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THE FEDERAL TRADE COMMISSION (FTC) REPORT

Moderator: BARTLEY L. MUNSON.
Panelists: JOHN P. MEYERHOLZ, WILLIAM A. WHITE*

1. What is it?
2. What is good about it?
3. What is bad about it?
4. What has been its effect on sales? What will be its effect?
5. What has been the industry response?
6. What will be the eventual impact on legislation or regulation?

MR. BARTLEY L. MUNSON: The Federal Trade Commission (FTC) report is quite imposing. It consists of 185 pages of text and 240 pages of appendices, containing 70 tables, many pages of formulas and 458 footnotes. It is the result of 30 months of research. Many statistics are produced and the derivation of most of them is quite completely documented in the appendices.

One looks for and generally finds a reasonable number of appropriate references to the actuarial profession. Many references are made to the 1974 report of the Society of Actuaries Committee on Cost Comparison Methods. This is not surprising since the Society report was prominently placed in the December, 1976 FTC press release which announced this investigation.

Utterances of many individual actuaries, at hearings or as recorded in the profession's written records, are sprinkled throughout. Nowhere is the profession specifically maligned or criticized. The report formally acknowledges the "shared knowledge" and "feelings" of actuaries and several other groups. It also recognizes the current activity of the profession in the matter of dividend philosophies and practices.

MR. JOHN P. MEYERHOLZ: The Federal Trade Commission staff report is deceptive in a number of respects. It gives the appearance of being well-organized and logical through extensive use of headings and outline techniques, yet much of it defies a clear and concise overview of its content. Nevertheless, I will answer the question of "what is it" by briefly describing the four major parts of the report.

Part I of the report describes the industry, differentiates between term and cash value insurance, and establishes the premise that the life insurance industry is one of the country's major savings institutions. The industry is described as being big. The industry's $98 billion income in 1977 equaled the amount the Federal Government spent for national defense that year. While term insurance is defined, it is clear that the focus of the authors is on the whole life policy. The whole life policy is described as a combination of an increasing savings element and a decreasing amount of pure life

*Mr. Meyerholz, not a member of the Society, is an Associate General Counsel of the American Council of Life Insurance.

insurance protection. The conclusion of the first part of the report is that the industry is a major savings institution because a major portion of the premium goes into the savings element. Finally, as a major savings institution, the industry pays a rate of return of only 1.3 percent on that savings.

Part II lists four consumer problems which the report indicates result from the lack of adequate and meaningful information. First, the rate of return consumers receive on the savings element is low. The report is particularly critical of older policies, especially nonparticipating policies. Secondly, consumers lose money because of early lapse. Thirdly, the cost of similar policies varies widely. This is strong evidence of a lack of effective price competition. Fourthly, consumers receive a small amount of protection against premature death relative to the premiums paid for ordinary insurance.

Part III discusses the reasons for these problems. The single most important cause 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. The marketplace does not provide this information because of the complexity of life insurance and the confusing variety of products, both of which make cost comparison difficult. The report examines evidence that consumers are not well informed about insurance in general. This part concludes with an attack on the agency system, describing certain aspects of it as contributing to the consumer and competition problems discussed in the report.

Part IV presents the FTC staff recommendations. First, the average annual rate of return using the Linton Yield method should be disclosed for cash value insurance and annuity policies at the 5th, 10th, 20th and 30th years for the purpose of comparing dissimilar insurance policies. Secondly, the NAIC surrender cost index for the 20th policy year should be disclosed for the purpose of comparing similar insurance policies. The net payment index and equivalent level annual dividend as required by the NAIC regulation for the 10th and 20th policy years and the NAIC surrender cost index for the 10th policy year would not be required to be disclosed. Thirdly, a yardstick indicating low cost, average cost, or high cost is recommended in connection with disclosure of the 20th policy year surrender cost index. Fourthly, a two-part disclosure system is recommended. First, a standardized preliminary policy summary should be given to prospective purchasers prior to the time they are provided with an application for a policy. Second, a policy summary should be delivered with the policy. The standardized preliminary policy summary would contain cost indices and information on how it can be used. The policy summary would show policy values. Fifthly, a new buyer's guide is recommended which changes the NAIC guide, purportedly to assist consumers in making the term/whole life decision. Sixthly, the coverage of the NAIC regulation would be expanded to include group life and group annuity products where the insured bears the cost. Lastly, insurers would be required to maintain copies of the preliminary policy summary and policy summary for each policy they issue.

