to commencing a life insurance sales presentation, that he is acting as a life insurance agent and inform the prospective purchaser of the full name of the insurance company which he is representing to the buyer. In sales situations in which an agent is not involved, the insurer shall identify its full name.
- (C) Terms such as financial planner, investment advisor, financial consultant, or financial counseling shall not be used in such a way as to imply that the insurance agent is generally engaged in an advisory business in which compensation is unrelated to sales unless such is actually the case.
- (D) Any reference to policy dividends must include a statement that dividends are not guaranteed.
- (E) A system or presentation which does not recognize the time value of money through the use of appropriate interest adjustments shall not be used for comparing the cost of two or more life insurance policies. Such a system may be used for the purpose of demonstrating the cash-flow pattern of a policy if such presentation is accompanied by a statement disclosing that the presentation does not recognize that, because of interest, a dollar in the future has less value than a dollar today.
- (F) A presentation of benefits shall not display guaranteed and non guaranteed benefits as a single sum unless they are shown separately in close proximity thereto.
- (G) A statement regarding the use of the Life Insurance Cost Indexes shall include an explanation to the effect that the indexes are useful only for the comparison of the relative costs of two or more similar policies.

- (II) A Life Insurance Cost Index which reflects Dividends or an Equivalent Level Annual Dividend shall be accompanied by a statement that it is based on the company's current dividend scale and is not guaranteed.
- (I) For the purposes of this regulation, the annual premium for a basic policy or rider, for which the company reserves the right to change the premium, shall be the maximum annual premium.

Section 7. Failure to Comply.

Failure of an insurer to provide or deliver a Buyer's Guide, or a Policy Summary as provided in Section 5 shall constitute an omission which misrepresents the benefits, advantages, conditions or terms of an insurance policy.

Section 8. Effective Date.

This rule shall apply to all solicitations of life insurance which commence on or after (Insert a date at least six months following adoption by the regulatory authority.)

APPENDIX

Life Insurance Buyer's Guide

The face page of the Buyer's Guide shall read as follows:

Life Insurance Buyer's Guide

This guide can show you how to save money when you shop for life insurance. It helps you to:

- Decide how much life insurance you should buy.
- Decide what kind of life insurance policy you need, and
- Compare the cost of similar life insurance policies.

Prepared by the National Association of Insurance Commissioners

Reprinted by (Company Name)
(Month and year of printing)

The Buyer's Guide shall contain the following language at the bottom of page 2:

The National Association of Insurance Commissioners is an association of state insurance regulatory officials. This association helps the various Insurance Departments to coordinate insurance laws for the benefit of all consumers. You are urged to use this Guide in making a life insurance purchase.

This Guide Does Not Endorse Any Company or Policy.

The remaining text of the Buyer's Guide shall begin on page 3 as follows:

Buying Life Insurance

When you buy life insurance, you want a policy which fits your needs without costing too much. Your first step is to decide how much you need, how much you can afford to pay and the kind of policy you want. Then, find out what various companies charge for that kind of policy. You can find important differences in the cost of life insurance by using the life insurance cost indexes which are described in this guide. A good life insurance agent or company will be able and willing to help you with each of these shopping steps.

If you are going to make a good choice when you buy life insurance, you need to understand which kinds are available. If one kind does not seem to fit your needs, ask about the other kinds which are described in this guide. If you feel that you need more information than is given here, you may want to check with a life insurance agent or company or books on life insurance in your public library.

Choosing the Amount

One way to decide how much life insurance you need is to figure how much cash and income your dependents would need if you were to die. You should think of life insurance as a source of cash needed for expenses of final illnesses, paying taxes, mortgages or other debts. It can also provide income for your family's living expenses, educational costs and other future expenses. Your new policy should come as close as you can afford to making up the difference between (1) what your dependents would have if you were to die now, and (2) what they would actually need.

Choosing the Right Kind

All life insurance policies agree to pay an amount of money if you die. But all policies are not the same. There are three basic kinds of life insurance.

1. Term insurance
2. Whole life insurance
3. Endowment insurance

Remember, no matter how fancy the policy title or sales presentation might appear, all life insurance policies contain one or more of the three basic kinds. If you are confused about a policy that sounds complicated, ask the agent or company if it combines more than one kind of life insurance. The following is a brief description of the three basic kinds:

Term Insurance

Term insurance is death protection for a "term" of one or more years. Death benefits will be paid only if you die within that term of years. Term insurance generally provides the largest immediate death protection for your premium dollar.

Some term insurance policies are "renewable" for one or more additional terms even if your health has changed. Each time you renew the policy for a new term, premiums will be higher. You should check the premiums at older ages and the length of time the policy can be continued.

Some term insurance policies are also "convertible". This means that before the end of the conversion period, you may trade the term policy for a whole life or endowment insurance policy even if you are not in good health. Premiums for the new policy will be higher than you have been paying for the term insurance.

Whole Life Insurance

Whole life insurance gives death protection for as long as you live. The most common type is called "straight life" or "ordinary life" insurance, for which you pay the same premiums for as long as you live. These premiums can be several times higher than you would pay initially for the same amount of term insurance. But they are smaller than the premiums you would eventually pay if you were to keep renewing a term insurance policy until your later years.

Some whole life policies let you pay premiums for a shorter period such as 20 years, or until age 65. Premiums for these policies are higher than for ordinary life insurance since the premium payments are squeezed into a shorter period.

Although you pay higher premiums, to begin with, for whole life insurance than for term insurance, whole life insurance policies develop "cash values" which you may have if you stop paying premiums. You can generally either take the cash, or use it to buy some continuing insurance protection. Technically speaking, these values are called "nonforfeiture benefits". This refers to benefits you do not lose (or "forfeit") when you stop paying premiums. The amount of these benefits depends on the kind of policy you have, its size, and how long you have owned it.

A policy with cash values may also be used as collateral for a loan. If you borrow from the life insurance company, the rate of interest is shown in your policy. Any money which you owe on a policy loan would be deducted from the benefits if you were to die, or from the cash value if you were to stop paying premiums.

Endowment Insurance

An endowment insurance policy pays a sum of income to you—the policyholder—if you live to a certain age. If you were to die before then, the death benefit would be paid to your beneficiary. Premiums and cash values for endowment insurance are higher than for the same amount of whole life insurance. Thus endowment insurance gives you the least amount of death protection for your premium dollar.

Finding a Low Cost Policy

After you have decided which kind of life insurance fits your needs, look for a good buy. Your chances of finding a good buy are better if you use two types of index numbers that have been developed to aid in shopping for life insurance. One is called the "Surrender Cost Index" and the other is the "Net Payment Cost Index". It will be worth your time to try to understand how these indexes are used, but in any event, use them for comparing the relative costs of similar policies. **LOOK FOR POLICIES WITH LOW COST INDEX NUMBERS.**

What is Cost?

"Cost" is the difference between what you pay and what you get back. If you pay a premium for life insurance and get nothing back, your cost for the death protection is the premium. If you pay a premium and get something back later on, such as a cash value, your cost is smaller than the premium.

The cost of some policies can also be reduced by dividends; these are called "participating" policies. Companies may tell you what their current dividends are, but the size of future dividends is unknown today and cannot be guaranteed. Dividends actually paid are set each year by the company.

Some policies do not pay dividends. These are called "guaranteed cost" or "non participating" policies. Every feature of a guaranteed cost policy is fixed so that you know in advance what your future cost will be.

The premiums and cash values of a participating policy are guaranteed, but the dividends are not. Premiums for participating policies are typically higher than for guaranteed cost policies, but the cost to you may be higher or lower, depending on the dividends actually paid.

What Are Cost Indexes?

