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INSURANCE ADVISORS

LIFE INSURANCE IN THE CLIENT'S BEST INTEREST

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Life insurance is a unique and important financial product for many clients and the only product that can protect clients' families and businesses against the risk of early death. Properly designed life contracts also allow the client to benefit from some unique tax benefits afforded only to life insurance products. But standards for life insurance advice have not kept pace with the marked increase in types of life products or the complexity of these products. Most state insurance regulators have not modernized consumer protections or duties to clients to keep pace with protections offered by banking regulation, securities laws, trust laws or pension laws where greater duties are owed to clients both when a recommendation is made and on an ongoing basis. Many complex modern life products involve important tradeoffs that are not well understood by consumers or perhaps by most agents who sell them. Nor is there any ongoing requirement to monitor and advise the client after the product is placed. This white paper will explore how two upcoming changes may bring life insurance standards into the modern era.

There are two important developments in 2019 that will impact the standard by which life insurance recommendations are made to clients. The first was the CFP Board's change in their Code of Ethics and Standards of Conduct ("Code and Standards"). The new standards now extend to any financial advice including all life insurance recommendations. These recommendations must now be in the client's best interest and advice about them offered under a fiduciary standard.

The second change is a regulation by the State of New York, Regulation 187,[1] that takes effect on February 1, 2020, for a recommendation to purchase life insurance products and August 1, 2019, for annuity products sold in the state. This regulation requires agents and insurance companies to make life insurance recommendations that are both suitable for the client and in the client's best interests. Both new standards change how advisors will need to document life insurance recommendations and substantially raise the standard for life insurance advice. This white paper will explore what it means to make a life insurance recommendation either as a CFP® professional under the new standards or under New York's best interest standard.

EXISTING STATE LIFE INSURANCE REGULATIONS ARE MAINLY BASED ON CONTRACT LAW

By and large, life insurance is regulated by the 50 state insurance departments and is based on contract law rather than any duty an agent has to the client. Currently, those who sell general account life or annuity contracts,[2] must pass a relatively simple exam after 40 hours of classroom or on-line learning. Under the law of agency, the agent who sells insurance does not work for the client but is technically an agent for the life insurance company in the transaction and places the policy on behalf of the company. Thus, the agent represents the insurance company in the transaction not the client. Under current standards, the life agent owes few legal duties to the clients and those limited duties terminate when the policy is placed.[3]

If there is a dispute on how a policy was supposed to work or the benefits that were to be provided, it is the policy contract language that controls it, not sales materials or representations by the agent. This language on how policy earnings are actually credited and the policy charges are often at odds with expectations the client may have had based on the sales proposals or illustrations used by agents.[4] Illustrations are supposed to show prospects how the product will work under certain premium payments and under certain

conditions, but they are often inappropriately used to compare contracts. This has been a persistent and seemingly intractable problem for the better part of the last 30 years.[5]

In our experience, most life agents really do seek to serve their clients and deliver a quality recommendation, but they are hampered by some of the same complexity of products that plagues clients. Few agents have the sophistication to look past the illustration to study the contract language from the products being recommended to make more informed recommendations. Fewer still have built a business model that monitors policies past placement and provides ongoing advice on how those policies should be managed over time. Any of these services, while beneficial to clients, are outliers to the very low minimum regulatory standards.

New York is the first state to significantly raise this low minimum standard for agents and insurance companies and has created a higher standard for life insurance recommendations. Under the NYDFS Regulation 187, the agent and the company will be held to a standard where recommendations concerning life and annuity contracts must be "exclusively in the client's best interest" and must also be suitable for this client based on understanding the client's goals and 13 specific suitability elements that agents must gather as part of a recommendation.[6]

To understand the significance of these changes, one must understand that for the last 150 years, life insurance has operated on what has been basically a "caveat emptor" or "buyer beware" regulatory model for the purchase of life insurance, based primarily on the contractual terms of the policy. Under current state insurance law, the purchaser of a life insurance or annuity contract is presumed to have read, understood and consented to the terms of the life insurance contract that is delivered after they have tendered premium. In actual practice, the client is often shown illustrations by the agent about how the policy will work and promised benefits based on a number of elements that will change over the life of the contract and are oftentimes not guaranteed. The actual cost and benefits may vary greatly from these "illustrations".

At the very end of the sales process, after being shown illustrations and after the client has gone through the underwriting process and actually paid a premium on the policy, it is only then that the actual contract from the company is delivered to the policyholder. It is the contract language, not the illustration, that is controlling how the policy values are credited and how charges are deducted from the policy. The client then has a limited time period to read and fully understand the terms of the contract and either keep or reject the contract (rescind the policy during the free look period for a refund of premium).

