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Has the Illustrations Regulation Been Successful?

by Scott Witt

By my count, the industry is currently in the midst of its ninth round of illustration testing. By now, I'm sure the testing process is fairly routine for most of you who are directly involved, but I thought it would be interesting to step back and attempt to answer the question: "Has the Illustrations Regulation been successful?"

I believe the answer to be more of a "yes" than a "no," but it is instructive to look at the impact of the regulation from the perspectives of four unique groups: consumers, companies, agents and regulators.

Despite all of the warnings on the illustration, many consumers still likely have a false sense of confidence in illustrated non-guaranteed elements.

Consumer Perspective

Many reasons abound for labeling the regulation a success:

- Consumers have an enhanced understanding of non-guaranteed elements.
- There is greater standardization of terms and formats.
- The likelihood of unfulfilled consumer expectations has been decreased.
- There is arguably a greater likelihood that in-force policyholders will be treated fairly.

But there are also legitimate ongoing concerns:

- Consumers have no frame of reference to know what is reasonable. Can they be expected to recognize unreasonable illustrations if and when they occur?
- The greater standardization also facilitates potentially inappropriate comparisons. Incorrect conclusions can be drawn regarding portfolio vs. new money illustrations, or companies may be using inconsistent definitions of what constitutes current mortality experience.
- Despite all of the warnings on the illustration, many consumers still likely have a false sense of confidence in illustrated non-guaranteed elements.
- Some consumers are reluctant to sign the certification forms, out of misplaced fear that they are waiving all future claims of wrongdoing.
- There is an overwhelming amount of information, and many consumers likely make it through only a small percentage of the material.
- For policies not covered by the regulation (e.g., variable policies), there is evidence that "illustration games" are still being played in the marketplace.

Company Perspective

Most companies today are better off with the regulation because of the following:

- Consumers better understand the illustrations, hopefully putting the company in a better position to defend its sales.
- There are fewer illustrations gimmicks, such as persistency bonuses or projected experience improvements. This strengthens the credibility of the industry.
- Regulatory framework may have improved company practices in some instances, such as developing a more rigorous methodology for determining non-guaranteed elements.

Shortcomings from the company perspective include:

- Instead of gamesmanship in product features, the "game" has now shifted to the assumptions used in demonstrating compliance with the regulation and Actuarial Standard of Practice No. 24.
- The industry still suffers from "The Illustration Is the Product" mentality. Some clients and producers use illustrations as the sole basis for choosing products, which can put pressure on companies to choose a crediting strategy based on what illustrates best today rather than one that is consistent with their long-term investment objectives.
- Companies have had to deal with the administrative burden of complying with the regulation.

- Several different sources indicate that the industry image has not substantially improved from pre-Illustrations Regulation days.

Agent Perspective

On the plus side:

- Agents generally no longer have to explain or compete against gimmicks such as persistency bonuses or explicit projected experience improvements.
- Product comparisons are easier.
- Because the process forces consumers to acknowledge an understanding of the illustration, the agent is less likely to leave the client in a position where they have false expectations.

And on the negative side:

- Many agents feel that the administrative burden is too onerous.
- Despite the improvement in consistency, there are still significant differences among companies' illustrations.
- The use of electronic media, which could lower the paper burden significantly, was not contemplated when the regulation was developed.
- Because of labeling requirements, it is very difficult to integrate life insurance illustrations into a broad financial plan.

Regulator Perspective

I suspect that regulators are pleased about the following aspects of the regulation:

- Consumers are better informed and better protected.
- There is generally more discipline and consistency in the determination of non-guaranteed elements.
- This same format is starting to voluntarily appear in other areas such as variable life insurance.
- Because of the labeling requirements, there has likely been a significant reduction in the number of "I didn't know it was life insurance" complaints that were commonly registered in the pre-regulation days.

On the other hand, there are still several significant issues for regulators to be concerned about:

- The regulation is difficult to enforce, essentially relying on companies to regulate themselves.
- Someone will always be pushing the envelope. For example, late-duration mortality has recently received much attention. Many actuaries feel that a mortality assumption equal to a flat percentage of the 1975-80 Basic Table incorporates implicit projected mortality improvements and is therefore inappropriate to use in illustration testing. Obviously, companies that take a more aggressive stance on this assumption will be better able to pass the tests (or able to illustrate higher non-guarantees), all other things being equal.

While the regulation was not the primary cause of this phenomenon, it is interesting to note that the shift in the marketplace toward fully guaranteed products has lessened the relevance of the regulation. The more aggressive the guarantees, the more difficult it will be for companies to pass the illustration tests with any level of non-guaranteed elements; this may increase the prevalence of products that offer guaranteed values only (and therefore are not subject to the regulation). Without the assurance that non-guaranteed elements are relying on a disciplined current scale, regulators may need to place additional importance on verifying that appropriate reserves are being held for fully guaranteed products, particularly those with little or no cash values.

I strongly believe that the insurance industry is in a better place today than it would have been without the adoption of the Illustrations Regulation. Although numerous shortcomings are identified above, many of those existed before the regulation was adopted. There are still opportunities for improvement, particularly in enforcing the regulation, but I would definitely characterize the Illustrations Regulation as more of a success than a failure. □

I strongly believe that the insurance industry is in a better place today than it would have been without the adoption of the Illustrations Regulation.

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