

Comments to NAIC Life Insurance and Annuities Illustration Working Group

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I submit the comments to supplement the comments submitted by NAIC consumer representatives and myself.

Urgent Need for Reform

Before I go into general concepts for reformed illustrations, I want to highlight the remarkable similarities between the current sales of indexed life insurance and annuities and the sales of defective mortgages that led the financial crisis in 2008.

Leading up to the 2008 financial crisis, mortgage lenders developed riskier and riskier mortgage products such as very short-term fixed rates followed by balloon payments based on faulty projections that home prices would always increase. The push to generate more and more mortgage loans was abetted by a variety of players from:

- mortgage originators offering mortgages to anyone who could fog a mirror;
- investment banks seeking to package the loans into mortgage-backed securities and then sell credit default swaps to;
- credit rating agencies whose pay to play business model generated inflated and unreliable ratings to
- bond and private mortgage insurers who abandoned risk management to secure business through greater and greater considerations to lenders (such as bogus captive reinsurance agreements).

The mortgage market crashed and threatened the financial system because the guarantors for these mortgage loans (and credit default swaps) failed – from mortgage and bond insurers to AIG to Fannie and Freddie leading to strain on non-mortgage financial markets.

All of this could have been prevented had the regulators of banks, credit unions and non-bank lenders stopped the sale of defective products that were producing a housing bubble or had state insurance regulators forced private mortgage and bond insurers to engage in sound risk evaluation and management, including, for example, stopping bogus captive reinsurance arrangements.

The similarities to the sale of indexed life insurance and annuity products in recent years and today are striking – except now we are talking about retirement savings in the trillions of dollars.

Life insurers have developed ever more complex products relying on derivatives to support the promises made, resulting in a concentration of market risk with the guarantors of these derivatives. Life insurance and annuities that promise exceptional market returns and protections are concentrating risk instead of the fundamental role of spreading risk.

The sale of these complex and destined-to-fail indexed products is facilitated by deceptive and misleading illustrations and the massive push by private equity to access peoples' retirement savings.

The illustrations are the facilitator of these risky products and market trends. The various revisions to AG-49 in response to insurers gaming each version to continue to generate massive future projected returns demonstrate conclusively that product design is driven by how to illustrate unrealistic returns and not by consumer demand. For example, why would a consumer be interested in a volatility-controlled index within their IUL, FIA or RILA when the product itself provides volatility protection? Given a product that caps losses and returns, a consumer would want the riskiest and most volatile assets because the losses are capped.

Industry (and some regulator) arguments that all these products are needed to secure retirement income for people is a red herring. The industry has simpler, relatively easy-to-understand and more reliable products for retirement income. Products that do not come close to meeting illustrated returns and end up stripping retiree assets rob people of their retirement security and foreclose safer, alternative investments.

Concepts

1. For consumer understanding, disclosure cannot overcome an overly complex product. The Dutch and Australian regulators' study demonstrate the limits of disclosure, consistent with information and research repeatedly provided by consumer representatives to the NAIC. The need to illustrate unreasonably high investment returns drives ever-increasing product complexity. Reforming illustrations will eliminate the drive for such product complexity.
2. Illustrations should show how the product operates. Thirty, forty or fifty-year projections of returns do not show how the product operates. Illustrations should show how the product operates by demonstrating what happens in a single given index return period with index outcomes below, in the middle and above the floor and cap. The demonstration of single-period operation should include all current and potential fees and expenses at both current and maximum levels.

3. Prohibit projections of hypothetical projected returns within an illustration. Providing projections for purposes of retirement income planning or investment planning generally requires the expertise of advisors trained in such financial planning. An insurance agent with only an insurance producer license does not have this training. If projections of future income will be provided, they should be provided by financial planning professional in the same way that such a professional might assist a consumer in understanding potential future income from a mutual fund, a stock or a bond. Indexed life insurance products should not be the only financial instrument for which projections of future performance are permitted.

Eliminating projected returns will have many benefits – shortening and simplifying the illustration, mooting loan arbitrage, more realistic expectations by the consumer, eliminating the illustration competition and the attendant growing product complexity

4. Illustrations should be realistic about what kind of product is being sold. Every illustration includes the disclaimer that the product is not an investment and then proceeds to show how the premiums will be invested. The disclosure should reflect reality – this is an insurance product with investment features.
5. The illustration must be massively shortened and simplified if consumers have any chance of understanding the product. Getting rid of page after page of tables of projected returns and all the associated caveats will help.
6. Performance disclosure should be limited to the actual performance of indexes in existence for 20 or more years and should show the worst and best 5 and 10-year performance of that actual index. The use of hypothetical illustration histories and histories less than 20 years must be prohibited. It is imperative that illustration reform eliminates the need to invent cherry-picked index components – this is an urgently-needed, foundational reform along with the prohibition on projected returns.
7. The only scenarios permitted should be the single-period operation of the product (item 2) and historical performance of indexes in existence for 20 or more years (item 6)
8. The key feature of indexed products are caps and floors. The illustration should highlight the insurer's history of changing caps and floors for each major product – all IUL, all FIA, all RILA, etc. Clearly, a consumer will place greater value on an insurer who rarely lowers the cap on, say, FIAs or IULs, than an insurer who routinely lowers the product cap.

9. Consumer testing is essential to ensure illustrations and other disclosures, as well as product designs are effective. Testing is needed in the development of illustration requirements and following implementation of a new illustration regime.
10. Prohibit loan arbitrage. If projections of future returns are prohibited (item 3), loan arbitrage is moot. But such arbitrage – market returns are greater than loan costs – yields current illustrations showing loans that never need to be repaid because investment returns dwarf loan costs. This is a version of the vanishing premium debacle of the 1990s and 2000s. On its face, using loan arbitrage to promote premium financing is deceptive and unfair. No financial adviser would ever suggest that an investor take out a mortgage to buy stock because the average historical stock return is greater than the loan payment.
11. While the working group's efforts should focus on the NAIC models and guidance directly relating to illustrations – Annuity Disclosure, Life Insurance Illustrations and Life Insurance Disclosure – the working group and NAIC staff should identify potential impact and intersection with the many other NAIC models and guidelines that address life insurance and annuity disclosure to avoid conflicts among different guidance.