CURRENT STATE-BASED STANDARDS REQUIRE CLIENTS TO DETERMINE IF A TRANSACTION IS IN THEIR BEST INTEREST

Under current state-based insurance laws, it is the policyholder who has to determine if the recommendation and the contract are in their best interest.[7] Under current state-based insurance regulation, the consumer may have no idea how important elements of what they were shown in an illustration could change over time or that the company can increase charges. This has always been the case with life insurance products, but it is especially true for some of today's more complex and opaque products.

This problem of wide difference between the illustration and the actual contract has been magnified by a new type of very complex life insurance product that passes even more risk to the consumer. Index Universal Life or IUL often promises equity-like returns in the illustration but is actually a bond-based general account product regulated only by state insurance law. In some of the IUL products we have reviewed, more than 90% of the projected benefits are based on contractual elements that the company can change at its discretion. These non-guaranteed elements can control how and even if the policy will work at a projected level of premium payments. Our experience over the years in placing tens of thousands

of policies of many types with dozens of companies leaves us confident that less than 1% of clients and prospects have the expertise, let alone the patience to go through 60 to 100 pages of policy contract language and then assess how probable the promised benefit is based on the contract language. In fact, many of today's products have become so complex that the vast majority of agents selling them don't really understand the key levers that companies have in this contract language or the risks that may pose for policyholders.

THE CHALLENGE:

This "caveat emptor" regulatory model made more sense when life insurance products were very simple and standardized and when almost all policies were sold by agents associated with a single career company. States adapted model insurance regulation laws that required standardized policy language that differed little from carrier to carrier. Whole life and term were the only policy types that all companies sold and had very comparable features, across companies. The language in policies' contracts that was required by states was based on models created by the National Association of Insurance Commissioners or NAIC. In fact, the whole concept of cash value was driven by standardized non-forfeiture language that states required in contracts for the purpose of preventing policyholders from getting nothing if they surrendered policies.

While this language was updated for variable life products and universal life in the 1970's and 1980's, it is still largely based on a whole life product from 70 years ago, before the invention of computerized illustrations, modern product types, increasingly complex contractual terms and independent agents who can represent multiple companies. Today's products are not at all standardized and vary greatly between companies. Not only are the products different, but individualized funding levels and riders that can be added to the policies can create widely different outcomes even from the same product. Contract language also varies widely between companies and in some cases gives companies wider discretion in what to credit policyholders or how policy charges are deducted.[8] Agents who represent multiple companies' products are not nearly as well informed on how the products operate as they were when they sold a few simple products for a for a single carrier. Educational and licensing requirements have not kept pace with these more complex products or the much broader set of product solutions that can be offered to clients. In many cases, these new opaque and increasingly complex products pass on significantly more risk to the client and contract law is antiquated as a sole standard of protection or suitability.

CFP BOARD BEST INTERESTS STANDARD

While basic minimum standards to sell life insurance are low under state-based insurance laws (40 hours of training and passage of a state insurance exam), some financial advisors have voluntarily decided to distinguish themselves with professional designations. State licensed insurance agents can obtain further training and professional designations including: CFP® professional, CLU, ChFC, CFA or CPA. Each of these professional designations place some additional education, ethics and practice standards on those who hold them. For example, those that hold the CFP® professional CERTIFIED FINANCIAL PLANNER™ professional designation must now have a bachelor's degree, pass a comprehensive exam and have three years of experience in the field. CFP® professionals must also subscribe to minimum ethical standards that changed materially in 2019.

This year those who hold the CFP® professional and offer insurance advice will make substantive changes in how they offer life insurance products to clients under new standards that go into effect in 2019. The new rules set forth the ethical standards for CFP® professionals, replaces the CFP Board's current Code of Ethics, Rules of Conduct, Financial Planning Practice Standards and Terminology effective October 1, 2019. The new Code and Standards includes the application of the fiduciary standard that requires CFP® professionals to "act in the best interest of the client at all times when providing financial advice". This would apply to any situation where a CFP® professional licensee would give advice or recommend life

insurance products. The advice or placement of life insurance can no longer be segregated from a financial plan under the new rules.

