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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

May 31, 2019

The Center for Economic Justice writes to further comment on the proposed changes reflected in the March 7, 2019 exposure draft of the Annuity Disclosure Model Regulation and to respond to industry comments by the Academy, the Committee of Annuity Insurers ("CIA"), the Indexed Annity Leadership Council ("IALC") and the American Council of Life Insurers ("ACLI"). These comments incorporate, expand upon, revise and replace our May 10, 2019 comments..

Based on the comments of the industry commenters, it appears necessary to review the history of the proposed revisions to the model regulation and the problems surrounding illustrations of indexed annuities.

The working group was created to evaluate two industry-proposed revisions to the model regulation – both intended to increase the range of products eligible for illustration. During the discussion of the first proposal – allowing assumptions for improvements in performance for participating annuities – we learned that insurers will not offer annuities unless the product can be favorably illustrated. This was dramatic evidence that the ability to generate favorable illustrations is the foundation of product design and competition among insurers.

The second industry proposal was to revise the current prohibition for illustrating a product tied to an index that has been in existence for less than ten years to permit the illustration of such products. The review of the industry proposal, the provisions of the current model and the proliferation of new indexed annuity products tied to a variety of new and opaque indexes revealed serious problems with both the industry proposal and the current model. The industry proposals would allow further discretion to insurers with illustrations and further encourage data mining of recent historical experience of securities and/or anything with a price to generate an index with a favorable recent history to illustrate fabulous "returns" for the consumer.

The problem of product design driven by illustration potential is evidenced by the explosion in indices created for and used in indexed annuity products. In some cases, the indexes have been created specifically for, and only for, an indexed annuity product and introduced at the same time as introduction of the annuity product.

Attachment 1 is a list of 90 indexes used in indexed annuities as of March 2019 prepared by Wink. We know that the vast majority of these indices have been in existence for less than 20 years because industry has asserted that changing the model regulation illustration prohibition from 10 to 20 years would affect some 70% of indices used today.

This expanding list of indexes created for or used with indexed annuities evidences the concern raised by CEJ that insurers and their index partners are data mining recent historical performance to create indexes that have no actual historical experience and/or a very limited theoretical historical experience, but which illustrate fantastic "returns" for consumers.

In reviewing the industry comments, the inescapable conclusion is that these commenters wish to sell annuity products tied to:

- an index that can be created out of thin air by data mining recent experience and using anything with a published price,
- an index reflecting securities and financial instruments the producer is prohibited from selling and unqualified to explain,
- an index that includes proprietary and confidential methods of calculating changes in the index rendering the insurer and index provider unaccountable to consumers, and
- an index built around controlling risk despite the fact that the entire purpose of the annuity is to control risk – the equivalent of purchasing a tax-deferred investment for a tax-deferred retirement account.

We ask, what could possibly go wrong with such products sold by producers who can put their interest above the consumer in a market where competition drives insurers to create products designed to produce ever more extravagant and fantastic illustrations? The answer is a large number of consumers can and will see their scarce retirement assets stripped away by massive fees resulting in a massive redistribution of wealth from middle-income savers to wealthy investors and insurer executives.

The industry has created a false narrative, captured perfectly in the comments of the CIA, which calls for "proper balance" and warns against restrictions that would "deprive consumers of information necessary for retirement planning" It is clear, however, from the remainder of the CIA comments – all directed at limiting oversight or restrictions on indexed annuity illustrations – that "proper balance" has nothing to do with consumer protection and everything to do with no disruption to the current indexed annuity business model and sales practices.

We urge working group members to affirm that "proper balance" means significant consumer protection for products involving the transfer of retirement assets to an insurer in hopes of securing reliable future retirement income. If the product marketing promises turn out to be false 15 or 20 years in the future, consumers have no meaningful remedy at that future date. Further the information asymmetry between the insurer / producer and the consumer is massive to the advantage of the insurer. In addition, while industry will be able to adapt to almost any set of illustration guidelines that create a level competitive playing field; consumers have neither the time nor flexibility to recover from misleading sales and defective products. We suggest that regulators keep in mind the debacles of massive long term care insurance rate increases, vanishing premium life insurance and universal life insurance cost of insurance issues to understand that "proper balance" must mean to empower and protect consumers in a market that is susceptible to misleading sales practices because of competitive pressures for insurers and producers to utilize ever more extravagant claims for their products while minimizing the disclosure to consumers of costs and downside risk.

We take issue with CIA's assertion that industry's ability to illustrate products tied to indexes which are confidential and cannot be explained to or understood by consumers is providing consumer choice or responding to actual consumer demand. We would welcome any evidence CIA can provide that consumers are demanding indexed annuity products tied to, say, the Guggenheim RBP, CROCI Sectors III USD 5.5% VCI or BlackRock iBLD Claria® ER indexes. We would also welcome any evidence that consumers are clamoring for indexed annuities from producers who are prohibited from selling the underlying securities – if such securities even exist.

