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Comments for the Center for Economic Justice

To the NAIC Annuity Disclosure Working Group

Proposed Revisions Annuity Disclosure Model Regulation Regarding Illustration of Products Tied to Indexes in Existence for Less Than Ten Years

July 26, 2019

The Center for Economic Justice emphatically opposes the most recent proposed revisions to the NAIC Annuity Disclosure Model Regulation. These revisions not only fail to address the current problem of unrealistic, misleading and deceptive annuity illustrations, but codify the very practices that result in the problematic illustrations.

Adoption of a NAIC Model by the states is not the goal – it is the means to the end of consumer protection.

We understand that that some regulators are concerned about complex, indexed annuities being approved by the Interstate Insurance Product Regulation Commission, which products are then available for use in 46 jurisdictions, most of which have not adopted the Annuity Disclosure model or related consumer protection. We also understand that the NAIC surveyed its members and learned that a reason stated for the failure to adopt the Annuity Disclosure model was the prohibition against illustrations for indexes not in existence for ten years. Consequently, one of the charges to the Annuity Disclosure working group is to look at this specific issue in the model.

We cannot disagree more strongly with the NAIC's response to the survey results, which – as reflected in the latest draft revisions – is to further weaken the already weak consumer protections in the Annuity Disclosure model presumably to eliminate industry objections to the model's adoption in the states.

The appropriate response to the survey results should be for the NAIC leadership to publicly declare the importance of a strengthened model as part of the NAIC's retirement security initiative. The NAIC leadership should be educating NAIC members about the potentially-devastating problems caused by misleading and deceptive illustrations and the recent development of products designed, not to meet consumer needs, but to use illustrations to depict annuities as risk-free investments with fabulous returns that defy the gravity of risk-return tradeoffs.

The NAIC leadership should be doubling down on stopping the use of deceptive and misleading sales by explaining the critical importance of the consumer protection efforts to NAIC members, by upgrading the consumer protections in the Annuity Disclosure (and other life insurance and annuity disclosure models) and by exhorting NAIC members to adopt the upgraded models.

The proposed revisions to the NAIC Annuity Disclosure model represent an abdication of your consumer protection mandate. We know you can do better.

While we appreciate the difficulty in adopting consumer protections over industry objections and also appreciate the efforts of the lead states working on the proposed changes, the proposal is astonishingly anti-consumer and must be rejected. Although the current provisions in the model for illustrations are not consumer friendly, the proposed changes will be far worse for consumers than the current provisions or no model at all.

Section 1 of the Annuity Disclosure Model Regulation states that the purpose of the regulation is to "protect consumers and foster consumer education" and that the goal is to "ensure that purchasers of annuity contracts understand certain basic features of annuity contracts."

Instead of protecting consumers, fostering consumer education and ensuring that purchasers of annuity contracts understand the contracts, the proposed changes accomplish just the opposite. Instead of action to stop the role of misleading illustrations in product development and sales, the proposal endorses and will accelerate the use of those profoundly anti-consumer practices

Calling the latest proposal a "compromise" is an insult to consumers. The proposal accedes to everything demanded by industry without any required change in industry practices. The proposal even removes consumer protections originally proposed by industry! By eliminating the time-in-existence requirement for an index to be illustrated (by creating "standards" for illustrating an index that has not been in existence for the required time frame), the proposal endorse the practice of insurers using all manner of pseudo indexes created out of thin air to illustrate fabulous and unrealistic returns. The proposal

- fails completely to protect consumers from misleading illustrations;
- encourages the development of complex products based on data mining of recent performance;
- fails to include any limitation on the financial arrangements between providers of the index and the insurer
- fails to provide any standards for the provider of an index; and
- incorporates pseudo consumer protections, including untested disclosures that create regulatory protection for anti-consumer practices.

The original industry proposal had more consumer protection (though still inadequate) than the current proposal.

In the original proposal by the American Academy of Actuaries (AAA), the AAA touched on the problem of insurers using indexes created by vendors (e.g., investment banks) with whom the insurer had a financial relationship beyond simply purchasing a license to use an index. The current proposal does nothing about such problematic relationships.

The explosion of new exotic indexes used by insurers for indexed annuities (and life insurance) includes a number of investment banks – BlackRock, Barclays, Morgan Stanley, JP Morgan, and Merrill Lynch. We have concern that these banks – with data and skills to data mine recent history to produce an index showing better-than-market results for the recent past – are pitching not only the indexes to insurers but also the hedging program to support the "products." Such arrangements create massive conflicts of interest and incentives for sales – in precisely the same manner that investment banks encouraged mortgage brokers to sell mortgages to support a flow of (defective) mortgage-backed securities underwritten by the investment bank.