Other relevant ethical standards which would impact the CFP® professional in the placement of life insurance contracts include requirements that they:

- Act with honesty, integrity, competence, and diligence
- Avoid or disclose and manage conflicts of interest
- Act in the client's best interests
- Exercise due care including in the recommendation of a product including life insurance

It is clear that these duties to the client require the CFP® professional to go beyond delivering a contract that they may have given little thought to. At a minimum they create an obligation that the CFP® professional give greater thought and care in the recommendation and put the duty to client ahead of that to the life company and their own financial interest. In fact, the duty of care would also require that the CFP® professional must provide professional services with competence (relevant knowledge AND skill to apply that knowledge). When not sufficiently competent in a particular area, a CFP® professional must:

1) Gain competence
2) Obtain the assistance of a competent professional
3) Limit or terminate the engagement
4) Refer the client to a competent professional

There are now firms that have built an entire business model around allowing fee-based advisors with CFP® professional designations to outsource these services in a way that is in compliance with these standards and delivers results that are significantly better for clients.

NEW YORK REGULATION 187

Effective February 2020 for life insurance products, the New York Department of Financial Services (DFS) established a final standard that requires life companies to put procedures in place to assure "a transaction is in the best interest of the consumer and appropriately addresses the insurance needs and financial objectives of the consumer at the time of the transaction."[9] This regulation, the first of its kind, represents a dramatic change in minimum standards for both life insurance producers and companies. It has wide impact for both those sales in New York and beyond.[10] The regulation which was finalized in 2018, was opposed by the American Council of Life Insurers (ACLI), the Advance Association of Life Underwriters (AALU), the National Association of Insurance and Financial Advisors (NAIFA) and the Life Insurance Council of New York (LICONY). All of these industry trade groups lobbied for changes in the rule and did win a delay in its implementation. NAIFA has also brought two court cases against NYDFS in an attempt to block the regulation.[11] The industry trade groups also lobbied for and got a slightly less rigorous suitability standard for term insurance policies and a carve out for agents of captive and carrier companies from the original proposed regulation. Those agents with limited product sets or proprietary products will be deemed to act in the best interests of clients even with a limited product set, so long as they identify themselves as such in writing to potential clients prior to the transaction. The regulation will now

take effect on August 1, 2019, for annuities and February 1, 2020, for life insurance policies. The regulation, which can be found here, fundamentally changes how life insurance will be marketed and serviced in the state of New York. It is not yet known how this new model will impact regulation in other states.[12] What we do know is that Regulation 187 will require that the agent:

1) **Must understand the client's goals and situation before making a product recommendation:**
Producers and insurance companies are to document client goals and financial information before making recommendations of life or annuity contracts.[13] This documentation includes 13 specified points of information that must be gathered prior to a recommendation, including: financial resources for funding the policy, intended use of the policy, financial time horizon, and "tolerance of non-guaranteed elements in the policy, including variability in premium, death benefit, or fees."[14]

2) **Address client/product-specific suitability:**
The producer must demonstrate and document how the specific recommendation, including "the underlying sub-accounts and riders and similar product enhancements, if any, are "suitable" for the specific client in question based on their goals and information. In fact, the very definition of "suitable" in the regulation is far reaching: "Suitable means in furtherance of a consumer's needs and objectives under the circumstances then prevailing, based upon the suitability information provided by the consumer and all products, services, and transactions available to the producer."[15]

3) **Must provide in any presentation a fair and accurate representation of products:**
Producer must have a reasonable basis to believe that the policyholder has been informed of the various features and consequences of the product both "favorable and unfavorable such as the potential surrender period and surrender charge, any secondary guarantee period, equity-index features, availability of cash value, potential tax implications if the consumer sells, modifies, surrenders, lapses or annuitizes the policy, death benefit, mortality and expense fees, cost of insurance charges, investment advisory fees, policy exclusions or restrictions, potential charges for and features of riders, limitations on interest returns, guaranteed interest rates, insurance and investment components, and market risk."[16]

4) **Must give an accurate description of the producer's role:**
The New York standard attempts to bring clarity to the role that life insurance producers play and how they are compensated. The regulation restricts what an insurance producer calls him or herself along with the description of their services. It states, "A producer shall not state or imply to the consumer that a recommendation to enter into a sales transaction is financial planning, comprehensive financial advice, investment management or related services unless the producer has a specific certification or professional designation in that area. A producer shall not use a title or designation of financial planner, financial advisor or similar title unless the producer is properly licensed or certified and actually provides securities or other non-insurance financial services."[17]

5) **Be aware that companies are required to supervise:**
These new standards are backed by requirements for the issuing companies to put in place systems for supervision and audit to enforce the standards. Specifically, insurance companies are also prohibited from "effectuating a transaction unless it believes that the transaction was suitable based on the client's suitability information."[18] The regulation backs up these standards; any producer or insurer who fails to follow the standards will be engaged in an activity "deemed to be an unfair method of competition or an unfair or deceptive act and practice in the conduct of the business of insurance."[19] Perhaps more important than sanction by the state, these new standards will give consumers increased leverage in gaining rescission in abusive transactions where the products recommended were clearly not in their best interests.