MR. WILLIAM A. WHITE: The Federal Trade Commission has accomplished more than just coming up with a giant report in the last thirty months. The FTC report is like a tip of an iceberg. The Wisconsin disclosure regulation was greatly influenced by the FTC report. The Moss subcommittee report of January, 1979 was done hand in glove with the Federal Trade people. Most recently, we have President Carter's letter to the governors urging that they adopt the FTC report.

The most convenient phrase in defending the FTC report is that "I disagree with what you say, but I will defend your right to say it". On balance, it is a good report that will have beneficial effects for regulation and for the purchase and sale of life insurance.

I have known the principal drafters of the report and most of their consultants for more than two years and, without exception, respect and admire them. The major authors of the report are named Fix and Lynch--names that seem to have been conjured up by Charles Dickens in a moment of ironic inspiration. Dave Fix is a lawyer, with an undergraduate degree from Stanford and a law degree from Harvard. He left private practice in his home state of Idaho to join the FTC's Bureau of Consumer Protection in the mid-1970s. Mike Lynch is a New Yorker who received his Bachelor's degree from Columbia College and a PhD in Economics from the University of Chicago. After teaching at Indiana and the Wharton School, Mike moved to the White House staff and then to the FTC's Bureau of Economics in 1972. Both Dave and Mike have brought high degrees of professionalism to their assignment and a real concern for seeking out the opinions of all parties involved with disclosure. The FTC's consultants--Moorhead and Hunt from the actuarial profession; Belth, Scheel, Jacoby and Formisano from the academic ranks--are all recognized authorities in their fields. It may be easy to criticize the conclusions of the report, but I feel that any criticism of the abilities or diligence of its authors and contributors is totally unjustified.

It is fashionable to attack the motives of the FTC staff, rather than their specific recommendations. These attacks suggest a hidden agenda and a not-so-secret plot to supplant state regulation with yet another Federal bureaucracy. In my opinion, the motivations of the FTC staff were, simply and sincerely, to encourage a more effective life insurance disclosure mechanism within the existing regulatory framework. The FTC staff went out of its way--to the extent of attending an NAIC zone meeting in Juneau, Alaska in the winter of 1978--in order to communicate with the states and to solicit their input.

The most valid contribution of the FTC report is the questions it raises. Many of the problems defined by the FTC report are legitimate and are not effectively addressed by the present NAIC model regulation. The NAIC regulation fails to require that disclosure material be provided before the prospect is psychologically committed to the life insurance policy he has purchased. The indices required by the NAIC regulation are unnecessarily numerous, confusing, and generally beyond the ability of the buyers to interpret them. Methods are absent by which the consumer might make cost comparisons of alternatives when the policies under consideration are not similar. The NAIC appears unwilling to come to grips through disclosure with the problem of the industry's poor early persistency on permanent policies. The NAIC regulation fails to impair the marketing success of policies which are not competitively priced. When the NAIC regulation was first created, it was designed to be an honor system enforced by the companies. Companies are not doing as much as they might in terms of providing information.

Publicity concerning the alleged defects of the NAIC model regulation may well be the most significant good to come from the FTC report. Ironically, many of the problems listed were identified in the original task force report to the NAIC in December, 1975 as matters in need of further study. The current model was intended to be the first step in the evolution of a disclosure system. Progress has been slow since the model was adopted in

May, 1976. Developments are now likely to occur more rapidly. The FTC report is unquestionably responsible for much of the attention being paid to life insurance disclosure at all levels within the NAIC.

MR. MEYERHOLZ: The American people have every reason to expect that any report prepared by the Federal Trade Commission would be the product of open-minded research and that its presentation would be fair. The record demonstrates, however, that this expectation was not met in the instance of the FTC report on life insurance cost disclosure--neither in regard to its development, nor its release.

On December 15, 1976, the FTC announced a staff investigation to determine whether adequate cost information was being provided to prospective life insurance purchasers. It was apparent at the outset that the FTC staff had determined otherwise. It was also apparent that the staff was determined to disparage cash value policies by artificially splitting them into savings and protection elements and applying a rate of return to the savings element. The announcement of this investigation surprisingly occurred just shortly after the NAIC had completed its own investigation encompassing over four years of effort, and culminating with the adoption of a model regulation to be enacted by the states.

