American Council of Life Insurance,
Washington, D.C.,

Hon. Howard W. Cannon,
Chairman, Committee on Commerce, Science, and Transportation, U.S. Senate, Russell Senate Office Building, Washington, D.C.

Dear Senator Cannon: Enclosed is a copy of the response of the American Council of Life Insurance to the comments by the Federal Trade Commission on the Council's testimony on the Commission's life insurance cost disclosure report which was issued on July 10, 1979.

Sincerely,

Robert Bland Smith, Jr.

Enclosure.

Comments by the American Council of Life Insurance on the FTC Staff's Responses to Criticisms of the Report on Life Insurance Cost Disclosure

The staff of the Federal Trade Commission has chosen to respond to eight of the criticisms of the staff report made by representatives of the life insurance business at the October 17, 1979 hearing of the Senate Committee on Commerce, Science and Transportation. These responses merely repeat the erroneous ideas and conclusions that were set out at length in the FTC staff report.

We should like to offer a few comments pointing out what we see as flaws in the responses of the FTC staff in order to clarify some of the matters under dispute. Our comments will follow the same sequence used by the FTC staff.

1. *The FTC staff report "adopts the flawed theory that whole life insurance is a hybrid combination of term insurance and a savings account." Instead, "whole life is not partially insurance and partially savings. It is wholly insurance."*

In the FTC staff's response to this criticism, it studiously continues to miss the point as to what the life insurance business is and persists in the view that our industry is selling savings accounts. The primary purpose of the life insurance

[63] Moss Comm. Rep., *supra* note 49 at 62–63.

business is to provide life insurance and annuity benefits through contracts that guarantee dollars for future delivery. Appropriate disclosure should tell the purchaser what benefits are payable, the conditions under which they will be payable and the price that must be paid to purchase a contract that makes such guarantees. The National Association of Insurance Commissioner's Model Life Insurance Solicitation Regulation which has been adopted in thirty states requires insurers to give purchasers this kind of information. (In addition, many insurers provide this information voluntarily so that about 80 percent of all purchasers receive it.)

Although the life insurance business accumulates capital as a result of insurance operations and does in a macroeconomic sense contribute to the nation's supply of savings, this does not transform life insurance companies into savings banks nor life insurance policies into savings accounts. Many other institutions, both private and public, contribute to the nation's supply of savings even though they do not offer savings accounts.

The fact that life insurance policies are assets of their owners leads to "savings" in the macroeceonomic sense. It does not result in these policies being equal or equivalent to term insurance plus a savings account. The use of the term "savings through life insurance" in the economic literature relating to the life insurance business is analyzed in Appendix A to this statement.

In summary, the response of the FTC staff to this criticism has been to repeat several quotations from the text of their report and to cite several authorities from the life insurance business to prove that life insurance companies are financial institutions that accumulate savings. The latter point is clearly correct and has not, to our knowledge, ever been questioned. It is, of course, irrelevant to the disagreement between the FTC staff and the life insurance business.

We do not object to anyone claiming that a whole life insurance policy may, for some purposes, be thought of as being analogous to a combination of term insurance plus a savings account. What we do object to is the FTC staff claiming that such an analogy is a fact and that policyholders must be told the "rate of return" earned on that savings account.

For cost comparison purposes, the natural unit price for insurance is dollars of premium per thousand dollars of death benefit per year—adjusted as appropriate for dividends and cash surrender values. The recommendation of the FTC staff that a cost index stated in terms of a rate of return on a hypothetical savings account can be justified neither by the utility of such an index nor by an argument that treats analogy as fact.

2. *The FTC staff's 1.3 percent average industrywide rate of return calculation is meaningless and its dissemination irresponsible.*

The FTC staff, in defending their meaningless average industrywide "rate of return," continues to ignore the fact that the life insurance business provides guaranteed benefits which involve a definite cost as contrasted to banks or savings and loan associations that offer savings accounts and that credit interest to these accounts periodically. The 1.3 percent figure is a fiction based upon FTC staff hypotheses and does not reflect the actual operation of the life insurance business. Life insurers currently use interest rates of from 5 to 6 percent in determining the price of the guaranteed benefits that they provide.