In order to compare the cost of policies, you need to look at:

1. Premiums
2. Cash Values
3. Dividends

Cost indexes use one or more of these factors to give you a convenient way to compare relative costs of similar policies. When you compare costs, an adjustment must be made to take into account that money is paid and received at different times. It is not enough to just add up the premiums you will pay and to subtract the cash values and dividends you expect to get back. These indexes take care of the arithmetic for you. Instead of having to add, subtract, multiply and divide many numbers yourself, you just compare the index numbers which you can get from life insurance agents and companies:

1. Life Insurance Surrender Cost Index. This index is useful if you consider the level of the cash values to be of primary importance to you. It helps you compare costs if at some future point in time, such as 10 or 20 years, you were to surrender the policy and take its cash value.

2. Life Insurance Net Payment Cost Index. This index is useful if your main concern is the benefits that are to be paid at your death and if the level of cash values is of secondary importance to you. It helps you compare costs at some future point in time, such as 10 or 20 years, if you continue paying premiums on your policy and do not take its cash value.

• • •

There is another number called the Equivalent Level Annual Dividend. It shows the part dividends play in determining the cost index of a participating policy. Adding a policy's Equivalent Level Annual Dividend to its cost index allows you to compare total costs of similar policies before deducting dividends. However, if you make any cost comparisons of a participating policy with a non participating policy, remember that the total cost of the participating policy will be reduced by dividends, but the cost of the non participating policy will not change.

How Do I Use Cost Indexes?

The most important thing to remember when using cost indexes is that a policy with a small index number is generally a better buy than a comparable policy with a larger index number. The following rules are also important:

- (1) Cost comparisons should only be made between similar plans of life insurance. Similar plans are those which provide essentially the same basic benefits and require premium payments for approximately the same period of time. The closer policies are to being identical, the more reliable the cost comparison will be.
- (2) Compare index numbers only for the kind of policy, for your age and for the amount you intend to buy. Since no one company offers the lowest cost for all types of insurance at all ages and for all amounts of insurance, it is important that you get the indexes for the actual policy, age and amount which you intend to buy. Just because a "Shopper's guide" tells you that one company's policy is a good buy for a particular age and amount, you should not assume that all of that company's policies are equally good buys.
- (3) Small differences in index numbers could be offset by other policy features, or differences in the quality of service you may expect from the company or its agent. Therefore, when you find small differences in cost indexes, your choice should be based on something other than cost.
- (4) In any event, you will need other information on which to base your purchase decision. Be sure you can afford the premiums, and that you understand its cash values, dividends and death benefits. You should also make a judgment on how well the life insurance company or agent will provide service in the future, to you as a policyholder.
- (5) These life insurance cost indexes apply to new policies and should not be used to determine whether you should drop a policy you have already owned for awhile, in favor of a new one. If such a replacement is suggested, you should ask for information from the company which issued the old policy before you take action.

Important Things To Remember - A Summary

The first decision you must make when buying a life insurance policy is choosing a policy whose benefits and premiums must closely meet your needs and ability to pay. Next, find a policy which is also a relatively good buy. If you compare Surrender Cost Indexes and Net Payment Cost Indexes of similar competing policies, your chances of finding a relatively good buy will be better than if you do not shop. REMEMBER, LOOK FOR POLICIES WITH LOWER COST INDEX NUMBERS. A good life insurance agent can help you to choose the amount of life insurance and kind of policy you want and will give you cost indexes so that you can make cost comparisons of similar policies.

Don't buy life insurance unless you intend to stick with it. A policy which is a good buy when held for 20 years can be very costly if you quit during the early years of the policy. If you surrender such a policy during the first few years, you may get little or nothing back and much of your premium may have been used for company expenses.

Read your new policy carefully, and ask the agent or company for an explanation of anything you do not understand. Whatever you decide now, it is important to review your life insurance program every few years to keep up with changes in your income and responsibilities.

ORDER OF THE OFFICE OF THE COMMISSIONER OF INSURANCE

RECEIVED AND FILED

Repealing and Adopting Rules

OCT 3 1978

Pursuant to authority vested in the Commissioner of Insurance by section 601.41 (3), Wis. Stats., the Commissioner of Insurance hereby repeals and adopts rules as follows:

Sections Ins 2.14 and 2.15 of the Wisconsin Administrative Code are repealed and section Ins 2.14 is adopted to read:

Ins 2.14 Life Insurance Solicitation. (Sections 601.01 (3), 601.41 (3) and 628.34, Wis. Stats.) (1) PURPOSE. The purpose of this rule is to require insurers to deliver to purchasers of life insurance information which will improve the buyer's ability to select the most appropriate plan of life insurance for his or her needs, improve the buyer's understanding of the basic features of the policy which has been purchased or which is under consideration and improve the ability of the buyer to evaluate the relative costs of similar plans of life insurance. This rule does not prohibit the use of additional material which is not in violation of this rule or any other Wisconsin statute or rule. This rule interprets and implements, including but not limited to the following Wisconsin Statutes: sections 601.01 (3) (b), (c), (g) and (j) and 628.34.

(2) SCOPE. (a) Except as hereafter exempted, this rule shall apply to any solicitation, negotiation or procurement of life insurance occurring within this state. This rule shall apply to any issuer of life insurance contracts including fraternal benefit societies and the State Life Insurance Fund.

(b) Unless otherwise specifically included, this rule shall not apply to:

1. Annuities.
2. Credit life insurance.
3. Group life insurance.
4. Life insurance policies issued in connection with pension and welfare plans as defined by and which are subject to the federal Employee Retirement Income Security Act of 1974 (ERISA).
5. Variable life insurance under which the death benefits and cash values vary in accordance with unit values of investments held in a separate account.

(3) DEFINITIONS. For the purposes of this rule, the following definitions shall apply:

(a) Wisconsin Buyer's Guide to Life Insurance. The Wisconsin Buyer's Guide to Life Insurance is a document which contains, and is

limited to, the language within the current edition of "The Wisconsin Buyer's Guide to Life Insurance" put out by the Insurance Commissioner of the State of Wisconsin. This pamphlet shall be reviewed periodically for accuracy and appropriateness. Prior to the publication of a revised pamphlet, it shall be submitted to the Life Subcommittee of the Forms and Classifications Advisory Council for public hearing and review. Insurers may purchase this pamphlet at cost from the Office of the Commissioner of Insurance, or they may reproduce it themselves (subject to reasonable standards of style, size, and layout).

(b) Cash Dividend. A Cash Dividend is the current illustrated dividend which can be applied toward payment of the gross premium.

(c) Equivalent Level Death Benefit. The Equivalent Level Death Benefit of a policy or term life insurance rider is an amount calculated as follows:

1. Accumulate the guaranteed amount payable upon death, regardless of the cause of death, at the beginning of each policy year for ten and twenty years at five percent interest compounded annually to the end of the tenth and twentieth policy years, respectively.
2. Divide each accumulation of step 1 by an interest factor that converts it into one equivalent level annual amount that, if paid at the beginning of each year, would accrue to the value in step 1 over the respective periods stipulated in step 1. If the period is ten years, the factor is 13.207 and if the period is twenty years, the factor is 34.719.

(d) Generic Name. Generic Name means a short title which is descriptive of the premium and benefit patterns of a policy or a rider.

(e) Life Insurance Indexes.

1. Surrender Cost Index. The Surrender Cost Index is calculated by applying the following steps:
 - a. Determine the guaranteed cash surrender value, if any, available at the end of the tenth and twentieth policy years.
 - b. For participating policies, add the terminal dividend payable upon surrender, if any, to the accumulation of the annual Cash Dividends at five percent interest compounded annually to the end of the period selected and add this sum to the amount determined in step a.
 - c. Divide the result of step b (step a for guaranteed-cost policies) by an interest factor that converts it into an equivalent level annual amount that if paid at the beginning of each year, would accrue to the value in step b (step a for guaranteed-cost policies) over the respective periods stipulated in step a. If the period is ten years, the factor is 13.207 and if the period is twenty years, the factor is 34.719.

