TESTIMONY OF

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CHAIRMAN

FEDERAL TRADE COMMISSION

ON

LIFE INSURANCE COST DISCLOSURE

BEFORE THE

SENATE COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

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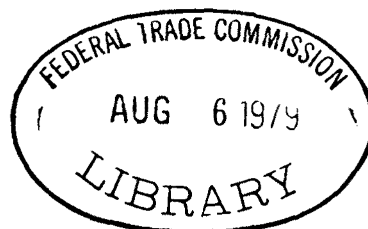
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Mr. Chairman, Thank you for the opportunity to testify before you today. Our topic -- life insurance -- is a deadly serious one for millions of American consumers. Each year they spend over 30 billion dollars on life insurance premium payments. And yet, despite the importance and expense of this purchase, the average consumer buys a life insurance policy without ever being given the information that is absolutely essential for him or her to be able to understand what that policy really costs. Indeed, I think it fair to say that no other product in our economy that is purchased by so many people for so much money is bought with so little understanding of its actual or comparative value.

A person who buys an ordinary whole life insurance policy -- the most popular type of insurance now sold -- is in reality buying both protection against dying soon, and protection against not dying soon. This latter protection takes the form of cash values, which the insured may obtain at will, merely by surrendering his or her policy. Building up cash values in a life insurance policy is little different from saving money in any other medium, and one would imagine that one of the first things that many consumers would want to know about their life insurance, like any other savings medium, is "what interest rate will I be getting." In fact, however, such information is simply not now available either to consumers or to life insurance agents, except perhaps for those few fortunate enough to have mastered courses in both actuarial science and computer programming.

I will elaborate on these observations in a moment, but I would first like to point out that very little of what I have just said or have yet to say is at all original. This committee has had a long term concern about the fate of the insurance consumer, as its arduous work on no-fault auto insurance attests.

Similarly, the inability of consumers to make knowledgeable decisions when purchasing life insurance has long been a topic of serious (if not sufficiently widespread) concern among insurance industry executives, state regulators and, not least of all, here on Capitol Hill.

In February, 1973, the late Senator Philip Hart held extensive hearings on the life insurance industry, with emphasis on the need for life insurance cost disclosure. In Senator Hart's words, the thrust of those hearings was that "consumers couldn't make rational buying decisions at the time of purchase of life insurance because detailed information on costs and benefits wasn't available."

In June, 1973, the National Association of Insurance Commissioners adopted an interim model cost disclosure regulation, and a final NAIC model was adopted in May, 1976. The NAIC model law was an important first step in the direction of promoting consumer awareness of insurance costs. However, it contained several major flaws that have since been recognized by other Congressional committees, including the Senate Committee on Veterans' Affairs, which, in June, 1977, postponed action on S. 718, a bill to require adherence to the NAIC model regulation in connection with the sale of life insurance to veterans. On the House side, the Subcommittee on Oversight and Investigation of the House Committee on Interstate and Foreign Commerce, chaired by Congressman Moss, held hearings on life insurance cost disclosure last August, focusing on the inadequacy of the NAIC model regulation.

It was in the context of this interest among congressional, state and industry authorities that the Commission began its own inquiry into the problem of life insurance cost disclosure. In December, 1976, the Commission announced that it had authorized its staff to investigate four questions: (1) whether adequate cost information is being provided to prospective life insurance purchasers; (2) what types of information would be most accurate and most likely to be useful to consumers; (3) the impact such disclosures would be likely to have upon the industry and upon consumers; and (4) what would be the most appropriate and feasible course of action for the Commission to take in this area to alleviate any problems found to exist.

The Commission has been, of course, mindful that our ultimate authority to take regulatory action with respect to life insurance may be significantly circumscribed by the McCarran-Ferguson Act. On the other hand, the Commission's authority to investigate the existence of potential consumer problems, and to report the results of its investigations where they reveal substantial consumer problems, is unimpaired by this Act. With this in mind, our staff began their inquiry in late 1976.

They have now produced a report which is being released today. Based on their findings and recommendations, the Commission has proposed a model state regulation on life insurance cost disclosure. The staff report is perhaps the best and most comprehensive exploration of the problems of life insurance cost disclosure undertaken to date. We thus believe that the report will serve an important educational purpose. By releasing it we hope to prompt careful scrutiny and evaluation of its findings by the expert community.

