



AMERICAN ACADEMY *of* ACTUARIES

March 3, 1998

Ms. Carolyn Johnson
National Association of Insurance Commissioners
120 W. 12th Street
Suite 1100
Kansas City, Missouri 64105

Dear Ms. Johnson:

Thank you for the opportunity to comment on the “Life Insurance and Annuities Replacement Model Regulation.” This response was prepared by the Committee on State Life Insurance Issues (COSLII) of the American Academy of Actuaries. We would like to comment on one provision in particular, as well as make several points for clarification.

In Section 6, “Duties of Replacing Insurers that Use Producers”, paragraph E would require the replacing insurer to allow credit for the time elapsed under the replaced policy’s incontestability and suicide period. This requirement would invite abuse on the part of insureds who would misrepresent their insurability, to the detriment of life insurance companies and other policyholders acting in good faith. This can be illustrated in the example that follows.

For annually renewable term life insurance products, it is typical for companies to use select and ultimate premium rates. Each year the policyholder essentially pays for the cost of the pure life insurance benefit. In the event of death while the policy is in force, the face amount is paid as a death benefit. If premiums are not paid when due, the policy lapses without value. An example of a premium rate scale for annually renewable term life insurance is shown in Table I.

Table I
Annually Renewable Term Life Insurance
Premium Rates per \$1000 (Illustrative Only)

Policy Year	1	2	3	4
Issue age				
44	2.23	2.66	3.13	3.66
45	2.41	2.87	3.38	3.96
46	2.61	3.11	3.66	4.28
47	2.83	3.37	3.96	4.61
48	3.07	3.64	4.27	4.97

As can be observed in the table, the cost of this term life insurance benefit is relatively low in the first policy year, and increases annually thereafter (to reflect the increasing cost of mortality in each successive policy year). Notably, it is a common occurrence that premium rates for newly issued policies of a certain issue age are less than those for existing inforce policies for insureds of the same attained age. For example, in Table I, the premium rate in the first policy year for a policy issued to a 47 year old (\$2.83), is less than the premium rate in the third year for a policy issued to a 45 year old (\$3.38), even though they are the same attained age.

This difference in premium rates is an effect of the selection process in which a newly underwritten life is expected to have mortality experience which is more favorable than that of a comparable person underwritten several years earlier. Representations as to the insurability of the proposed insured are an integral part of this selection process. This ability to group similar insureds for the purposes of insurance rate determination is fundamental to the concept of insurance. And this ability is protected, in part, by the incontestability and suicide provisions in the policy.

The proposed requirement to waive the incontestability and suicide provisions on replaced policies would facilitate those applicants who choose to misrepresent their insurability. In the extreme case, the insured could theoretically obtain the premium rates available to newly issued policies every year, regardless of actual insurability, by misrepresenting insurability on the application for the replacement policy. As a result, insureds that may not share the same characteristics with respect to insurability may be included in the group, and the cost for the group would be higher than that otherwise assumed. This increased cost will ultimately be borne by all policyholders.

The example shown for an annually renewable term life insurance policy is the most obvious for purposes of illustration. Inasmuch as companies use similar assumptions as to groupings for premium rate purposes on life insurance policies of other designs, the same conclusion would hold as well.

As evidence that policyholders will act in their own best interests, COSLII cites the experience under extended term insurance. Many permanent life insurance policies offer the policyholder two nonforfeiture options in the event that the policy lapses for nonpayment of premiums. The option that is most advantageous to insureds who, for instance, learn they have a terminal illness is extended term insurance. Under this option, the policyholder may essentially apply any existing cash value to pay term premiums. The coverage will continue as long as the cash value is sufficient to pay the term premiums. It is well established that mortality experience for policyholders that elect this option is materially worse than the mortality for otherwise persisting policyholders.

For this reason COSLII recommends that this requirement be removed from the proposed model regulation. Keep in mind that applicants who complete the application for insurance fully and truthfully will not be harmed by eliminating this provision. Under this proposed requirement, only those insureds who would misrepresent their insurability would benefit at the expense of insureds who act in good faith.