If the insurer has a financial interest in the vendor providing the index or if the vendor providing the index has a financial interest in the products tied to the index (through, say, a hedging program for the insurer), there is now incentive to adjust or modify the index or the product (e.g. changing caps) for the vendor (or the insurer if it has a financial interest in the index vendor) for improper reasons, among other potential problems.

Regardless of the time-in-existence limitation (discussed below), the Annuity Disclosure model should be revised to include the following, applicable to all indexes:

The insurer shall have direct or indirect financial interest in the vendor providing the index.

The vendor providing the index shall have no direct or indirect financial interest in the insurer offering the annuity or the financial performance of the products referencing the vendor's indexes, including but not limited to, sale of derivatives or financial instruments to the insurer for an index provided by the vendor.

The best and worst ten-year performance results are the critical disclosure to the consumer regarding volatility and sequencing risk of the indexed annuity. For such ten-year performance metrics to be meaningful, the minimum time frame for evaluation should be 20 years. CEJ has demonstrated that a 15 year-time-in-existence is inadequate to achieve the purposes of the ten-year performance metrics. The ten-year performance metrics should be based on the entire time-in-existence of the index and not the most recent 20-year (let alone 15-year) time frame. Again, CEJ has demonstrated a rolling time-in-existence time frame defeats the purpose of disclosing volatility of the product to the consumer.

Regarding Section 6(F)(9)**, u**tilizing the most recent 20 years instead of the entire history of the index better reflects the purpose of the time in existence limitation – to ensure meaningful results for best and worst product results over a ten-year period. The goal should be to expand the time frame for the calculation of best and worst ten year periods going forward. Utilizing the entire history of the index prevents misleading information. For example, if the worst ten year period is 1999 to 2008, why would we want to eliminate that data point for consumers as we move into 2019 and beyond? Under the current proposal, that 1999 to 2008 ten year performance is lost on and after 2019.

In addition, the proposed 15 year in existence provisions undercut even the rolling 20 year history.

There is a contradiction between Sections 6(F)(9) and 9(F)(9)b.

Section 9 refers to best, worst and most recent 10 of most recent 20 years. Section 9b refers to indexes in existence for 15 years or less. Consequently, Section 9b would not apply to indexes in existence for 16 to 20 years, because there would be insufficient history to comply with Section 9.

In order to address this contradiction, new Section 9(d) is created which changes the best and worst ten of the last 20 to the best and worst ten of the last 15. The goal of demonstrating volatility of returns is eviscerated by allowing best and worst ten of only the last 15.

While a time-in-existence of only 15 years is bad enough for an actual index, it is virtually meaningless for “composite indexes.” Requiring that the components of the index be in existence for only 15 years encourages the development of data mined composite indexes.

The reference to other financial instrument is egregiously open-ended and profoundly anti-consumer.

The term "financial instruments" is not defined in the model. According to Investopedia,

- A financial instrument is a real or virtual document representing a legal agreement involving any kind of monetary value.
- Financial instruments may be divided into two types: cash instruments and derivative instruments.
- Financial instruments may also be divided according to an asset class, which depends on whether they are debt-based or equity-based.
- Foreign exchange instruments comprise a third, unique type of financial instrument.

In other words, anything goes. Insurance producers will be selling products based on indexes of financial instruments the producer does not understand and is not qualified to sell. I can't sell you this financial instrument, but I can sell you an annuity tied to this financial instrument. In what parallel universe is that an actual consumer protection?

Another problem with using only the most recent 20 or 15 years for purposes of the best and worst ten instead of the entire history of the index is that the investment bank or insurer can design an index based on the most favorable starting point. Continuing our example with 99.9% S&P index, by starting in 2004, the historical returns start from a low point instead of a representative period of time.

The proposed 15-year time-in-existence in section 5(F)(9)(b)(i) –fails to materially improve on the current, illogical 10 years in existence provision.

The minimal consumer protection improvement of going from 10 to 15 years is dwarfed by the consumer harm of permitting indexes that have not been in existence for 15 years to be used. Instead of discouraging the data mining of "financial instruments" recent performance to juice an illustration, the proposal endorses that anti-consumer practice.

Instead of limiting insurers' practices for consumer protection, this provision utilizes a time frame so short that the purpose of fostering consumer understanding of risk and volatility is defeated by insurers' data mining of recent performance of "financial instruments."

There is nothing here that would prevent the creation of an index of, for example, the 25 best performing companies or financial instruments over the past 15 years. Yet, how does an illustration of such an index protect consumers or foster understanding of the product?

The time in existence requirement for indexes is fatally compromised because it is based on the index component with the shortest time in existence.