In commenting on the FTC staff's renewed argument that industrywide "rate of return" has some significance, we wish to note again that there is no reason to attempt to develop a "rate of return" for the industry from composite financial statements since this has nothing to do with disclosing the price of life insurance to individual buyers. The FTC staff's response appears to indicate that the industrywide "rate of return" was developed primarily in order to provide a basis for sensational claims about lack of competition in the life insurance business and resulting losses to policyowners of billions of dollars.

3. *The one year industrywide rate of return paid to ordinary policyholders in 1977 by the life insurance industry was 5.9 percent, not the 1 to 2 percent estimate contained in the FTC staff report.*

As we noted in our testimony on October 17, the calculation of an industrywide "rate of return" according to the FTC staff's method could produce a result ranging anywhere from −0.1 percent to 9 percent depending upon the assumptions chosen. The result would depend on how low a set of premium rates were used to calculate the "term insurance costs." The lower the premium rates, the lower the "term insurance cost," the larger the "deposit to savings" from the balance of premiums and the lower the rate of return produced by the calculation. The term insurance premium rates chosen by the FTC staff for the calculation of the "industrywide rate of return" were, in fact, very much lower than those used elsewhere in the FTC

staff report or those actually charged by life insurance companies. They resulted in very low "rates of return."

This calculation ignores the interest actually credited by companies to their individual life insurance line of business and, thus, to the benefit of their policyowners collectively. In contrast, the calculation in Mr. Taylor's statement begins with the $12.4 billion actually credited by companies to the individual life insurance line. This amount is reduced by a portion that may be allocated to cover a share of expenses, taxes and profits. Since a life insurance company operates as a single unit, all income received by a company from both premiums and investment income is available to pay all benefits and expenses. If an industrywide "rate of return" representing investment income used for policyholder benefits is to be computed, it cannot be unreasonable to assume that premiums and investment income are allocated proportionately to provide for benefits and expenses.

The FTC staff shrugs off this allocation as "arbitrary" but does not suggest that it is unreasonable. In contrast, the alternative allocation implicit in their calculation—namely, that 80 percent of expenses, taxes and profits comes from the $12.4 billion of investment income credited by companies to their individual policyholders in 1977 and that the remaining 20 percent comes from the $24.2 billion of premium income received by companies that year is both arbitrary and unreasonable.

The FTC staff comments emphasize the importance of their estimate of the cost of "providing pure insurance protection" to the results of their calculation. To correct their calculations, the most important adjustment is to replace their estimate by premium rates that are representative of low cost term insurance rates actually charged by life insurance companies. A discussion of this point and of other corrections that should be made to the calculations of the FTC staff is contained in Appendix B.

4. *The FTC cost disclosure report was unfairly biased in favor of term insurance.*

The FTC staff was able to find two quotations from their report which they could cite to argue that their report was neutral. A careful reading of the entire report leads to quite a different conclusion. In fact, those biases continue to show in their letter of January 15. They still take the position that term insurance plus a savings fund is the same as permanent insurance which guarantees dollars for future delivery whenever an insured may die. Guarantees of insurance benefits cost money. For the insured who lives, the purchase of an insurance contract, whether term or permanent, may or may not prove to be as financially rewarding as substituting an investment for the insurance protection. But, this is not the point. The question is whether an individual needs guaranteed dollars to be delivered when specified events occur. If this is what is needed, a comparison of a hypothetical "rate of return" on an insurance contract with rates of return on investments is irrelevant. What is needed is a means of comparing the costs of insurance contracts that guarantee the particular pattern of future dollars to meet insurance needs.

5. *Many consumers would be ill-advised to buy only term insurance because term insurance becomes prohibitively expensive at older ages.*

The FTC staff response ignores the experience of insurance companies, regulators and the Veteran's Administration with policyholders who were forced to drop term insurance policies when premium rates became prohibitive even though they still needed life insurance. The blindness of the FTC staff to this problem is symptomatic of their view of term insurance and an unspecified investment as an acceptable substitute for whole life insurance.