In spite of the apparent repudiation of the NAIC effort and the evidence of prejudice for the rate-of-return method, the industry offered its assistance to the FTC. There were lengthy discussions with the FTC staff in an attempt to inject objectivity into what we believed to be a close-minded atmosphere. We urged that the industry be given an opportunity to present its case to the Commission before the report was released. Members of the NAIC similarly met with the FTC. Despite these efforts, the report was released without ever making it available to state regulators or the industry for comment, and without much appearance that the staff had done anything other than to justify conclusions reached at the outset of its investigation.

During this period of time, the FTC commissioned two research projects--one with Professor Jacoby of Purdue University, and another with Professor Formisano of the University of Wisconsin. The results of this research were admittedly not conclusive, as witnessed by the fact that both the FTC and the industry used the research to support their respective conclusions. It is clear that the FTC staff was not satisfied that the results of its own research supported its conclusions, since the Jacoby research was mentioned only in a footnote to the report and briefly summarized in an appendix.

During the course of the investigation, there was considerable evidence that the FTC staff had concluded that there was a need for Federal regulation of the insurance industry and cost disclosure was a vehicle toward that end. As early as 1977, it became apparent that the FTC intended to promulgate a Trade Regulation Rule on cost disclosure. In 1978, the FTC budget request revealed that at least one, and perhaps two, Trade Regulation Rules on cost disclosure would be proposed during the year. However, the budget was approved only after Congress received assurances from the Chairman of the FTC that the FTC would not propose Trade Regulation Rules, but rather would seek to encourage meaningful regulation in this area at the state level.

Most disturbing to those hard at work seeking the adoption of the NAIC model regulation was the constant interference by the FTC staff in this effort. Prior to 1978, the FTC staff was working hard to defeat the NAIC model at the state level. In 1978, the Senate and House directed the FTC not to attempt to impede or thwart the adoption by the states of the NAIC model. Despite this admonition, FTC staff members continued to visit state insurance departments urging modification of the 1976 model.

It came as no surprise that the report on life insurance cost disclosure released on July 10, 1979 by the FTC staff was critical of the industry and was disparaging of the NAIC model. What did come as a surprise was that the FTC report had very little new information or suggestions. The report contained many of the same ideas that had previously been considered by experienced state regulators and were either adopted or rejected by them.

Equally surprising was the manner in which the report was released. No one was provided with advance copies of the report. The surprise attack was not to be expected from a Government agency. As Senator Cannon, Chairman of the Senate Committee on Commerce, Science and Transportation which received the report, remarked: "Most disturbing to me is the way in which the FTC attempted to sell its report to the press without first giving the industry the opportunity to review and comment on the report." As the President of the American Council of Life Insurance later wrote: "The publicity tactics surrounding the report of the Federal Trade Commission, issued earlier this summer on the life insurance business, represent an inexcusable and apparently deliberate attempt to destroy public confidence in the life insurance business, and to create headlines through accusations which are so misleading they can only be called deceptive."

In short, the American people had a right to expect more of an agency created to protect them, and the life insurance industry deserved better than the shabby treatment afforded it by the FTC.

MR. WHITE: Surprisingly, the FTC failed to identify the audience to whom the NAIC model regulation was addressed. The NAIC consciously targeted the young, relatively uneducated family head who is about to make his first purchase of life insurance; and who is almost completely uninformed about the nature of life insurance. This audience was viewed as the top priority among the many audiences--of varying degrees of education, sophistication, and life insurance needs--to whom disclosure efforts might eventually be addressed. The FTC, on the other hand, seems to have selected an audience of which the report's authors are representative--well-educated professional people for whom life insurance is potentially part of a total financial planning program that includes extensive savings and investments. This is an important market for life insurance, and this audience can almost certainly benefit from more effective disclosure; but it was the NAIC's feeling that this was not the portion of the total life insurance-buying public most in need of regulatory protection.

The FTC appears to have an unproven and unwarranted faith in what disclosure can accomplish. The report attempts to resolve major industry problems--the term versus permanent controversy, the par versus nonpar conflict, and lapsation--by relying on the public's ability to obtain, understand, and decide intelligently on the basis of some very elaborate disclosure materials. It is understandable that the FTC tried to remedy what it perceives as industry abuses via disclosure, since disclosure was the only tool available to the FTC. The NAIC, on the other hand, has available a whole gamut of potential model regulations and statutes by which to control the industry. The NAIC's objectives of disclosure, for that reason, have been directed more toward educating the consumer than to reforming the industry. One of the most telling statements about the ineffectiveness of disclosure as a regulatory tool can be attributed to Herbert Deneneberg. In the text, RISK AND INSURANCE, he states that effective regulation by means of disclosure may be defective because of "...two false and fatal assumptions--that the unscrupulous would truthfully disclose their own dishonesty and, that given the facts, the insured could properly evaluate them." The quote is somewhat out of context as it describes regulatory efforts of the 19th century, but the principal still holds true today.

