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Comments of the Center for Economic Justice

To the NAIC Market Conduct Examination Standards Working Group

August 30, 2017

CEJ submits the following comments on:

- Additions to the Market Regulation Handbook resulting from the adoption of Actuarial Guideline 49; and
- Additional comments on process review and compliance risk review methodologies.

Additions to Market Regulation Handbook Related to AG 49

Our comments refer to page numbers of the exposed draft.

Page 3 of 78: STANDARDS, OPERATIONS/MANAGEMENT, Standard 1 The regulated entity files all certifications with the insurance department, as required by statutes, rules and regulations.

Discussion: This standard references the annual certification requirements required of the illustration actuary in the Life Insurance Illustration Model Regulation (Model 582) – sections specified in Sections 4D, 4I and 11 regarding compliance with the requirements of the regulation of the disciplined and illustrated scales used in the illustration. Section 11F also requires a certification by "a responsible officer of the insurer, other than the illustration actuary" that illustration format requirements have been met and that expense allocation information has been provided to the producer. In simple terms, model 582 specifies the methodology to cap illustrated crediting rates in the "disciplined scale" and specifies that another" illustrated scale" must use crediting rates that are the lesser of those in the discipline scale or the currently payable scale.

Actuarial guideline 49 adds to and supersedes some of the illustration requirements in Model 582.

In addition, Model 582 includes certification requirements of the producer or representative. Section 7D(2) is a requirement for a producer or representative to certify having made the following truthful statement to the applicant for insurance: "I certify that this illustration has been presented to the applicant and that I have explained that any non-guaranteed elements illustrated are subject to change. I have made no statements that are inconsistent with the illustration." Section 9B(1) and of the model requires a certification "If no illustration is used by an insurance producer or other authorized representative in the sale of a life insurance policy or if the policy is applied for other than as illustrated, the producer or representative shall certify to that effect in writing on a form provided by the insurer. Section 9D of the model requires the insurer to maintain a copy of the basic illustration and any certifications that no illustration was used for three years after the policy is no longer in force.

In addition, Model 580 – the Life Insurance Disclosure Model Regulation – requires a policy summary for products sold without an illustration pursuant to Model 582. However, Model 582 permits an illustration within the policy summary based on "nonguaranteed elements:"

> "Nonguaranteed elements" means the premiums, credited interest rates (including any bonus), benefits, values, non-interest based credits, charges or elements of formulas used to determine any of these, that are subject to company discretion and are not guaranteed at issue.

Although Model 580 does not contain a requirement for an illustration actuary certification regarding the "current scale of nonguaranteed elements" is defined as "means a formula or other mechanism that produces values for an illustration as if there is no change in the basis of those values after the time of illustration.

With this as background, we agree with the addition of the reference to AG49 in the NAIC Model References and suggest the following addition at the end of the first paragraph in Review Procedures:

> The illustration actuary should file a certification with the insurance department annually for all policies for which illustrations are used (Life Insurance Illustrations Model Regulation
> (#582), Section 11). For indexed universal life illustrations, Actuarial Guideline 49 expands upon and supersedes the illustration requirements in Model 582.

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Page 5 of 78: C. Marketing and Sales Introduction

Market regulators should also be aware that sales of products, such as fixed -index annuities (formerly referred to as equity -indexed annuities) and index life insurance products (such as universal index life insurance) continue to increase. These products typically include features that require an understanding of bonuses, guaranteed elements and an array of interest -crediting methods. In some cases, existing NAIC model laws and regulations may not give specific guidance on all aspects of all products. In such instances, examiners may rely on general principles found in the Unfair Trade Practices Act (#880), the Life Insurance Disclosure Model (#580) and the Annuity Disclosure Model Regulation (#245).

The Life Insurance Illustrations Model (#582) sets out a variety of requirements to prevent insurers from using unreasonable or misleading illustrations in the sale of life insurance. Actuarial Guideline 49 –The Application of the Life Illustrations Model Regulation to Policies with Index Based Interest, ~~was~~ originally adopted by the NAIC in 2015, expands upon and in supersedes some of the illustration requirements of Model 582 ~~. It provides guidance and limitations~~ for Indexed Universal Life illustrations. In simple terms, Sections 4 and 5 of AG 49 set maximum crediting rates for illustrations. Section 6 addressed illustration of policy loans and Section 7 requires illustrations beyond those required in Model 582. The implementation of AG 49 was phased as follows:
~~with implementation of Sections 4 and 5 of the Actuarial Guideline required for new business and inforce illustrations beginning September 1, 2015 and with implementation of Sections 6 and 7 required for new business and inforce illustrations beginning March 1, 2016.~~

i. Sections 4 and 5 shall be effective for all new business and in force life insurance illustrations on policies sold on or after September 1, 2015.

ii. Effective March 1, 2017, Section 4 and Section 5 shall be effective for all in-force life insurance illustrations on policies within the scope of this actuarial guideline, regardless of the date the policy was sold.

iii. Sections 6 and 7 shall be effective for all new business and in force life insurance illustrations on policies sold on or after March 1, 2016.