- d. Determine the equivalent level premium by accumulating each annual premium payable for the basic policy or rider (if the annual premium includes supplemental benefits without separate identifiable charge, a reasonable adjustment may be made) at five percent interest compounded annually to the end of the period stipulated in step a and dividing the result by the respective factors stated in step c. (This amount is the annual premium payable for a level premium plan).
 - e. Subtract the result of step c from step d.
 - f. Divide the result of step e by the number of thousands of the Equivalent Level Death Benefit to arrive at the Surrender Cost Index.
2. Net Payment Cost Index. The Net Payment Cost Index is calculated in the same manner as the comparable Surrender Cost Index except that the cash surrender value and any terminal dividend are set at zero.
 3. Equivalent Level Annual Dividend. The Equivalent Level Annual Dividend is calculated by applying the following steps:
 - a. Accumulate the annual cash dividends at five percent interest compounded annually to the end of the tenth and twentieth policy years.
 - b. Divide each accumulation of step 1 by an interest factor that converts it into one equivalent level annual amount that, if paid at the beginning of each year, would accrue to the values in step 1 over the respective periods stipulated in step 1. If the period is ten years, the factor is 13.207 and if the period is twenty years, the factor is 34.719.
 - c. Divide the results of step 2 by the number of thousands of the Equivalent Level Death Benefit to arrive at the Equivalent Level Annual Dividend.
 4. Average Annual Rate of Return Index. This index is calculated on cash value policies using the Linton yield method.
 - a. The Linton yield method solves for a level, effective, annually compounded interest rate, or yield. This yield is determined by equating the cash available at the end of a specified number of years from two different protection/savings programs, each with identical yearly death benefits, and then solving for the annual yield that must be achieved on the separate savings fund of the second program in order to produce the cash equivalency with the first program. The two programs compared are:
 1. A life insurance policy on, normally but not necessarily, some permanent plan. The cash used at the end of the specified year is the policy's guaranteed cash surrender value plus the terminal dividend payable upon surrender and the dividend payable at the end of the specified year.

11. A combination of a savings fund and yearly renewable term (YRT) insurance. The amount deposited in the savings fund each year is assumed to be equal to the annual premium payable under the alternate program for the permanent life insurance policy (less any dividend payable at the end of the preceding year) less an assumed premium payable for YRT insurance. The amount of YRT purchased each year is that which would be adequate to bring the combined death benefit from the savings plan and the YRT to the same as that payable under the permanent life insurance policy. The cash used for comparison with the permanent policy is the amount accumulated in the savings fund at the end of the specified year.

b. Average Annual Rate of Return index figures given out in Wisconsin by insurers or intermediaries shall be calculated separately for males and females and shall be based upon the following assumptions:

1. As to YRT premium rates:

YRT premiums = $(1,000 q_x) (K) + \$0.90 + \$25/S$ where K equals 1.00 for ages 0 through 14 and 0.95 for ages 15 and above, S equals policy size in thousands and $1000 q_x$ equals the mortality rate for age x shown in subsection (8);

11. As to elements entering into the calculation: Gross premiums shall include the total premiums charged for all life insurance benefits; dividends shall be total illustrated dividends excluding any separately identifiable dividends payable for benefits other than life insurance.

Note: A discussion of the Linton yield method may be found on page 28 - 30 in the Analysis of Life Insurance Cost Comparison Index Methods, prepared by the Society of Actuaries Committee on Cost Comparison Methods and Related Issues (Special), September, 1974. Further discussion on the "low" YRT rates to be used in computing the Linton yield, which are the rates specified in this rule, may be found in Appendix B, pp. 187 - 192 of that same publication.

(f) Preliminary Policy Summary. For the purposes of this rule, Preliminary Policy Summary means a document provided to the buyer of a life insurance policy prior to sale which contains necessary consumer cost disclosure information, in substantially the same format for all companies, as specified by the commissioner. Appendix 1 to this rule contains a Preliminary Policy Summary form for Whole Life and Endowment Policies. Appendix 2 contains a Preliminary Policy Summary Form for Term Policies. Insurers may, upon request, incorporate Preliminary Policy Summary forms (if they are to be filled out by intermediaries) into copies of the Wisconsin Buyer's Guide to Life Insurance which they reprint.

(g) Policy Summary. 1. For the purposes of this rule, Policy Summary means a written statement in substantially the same format for all companies and describing the elements of the policy including but not limited to:

- a. A prominently placed title as follows: STATEMENT OF POLICY COST AND BENEFIT INFORMATION.
- b. The name and address of the insurance intermediary, or, if no intermediary is involved, a statement of the procedure to be followed in order to receive responses to inquiries regarding the Policy Summary.
- c. The full name and home office or administrative office address of the company in which the life insurance policy is to be or has been written.
- d. The Generic Name of the basic policy and each rider.
- e. The following amounts, where applicable, for the first five policy years and representative policy years thereafter sufficient to clearly illustrate the premium and benefit patterns, including but not necessarily limited to, the years for which the Surrender Cost Index is displayed and at least one age from sixty through sixty five or maturity whichever is earlier:
 - i. The annual premium for the basic policy.
 - ii. The annual premium for each optional rider.
 - iii. Guaranteed amount payable upon death, at the beginning of the policy year regardless of the cause of death other than suicide, or other specifically enumerated exclusions, which is provided by the basic policy and each optional rider, with benefits provided under the basic policy and each rider shown separately.
 - iv. Total guaranteed cash surrender values at the end of the year with values shown separately for the basic policy and each rider.
 - v. Cash Dividends payable at the end of the year with values shown separately for the basic policy and each rider. (Dividends need not be displayed beyond the twentieth policy year.)
 - vi. Guaranteed endowment amounts payable under the policy which are not included under guaranteed cash surrender values above.
- f. The effective policy loan annual percentage interest rate, if the policy contains this provision, specifying whether this rate is applied in advance or in arrears. If the policy loan interest is variable, the Policy Summary shall include the maximum annual percentage rate.
- g. Surrender Cost Indexes for ten and twenty years. Separate indexes are displayed for the basic policy and for each optional term life insurance rider. Such indexes need not be included for optional riders which are limited to benefits such as accidental death benefits, disability waiver of premium, preliminary term life insurance coverage of less than 12 months and guaranteed insurability benefits nor for the basic policies or optional riders covering more than one life.

- h. A Policy Summary which includes dividends shall also include a statement that dividends are based on the company's current dividend scale and are not guaranteed.
- i. A statement in close proximity to the Surrender Cost Index (and other cost indexes) as follows: A further explanation of the intended use of this (these) index(es) is provided in the Life Insurance Buyer's Guide.
- j. The date on which the Policy Summary is prepared.
2. The Policy Summary must consist of a separate document. All information required to be disclosed must be set out in a manner as to not minimize or render any portion thereof obscure. Any amounts which remain level for two or more years of the policy may be represented by a single number if it is clearly indicated what amounts are applicable for each policy year. Amounts in subdivision 1 e above shall be listed in total, not on a per thousand nor per unit basis. If more than one insured is covered under one policy or rider, guaranteed death benefits shall be displayed separately for each insured or for each class of insureds if death benefits do not differ within the class. Zero amounts shall be displayed as zero and shall not be displayed as a blank space.

(4) DISCLOSURE REQUIREMENTS. (a) The insurer shall provide, to all prospective purchasers of any policy subject to this rule, a copy of the current edition of the Wisconsin Buyer's Guide to Life Insurance and a properly filled out Preliminary Policy Summary prior to accepting the applicant's initial premium or premium deposit, except that insurers which do not market policies through an intermediary may provide the Preliminary Policy Summary and Wisconsin's Buyer's Guide to Life Insurance at the point of policy delivery, so long as they:

1. guarantee to the policyholder a 30-day right to return the policy for a full refund of premium, and
2. alert the prospective policyholder, in advertisements or direct mail solicitations, of his or her right to obtain a copy of the Wisconsin Buyer's Guide to Life Insurance and a Preliminary Policy Summary prior to sale.

(b) The insurer shall provide a Policy Summary upon delivery of the policy.

(c) The insurer shall provide a Wisconsin Buyer's Guide to Life Insurance and a Preliminary Policy Summary to individual prospective purchasers upon reasonable request.