The required placement notice shown in Appendix A states the potential effect of new incontestability and suicide periods in the section heading, “Insurability”. This important disclosure serves notice that the contestability and suicide periods may begin anew on the new policy.

The remaining suggestions would improve the clarity of the model. In Section 2 we would add the following:

Section 2. Definitions

D. “Financed purchase” means the purchase of a new policy or contract involving the actual or intended use of funds obtained by the withdrawal or surrender of, or by borrowing from the policy or contract values of an existing policy or contract to pay all or part of any premium or consideration due on the new policy or contract. If a withdrawal, surrender or borrowing involving the policy or contract values of an existing policy or contract on the life of the intended insured occurs within thirteen (13) months before or after the effective date of the new policy and is known by the replacing company, or if the withdrawal, surrender or borrowing is shown on any illustration of the existing and new policies or contracts made available to the prospective policyowner by the existing or replacing insurer or its representatives, it will be deemed *prima facie* evidence of a financed purchase.

* * *

In Section 4 reproduced below, there is reference made to “basis or supplemental illustrations or the required statement”. These terms are not defined in this model. Is this a reference to illustrations defined in the Life Insurance Illustrations Model Regulation? If so, the definitions should be repeated. This is particularly relevant to those jurisdictions that might adopt this model but not the illustrations model.

Section 4. Duties of Producers

E. The producer shall submit to the insurer to which an application for a policy or contract is presented, a copy of each document required by this subsection, as well as any written or printed sales materials used in the presentation, including any basic or supplemental illustrations or the required statement where no illustrations are used.

* * *

In Section 5 shown below, we note the following change needed to reference the correct paragraph:

Section 5. Duties of All Insurers that Use Producers

Each insurer shall:

A. Maintain a system of supervision and control to insure compliance with the requirements of this regulation that shall include at least the following:

(1) Inform its producers of the requirements of this regulation and incorporate the requirements of this regulation into all relevant producer training manuals prepared by the insurer;

(2) Provide to each producer a written statement of the company's position with respect to the acceptability of replacements providing guidance to its producer as to the propriety of these transactions;

(3) A system to review the propriety of each replacement transaction that the producer does not indicate is in accord with Paragraph ~~(3)~~ A(2) above;

* * *

In Section 7, we think the following change would make paragraph C. more clear:

Section 7. Duties of the Existing Insurer

Where a replacement is involved in the transaction, the existing insurer shall:

A. Upon notice that its existing policy or contract may be a source of financing or replaced, retain copies of the notification, indexed by replacing insurer, notifying it of the replacement for at least five (5) years or until the conclusion of the next regular examination conducted by the Insurance Department of its state of domicile, whichever is later.

B. Within five (5) days of receipt of a notice that an existing policy or contract is being replaced, send a letter to the policy or contractholder of the right to receive information regarding the existing policy or contract values including ~~where appropriate~~ if available, an in force illustration or policy summary if an in force illustration cannot be produced. The information shall be provided within five (5) business days of receipt of the request from the policyholder or contractholder.

C. Upon receipt of a request to borrow, surrender or withdraw any policy values, send to the applicant a notice, advising the policyowner or contract owner of the effect that release of policy values will have on the non-guaranteed elements, face amount or surrender value of the policy or contract from which the policy values are released. The notice shall be sent separate from the check if the check is sent to anyone other than the policy or contract owner.

* * *

Finally, in Section 8 we think that the following change would also clarify the reference being made:

Section 8. Duties of Insurers with Respect to Direct Response Sales Solicitations

A. In order to comply with its duties regarding replacement, an insurer shall require with or as part of each completed application for life insurance or an annuity a statement as to whether the applicant has existing policies or contracts. If the answer is "no," the duties of the insurer with respect to replacement are complete. If the answer is "yes," and the insurer elects to proceed with the replacement, the insurer shall comply with the requirements of Subsection 8(B) or 8(C) -B or C. However, an insurer is under no obligation to replace an existing policy or contract.

Again, thank you for the opportunity to comment. Please call on us if we can be of further assistance.

Yours truly,

Craig R. Raymond
Chairman
Committee on State Life Insurance Issues

cc: Paul DeAngelo
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