With that introduction, then, let me summarize the findings of the staff report and the Commission's own recommendations:

1. Saving through life insurance.

The first major conclusion of the report, as I noted, is that ordinary life insurance isn't just insurance. For most consumers, a life insurance policy is also a type of savings account. Only part of the premiums pay for death protection. Another large portion of the premiums consumers pay each year goes toward the policy's "cash value," which grows over time and may be obtained simply by surrendering the policy.

Industrywide, this savings component of cash value life insurance is extremely significant. Based on industry estimates, our staff puts the total consumer savings held by life insurance companies in 1977 at 140 billion dollars. In other words, consumers save about the same amount through life insurance as through savings and loan passbook accounts.

Let me illustrate the relative importance of the savings component of cash value insurance in two ways.

The first is to examine the cash flow of the life insurance industry in gross dollar terms. Our staff analysis shows that almost 34 billion dollars flowed into life insurance companies in 1977 from premiums and investment earnings. On the other side of this rough balance sheet, only 5 billion dollars were paid out in death benefits. The rest of the revenue went toward savings-related benefits such as dividends, surrender values, and increased holdings, as well as to the cost of doing business.

The other way to look at the savings element of life insurance is to break down each premium dollar into its end uses. How much is used to pay death benefits? About 15 cents. What portion is charged to overhead? Just over 30 cents. And the remaining 55 cents -- over half of every dollar paid in premiums? It goes into the savings component, to be used to fund withdrawals and to increase the consumer savings held by the companies.

2. Industrywide rate of return

Once we recognize that cash value life insurance is both death protection plus savings, the logical next question is: What interest rate are consumers receiving on their money? The answer is that, in almost all cases, the average annual rate of return on the savings component of life insurance policies is far below the market value of money.

As one measure of the interest rates paid by life insurance companies, our staff computed the average industry-wide rate of return paid on all cash value policies in 1977. After conservatively estimating the portion of the premiums needed to provide death protection, they found that the insurance industry paid consumers an average of between 1 and 2 percent on savings, with the best estimate being 1.3 percent.

This industrywide return rate is a summation of all the rates of return on individual policies. Thus it reflects the fact that the rates vary widely depending on the policy type, and more importantly, on the age of the policy. Because of the uneven way in which cash values grow over the life of a policy, the return rate realized by a consumer is largely dependent on how long the policy is held.

3. Penalties for early termination

In the early years, there is actually a negative rate of return -- the cash value is less than that part of the premium attributable to the savings element. Most policies have no cash value for the first year, so if the policy is allowed to lapse after only one annual payment, the entire savings is lost, and the rate of return is minus 100 percent. And the fact is that about one in every five new policyholders drops his or her policy in the first thirteen months. Using the data gathered in 1973 by the Hart committee, we have estimated total consumer loss from first year lapses to be in excess of $200 million annually.

Due to the slow cash value buildup, whole life policies are rarely a desirable purchase unless held for more than 10 years. When our staff analyzed policies issued in 1973 and 1977, they found that policies terminated in the fifth year had an average return rate of minus 10 percent. At the end of 10 years, those policies would pay approximately one percent.

4. Insurance vs. other investments

From these findings, it is clear that many cash value insurance policies offer rates of return several percentage points below alternatives readily available in the marketplace, even taking into account the fact that interest earnings from insurance are essential tax-free. For example, passbook savings accounts pay 5 percent or more. Time deposit rates for small savers are between 6 and 8 percent. And there have recently been complaints that these rates are artificially low, that they prevent small savers from keeping pace with inflation.

The potential consumer loss makes these rate of return differentials extremely significant. A person who invests $1000 each year at 3 percent -- a rate of return yielded by many whole life policies if they are held for 20 years -- will have roughly $47,000 at the end of 30 years. The same amount invested for the same period at 6 percent will yield almost twice as much, about $84,000.

To give us an idea of the aggregate impact, the staff estimated that if the industrywide average return rate in 1977 had been 4 percent rather than 1.3, policyholders would have received an additional 3.7 billion dollars in that year alone.