(d) The insurer may provide information concerning life insurance cost indexes other than the surrender cost index so long as the information and its method of presentation is in conformance with this rule.

(e) For policies already issued and paying premiums on the effective date of this rule, policyholders shall have the right to obtain a Policy Summary at cost. The company may charge a reasonable fee for preparing this summary, not to exceed \$5, and may utilize reasonable assumptions in providing the cost disclosure information, so long as they are clearly disclosed.

(5) GENERAL RULES. (a) Each insurer shall maintain at its home office or principal office, a complete file containing one copy of each document authorized by the insurer for use pursuant to this rule. Such file shall contain one copy of each authorized form for a period of three years following the date of its last authorized use.

(b) An intermediary shall inform the prospective purchaser, prior to commencing a life insurance sales presentation, that he is acting as a life insurance intermediary and inform the prospective purchaser of the full name of the insurance company which he is representing to the buyer. In sales situations in which an intermediary is not involved, the insurer shall identify its full name.

(c) Terms such as financial planner, investment advisor, financial consultant, or financial counseling shall not be used in such a way as to imply that the insurance intermediary is generally engaged in an advisory business in which compensation is unrelated to sales unless such is actually the case.

(d) Any reference to policy dividends must include a statement that dividends are not guaranteed.

(e) Any sales presentation which repeatedly refers to an insurance premium or element of the insurance premium as a deposit, an investment, a savings or in any other phrase of similar import, and does not disclose the Average Annual Rate of Return Index figures for 10 and 20 years is an unfair marketing practice, within the meaning of section 628.34, Stats.

(f) The purchase or replacement of any life insurance contract or annuity shall not be recommended by any insurer or intermediary without reasonable grounds to believe that the recommendation is not unsuitable for the applicant on the basis of information furnished by such person after reasonable inquiry as may be necessary under the circumstances concerning the prospective buyers insurance and annuity needs and means.

(g) A system or presentation which does not recognize the time value of money through the use of appropriate interest adjustments shall not be used for comparing the cost of two or more life insurance policies.

(h) A presentation of benefits shall not display guaranteed and non-guaranteed benefits as a single sum unless they are shown separately in close proximity thereto.

(i) A statement regarding the use of the Surrender Cost Index shall include an explanation to the effect that the index is useful only for the comparison of the relative costs of two or more similar policies.

(j) A Life Insurance Index which reflects dividends or an Equivalent Level Annual Dividend shall be accompanied by a statement that it is based on the company's current dividend scale and is not guaranteed.

(k) For the purposes of this rule, the annual premium for a basic policy or rider, for which the company reserves the right to change the premium, shall be the maximum annual premium.

(6) EFFECTIVE DATE. This rule shall apply to all solicitations of life insurance which commence on or after January 1, 1979.

(7) UNUSUAL CIRCUMSTANCES. Insurers with unique difficulties in implementing sections of this rule may petition the commissioner for allowance to meet the requirements of the rule through alternative approaches.

(8) YEARLY RENEWABLE TERM INSURANCE MORTALITY RATES:

The following mortality rates are to be used in determining YRT premiums for calculating Average Annual Rate of Return Index figures.

MORTALITY RATES PER 1,000

<u>Attained Age (x)</u>	<u>Male Lives</u>	<u>Female Lives</u>	<u>Attained Age (x)</u>	<u>Male Lives</u>	<u>Female Lives</u>
0	5.80	4.80	30	1.15	.75
1	1.33	1.22	31	1.22	.83
2	0.84	0.72	32	1.28	.93
3	0.65	0.55	33	1.32	1.04
4	0.53	0.48	34	1.34	1.14
5	0.48	0.42	35	1.40	1.21
6	0.42	0.37	36	1.49	1.23
7	0.39	0.33	37	1.60	1.25
8	0.35	0.29	38	1.75	1.29
9	0.32	0.22	39	1.91	1.37
10	0.31	0.25	40	2.12	1.47
11	0.31	0.26	41	2.36	1.59
12	0.33	0.27	42	2.66	1.74
13	0.42	0.29	43	3.02	1.91
14	0.52	0.31	44	3.45	2.10
15	0.73	0.36	45	3.96	2.32
16	0.87	0.36	46	4.51	2.58
17	1.02	0.37	47	5.09	2.88
18	1.18	.38	48	5.71	3.20
19	1.29	.40	49	6.34	3.52
20	1.37	.41	50	6.94	3.84
21	1.46	.44	51	7.56	4.15
22	1.52	.48	52	8.32	4.48
23	1.47	.53	53	9.20	4.84
24	1.32	.60	54	10.09	5.23
25	1.25	.66	55	11.00	5.67
26	1.22	.70	56	12.06	6.16
27	1.19	.70	57	13.26	6.70
28	1.17	.70	58	14.60	7.27
29	1.13	.71	59	16.06	7.87

<u>Attained Age (x)</u>	<u>Male Lives</u>	<u>Female Lives</u>	<u>Attained Age (x)</u>	<u>Male Lives</u>	<u>Female Lives</u>
60	17.69	8.52	78	81.98	53.45
61	19.55	9.21	79	89.68	59.01
62	21.61	10.00	80	97.68	66.03
63	23.75	10.83	81	105.42	73.80
64	25.83	11.81	82	113.40	79.38
65	27.99	13.07	83	122.90	86.03
66	30.34	14.72	84	135.00	94.50
67	33.04	16.80	85	149.17	107.40
68	35.92	19.28	86	165.94	122.80
69	39.27	22.28	87	182.12	138.41
70	42.90	25.69	88	196.71	153.43
71	46.45	29.43	89	213.26	170.61
72	49.96	33.43	90	229.66	188.32
73	53.72	37.30	91	246.98	207.47
74	58.16	40.72	92	262.03	225.34
75	63.36	43.59	93	276.79	243.58
76	69.04	46.36	94	302.02	271.82
77	75.09	49.38	95	338.33	311.26

NOTE: The mortality rates for ages 0 through 14 are from the 1965-1970 Select Basic Tables published on pages 202 and 203 of the Transactions of the Society of Actuaries Publication Year 1974, Number 3, 1973 Reports of Mortality and Morbidity Experience. The mortality rates for ages 15 and above are from the Ultimate Basic Tables, Males Lives (1957-1960 Experience), Female Lives (1957-1960 Experience) published on page 48 of the Transactions of the Society of Actuaries, Publication Year 1963, Number 2 1962 Reports of Mortality and Morbidity Experience.

(9) PENALTY. Violations of this rule shall subject the violator to section 601.64, Stats.

(10) SEPARABILITY. If any provision of this rule shall be held invalid, the remainder of the rule shall not be affected thereby.

PRELIMINARY POLICY SUMMARY

IMPORTANT: Many people think all life insurance policies cost about the same. They don't. The cost of similar policies varies sharply. You can save many hundreds or even thousands of dollars by choosing a low-cost policy. To find out how this particular policy ranks, compare its Cost Index (found below) to the range of cost indexes for similar policies. For further information on cost comparison and examples of the range of cost indexes for a number of policies, see pages 4-8 in the Wisconsin Buyer's Guide to Life Insurance which you should have received with this policy summary.

Name and Address of Company: _____

Type and Name of Policy: _____

Face Amount at Time of Issue: _____ Policyholder's Sex and Age at Issue: _____

YEARLY PREMIUM: _____

This is the amount of cash you'll have to spend each year to keep the policy in force. Be sure you can afford it.

COST INDEX:

To find a low-cost policy, look at the policy's Surrender Cost Index, not its premium. Then compare that index number with the figure for other similar policies. Premiums only measure what you pay for a policy. The benefits you receive from policies with similar premiums vary widely. The Surrender Cost Index takes premiums, cash values, dividends (if any) and interest into consideration. In doing so, it provides a more complete measure of the cost of similar life insurance policies. The lower the Surrender Cost Index, the lower the policy's cost to you.

10 Years

20 Years

SURRENDER COST INDEX (Per \$1,000 face amount)

The Surrender Cost Index should only be used to compare the cost of similar policies. Don't use it to compare the cost of a term policy to that of a whole life policy.