6. *The FTC's cost disclosure report was unnecessary because the NAIC has issued a model cost disclosure regulation.*

The FTC staff claims the use of a cost index showing a "rate of return" is a needed change to the NAIC model regulation that justifies their activities in this field.

The FTC staff's claim that rate of return disclosure offers a better way to compare dissimiliar policies is totally false. The FTC staff's so-called rate of return for a particular policy is not a true interest earnings rate at all but merely another cost index which reflects the same premiums, dividends and cash values as are reflected in the NAIC Surrender Cost Index. In the case of the former, a cost of insurance is assumed and the index is expressed in terms of an interest rate; in the case of the latter, an interest rate is assumed and the index is expressed in terms of a cost of insurance. Comparative rankings of policy costs according to the two indexes show a high statistical correlation which means that the NAIC Net Surrender Cost Index is at least as ueful a cost comparison index as the FTC staff's rate of return. In fact, it is more useful since it can be used to show the relative costs of term policies as well as permanent policies which is not possible with the rate of return index. The NAIC disclosure package provides sufficient disclosure information to illustrate the pat-

tern of guaranteed insurance benefits and their costs and cost indexes to summarize what are generally the most important of these costs, together with balanced and unbiased information to aid in shopping for life insurance. In contrast, the FTC staff report contains a proposed disclosure regulation which encourages buyers to provide for their insurance needs by shifting from whole life insurance to term insurance plus an investment. Advocacy of such an incomplete insurance program may do a great disservice to insurance buyers, particularly as they find they have insurance needs which do not diminish with advancing age.

7. *The FTC staff disregarded or suppressed the results of consumer research which the FTC commissioned because the results of that research contradicted the staff's conclusions about the need for cost disclosure.*

The FTC staff misconstrues the results of the studies referred to in their response. This question is discussed at more length in Appendix C.

8. *The Federal Trade Commission should not be involved in the life insurance area because it has not received a sufficient number of consumer complaints.*

Predictably, the FTC staff responds that "consumer complaints do not always provide an accurate gauge of consumer problems."

The FTC staff's assertion that the life insurance business is not price competitive simply does not reflect trends over the last generation which are continuing up to today. The price of both permanent and term plans has been steadily decreasing reflecting improvements in investment earnings and mortality. New types of products have been introduced to meet changing insurance needs and conditions.

The FTC staff tends to focus on the extremes in insurance pricing to assert their claim that there is a lack of competition within the insurance business. Even if they could find some few life insurers that are not keeping up with changing trends in pricing, most life insurance is sold by companies that actively and aggressively compete for new business. A review of recent announcements of rate changes would indicate that there is real competition in the life insurance marketplace.

REVIEW OF PRESS REPORTS AND ADVERTISING MATERIALS

The FTC staff blames the press for failing to present a complete view of their findings. Yet the FTC press release gave greatest prominence to their false assertion that the life insurance business allocates a 1.3 percent "rate of return" to policyholders and that consumers are "losing billions yearly." These reckless and unsubstantiated assertions which were so much at variance with the facts were bound to produce sensational news stories. Now that these assertions bear the imprimatur of a federal agency, they will be used for years in the future by those who seek to persuade unwary policyholders to exchange good insurance protection for inferior alternatives. Unfortunately, the damage has been done. We are disappointed that the FTC staff continued to defend such a flagrant falsehood.

APPENDIX A

THE USE OF THE TERM "SAVING THROUGH LIFE INSURANCE"

The FTC memorandum correctly points out the common use of the term "saving through life insurance" in the economic literature relating to the life insurance business. Thus, for over 25 years, the ACLI and its prececessor organizations have provided a statistical series showing saving through life insurance compared with saving through other financial institutions.