Another problem with the 15 years in existence for composite indexes is that the time in existence is based on the component with the shortest time in existence. For example, the composite index might be comprised of say five financial instruments, four of which have been in existence for 30 years or more, but one instrument has been in existence for 15 years. The proposal permits the insurer to utilize only the most recent 15 years of experience of the four financial instruments that have been in existence for a longer period of time – even if that longer experience period would better demonstrate frequency and size of volatility of returns.

The proposal permits easy circumvention of the 15 year in existence requirement. The investment bank or insurer can design an index that includes only an iota of a financial instrument in existence for 15 years, but which now, as part of a composite index, triggers the less-than-15 years in existence provisions.

We can imagine insurers utilizing such an approach to utilize a 15 year look back instead of a 20 year look back when adding years 16 to 20 of the lookback harms the illustration. For example, the year is 2019 and the index is 99.9% based on the S&P 500. The S&P returns for 2000, 2001 and 2002 were -10%, -13% and -23%, respectively. But if 0.1% of the index is based on a financial instrument in existence since 2005, then the best and worst ten-year metrics are now based on only a 15-year look back – the best and worst ten years only go from 2005 to 2019 instead of 2000 to 2019.

To address this problem, CEJ suggests the following provision:

For a composite index, the time in existence will be based on the component with shortest time in existence that accounts for at least 10% of the index outcome.

In summary, the new time-in-existence provisions encourage instead of discouraging this type of data mining activity to produce indexes.

It is unclear what the modifier "unique" in Section 9b(ii) adds to the requirement of creating a 15 year history of the index that has not been in existence for 15 years.

What is a unique history as opposed to a history? If there is a specific meaning attached to "unique," it should be defined.

As with other industry objections, the proposed Section 9(b)(iii) capitulates to industry demands. Instead of requiring that the method of calculating the index be established and held constant, this provision permits any change to the method of determining the value of the index – without consumer disclosure – by allowing changes "pursuant to the index provider's established governance rules and procedures.

There is nothing to prevent an index vendor from creating governance rules and procedures that consist of nothing more than "we can change the method of calculating the index whenever we think it is necessary."

In Section 9(b)(iv), the industry demand to remove disclosure of the algorithm to the consumer is granted.

In addition to data mining the recent performance of any financial instrument, the industry now gets to create indexes based on algorithms not disclosed to the consumer, with no accountability to the consumer for accuracy and which the index provider can change any time it wants.

Section 9(b)(v), referring to products based on indexes in existence for less than 15 years, calls for "visual differentiation" of indexed returns prior to existence of the index from indexed returns based on performance for performance after the index. It is unclear what this means or why another table or disclosure in an illustration that is already lengthy and complex will foster consumer understanding.

Let us consider an index that is created in combination with the introduction of the product in 2019. We have the 15 year hypothetical history (which we know will be the result of data mining). There is no history subsequent to the creation of the index. What would be visually differentiated?

How about an index created five years ago? Would this provision require the 15 hypothetical index return, a ten year hypothetical index starting 15 years ago through six years ago and a third indexed return of the actual recent five-year's experience? What is the purpose of the purpose of this provision other than inundating consumers with more tables? How does this proposed provision interact with the requirement for the best and worst ten year periods?

What additional information do the drafters believe this visual differentiation will provide?

Further, what do the drafters expect insurers will do if the recent performance is poor of an index in existence for less than 15 years? The insurer will stop offering the product and replace it with a new product based on a new index showing stellar performance over the now more recent 15 year period. In fact that is already happening:

There are indices not performing the way the insurance companies wants (or as illustrated to consumers), so insurers are replacing the "non-performing" indexes with new indices by making modifications to the indices. For example, Allianz replaced the Barclays U.S. Dynamic Balance Index with the Barclays U.S. Dynamic Balance Index II by merely increasing the amount of the bond component in the index. Many others have done the same, including Nationwide with their JP Morgan Mozaic and JP Morgan Mozaic II, as well as Athene with their Shiller Index.

The proposed disclosures are wholly inadequate for consumer comprehension.

As industry has admitted, it is the illustration of the crediting amount that drives consumers' purchases, not related disclosures. In addition, it is completely unlikely that a consumer will be able to process and comprehend the proposed specific disclosure within the context of many other disclosures with a very complex product.

Generally, CEJ does not believe the proposed additional disclosures will be meaningful or useful to consumers. For example, what is the expectation for how a consumer will use these disclosures?

> Indexed returns that are based on historical performance prior to the existence of the index are visually differentiated from indexed returns that are based on historical performance thereafter
>
> or
>
> Because the index has not been in existence the entire time period used in the illustration, some of the values of the index shown are a weighted average of indices or other financial instruments that were in existence for that time period;
>
> or
>
> Either the weights used in combining the indices or other financial instruments are constant over time, or the weights are based on an algorithm that is consistently applied over time but may produce different weights in different years.