Testing the compliance of illustrations with Model 582 and AG 49 will be complex and the examiner will likely seek assistance from an actuary familiar with and capable of testing compliance with Model 582 and AG49. However, the examiner should request and obtain information from the insurer necessary for the actuary or other person with expertise in testing illustrations' compliance.

Page 8 of 78: STANDARDS MARKETING AND SALES, Standard 1: All advertising and sales materials are in compliance with applicable statutes, rules and regulations.

We agree with the addition of the reference to AG 49, but suggest it be moved to better reflect the fact that AG 49 relates specifically to Model 582:

> Life Insurance Illustrations Model Regulation (#582) and Actuarial Guideline 49 – The Application of the Life Illustrations Model Regulation to Policies with Index Based Interest

We suggest that the document to be reviewed list include the materials necessary to test compliance of illustrations with Model 582 and AG 49. One possibility is a generic description, like:

> All documentation demonstrating the development of illustration crediting rates in compliance with Model 582 and AG49.

Another approach would be to list specific documentation required for testing compliance with Model 582 and AG49.

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The draft proposal provides additional text to the second to last paragraph. The new text seems out of place because the existing text relates to advertising while the new text refers to the contents of illustrations. We suggest the following to fix this problem.

> Index products
> For advertising for interest -sensitive products, review explanations of the crediting methods and terms. Review the functioning of the crediting methods to determine that the explanations are understandable and accurate. Verify that accurate information is provided regarding the options available to the consumer and the methods by which the consumer is to exercise the options.
>
> In addition to reviewing the advertising of indexed products, the examiner should review the illustration for compliance with Model 582 to ensure that, among other things, unreasonable or deceptive crediting rates are not being used in the illustrations and that the illustrations provide the consumer with the information required by model 582 and, for indexed universal life products, AG 49. ~~For Indexed Universal Life, d~~Determine whether the explanations and information provided regarding the options available to the consumer are consistent with the requirements and limitations of Model 582 and AG49~~presented in Actuarial Guideline 49 – The Application of the Life Illustrations Model Regulation to Policies with Index Based Interest.~~

Page 18 of 78: STANDARDS, MARKETING AND SALES, Standard 4, An illustration used in the sale of a policy contains all required information and is delivered in accordance with statutes, rules and regulations.

We make the same suggestion as above for placing the new reference to AG 49 with Model 582.

> Life Insurance Illustrations Model Regulation (#582) and Actuarial Guideline 49 – The Application of the Life Illustrations Model Regulation to Policies with Index Based Interest

We make the same suggestion as above for Documents to be Reviewed. One possibility is a generic description, like:

> All documentation demonstrating the development of illustration crediting rates in compliance with Model 582 and AG49.

Another approach would be to list specific documentation required for testing compliance with Model 582 and AG49.

The additional text on page 19 of 78 is useful, but the implementation dates omit the most recent change to AG 49, cited above and here again. We suggest replacing the first two paragraphs of the proposed new text with the following;

> The Life Insurance Illustrations Model (#582) sets out a variety of requirements to prevent insurers from using unreasonable or misleading illustrations in the sale of life insurance. Actuarial Guideline 49, originally adopted by the NAIC in 2015, expands upon and in supersedes some of the illustration requirements of Model 582 for Indexed Universal Life illustrations. In simple terms, Sections 4 and 5 of AG 49 set maximum crediting rates for illustrations. Section 6 addressed illustration of policy loans and Section 7 requires illustrations beyond those required in Model 582. The implementation of AG 49 was phased as follows:

i. Sections 4 and 5 shall be effective for all new business and in force life insurance illustrations on policies sold on or after September 1, 2015.

ii. Effective March 1, 2017, Section 4 and Section 5 shall be effective for all in-force life insurance illustrations on policies within the scope of this actuarial guideline, regardless of the date the policy was sold.

iii. Sections 6 and 7 shall be effective for all new business and in force life insurance illustrations on policies sold on or after March 1, 2016.