The economic use of the term "saving through life insurance" relates to the overall picture of the economy provided by the national income accounts and the flow-of-funds accounts. It has little to do with the nature of the whole life contract and exactly what the policyholder gets in exchange for his premiums. In the national income and product accounts, there is by definition a total of saving equal to the volume of capital investment that takes place each year. This total of saving is made up of saving by individuals or households, business firms, and governments. It includes saving through life insurance companies and other financial institutions.

In the national income accounts, considerable emphasis is placed on the "personal" component of national saving. However, the distinction between "personal" and other saving is not an easy one to make. "Personal saving," as currently defined by the U.S. Department of Commerce, includes saving by proprietors, nonprofit institutions, and saving done through various financial institutions including life insurers. When governments (federal, state or local) run a surplus, they are "saving" according to the concepts in the national income accounts, although individuals' taxes contributed to this saving. When business firms have undistributed corporate profits, they are "saving" even though individuals have a claim on these profits.

In the case of life insurance companies, the ACLI has defined "saving through life insurance" as the increase in total assets of life insurers less valuation changes and the increase in policy loans. It represents a total of business and "personal saving" and undistributed profits reflected in the operations of life companies. This concept follows the definition developed by Dr. Raymond Goldsmith in his monumental work, "A Study of Saving in the United States." We have used corresponding definitions for saving through other financial institutions. In the ACLI statistical series, no attempt is made to break down the increase in assets attributable to different kinds of business or policyholders or to estimate shares contributed by business and individual customers.

The flow-of-funds accounts show how total saving derives from changes in tangible and financial assets less changes in liabilities. Saving by individuals is shown as a subsector of these accounts with breakdowns by major type of asset including those held indirectly through life insurance and pension plans. The individual saving series in these accounts is reconciled to "personal saving" as shown in the national income accounts primarily by the deduction of increases in consumer durables and in government insurance and pension reserves (which are not counted as part of personal saving in the national income accounts).

The flow-of-funds accounts use the increase in life insurance reserves as a measure of household or individual saving. The ACLI has avoided use of this series because total reserves represent a somewhat arbitrary measure of liabilities calculated on the basis of selected interest rate and other assumptions. The total of these reserves is not the sum of specific amounts owed to individual policyholders but an amount calculated by the life insurer to estimate aggregate liabilities to groups of policyholders.

The amounts that policyholders expect to receive are the various benefits enumerated in the contract subject to the contigencies also stated there. Some of these benefits may be regarded as akin to savings by the policyholder, but they are not the reserves set up by life insurers to cover all types of benefit payments expected to be made.

The distinction between policyholders' benefits and reserves, assets, and savings is perhaps clearer in the case of property-casualty insurance. The policyholder buys protection against fire, theft, etc., and the insurer accumulates reserves and assets to meet expected claims. The accumulation of assets by the insurers is a part of national saving but it is not an accumulation on which the policyholder expects to earn a return similar to interest on a savings account.

The controversy over the concept of a divided whole life contract, with a savings and a protection element, has gone on for years.[1] It has been exacerbated by the attempt to estimate a rate of return on the "savings element." To come closer to the realities involved means examining in detail what the policyholder pays in premiums and what he or she may legally and in fact expect in terms of benefits. It also means recognizing that the accumulated assets held by life companies ("savings" in an economic sense) earn the market rates of return typical of these assets no matter who holds them or how insurers make use of those returns.

Appendix B

Corrections to the Calculations of the FTC Staff of an Industrywide Rate of Return

The FTC staff characterizes the cost of insurance protection used in their calculation of an industrywide "rate of return" as being "consistent in principle" with the term premium rates used in their text and with the low cost term life insurance premium rates developed by a committee of the Society of Actuaries and used by the FTC staff in their suggested changes to the NAIC model regulation. The three sets of rates may be characterized by the FTC staff as "consistent," but the rates are, in fact, quite different. For example, the first year term premium for a $25,000 policy issued to a male, aged 35, is $80.75 according to the formula of the Society of Actuaries committee. The first year term premium for the same policy used by the FTC staff in the text of its report was $64.25—a reduction of 20 percent. Term rates equal to 150 percent of actual claims in 1977—the rates used by the FTC staff to calculate the industrywide rate of return—would be $22.50 for the same policy—a reduction of 72 percent from the low cost term rates developed by the Society of Actuaries committee.