The contradictions and false statements within the industry arguments are surely apparent to regulators. We point out a few:

1. The purpose of time in existence requirement is not to capture an economic cycle or to permit the greatest number of indexes to be illustrated, ~~but,rather~~but, rather, to provide consumers with a simple demonstration of the volatility of the returns for the product and meaning of the risk versus return tradeoff. This purpose is defeated by the industry proposals.

2. CIA argues both that no time-in-existence requirement is needed because indexed annuities reduce risk and that volatility-controlled indexes (VCI) are needed to reduce risk within the insurance product.

3. Industry commenters, particularly the Indexed Annuity Leadership Council (IALC), conflate the role of the index in an indexed annuity with the risk management responsibilities of the insurer. The purpose of the indexed annuity, with caps and floors tied to the performance of index for changes to the consumer's annuity value, is to control volatility for the consumer. The index itself is not needed to do that for the consumer. In fact, the consumer benefits from a more volatile index because of the greater opportunity for higher upside returns. The fact that a product uses a particular index does not tie an insurer to that index for risk management. Stated differently, an indexed annuity doesn't have to use a VCI for the insurer to utilize VCI investments for risk management.

4. CIA argues that the products are transparent with robust disclosures even though the actual method of calculating changes in the index and related annuity accumulation values in some products is deemed a secret and not disclosed to the consumer.

We turn now to specific issues raised by the Academy and CIA

Business Cycle

Both the Academy and the CIA refer to the length of a business or economic cycle as a determinative basis for the length of the index existence requirement. This is a straw-man argument because the length of a business or economic cycle is not relevant for purposes of the disclosure model. The ACLI's only rationale is that the shorter time frame is "less likely to jeopardize illustration of existing fixed annuities." The status quo is not the objective here.

Key required information in the illustration is a demonstration of the worst ten-year period product results in the history of index. The purpose of the requirement is not to capture a business or economic cycle, as asserted by the Academy and the CIA, but to provide consumers with simple information about downside risk and associated product costs. It is a necessary counterpoint to the favorable scenarios highlighted by insurers and producers.

The current model renders this requirement meaningless by permitting products tied to indices in existence for just ten years to be illustrated – with the result that the all three required scales can produce essentially the same result and defeat the purpose of demonstrating variability in outcomes to consumers.

The proposal to change the minimum time in existence for an index from 10 to 20 years is already a compromise. Going back 20 years does not provide a lengthy time frame from which to select the best and worst ten year results. Nor does the requirement eliminate the problem of data mining recent historical returns to create a new index that will illustrate well, but has insufficient history to provide consumers with adequate information for an informed and empowered purchase decision.

The industry argument for a 15-year minimum is not based on any consumer protection logic, but is simply an effort to retain as many indices as possible. The Academy and CIA proposal for a 15-year prohibition time frame is based on the outcome for insurers – how many products will be affected – and ignores the consumer protection purpose of the requirement. Changing the prohibition time frame from 10 to 15 years does little to address the problem that the time frame is so short to preclude a meaningful worst case ten-year scenario. In fact, 20 years is too short to fulfil the purposes of model, but it represents a compromise.

The metric used by CIA and the Academy in opposition to a 20 year time frame prohibition is how many current indices will be affected. Industry employs the implicit assumption that all current products are good products and any elimination of current products is harmful to consumers. We strongly disagree with both the logic and implicit assumption of the industry argument. The consumer protection goal and the goal of insurers concerned with reputational risk should be to eliminate misleading illustrations based on products fabricated to produce such misleading illustrations. If the proposed changes to the model regulation eliminate the sale of such products because the use of a misleading illustration is no longer permitted, such a result benefits consumers. Such a result does not limit consumer choice any more for fixed indexed annuity products than certain requirements for producers – including criminal history checks and education requirements – limit consumer choice. Yes, imposing reasonable requirements on producers reduces the number of people eligible to sell insurance, but that is not a limit of consumer choice. And imposing restrictions on annuity illustrations to eliminate deceptive illustrations is not a limit on consumer choice.

The CIA assertion that the proposed 20 year existence creates "operational burdens" and "disruption to existing products" is without merit – CIA itself contradicts the assertions. CIA argues, without a scintilla of evidence, that the proposed 20 year existence would impose "operational burdens on the current illustration systems" and would cause "disruption to existing products." Taking the second point first, the purpose of the proposed changes to the model is to disrupt existing products. By eliminating products designed to produce misleading illustrations, the proposed changes promote both consumer protection and fair competition – competition based on product design and insurer service and stability as opposed to a race to the bottom to create ever more fabulous illustrations.

CIA undercuts and contradicts is assertions in opposition to the 20 year prohibition when it concludes that moving from a 10 year to a 15 year time in existence requirement "could be workable." According to CIA, somehow, annuity insurers can handle the "operational burdens" and "disruption" of moving to a 15 year time frame, but moving to 20 years would be insurmountable. Given the ability of insurers to routinely deploy new products and associated illustration systems, we find it implausible that the proposed changes will create significant "operational burdens" on the insurers. And we are certain that the cost of any such "operational burdens" pale in comparison to the consumer protection benefits of providing more reliable product information and eliminating products designed to produce misleading illustrations.