Testing the compliance of illustrations with Model 582 and AG 49 will be complex and the examiner will likely seek assistance from an actuary familiar with and capable of testing compliance with Model 582 and AG49. However, the examiner should request and obtain information from the insurer necessary for the actuary or other person with expertise in testing illustrations' compliance. The examiner may be able to test implementation compliance issues by confirming that IUL illustration changes were made on or before the effective dates set out above. For example,

- Did the insurer implement on or before September 15, 2015 a compliant crediting rate methodology for new and in-force illustrations on policies sold on or after September 15, 2015?
- Did the insurer implement on or before March 1, 2016 a compliant credit rate methodology all new illustrations produced on or after March 1, 2016 on in-force policies?
- Did the insurer implement the policy loan and additional illustration scales requirement of Sections 6 and 7 of AG 49 on or before March 1, 2016

The following are more complex requirements of AG49, which may require the assistance of an actuary or other person with expertise in evaluating illustration crediting methodologies and calculations:

- For new business and in force life insurance illustrations on policies sold on or after September 1, 2015, determine whether the credited rate for the Illustrated Scale has been limited according to the requirements of Section 4.

- For new business and in force life insurance illustrations on policies sold on or after September 1, 2015, determine whether the earned interest rate for the Disciplined Current Scale has been limited according to the requirements of Section 5.

- For new business and in force life insurance illustrations on policies sold on or after March 1, 2016, ensure that, if the illustration includes a loan, the illustrated rate credited as compared to the illustrated loan charge has been limited according to the requirements of Section 6.

- For new business an-d in force life insurance illustrations on policies sold on or after March 1, 2016, ensure that the basic illustration includes a ledger using the Alternate Scale shown alongside a ledger using the illustrated scale with equal prominence according to the requirements of Section 7.A.

- For new business and in force life insurance illustrations on policies sold on or after March 1, 2016, ensure that the basic illustration includes a table showing the minimum and maximum of the geometric average annual credited rates as referenced in Section 7.B.

- For new business and in force life insurance illustrations on policies sold on or after March 1, 2016, ensure that the basic illustration includes a table showing actual historical index changes and corresponding hypothetical interest rates using current index parameters for the most recent 20-year period for each Index Account illustrated, as required by Section 7.C

Page 42 of 78: STANDARDS, MARKETING, AND SALES, Standard 14: The insurer has procedures in place to provide full disclosure to consumers regarding all sales of products involving index life and all sales are in compliance with applicable statutes, rules and regulations.

We make the same suggestion as above for placing the new reference to AG 49 with Model 582.

> Life Insurance Illustrations Model Regulation (#582) and Actuarial Guideline 49 – The Application of the Life Illustrations Model Regulation to Policies with Index Based Interest

We make the same suggestion as above for Documents to be Reviewed. One possibility is a generic description, like:

> All documentation demonstrating the development of illustration crediting rates in compliance with Model 582 and AG49.

The draft proposal includes a comment stating that AG49 does not require new disclosures beyond those of Model 582. This is not clear since AG 49 introduces a new illustration called the Alternate Scale as well as a number of terms different from those used in Model 582.

We suggest adding the following to Review Procedures and Criteria

> Review documentation to ensure compliance of the insurer's illustration methodologies with Model 582, generally, and with AG 49, specifically for IUL products. Review documentation to confirm implementation of AG 49 at required effective dates.

Page 75 of 78: Supplemental Checklist

We support the addition of this checklist. We suggest the addition of other items related to implementation of AG49:

- For new business and in force life insurance illustrations on policies sold on or after September 1, 2015, determine whether the credited rate for the Illustrated Scale has been limited according to the requirements of Section 4.

- For new business and in force life insurance illustrations on policies sold on or after September 1, 2015, determine whether the earned interest rate for the Disciplined Current Scale has been limited according to the requirements of Section 5.

- For new business and in force life insurance illustrations on policies sold on or after March 1, 2016, ensure that, if the illustration includes a loan, the illustrated rate credited as compared to the illustrated loan charge has been limited according to the requirements of Section 6.