While CEJ and other consumer advocates routinely call for consumer testing of disclosures to determine whether the disclosure will be effective, such testing is not needed to conclude that these disclosures will have no substantial impact to empower consumers.

In addition, the proposed disclosure, "the consumer may request further explanation of the algorithm used to determine the weights," is false and deceptive. The requirement in an earlier draft for the insurer to disclosure this information to the consumer has been deleted.

We suspect that consumers believe that if a producer or insurer provides the consumer with an illustration that such an illustration is permitted by regulators and that regulators will stop a producer or insurer from utilizing deceptive or misleading marketing materials, including a deceptive or misleading illustration that mispresents what the consumer should reasonably expect of product performance. We suggest fewer, simpler and more direct disclosures for the consumer. In place of Section 6.G (4)(b), CEJ suggests:

> *For fixed indexed annuities*
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> *The illustration is <u>not</u> a guaranty of future performance. The illustration is required to include the results for the worst ten year period since the index has been in existence as well as the best ten year performance and the most recent ten year performance. Use this information to understand how future results can vary from the recent past. Use this information to understand how various expense charges associated with your product can affect your account value beyond the impact of changes in the value of the index.*
>
> *You have the right to know how much you will pay for your annuity. An "element" is any factor that the insurer uses to determine the value of your annuity over time. Some elements are guaranteed, which means that the value used for that element cannot change over time. Most elements are non-guaranteed. Be sure to understand what elements are guaranteed and what elements are not guaranteed. Ask the agent, broker, adviser or insurer to provide a complete list of guaranteed and non-guaranteed elements. For the non-guaranteed elements, be sure to find out if there is a limit on how much the value of the element can change over time.*
>
> *Do not assume that the performance of the index is the same as what you would earn if you invested directly in the securities or other things comprising the index. For example, if you invested in an S&P 500 fund, you would receive dividends as well as any gains in the value of the fund. An illustration is not a comparison of what you would earn with an investment in the actual index security.*
>
> *If your annuity uses an index or indexes to determine account value, you have the right to know how long the index has been in existence. The longer an index has been in existence, the more history of the actual performance of the index is available for you to see.*
>
> *You have the right to know how the insurer uses the index to calculate changes in your account value. If the agent, broker, adviser or insurer tries to convince you that you don't need to know the details of how your product value changes, you should be skeptical and contact the department of insurance.*
>
> *Ask you agent, broker, adviser or insurer if they are <u>required</u> to work in your best interest. If they answer no or fail to answer your question, be sure to get a second opinion regarding the value and suitability of the indexed annuity for you. Be sure to ask the agent, broker or adviser about their compensation to see if the agent, broker or adviser compensation may be affecting the product recommendation.*

There are obvious consumer protection improvements needed for the model.

The practice of data mining recent historical performance of "financial instruments" to produce indexes that generate misleading illustrations must be discouraged by:

- Changing the time in existence requirement from 10 to 20 years for an index and from 10 to 30 years for the components of an index that has not been in existence for 20 years;
- Changing the look-back period for the best and worst ten-year performance metrics from the most recent 20 years to the entire time in existence for the index; and, by
- Requiring that the period for evaluating the best and worst ten performance metrics for composite index be limited to components contributing at least 10% to the outcome of the index.

The proposed new and untested disclosures should be discarded in favor of the simpler, more direct disclosures previously proposed by CEJ.

If cap rates are not guaranteed, then the use of the current / initial cap rate should be prohibited in the non-guaranteed illustration in favor of a lower cap reflecting the actual insurer history of changing cap rates across all indexed annuities.

Broader adoption and enforcement of the Advertisements of Life Insurance and Annuities Model Regulation. Section 4 of the Model states:

> (a) Advertisements shall be truthful and not misleading in fact or by implication. The form and content of an advertisement of a policy shall be sufficiently complete and clear so as to avoid deception. It shall not have the capacity or tendency to mislead or deceive. Whether an advertisement has the capacity or tendency to mislead or deceive shall be determined by the Commissioner of Insurance from the overall impression that the advertisement may be reasonably expected to create upon a person of average education or intelligence within the segment of the public to which it is directed.

Misleading advertisements are rampant. For example, insurers advertise a comparison of the performance of their index (which is used solely for determining account value) with the performance of the S&P 500 showing only the value of the index and ignoring the dividends that have historically added about 2% to 3% to the gains from the index value.

We close by asking the working group to focus on the proper goal – consumer protection.