A disturbing tendency of the FTC report is to oversimplify. "Savings" and "investments" are used interchangeably, with no apparent attempt to distinguish between the two in terms of liquidity or freedom from risk as to principal or interest. Participating and nonparticipating insurance are treated as equivalent, with no recognition of differences between nonpar guarantees and participating illustrations. Most alarming is the idea that "cost" is the most significant factor in determining the suitability of a plan of insurance for a prospect's needs. The NAIC feels it is appropriate to give equal importance to both the relative cost and how it meets the insured's needs.

It is interesting that the small amount of industry support the FTC report has received comes from companies and agents that specialize in replacing other companies' policies. This, in part, results from a misconception on the part of the FTC staff as to the Linton Yield. It is assumed that the yield calculated as of the issue date of a policy applies uniformly at all durations and would be an appropriate measure of future yields on any policy already in effect. Thus, in the FTC's view it would be entirely appropriate to replace in 1980 a whole life policy issued in 1975 whose 20-year Linton Yield at issue was 4%, with a new whole life policy whose yield is projected to be 5%. Totally lacking is an understanding of the impact on yields of acquisition expenses and the fact that prospective yields improve dramatically after the initial expenses have been incurred.

One major difference in philosophy between the NAIC and the FTC is that the NAIC disclosure material strives to be objective, impartial and informative; while the FTC material is more subjective, controversial and advisory. In simpler terms--the NAIC educates, whereas the FTC instructs. Instruction is not a proper role for government-mandated disclosure.

MR. JAMES H. HUNT: The NAIC disclosure system rests on the following basic premise. One should make a choice as to the type of plan one wants on a nonfinancial basis. Having made that choice, one then should compare prices. For example, one should decide between term and whole life on a nonfinancial basis and, having made that choice, should then compare prices. That basic premise is behind most of the criticism by the FTC report.

MR. MEYERHOLZ: I do not know what effect the FTC report has had, or will have, on sales. I do know that the report has had a significant impact upon agents. They needed to be reassured that the product they were selling could be defended against the attacks made by the FTC. This need, and the need to respond to Congress and state regulators, generated considerable response from both industry trade groups and the companies. My strong suspicion, however, is that the report itself has had very little impact on the sale of life insurance.

The American Council of Life Insurance conducted an interesting survey on the impact of the FTC report on consumers. Five hundred people were contacted approximately ten days after the report appeared. Only about fifteen percent recalled having "heard or read or seen any news stories or editorials" about whole life insurance or about an FTC report on life insurance. The public still believed life insurance gave good value for the money. Any article that appeared had little negative impact on those who read it. While the report may not have had an immediate impact on consumers, it has had an impact upon writers who seek to influence consumers. The report did give apparent Government sanction to the rate-of-return method. A notable example is the two-part special report published this spring on life insurance in Consumer Reports. Activity such as this, which is in part an outgrowth of the FTC report, seems likely to have some continuing effect on consumers.

MR. WHITE: The FTC report did not have the impact on the public that it had on the industry. It went generally unnoticed by most potential life insurance purchasers. To the extent that it has had an impact, it has been used by twisters. The FTC statement that older policies are being mistreated is based on the assumption that the rate of return of 1.3 percent is applied uniformly to the savings elements of all existing policies. Any twister who can pick up information like this and misinterpret it or quote it, is going to do that to his advantage. A measure of improper replacements of life insurance would indicate an increase in twisting since the FTC report.