The first year premium rates actually charged for such policies in 1979 was shown in the February 1980 issue of Consumer Reports. The ten yearly renewable term

[1] For example, see Robert I. Mehr, "The Concept of the Level-Premium Whole Life Insurance Policy—Reexamined," The Journal of Risk and Insurance, September 1975.

insurance policies with the lowest premiums shown in the tables published in that issue ranged from $82 to $95, with an average premium of $88.

Varying differences occur at other issue ages and durations. After making the appropriate adjustments to the data reported in the 1977 annual financial statements of life insurance companies, we estimate that the "low cost" term insurance rates according to the formula developed by the Society of Actuaries committee would have produced term premiums in excess of $11 billion for the individual life insurance in force in 1977. This is in contrast to the $7.4 billion produced by the FTC formula of 150 percent of actual claims.

The FTC staff had noted several criticisms pointing out that applying the loading from the premium formula of the Society of Actuaries committee ($.90 per thousand dollars of in force and $25 per policy) to the individual life insurance in force in 1977 would make provision for expenses and profits of $4.9 billion in contrast to the $2.4 billion produced by their formula. Their response reflects the extent to which they are committed to their thesis. They demonstrate that if you reduce the number of policies in force by two-thirds, you can produce a loading that is similar to that produced by multiplying death claims by 150 percent. Their arithmetic is correct but their logic is warped.

There are two further corrections that should be made in the FTC staff's calculations. First, the $24.2 billion of premiums should be reduced by $.9 billion of premiums for incidental benefits such as waiver of premiums, accidental death benefits, etc. since these benefits do not involve any so-called "savings accounts." Second, premiums should be reduced to reflect the fact that term insurance premiums actually charged by life insurers exceed those produced by the FTC staff's formula by $.9 billion. This would leave premiums of $24.4 billion for those policies that involve a "savings" element.

The net result of these three corrections is to reduce that part of the increase in savings in the FTC staff calculations that comes from premium "deposits" by about $6 billion and to increase that part that comes from interest credited by the companies by a corresponding amount. The net result is to increase the resulting "industrywide rate of return" from 1.3 percent to between 5.5 and 6 percent.

The FTC staff claims that the benchmarks used do not justify a 5.9 percent "rate of return." These benchmarks were cited because they are facts which would indicate how widely the FTC staff's "rate of return" missed the mark in describing the portion of investment income that is used for the benefit of policyholders. It is a fact that interest rates of 5 or 6 percent or higher are currently used by life insurers in determining premiums policyholders pay and dividends they receive. If statements are to be made about the average performance of the industry as a whole in allocating investment income for the benefit of policyholders, this must be taken into account. It is a fact that the average interest rate required to maintain policyholder reserves for their future insurance benefits is about 3 percent. Life insurers were required by law to allocate $4.2 billion of investment income to policyholders reserves in 1977 which is two-third times the $1.8 billion the FTC staff claims was allocated for policyholder benefits. It is a fact that 5 percent interest or higher is paid on dividends left on deposit. The fact that this portion of investment income used for the benefit of policyholders is clearly visible does not mean that lesser amounts are credited to policyholders elsewhere. Equity and competitive pressures require that investment income be allocated consistently in determining premiums, dividends and interest credited on dividends left on deposit.

The FTC staff notes in several places that citing overall industrywide interest rate benchmarks tells little or nothing to the individual policyholder. We are heartened that the staff recognizes this fact and note that it applies with equal force to their 1.3 percent industrywide rate of return. The benchmarks were not intended to measure "rate-of-return" but are facts presented to show how absurd it is to claim that life insurers allocate only 1.3 percent interest for the benefit of policyholders.