RATE OF RETURN:

Under most circumstances, life insurance should not be sold or purchased as "an investment." Cash values build up slowly in the first years of a whole life or an endowment policy, and for the first five or ten years, the rate of return on your money will be minimal. For further information, see the Wisconsin Buyer's Guide to Life Insurance.

Signature of Agent

Date

Address: _____

[This form should be used for whole life and endowment insurance.]

PRELIMINARY POLICY SUMMARY

IMPORTANT: Many people think all life insurance policies cost about the same. They don't. The cost of similar policies varies sharply. You can save many hundreds or even thousands of dollars by choosing a low-cost policy. To find out how this particular policy ranks, compare its Cost Index (found below) to the range of cost indexes for similar policies. For further information on cost comparison and examples of the range of cost indexes for a number of policies, see pages 4-8 in the Wisconsin Buyer's Guide to Life Insurance, which you should have received with this policy summary.

Name and Address of Company: _____

Type and Name of Policy: _____

Policyholder's Sex and Age at Issue: _____

Renewable* Yes _____ No _____ If yes, through what age? _____
Convertible Yes _____ No _____ If yes, through what age? _____

Policy Years	Annual Premium	Guaranteed Amount Payable on Death
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NOTE: Companies (or intermediaries) should enter in this space the annual premium and guaranteed amount payable on death for representative policy years.

COST INDEX:

To find a low-cost term policy, look at the policy's Surrender Cost Index, not just its first-year premium. That's because the premiums for some term policies go up faster than others. In addition, many term policies pay dividends. When they do, that lowers the cost of those policies. The Surrender Cost Index takes both dividends and later-year premiums into consideration and thus gives a better measure of a term policy's cost than the first-year premium alone. The lower the Surrender Cost Index, the lower the policy's cost to you.

10 years 20 years

SURRENDER COST INDEX (per \$1,000 face amount)

The Surrender Cost Index should be used only to compare the cost of similar policies. Don't use it to compare the cost of a term policy to that of a whole life policy.

Signature of Agent

Date

Address of Agent: _____

*Renewability: If you're buying term insurance for long-term needs, make sure your policy is guaranteed renewable through at least age 65. Check above for the age through which this policy can be renewed. For more information, see page 2 of the Wisconsin Buyer's Guide to Life Insurance.

[This form should be used for term insurance.]

STATE OF WISCONSIN

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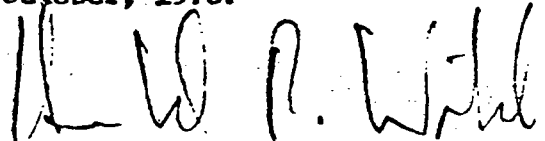
OFFICE OF THE COMMISSIONER OF INSURANCE)

TO ALL TO WHOM THESE PRESENTS SHALL COME, GREETINGS:

I, Harold R. Wilde, Commissioner of Insurance and custodian of the official records of said office, do hereby certify that the annexed order repealing and adopting rules regarding life insurance solicitation was issued by this office October 2, 1978.

I further certify that said copy has been compared by me with the original on file in this office and that the same is a true copy thereof, and of the whole of such original.

IN TESTIMONY WHEREOF, I have
hereunto subscribed my name
in the City of Madison, State
of Wisconsin, this 2nd day of
October, 1978.



Harold R. Wilde
Commissioner of Insurance

STATE OF WISCONSIN
DEPARTMENT OF STATE
RECEIVED AND FILED

OCT 3 1978

DOUGLAS MACLETT
SECRETARY OF STATE

NOTICE OF HEARING

Commissioner of Insurance

NOTICE IS HEREBY GIVEN That, pursuant to sections 601.41 (3) and 227.021, Wis. Stats., the Commissioner of Insurance will hold a public hearing at Room 421, South State Capital, in the city of Madison, Wisconsin, on the 16th day of April, 1979, at 10:00a.m. or as soon thereafter as the matter may be reached to consider the amendment of Wisconsin Administrative Code section Ins 2.14 by amending the following subsections, repealing and recreating Appendices 1 and 2 and adopting Appendix 3.

Analysis By the Commissioner of Insurance

On October 4, 1978, following extensive administrative hearings, the Commissioner of Insurance promulgated and adopted section Ins 2.14 of the Wisconsin Administrative Code to apply to all solicitations of life insurance which commenced on or after January 1, 1979. This rule requires that life insurers and their representatives deliver to purchasers of life insurance information which will improve the buyer's ability to select the most appropriate plan of life insurance for his or her needs, improve the buyer's understanding of the basic features of the policy and improve the ability of the buyer to evaluate the relative costs of similar plans of insurance. This rule replaced two rules with similar purpose which had been in effect since 1972.

On February 28, 1979, the Court of Appeals, District IV, entered an Order and Decision directing the Circuit Court for Dane County to issue a temporary injunction against the enforcement of portions of section Ins 2.14 in its present form.

The following changes in section Ins 2.14 are promulgated to change the parts of section Ins 2.14 to which the Court of Appeals objected so that distribution of the Wisconsin Buyer's Guide to Life Insurance and the mandatory furnishing of a preliminary policy summary can be a part of life insurance disclosure required by Wisconsin rules.

Section Ins 2.14 (3) (a) is amended to read:

(a) Wisconsin Buyer's Guide to Life Insurance. The Wisconsin Buyer's Guide to Life Insurance is a document which contains, and is limited to, the language within the current edition of "The Wisconsin Buyer's Guide to Life Insurance" put out by the Insurance Commissioner of the State of Wisconsin. This pamphlet shall be reviewed periodically for accuracy and appropriateness. Appendix 3 to this rule contains the current edition of "The Wisconsin Buyer's Guide to Life Insurance." Prior to the publication of a revised pamphlet, it shall be submitted to the Life Subcommittee of the Forms and Classification Advisory Council for public hearing and review of other than technical or nonsubstantive changes. Insurers may purchase this pamphlet at cost from the Office of the Commissioner of Insurance, or they may reproduce it themselves (subject to reasonable standards of style, size, and layout).

Section Ins 2.14 (6) is amended to read:

(6) EFFECTIVE DATE. This rule shall apply to all solicitations of life insurance which commence on or after January 1, 1979, except that the requirements of subsection (4) (a) shall apply to solicitations which commence on or after July 1, 1979.

Appendix 1 is repealed and recreated to read:

PRELIMINARY POLICY SUMMARY
FOR WHOLE LIFE OR ENDOWMENT INSURANCE

IMPORTANT: Many people think all life insurance policies cost about the same. They don't. The cost of similar policies varies sharply. You can save many hundreds or even thousands of dollars by choosing a low-cost policy. To find out how this particular policy ranks, compare its cost index figures to the range of cost indexes for similar policies. For further information and examples on cost comparison, see "Finding A Low Cost Policy" (pages) in the Wisconsin Buyer's Guide to Life Insurance, which you should have received with this summary.

Name and Address of Company: _____

Type and Name of Policy: _____

Face Amount at Time of Issue: _____ Policyholder's Sex and Age at Issue _____

ANNUAL PREMIUM: _____

This is the amount of cash you'll have to spend each year to keep the policy in force. Be sure you can afford it.

COST INDEX:

To find a low-cost policy look at the policy's cost index figures, not just its premium. Then compare these index numbers with the figures for other similar policies. Premiums only measure what you pay for a policy. The benefits you receive from policies with similar premiums vary widely. For a description of various life insurance cost indexes and the assumptions on which they are based, see pages _____ of the Buyer's Guide. The figures below are derived using the Surrender Cost Index. The Surrender Cost Index takes premiums, cash values, dividends (if any) and interest into consideration, and provides a measure of the relative cost of a policy, assuming its surrender at a given point in the future (e.g., 10 or 20 years). Given this assumption, the lower the Surrender Cost Index, the lower the policy's cost to you.