I should emphasize here that neither the Commission nor our staff is opposed to saving through life insurance. Neither do we favor the purchase of one form of insurance over another. Some available whole life policies offer return rates which are competitive with other savings media. And there are reasons for saving through insurance: it is convenient, some people prefer the forced savings aspect, and tax advantages may exist. In addition, whole life policies have certain attractive features which may not be available through term insurance.

5. The need for rate of return disclosure

But we are convinced that consumers cannot make an intelligent judgment about the merits of different insurance and investment packages without rate of return information, because the true cost of a life insurance policy can only be evaluated if one considers the interest rate paid on the savings component. A sizeable portion of the premium goes toward savings. If consumers are receiving a lower interest rate on those savings than they could get from other investments, then, in effect, they are paying more for the insurance, something any informed buyer should certainly know.

But of course most consumers are not aware of this, so we come to the pervasive problem with the way ordinary life insurance is marketed today: inadequate cost information. No life insurance company in this country currently discloses a standardized rate of return to its customers. Yet, without such cost information, consumers cannot shop comparatively for the most suitable insurance product at the lowest price. Comparisons between insurance and other types of savings are also impossible.

And, where buyers have no way to distinguish competing products on the basis of their true cost, the forces of competition -- which we rely on to eliminate inefficiencies and reward low cost products with larger market shares -- cannot operate effectively.

One indication that competition is not working in the life insurance industry is the wide variation in the cost of similar policies. As an example, the 20 year rate of return in 1977 for $25,000 dividend-paying whole life policies, issued to males aged 35, ranged from a high of 7.6 percent to a low of 1.5 percent. For similar non-dividend-paying policies, the scale went from 3.9 down to .66 percent.

Our staff's analysis of the Hart committee data reveals virtually no correlation between the true costliness of an insurance policy and its market share. They suspect that this variation means that many consumers are paying far more for life insurance than they would choose to pay if they had some way to compare costs.

Without the meaningful disclosure of accurate cost information, we submit, price competition in the life insurance industry is impossible, and the economic injury to consumers is extraordinarily high.

6. The Commission's recommendations

Mr. Chairman, my testimony so far has been about consumer problems in the life insurance industry and their causes. Now let me turn to the Commission's suggestions as to how those problems can be solved.

The Commission agrees with the Hart and Moss committee reports that an essential first step is to provide insurance consumers with information that will enable them to compare the costs of different policies and to compare saving through life insurance with saving through other means.

As I mentioned, the NAIC adopted model cost disclosure regulations in 1976. The Federal Trade Commission commends the NAIC for its sensitivity to the fundamental need for cost disclosure. However, based on the findings of our staff's investigation, the Commission believes that the NAIC model regulation could be improved. Therefore, we are proposing certain amendments to the NAIC regulation, the major features of which I shall describe. As amended, the NAIC regulation can, we feel, accomplish the goals that were originally set for it.

a. Rate of return information

First, and of greatest importance, prospective purchasers of cash value insurance and annuities should be provided with average annual rate of return information for any cash value insurance or annuity product they are considering purchasing.

Under the NAIC model, the only information consumers receive concerning cash values is a schedule showing what the value will be at the end of selected years. In other words, they are told that after 5 years, the cash value of the policy is, say, $1,000; after 10 years, it is $8,500; and so on. But they are not told whether this sum represents a 1%, a 5% or some other rate of return on their investment.

Let me reiterate the serious consequences of this informational void. Without rate of return information, consumers cannot compare the relative merits of saving through the whole life policy with other alternatives such as buying a term policy and investing the difference in another savings medium. Nor are they able to compare the whole life policy's rate of return with anticipated rates of inflation to judge whether their "investment" is likely to stay ahead or fall behind inflation rates.

We know that many industry spokespersons object to rate of return disclosure because it requires what to them is an improper separation of whole life insurance into two elements: savings and protection. They assert that life insurance is a unitary contract that, like the law, must be viewed as a "seamless web." Cash values are said to be only an incidental by-product of the level premium nature of whole life policies.

Whether the whole life insurance contract should be characterized as an "indivisible whole," "insurance purchased on the installment plan" or a "combination of death protection and savings" is largely a matter of semantics. The indisputable fact of the matter is that, regardless of how the savings element is described, it is hardly incidental. The savings element accounts for three or four times as much of the premium dollar as does the insurance protection, and this has made the life insurance industry a major repository of consumer savings.