An even more bizarre approach to calculating an industrywide rate of return is presented by the FTC staff in their letter as an alternative benchmark. It is based on the assumption that the entire industry has for the past twenty years issued a single policy selected by the FTC staff. Assumption is piled upon assumption and hypothesis is built upon hypothesis. It is little wonder that the rate of return for this model of an imaginary industry is consistent with FTC staff's policy rates of return. Both are derived from the same fiction. If the FTC staff wants to attempt to separate the various factors that affect the price of life insurance, it should abandon its fantasies and arbitrary assumptions and look at how the life insurance business, in fact, really works.

Appendix C

Consumer Research Sponsored by the FTC

The FTC makes a series of assertions about the results of the consumer research they sponsored. A careful reading of the actual research reports indicates, however, that the FTC assertions are contradicted by the real results of their research.

For example, the FTC states (page 9) that the findings of Professor Jacoby's research "support the staff's conclusion that the NAIC disclosure system is ineffective in imparting meaningful cost comparison information to consumers." But Professor Jacoby himself concluded, in the summary of his second study, that consumers exposed to the NAIC materials (and others) were "able to make good purchase decisions" and "did very well in the quizzes which tested for basic life insurance knowledge." Indeed, on a quiz designed by the FTC, research subjects exposed to the NAIC materials got, on average, 18.3 of 21 questions correct. This was achieved despite the fact that the questions poised to the NAIC subjects were, overall, more difficult than those posed to subjects exposed to the FTC material.

It also should be noted that 61 percent of the NAIC subjects had a positive impression of the NAIC materials, compared to 51 percent of the respondents given the FTC materials.

The FTC asserts that Professor Jacoby's research shows that the FTC materials can significantly improve consumer's motivation and ability to comparison shop for the lowest cost insurance. But Jacoby's first FTC sponsored study states (page 29) that, "The NAIC Buyer's Guide seems to have had a direct and clear-cut effect on the two cost indices emphasized there (i.e. Surrender Cost and Net Payment). Regardless of whether a trigger was present or not, the NAIC Buyer's Guide alone was sufficient to generate a substantial increase in the attention paid to these cost indices, as compared to the accessing rates for subjects in the Control condition and the three other experimental conditions." Of course, one of the experimental groups referred to was the FTC group.

The FTC asserts that the second Jacoby study showed that people who received the FTC materials "outperformed" other groups, particularly the NAIC group. However, Professor Jacoby on pages 54 and 55 of this record report clearly indicates that the FTC designed the research in such a way to make that comparison questionable at best. Professor Jacoby states that the "policies" devised and supplied by the FTC gave "considerable assistance" to FTC subjects in choosing low cost policies. By contrast, the FTC *devised* the materials given to the NAIC groups to be much more difficult to understand. For example, as Jacoby states (pages 55)," the cost indices on both the NAIC and Belth "policies" are not prominently displayed, as in the FTC format, but are buried in the tables of the other cost information that are given." Therefore, comparisons between the groups, considering the differences in the assistance given should be made with extreme caution, if at all. The study clearly shows, however, that the NAIC materials lead to good consumer decisions, good knowledge of life insurance and that the materials are considered helpful by those who read them.

The FTC asserts that the research conducted on their behalf by Professor Roger Formisano shows that test subjects who received the NAIC disclosure materials did not have the information essential for rational decision making. Since subjects were interviewed up to six months after the purchase, their memory of what occurred during their purchase decision was understandably hazy. The Jacoby research indicated that the NAIC materials are informative and helpful. Thus, the performance of the Formisano respondents on their life insurance quiz must be attributed to knowledge diminished with the passage of time. Anyone who has studied for a test in school knows that if tested six months later, their performance would be much diminished despite their knowledge at the time of the test.

Although memory of specific events is hazy, impressions about life insurance and the performance of life insurance agents are longer lasting. Therefore, we should trust the statements of the Formisano subjects that they were very satisfied by their purchases and the agents they bought from.

To summarize, the message of the consumer research sponsored by the FTC is quite clear. The NAIC materials are helpful and do lead to good decisions. Buyers in a state that adopted the NAIC Model Regulation are well satisfied with their purchases. A careful reading of the research results would lead to an encouragment of the NAIC Model Regulation now in effect in 30 states.