10 Years

20 Years

SURRENDER COST INDEX (Per \$1,000 face amount)

The Surrender Cost Index should only be used to compare the cost of similar policies. If death would occur during the designated period, the policy with the lower index would not necessarily be the lower cost policy. All index figures for participating policies are based on illustrated dividends which are not guaranteed.

RATE OF RETURN:

Under most circumstances, life insurance should not be sold or purchased as "an investment." Cash values build up slowly in the first years of a whole life or an endowment policy, and for the first five or ten years, the rate of return on your money will be minimal. For further information, see page _____ of the Buyer's Guide.

Name of Agent _____

Date _____

Address of Agent: _____

Appendix 3 to adopted to read:

WISCONSIN BUYER'S GUIDE

TO

LIFE INSURANCE

Office of the Commissioner of

Insurance

123 West Washington Avenue
Madison, Wisconsin 53702

1979

Frank Coyer

A STATE-WIDE TOLL-FREE "WISCONSIN LIFE INSURANCE COST
DISCLOSURE INFORMATION LINE" WILL BE IN OPERATION
THROUGHOUT 1979. THE NUMBER IS: 1-800-362-8380.

Inside Cover

IMPORTANT:

Shopping around for life insurance can mean big savings for you. The difference between two policies offering the exact same amount of protection may add up to thousands of dollars over a period of years.

Unfortunately, it is not always easy to rate or compare policies. Premiums alone may tell you little or nothing about the actual cost of a policy. That's why the Wisconsin Office of the Commissioner of Insurance prepared this guide — and requires all life insurance agents to provide it to their customers prior to any sale. It is designed to help you make comparisons that may save you a considerable amount of money.

See the section of this guide entitled Finding a Low Cost Policy (pages) for specific details on life insurance cost comparisons — and examples of cost figures on various types of policies. If you have time to read nothing else in this guide take a look at these pages first.

This guide has been prepared by the Wisconsin Office of the Commissioner of Insurance, in part using materials developed by the National Association of Insurance Commissioners.

This guide does not endorse any company or policy. It is designed to meet the needs of most consumers.

Individuals with complicated or unusual financial situations are advised to seek professional advice.

If you have any questions about any of the material in this guide, a good agent or company should be willing to go over it with you.

BUYING LIFE INSURANCE

When you buy life insurance, you want a policy which fits your needs without costing too much. Your first step is to decide how much you need, how much you can afford to pay and the kind of policy you want. Then, find out what various companies charge for that kind of policy. You can find important differences in the cost of life insurance by using the life insurance cost indexes which are described in this guide.

A NOTE ON GROUP LIFE INSURANCE

Life insurance can be purchased either as an individual or as a member of a group. Group coverage through an employer or employee group is generally less expensive than policies bought on an individual basis, because the administrative costs are low and because employers often contribute toward the premium. If you are eligible

for such coverage, check it out carefully. It may be the easiest and least costly way to meet your basic life insurance needs.

If you are going to make a good choice when you buy life insurance, you need to understand what kinds are available. If one kind does not seem to fit your needs, ask about the other kinds which are described in this guide. If you feel that you need more information than is given here, you may want to check the many books and pamphlets on life insurance in your public library. Every library in Wisconsin should have basic information on life insurance cost comparisons readily available.

CHOOSING THE AMOUNT

One way to decide how much life insurance you need is to figure how much cash and income your dependents would need if you were to die. You should think of life insurance as a source of cash needed for expenses of final illness, paying taxes, mortgages or other debts. It can also provide income for your family's living expenses, educational costs and other future expenses. Your new policy should come as close as you can afford to making up the difference between (1) what your dependents would have if you were to die now, and (2) what they would actually need.

It is important to reassess your life insurance program frequently. Needs will probably be greater if there is only one wage-earner in the family than if there are two people with substantial earning capacity. More protection will be required when your children are young than when they are older. A person with several dependents usually will need more insurance than a person with few.

CHOOSING THE RIGHT KIND

All life insurance policies agree to pay an amount of money if you die. Not all policies are not the same. There are three basic kinds of life insurance.

1. Term Insurance
2. Whole Life Insurance
3. Endowment Insurance

In recent years, various life insurance products have been developed which are "hybrids" of these basic types. Remember, no matter how fancy the policy title or sales representation might appear, all life insurance policies contain one or more of the three basic kinds. If you are confused about a policy that sounds complicated, ask the agent or company how it combines the various kinds of life insurance, and what the advantages and disadvantages of this combination are. (One possible disadvantage is that it may sometimes make meaningful cost comparisons difficult.) The following is a brief description of the three basic kinds:

Term Insurance

Term insurance, as the name implies, insures your life for a specific period of time, such as one year, five years or ten years. Death benefits will be paid only if you die within that term of years. Term insurance generally provides the largest immediate death protection for your premium dollar.

Term insurance policies are usually "renewable" for one or more additional terms, even if your health has changed. Each time you renew the policy for a new term, premiums will be higher, to reflect the

higher likelihood of a person dying as he or she grows older. For "annually renewable term," this means that your premiums will increase every year; for "10 year renewable term," every ten years. (One form of term insurance, "term to 65," has only one "term," so annual premiums are level.) Since not all term policies are renewable, be sure to check on this feature before buying.

Term Insurance and "Death Protection"

People purchase term insurance to maximize the amount of death protection they can obtain for their beneficiaries for a given sum of money. How this works can best be seen using an example, based on the actual rates of a company offering various kinds of life insurance.

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For \$200, a 35 year old male could obtain:

Type of Policy	Premium	Death Protection
Term (annually renewable)	\$200	\$77,200
Term (to 65)	200	19,500
Whole Life	200	10,900
Endowment (at 65)	200	7,200

For this one year and age, the man could get ten times as much death protection for his money purchasing annually renewable term instead of endowment insurance.

Term insurance is sometimes sold as "decreasing term." This means that you start out with a set amount of insurance which decreases over time. Instead of the premium increasing as you get older, the coverage decreases. It is this type of policy which is often used to protect a long-term decreasing debt, such as a mortgage.

Some term insurance policies are also "convertible." This means that before the end of the conversion period, you may trade the term policy for a whole life or endowment insurance policy even if you are not in good health. Premiums for the new policy will be higher than you have been paying for the term insurance.

Whole Life Insurance

Whole life insurance is designed to give death protection for as long as you live. The most common type is called "straight life" or "ordinary life" insurance for which you pay the same premiums for as long as you live. Whole life premiums start out at a higher level than term insurance for an equivalent amount of insurance protection, but they do not increase with age; they remain level throughout the payment period. The "extra" payments made in the early years of the policy accumulate in the form of "cash values," which must be returned if a policy is surrendered, and may be borrowed while a policy is in force. At death any amount which has been borrowed (plus interest) is subtracted from the face value of the policy.

Some whole life policies let you pay premiums for a shorter period such as 20 years, or until age 65. Premiums for these policies are higher than for ordinary life insurance since the premium payments are squeezed into a shorter period.

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Whole Life as "An Investment"

Whole life insurance and other forms of life insurance which build up cash values are sometimes sold by companies and agents as "an investment," because of the cash value feature. They shouldn't be — and probably couldn't be, if the cash value "yield" of most policies was properly understood. Cash values are very low in the first years of the policy, and for the first five or ten years the rate of return on your money may actually be negative. This is a major reason that you should not contemplate purchasing a whole life policy (or any cash value policy) unless you intend to hang onto it for at least ten years, and preferably longer.

Endowment Insurance

An endowment insurance policy pays a sum of money or an income to you — the policyholder — if you live to a certain age. If you were to die before then, the death benefit would be paid to your beneficiary. Premiums and cash values for endowment insurance are higher than for the same amount of whole life insurance. Thus endowment insurance gives you the least amount of death protection for your premium dollar.

SOME WORDS OF CAUTION

Don't buy a life insurance policy unless you are sure that it's the type of policy you want and that you can afford the premiums. Few people plan to drop their whole life policies soon after buying them. Yet about one in five new policyholders do just that. (This may be especially true of young people who are talked into buying expensive policies when in college, before they have an accurate understanding of either their insurance needs or their financial capacity.)