The argument is simply not a persuasive response to the call for rate of return disclosure. The Moss committee recently considered this same issue and concluded as follows: "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 irresponsibility."

The Commission recognizes that there is more than one disclosure method which can be used to compare different type insurance policies. Based on the available evidence, we selected the rate of return as the one most likely to aid consumers in making informed purchases. The staff report contains a detailed description of the advantages and disadvantages of this and other systems.

b. <u>An appropriate index number</u>

As I have just described, rate of return information is necessary for comparing dissimilar policies and alternate savings mechanisms. Another important part of any cost disclosure system is an index that will enable prospective purchasers to identify and select low cost policies from among an array of similar policies. This need is particularly acute in the case of cash value insurance. For these policies, it is often impossible to ascertain their true cost simply by looking at premiums because, in addition to providing death benefits, whole life policies accumulate cash values and, in many cases, pay dividends.

The NAIC model regulation recognizes this problem and requires the provision of three different indices -- the surrender index, the payment index and the equivalent level annual dividend. It also requires that each of these indices be given for the tenth and twentieth years.

Providing three different indices, each for two different years, for a total of six numbers, has the potential, we believe, to confuse consumers and to defeat the purpose of cost disclosure. The life insurance industry's own Joint Special Committee on Life Insurance Costs recognized this fact in recommending the use of only the surrender index. The Committee warned in its 1970 report, that "to do [otherwise] would inevitably complicate a subject that greatly needs to be kept straight-forward."

Based on the staff's study, we have concluded that the industry Joint Special Committee's early judgment that only the surrender index should be used, was right on target.

We believe that the other two NAIC indices provide little, if any, useful information to consumers. And because the assumptions on which these other indices are based are extremely unlikely to occur, these two indices are potentially misleading.

In addition, to further streamline the disclosure statement, the Commission recommends omitting the tenth year surrender index. Whole life policies are rarely a desirable purchase unless they are held for substantially longer than 10 years. As a consequence, the tenth year indices are of little use to the prospective purchaser.

The focus of the industry Joint Committee and our own recommendations are consistent with the various studies that have been conducted since 1970. These studies, some of which were done by the industry and some at the FTC staff's request, indicate that consumers have difficulty using and understanding the NAIC six number system.

For this reason, the Commission's suggested regulation would require that consumers be provided with but one index number: the surrender index computed for the twentieth year.

c. Timing of disclosure

Finally, the Commission was concerned about the timing of the disclosure. Under the NAIC model regulation, consumers generally received the buyer's guide and policy summary only when the policy is actually delivered, often a week to ten days after purchase. Our experience indicates that if cost disclosure is to be effective, it must take place before the purchase decision. Consumers are very unlikely to read and use a disclosure package provided after the transaction has been completed.

For this reason, we recommend that a buyer's guide be given at the beginning of the sales presentation and that a preliminary policy summary be given prior to the time prospective purchasers are provided an application for a policy. The preliminary policy summary would contain the basic information concerning the policy, such as the policy type, premium, surrender index and the rate of return. The proposed preliminary policy summary contains only those limited items of information essential to an informed purchase decision. It would not be impractical for agents to have all of the information needed to fill out the preliminary policy summary with them during the sales presentation.

However, we concur in the NAIC's recommendation that a full policy summary be delivered with the policy. That summary contains more detailed information concerning the cash flow elements of the policy. The Commission believes that this information is important and useful to the consumer. Because the information is more detailed it may not be readily available to the agent during the sales presentation, but it can easily be provided with the policy, as is currently the practice of companies which comply with the NAIC model.

7. Conclusion

Submitted with this statement are the staff report, the Commission's suggested regulation, and a model buyer's guide and disclosure statement recommended by our staff. While the Commission firmly believes that disclosures of this type are necessary, these latter two documents are not meant to be the definitive solution. Rather, they are provided to illustrate how the necessary elements of a 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. The Commission staff will be available, where called upon, to assist the states in what we hope will be serious efforts to consider life insurance cost disclosure regulations.

Mr. Chairman, that concludes my remarks. We would be delighted to respond to whatever questions the Committee may have.