Process Risk Methodology and Compliance Risk Assessment Methodology

We appreciate the work of the consultants who prepared the two process-oriented examination methodologies. We also believe that there may be useful tools within the proposals for market regulators. But, neither proposal clearly articulates when the tool should be used as opposed to other tools or whether the tool is intended to prevent, identify or remediate market conduct failures. Don Koch's July 20, 2017 letter illustrates this ambiguity:

> In the proposal we submitted for the working groups review, we have tried to point out that once a market conduct examination is called there are several methodologies that can be utilized to determine the credibility of the issue being considered. Process review, we believe is a good tool at pinpointing where failures in a Company's process are the causation for an adverse consumer market outcome. It also serves as a remedial tool to ensure adverse consumer market outcomes do not continue in the future. If a regulated entity is engaging in activity that results in consumer market outcomes that harm the consumer, it is not particularly helpful to sift all outcomes to find the ones that are of interest because they are harmful. Tools already exist that do that kind of sifting. The most effective of these is the consumer complaint system in use in most states. When patterns of inappropriate activity arise, it is generally from the tools already in use.

In this paragraph, process review is presented as a tool to "determine the credibility of the issue being considered" and "pinpointing failures" in Company processes causing the adverse outcome and a "remedial tool." The process review described is based on the assumption that a problem has been identified by some other means with consumer complaints proffered as the most effective of these tools.

With a little bit of overstatement, process review is a solution in search of a problem. In our view, market regulators need much better tools to identify poor consumer outcomes – certainly much better than consumer complaints or the current Market Conduct Annual Statement. Consider that Wells Fargo falsely placed 800,000 force-placed policies on auto loan borrowers over a five year period causing hundreds of thousands of delinquencies and tens of thousands of defaults and repossessions. Yet, consumer complaints did not bring this conduct of the force-placed insurers to whom Wells Fargo had outsourced the tracking and force-placed insurance placement.

Similarly, even when consumer complaints or MCAS raise a concern, these tools are so blunt that much further examination is needed. Mr. Koch's stated rationale for the process review is a result of the inadequate market monitoring tools available to regulators. While Mr. Koch simultaneously criticizes analysis of granular market outcome data – "it is not particularly helpful to sift all outcomes to find the ones that are of interest because they are harmful" – and asserts that there are existing tools to identify the harmful outcomes, his description of the process review methodology is simply a non-data methodology to identify harmful market outcomes.

As stated in our July 19, 2017 comment, process review or compliance risk methodologies may have a role in market regulation, but they are not a substitute for or precursor to the collection and analysis of granular market outcome data – data far more granular than currently being collected.

Consider the following scenario. A consumer complaint or MCAS indicates a potential problem with suitable sales of complex annuities or life insurance products. We know that with MCAS, the problem will have to be severe to cause the company to be an outlier, so the bad outcomes produced by a bad producer may not cause anything noticeable in MCAS ratios. Similarly, there may or may not be a number of complaints regarding the producer. Utilizing process review in this context is, literally, a fishing expedition that might involve an extensive review of a number of systems and processes for a problem limited to a single producer and a single system or manager.

Now consider how this problem might be identified if MCAS consisted of data on every life insurance and annuity sale including key characteristics of the sales transaction including specific type of product, producer involved, consumer characteristics, product characteristics. By utilizing robust data mining and statistical analysis, the market analyst could identify unsuitable sales by a specific producer or for a specific product. Armed with this analysis, the regulator is much better positioned examine the causes of the problem and to ascertain whether there is a systemic problem with company processes or a problem limited to particular products, producers or classes of consumers.

As a tool for market regulators, the process or compliance risk review requires much more specific description of the types of situations in which it can be used. But, the broad application of process or compliance risk review set out in the proposals as a tool to identify causes of bad consumer outcomes is more appropriately a tool marketed to insurers to help them evaluate and improve their processes to ensure consumer market outcomes. The process or compliance risk review proposals are further inappropriate for market regulators because they reflect and perpetuate a particular view of what good corporate governance and procedures regarding treatment of consumers should be. Our view is that regulators should focus on identifying market problems and poor consumer outcomes when they occur and not attempt to become partners with insurers for corporate governance related to market regulation.

In summary, process or compliance risk review may have a role in market regulation if the specific circumstances of its use are clearly articulated and if process or compliance risk review has a limited and clearly defined role. As presented, these proposals articulate a broad role for process and compliance risk review serving as an alternative to traditional examination methodologies.

But, the most important point we wish to make is that the future direction of market regulation should be one in which more granular consumer market outcome data are collected and analyzed by market analysts utilizing the same types of Big Data tools as insurers, but for purposes of more efficient and effective market regulation. We ask the Market Conduct Examination Standards Working Group to join in this vision of the future of insurance market regulation and recommend to the Market Regulation Committee and the NAIC to move towards a regulatory Big Data future by enhancing the Market Conduct Annual Statement with transaction detail data on individual sales and claims.