There are many varieties of life insurance currently being marketed as part of "packages" which combine elements of term and whole life insurance, and annuities or an investment "side fund." (An annuity is a long-term investment, generally used to provide retirement income.) Some of these package policies (e.g., so-called "deposit term") have a large first year premium designed to provide a strong incentive for policyholders to stay with their term policies for a specified period — such as ten years. Early surrender of these policies can be extremely costly.

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When considering purchasing of a policy or "package" combining elements of life insurance, annuity, or "side funds," you should ask for the guaranteed rate of return on all the premiums which you pay, not just on the amounts which are left after insurance expenses (such as agent commissions) are deducted. You should carefully investigate claims made as to tax advantages and implications. While some "new" products may be a significant improvement over insurance you have purchased in the past (particularly if that insurance policy's cash value has a low rate of return), others may be designed to fall into the cracks between insurance and securities, and not be regulated adequately by any government agency.

It is a good idea to seek financial advice from several competing sources before making a major investment or insurance decision.

TRADING A LOW COST POLICY

After you have decided which kind of life insurance fits your needs, look for a good buy. Your chances of finding a good buy are better if you use the cost indexes that have been developed by actuaries to aid in comparing life insurance values. The basic life insurance cost index is called the "Surrender Cost Index." Examples and illustrations on how to use this index are given in the rest of this guide.

What Is Cost?

To understand life insurance costs, start with the simplest possible example — an annually renewable term policy which builds up no cash value and pays no dividends. For this policy the cost of death protection is your annual premium payment. If you drop (surrender) the policy, you get no money back (because you've paid in nothing extra; you've purchased "pure death protection"). Premiums become progressively larger each year, to reflect the increasing actual cost of your death protection.

Now, purchase the same amount of death protection through a level premium policy, which has a higher initial expense but which also accumulates cash values. Here the concept of cost becomes more complicated. The "true" cost of this whole life policy might be one amount if you were to die and your beneficiaries were to collect the face value and quite another if you were to surrender the policy or use the cash value in some other way.

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The cost of a policy may also be affected by whether or not it pays dividends. A policy that does is called "participating." Companies that offer participating policies may tell you that their current dividends are, but the size of future dividends is unknown today and cannot be guaranteed. Dividends actually paid are not each year by the company.

Some policies do not pay dividends. These are called "guaranteed cost" or "non-participating" policies. Varying features of a guaranteed cost policy is fixed so that you know in advance that your future cost will be.

The premiums and cash values of a participating policy are guaranteed, but the dividends are not. Premiums for participating policies are typically higher than for guaranteed cost policies, but the cost to you may be higher or lower, depending on the dividends actually paid. The advantage — or the disadvantage — of a guaranteed cost policy is the certainty it provides. This should be evaluated against the flexibility provided by the participating policy. Where dividends — and therefore, actual costs — may be responsive to investment and inflation trends, and changes in the average life span of policyholders.

What are Cost Indexes?

In order to compare the cost of policies, you need to look at:

1. Premiums
2. Cash Values
3. Dividends

Cost indexes use one or more of these factors to give you a convenient way to compare relative costs of similar policies. When you compare costs, an adjustment must be made to take into account that money is paid and received at different times. It is not enough to just add up the premiums you will pay and subtract the cash values and dividends you expect to get back. Index figures take care of the arithmetic for you. Instead of having to add, subtract, multi-

ply and divide many numbers yourself, you just compare the index numbers which you can get from life insurance agents and companies!

The Basic Cost Index

This index takes into account cash values, as well as premiums, dividends, and the value of money over time. It is called the surrender cost index because it compares costs as if at some future point in time you were to surrender the policy and take the cash value.

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BEFORE ANY AGENT SELLS YOU A LIFE INSURANCE POLICY IN WISCONSIN, HE OR SHE MUST PROVIDE YOU WITH THE SURRENDER COST INDEX FIGURE FOR THAT POLICY AT 10 AND 20 YEARS. TO SEE HOW THAT POLICY RATES, YOU SHOULD THEN COMPARE THAT FIGURE WITH THOSE FOR SIMILAR POLICIES FROM OTHER COMPANIES.

How Do I Use This Cost Index?

The most important thing to remember when using the surrender cost index is that, based upon the assumptions of the index, a smaller number is generally a better buy than a comparable policy with a larger index number.

To see how this works, let's look at an example. On the next page there is a table giving illustrations of the range of surrender cost indexes for four commonly sold policies, both participating ("part") and non-participating ("non-part"). (The figures given are for females; the male figures would be generally a little higher.) The graph below uses our set of figures from the table: 20 year surrender cost indexes for \$25,000 non-participating whole life policies sold to females at ages 25, 35 and 45.

**THE RANGE OF SURRENDER COST INDEXES:
AN ILLUSTRATION**
20 Year Surrender Cost Index
Female Non-participating Whole Life \$25,000

Index Age	High Cost	Low Cost
25-25	B 23.27	
35-35	B 12.36	A 7.02
45-45	B 7.96	A 2.10
5-5	A 2.10	A 3.57
0-0		

The purpose of the graph is to illustrate the wide range of cost differences on just one life insurance policy. To emphasize the importance of comparative shopping, it may be useful to give that range of cost indexes a more concrete meaning. Using the assumptions of the surrender cost index calculation, the money saved between the lowest cost policy (A) and the highest cost policy (B), if purchased at age 25 and surrendered at age 45, would be approximately \$2,900; if the policy were purchased at age 35 and surrendered at age 35, the savings would be approximately \$4,300.

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LIFE INSURANCE COST COMPARISON*
Surrender Cost Index - Female

Policy Type	Face	Range of Values	Age 25		Age 35		Age 45	
			10 Yr	20 Yr	10 Yr	20 Yr	10 Yr	20 Yr
Whole Life	\$10,000	Low	2.80	2.96	3.31	4.63	6.06	8.34
		25th	3.40	3.11	4.33	4.92	10.04	11.40
		75th	6.74	6.20	8.27	4.39	12.32	13.74
		High	14.66	14.45	18.47	19.22	26.89	30.95
Term	\$15,000	Low	1.57	1.10	1.43	3.37	4.60	7.33
		25th	4.08	3.72	3.05	5.50	8.37	9.87
		75th	5.49	5.02	6.99	7.31	11.10	12.52
		High	8.66	7.94	10.64	12.36	15.77	23.27
Term	\$25,000	Low	1.18	1.34	1.76	3.47	5.25	5.81
		25th	3.21	3.34	4.08	5.27	7.34	10.50
		75th	4.19	4.45	5.14	6.37	9.37	12.99
		High	6.15	7.33	7.53	16.24	16.24	17.60
Term	\$50,000	Low	1.18	1.34	1.64	1.91	3.27	3.35
		25th	2.60	3.08	3.55	4.77	6.92	10.09
		75th	3.94	4.23	4.89	6.27	9.04	12.6*
		High	5.33	7.03	7.03	13.74	15.74	17.64
Whole Life	\$10,000	Low	1.28	.86	2.36	1.44	3.44	2.48
		25th	4.49	3.05	3.15	4.25	7.84	7.10
		75th	4.43	3.05	7.91	6.79	11.54	10.44
		High	12.10	12.28	15.76	14.63	22.07	24.54
Whole Life	\$15,000	Low	1.34	.54	1.87	.32	2.73	1.34
		25th	3.37	2.74	4.27	3.30	6.95	6.34
		75th	3.30	3.93	4.44	3.34	10.32	9.52
		High	12.10	12.28	15.76	14.63	22.07	24.54
Term	\$15,000	Low	1.92	1.84	1.43	3.05	4.64	4.60
		25th	3.04	3.17	3.84	5.03	7.27	10.09
		75th	3.34	3.97	4.44	6.21	8.78	13.23
		High	7.64	7.27	16.87	16.40	12.32	17.79
Term	\$50,000	Low	1.34	1.60	1.01	1.81	4.30	4.23
		25th	2.63	2.83	3.44	4.44	6.78	9.84
		75th	3.23	3.74	4.37	3.87	8.51	12.21
		High	7.14	6.87	14.37	15.00	12.09	17.34

Non-Participating

Participating

* The figures in the table are for illustrative purposes only. Policies with low index numbers may not always be available to all consumers because of underwriting restrictions. Surrender cost data has been taken from information supplied by insurance companies on policies sold in Wisconsin. The interest assumption used in computing surrender cost index data in Wisconsin is 12. All values are per \$1,000 face amount.