CEJ suggests that in Section 6(F)(9)(b)(i) and (ii), the minimum time in existence for <u>indexes that are comprised of other indices</u> be changed to 30 years. CEJ draws a significant <u>distinction between an index that has been in existence for 20 years and a composite index comprised of other indices</u>. For an index that has been in existence for 20 years, the opportunity for data mining favorable historical returns effectively does not exist because the index was created prior to current data mining practices. In contrast, with a composite index, there is the possibility of data mining over a recent 20-year time frame specific indices and weights to produce favorable illustrations. This difference is significant and logically leads to a <u>longer time in existence for indexes used in a composite index</u>.

CEJ suggests that the time in existence requirement in Section 6(F)(9)(b) be changed from "has not been in existence for at least twenty (20) calendar years" be changed to "has not been in existence for the lesser of 20 consecutive years or continuously since January 1, 2000." We suggest this change to better reflect 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. CEJ's proposal does this by starting at the draft's proposed 20 year time in existence limitation – which would be approximately in existence continuously since 2000 – and makes that the lesser of 20 years or since January 1, 2000. This has the effect of expanding the time frame for the best, worst and current 10-year performance periods for indexes in existence for the required time period.

In addition to the improved consumer protection of longer time frames to produce the critical best and worst ten year outcomes, the fixing of a starting date will create operational efficiencies for insurers. For example, if the worst ten year period is 2000 to 2009, why would we want to eliminate that data point for consumers as we move into 2020 and beyond? In addition, by setting a fixed starting date (instead of a rolling 20 year time frame) there should be fewer changes to best and worst ten year outcomes resulting in operational efficiencies for insurers and improved understanding by consumers.

Taken together, CEJ suggests the following for Section 6(F)(9), 6(F)(9)(a), 6(F)(9)(b) and 6(F)(9)(b)(i),(ii) and new (vi) to reflect our recommendations:

> (9) In determining the non-guaranteed illustrated values for a fixed indexed annuity, the index-based interest rate and account value shall be calculated for three different scenarios: one to reflect historical performance of the index for the most recent ten (10) calendar years; one to reflect the historical performance of the index for the continuous period of ten (10) calendar years from the beginning of the existence of the index through the most recent calendar year~~out of the last twenty (20) calendar years~~ that would result in the least index value growth (the "low scenario"); one to reflect the historical performance of the index for the continuous period of ten (10) calendar years from the beginning of the existence of the index through the most recent calendar year~~out of the last twenty (20) calendar years~~ that would result in the most index value growth (the "high scenario"). The following requirements apply:
>
> (a) The most recent ten (10) calendar years and the most recent ~~last twenty (20) calendar~~ year~~s~~ are defined to end on the prior December 31, except for illustrations prepared during the first three (3) months of the year, for which the end date of the calendar year period may be the December 31 prior to the last full calendar year;
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> (b) If any index utilized in determination of an account value has not been in existence continuously for at least the lesser of twenty (20) calendar years or since January 1, ~~,~~2000, indexed returns for that index shall not be illustrated unless all of all of the following criteria are met:
>
> (i) If ~~T~~the index is a combination of indices, each component index shall have ~~of which has~~ been in continuous existence for the lesser of ~~at least twenty~~thirty (~~2~~30) calendar years or since January 1, 1990;
>
> (ii) If the index is a combination of indices, t~~T~~he method of combination is such that a unique ~~twenty (20) calendar year~~ history of the index can be constructed;
>
> (iii) If the index is a combination of indices, any~~Any~~ algorithm or other method of combining the indices shall be fixed from the creation of the composite index;~~ and~~

(iv) Any algorithm or other method that is supporting ~~such~~ an index that is a combination of indexes and is utilized ~~included~~ in the illustration shall be made available for inspection at the request of the commissioner or the consumer.

(v) If the fixed indexed annuity provides an option to allocate account value to more than one indexed or fixed declared rate account, and one or more of those indexes has not been in existence for at least twenty (20) calendar years, the allocation to such indexed account(s) shall be ~~assumed to be~~ zero. If one or more of the indexes is a combination of indexes of which any component index has not been in existence for at least thirty (30) years, the allocation to such indexed account(s) shall be zero;

(vi) the scenarios shall include all expenses and charges that could reduce account value. For example, if there is a charge expressed as a percentage of an asset associated with a guaranty that the account value will not decline even if the associated index value declines and if that charge is assessed regardless of the performance of the index, the impact of the charge shall be included in the ten-year scenarios.

The effect of CEJ's proposed changes is to endorse the 20-year time-in-existence requirement (the lesser of 20 years or in existence since January 1, 2000) for an identifiable index with a longer time-in-existence requirement for the component indices (thirty which will increase over time to the lesser of 30 years or components in existence since January 1, 1990. The proposed changes to 6(F)(9) complement one another and provide a logical framework consistent with the purpose of the model regulation. The proposed additional requirement – to reflect expense charges in the ten-year scenarios –is critical for alerting consumers to the difference between performance of the index and performance of the annuity.

Proposed Consumer Disclosures in section 6.G.4.(b)

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 a disclosure that an index used in an illustration has not been in existence for 20 years? 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

The illustration is not 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 required 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.

Thank you for your consideration.