MR. MEYERHOLZ: The FTC report was released on July 10, 1979 at a hearing before the Senate Committee on Commerce, Science and Transportation chaired by Senator Howard Cannon, at which there was considerable press representation. Only FTC Chairman Michael Pertschuk testified at that hearing. It was clear that the allegations and misrepresentations surrounding the FTC report could not go unchallenged. The National Association of Life Underwriters and the American Council of Life Insurance issued strongly-worded rebuttals to the report, as did many of the companies. They attacked not only the substance of the report, but the manner with which it was released. The President of the ACLI wrote an article for publication in the October, 1979 CLU Journal responding in detail to the report. Subsequently, the life insurance industry asked for and received a hearing before Senator Cannon's Committee on October 17, 1979. Four ACLI and two NALU witnesses testified for the purpose of responding publicly to Congress, to the state regulators, and to the public. ACLI Chairman John Filer said that the industry wanted to set the record straight because of its concern "for our many millions of policyholders" who may have been mislead by the FTC report. He said that the FTC staff "began its investigations with fixed opinions about the nature and value of whole life insurance..." and that the FTC report was a "reckless misrepresentation of our business", in which the FTC staff had "rejected facts and pursued its foregone conclusion". The rate-of-return method was described by industry witnesses as inappropriate and misleading for a comparison of life insurance costs. Moreover, it was pointed out that there is no reason to attempt to develop a rate of return for the industry from composite financial statements as that rate has nothing to do with disclosure of the price of life insurance policies to individual buyers. Nevertheless, using reasonable assumptions the number the industry calculated was 5.9 percent rather than the 1.3 percent used by the FTC staff. Obviously concerned at the end of the hearing, Chairman Cannon remarked: "I think the FTC report was wrong in stressing the comparison of life insurance with a savings account. The consumer's goal in buying life insurance is not just the maximum rate of return, but the protection provided by an insurance policy."

MR. WHITE: It seems clear that the NAIC and the states will react--and react positively--to the criticisms of the FTC report. Activity is occurring presently at two levels: first, with the NAIC Cost Disclosure Task Force--a continuation of the task force responsible for the original model disclosure regulation; and second, with a new task force to evaluate the NAIC model.

The first group is proceeding with the routine follow-up projects that were defined when the model was first presented to the NAIC. The second task force, chaired by Indiana Commissioner H. P. Hudson, has conducted hearings on the FTC report and may be expected to prepare recommendations to the NAIC before year-end.

The NAIC has an obligation to make cost indices that will facilitate their interpretation. A series of shopper's guides, such as New York's, showing comparative indices might be one answer. This development may imply a reduction in the number of indices that would be required and will likely entail development of a "data bank". Elaborations of the disclosure system may result in more information being available on request to those individuals who want to receive it without providing more information to all buyers. An intended effect of these elaborations will be to heighten competition by making generally available data which is indicative of individual companies' (and their products') competitive strengths and weaknesses. Enforcement steps will include development of uniform guidelines to assist companies in their interpretation of the disclosure regulations, together with ascertaining whether agents are complying with the regulations.

These developments represent a "quickening of the pace" rather than a "change of direction". The FTC report has been responsible for "lighting a fire" under the NAIC. For this, many people in regulation and the consumerism movement can be grateful.

MR. MEYERHOLZ: The issue of cost disclosure at the Federal level is not new. Senator Hart was involved in it, Senator Stone was involved in it, Congressman Moss was involved in it, and Senator Metzenbaum was involved in it.

There may continue to be attempts to regulate life insurance cost disclosure at the Federal level, but these attempts will not be translated into regulation of this area by the Federal Government. The activity at the Federal level has been largely an outgrowth of the interest in cost disclosure by just a few members of Congress and the FTC staff during the 1970s. These individuals have not been successful in obtaining broad-based support at the Federal level. The FTC will not devote much more attention to cost disclosure. The FTC has not been successful in moving the regulation of this area to the Federal arena, and the states are continuing to regulate it. In fact, the FTC may effectively be prohibited from interfering with the regulation of insurance by the states because of recent actions by Congress.

It is important that we all avoid complacency. The cost of our products and the proper disclosure of such cost are primary roles in our industry for actuaries. Actuaries should carefully examine not only the criticisms in this area, whether from the FTC or others, but give serious consideration to further perfecting the existing system of cost disclosure. In particular, careful attention should be given to the work of the NAIC task force reviewing the model disclosure system, with a view toward recommending improvements in that system. To minimize criticism from the Federal Government, the effectiveness of state regulation must be maximized.

A more progressive stance in the marketing of insurance would lessen the need for regulation at any level. The industry should act rather than react. There should have been no need for regulating the readability of our contracts and for cost disclosure regulations. These should have been done to make the products more attractive to the consumer rather than simply to comply with the law. A more perfect environment for the industry is one with considerably less regulation. Actuaries can have an impact upon that.