Surrender cost index figures for participating policies are based on illustrated dividends, which are neither guaranteed, nor projections of what actual dividends payable in the future will be. The experience of participating policies in general over the past 20 years has been to exceed the dividends illustrated at the time of sale.

Concerning the "range of values": "Low" means that no policy among those surveyed had a lower index. "25th" means that 25% of all policies surveyed had an index equal to or below that shown. "75th" means that 75% of all policies surveyed had an index equal to or below that shown. "High" means none of the policies surveyed had an index greater than that shown.

This table is based on data collected in November, 1978, and will be revised periodically.

** 1 year renewable and convertible.

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The ranges of surrender cost indexes shown on the table only apply to the particular policies and ages given. The easiest way to find out if the particular policy you are considering is low or high is to call up a number of competing companies and ask for the 10 and 20 year surrender cost index figures (at your age) for their comparable policy — or look up these figures in the library. As you do this, you should also keep in mind the following rules:

1. Cost comparisons should only be made between similar plans of life insurance. Similar plans are those which provide essentially the same basic benefits and require premium payments for approximately the same period of time. The closer policies are to being identical, the more reliable the cost comparison will be.
2. Compare index numbers only for the kind of policy for your age and for the amount you intend to buy. Since no one company offers the lowest cost for all types of insurance at all ages and for all amounts of insurance, it is important that you get the indexes for the actual policy, age and amount which you intend to buy.
3. Small differences in index numbers could be offset by other policy features, or differences in the quality of service you may expect from the company or its agent.
4. In any event, you will need other information on which to base your purchase decision. Be sure you can afford the premiums, and that you understand the policy's cash values, dividends and death benefits. You should also make a judgment on how well the life insurance company or agent will provide service in the future to you as a policyholder.
5. This life insurance cost index is not designed for the purpose of determining whether you should drop a policy you have already owned for awhile, in favor of a new one. If such a replacement is suggested, you should ask for information from the company which issued the old policy before you take action.

Other Useful Cost Indexes

In addition to the surrender cost index, experts on insurance have developed other cost indexes which may be helpful in comparing various life insurance products. Insurers which provide these index figures must do so in accordance with standards set by the Insurance Commissioner.

Life Insurance Net Payment Index.

This index does not take into account the cash surrender value (and terminal dividends, if any) that would be available to you if you surrendered the policy at the end of the period being measured by the index. It is useful if your main concern is the average annual out-of-pocket expense to you (premiums less dividends, if any) over a period of time, such as 10 or 20 years, ignoring the policy's cash surrender value build-up. Understood within this framework, a lower index generally indicates a lower out-of-pocket expense.

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The Equivalent Level Annual Dividend. This figure shows the part dividends play in determining the surrender cost index or the net payment cost index of a participating policy.

Average Annual Rate of Return Index. This index gives an approximation of the rate of return on the cash value element of a whole life policy. Because it does not lead to a significantly different ranking of policies from the surrender cost index, insurers are not currently required to provide this information to consumers. But if any agent or company attempts to sell you a whole life policy by emphasizing its investment or savings element, you should ask to see its 10 and 20 year rate of return, using this index, so that you can compare the policy's "yield" with the after tax return of alternate, "safe" investments (such as the interest you would earn on your money in a savings institution). Under most circumstances, life insurance should not be sold or purchased as an investment. The rate of return index provides you with important information necessary to make this determination for yourself.

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IMPORTANT THINGS TO KEEP IN MIND

1. **BUY ONLY WHAT YOU CAN AFFORD.** If you drop your whole life policy within the first 10 years because the premiums turn out to be more than you can afford, you will lose a substantial amount of the money you have paid in.
2. **GROUP INSURANCE.** If you have access to good group term insurance, take advantage of it.
3. **TRY NOT TO LEAVE YOURSELF UNDERINSURED.** Remember, during your younger years, when your needs are generally greatest, term insurance may provide you with many times as much insurance protection for your premium dollars as whole life or endowment.
4. **SHOP AROUND.** Many people think all policies cost about the same. They don't. Before you buy a life insurance policy, always check to see if it has a low surrender cost index. To determine whether a policy is high, medium or low cost, compared to other similar policies available in Wisconsin, check the life insurance cost comparison information on file at your local public library; call up competing companies and get their policy costs and indexes; or, if you need further assistance, contact the Wisconsin Insurance Commissioner's Office.
5. **COMPARE POLICIES, NOT COMPANIES.** Policyholders should look at the indexes for the particular policy which they intend to purchase. Companies vary and the company with the lowest indexes for one policy will not necessarily have the lowest indexes for all policies.
6. **REASSESS YOUR LIFE INSURANCE NEEDS FREQUENTLY.** Your life insurance needs will change as the number of your dependents and your income changes.
7. **SHOP FOR A GOOD AGENT AS WELL AS A GOOD POLICY.** You can't over estimate the value of an honest, well-informed agent. Inexperienced agents often lack detailed knowledge about their company's products and don't realize that the costs of similar policies differ markedly from company to company. In addition, because agent commissions are tied to premium size, there is some incentive for unprofessional agents to sell higher cost products where they may not be appropriate. So shop around. Talk to two or three agents including agents who represent several companies. Compare the advice each one gives you and the indexes of the policies each one recommends.

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8. **BE VERY CAREFUL ABOUT SWITCHING OR REPLACING LIFE INSURANCE POLICIES.** Sometimes an expensive whole life or endowment policy may be providing you with little protection for the money you spend — and a switch to such higher level of term protection for the same amount of money may make sense. In other cases, switching policies may be a mistake because you will have to pay the heavy first year expenses again, and will lose certain rights you have under the old policy.

9. **LIFE INSURANCE MAY BE ONE OF THE MOST SIGNIFICANT PURCHASES YOU CAN MAKE FOR YOUR FAMILY IN A LIFE TIME.** If you are buying life insurance as "an investment," be sure to check its rate of return. It's definitely worth your time (and money) to read up on life insurance and compare relative values before you make a purchase.

REMEMBER: COMPARISON SHOPPING SAVES MONEY. ANY TIME WHICH IS SPENT INFORMING YOURSELF ABOUT THE DIFFERENT TYPES OF LIFE INSURANCE POLICIES AVAILABLE — AS WELL AS COMPARING THE COSTS OF THESE POLICIES — WILL BE WELL WORTH IT. IF YOU NEED FURTHER ASSISTANCE, YOU MAY WANT TO CONSULT YOUR LOCAL LIBRARY WHICH SHOULD HAVE CURRENT INFORMATION ON COMPARATIVE LIFE INSURANCE PRICES AND INDEXES.

A STATE-WIDE TOLL-FREE "WISCONSIN LIFE INSURANCE COST DISCLOSURE INFORMATION LINE" WILL BE IN OPERATION THROUGHOUT 1979. THE NUMBER IS: 1-800-362-8380.

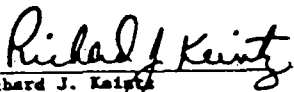
If you cannot get the answers you need from the agent or company, or if you have a specific complaint, contact

The Office of the Commissioner of Insurance
123 West Washington Avenue
Madison, Wisconsin 53702

(608) 266-0103 (if in Milwaukee, call 224-2925)

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Dated at Madison, Wisconsin, this 13th day of
March, 1979.


Richard J. Knight
Deputy Commissioner of Insurance

LIFE INSURANCE COST DISCLOSURE

A Staff Report to the
Federal Trade Commission

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