WHY WE THINK ETHICAL LIFE PRODUCERS OUGHT TO BE IN FAVOR OF THESE NEW STANDARDS

These changes by both the CFP Board and the state of New York force long overdue reform to the US life industry. Of all financial products, life insurance remains the most complex and long-held financial product most consumers will buy. Cogent advice about which company to choose, how to adequately fund these policies and perhaps, most importantly, how to manage these policies over time requires professional advice. Those who really wish to be "life insurance professionals" should not fear these higher standards but welcome them as an important point of differentiation from those who want to "sell something" and move on.

An example of one of the firms we are assisting to disrupt the "status-quo" life insurance delivery model is Long Road Risk Management Services. They serve fee-based advisors and their clients under a best interests standard, are able to align with these firms to deliver insurance recommendations and ongoing policy management in the same way they deliver wealth management advice to their clients. They have voluntarily chosen to operate under the highest standards of care in the financial services industry by using a best interests standard while incorporating the elements of the CFP® professional ethics requirement. One of the most important differentiators of their offering is the mandatory use of annual policy management reports produced each year for clients. The annual reports ensure advisors and clients are continuously evaluating their insurance portfolio as it relates to their overall wealth plan.

When we compare the standards for transacting general account life and annuity products to every other kind of financial transaction and products, it should not be the clients who have to determine if the policy is in their best interests. Nor is it fair to say their primary legal protection to consumers comes from their having read and understood these increasingly complex contracts. If financial advisors or insurance agents really want to be compared to physicians, CPAs or other professionals, we should welcome the opportunity to really understand the client's situation and be willing to document why our recommendation makes sense for that client's individual situation.

The existing state-based standards actually incent life insurance companies and less-ethical or less-informed agents to create or present illustrations that are prone to understate costs and overstate benefits. Not only has this problem persisted for more than 30 years, it has gotten worse. This has resulted in the perverse outcome that life insurance companies and agents that are willing to create the most outrageous assumptions in their illustration to gain market share because consumers, directed by their agents, compare illustrations without thought of the underlying economics or contractual terms of the contract.

Over the years, we have been very involved in helping our industry lobby for fair and reasonable standards for financial advisors. Previously, we had opposed and lobbied against ill-conceived notions of "best interests", including DOL best interest standards applicable to financial advisors. However, when it comes to Regulation 187, we favor New York DFS' version of best interests for life insurance and annuities and think it should be expanded to all states. Why? Because we believe that the regulation will force change by carriers that will help consumers and agents who really care about their clients and want to do what is right. It will bring a new discipline to the process of making recommendations to clients to make sure the products work for the benefit of consumers and help them meet their goals. The regulation will insure that agents have a much better understanding of the client's financial situation and a better match of products to the need. Under the New York Regulation 187, carriers will no longer be able to look the other way as untrained or unethical agents push products that are unaffordable, unneeded or set unreasonable expectations.

For years, good insurance professionals have bemoaned gimmicky carrier contract language that allowed the carriers to materially change the costs or benefits of a policies. Companies have gained market share by using illustrations to make their product look to be the most competitive, while having contract language that allows them to charge higher expenses and credit less earnings. Current standards have allowed life companies to look the other way while their products were used inappropriately. Regulation 187 and the addition of suitability and a best interests test, in addition to contract law, will create financial incentives for companies to make sure that illustrations set more realistic expectations and consumers are better informed. The New York regulation is a step in the direction of changing these things. It will fundamentally force insurance companies to change how business is done and will force long-tolerated abusive practices (primarily by insurance companies) to change. It will require that both products and the illustrations we use to explain them better help consumers understand the tradeoffs and moving pieces of life insurance.

In our firm's 55 years of business in the life insurance space, we have observed that the majority of financial advisors want to do the right thing for clients. They treasure the independence of being able to represent multiple products from several companies. This regulation will create better alignment of interests between ethical and professional advisors and the interests of clients. The companies that will succeed in this new environment will need to change sales materials and information so that the product tradeoffs and funding levels can be more effectively communicated to the prospect or client. It will result in better product recommendations where clients understand the positives and negatives of a given recommendation.

For years at our firm, we have been building tools with the advisors associated with our company to do this very thing. We did this not because we were required to do so, but because we saw it as a competitive advantage to make better recommendations and to reconcile illustrated benefits to specific contract language. We call this The Life Assurance 360™ Process. This process represents the collective thoughts of how dozens of the best insurance professionals have put a unique process for life insurance in place that results in recommendations that are in the client's best interests.

At Valmark, we have also invested in creating a dedicated policy management company that annually reconciles the initial design of a policy to its annual in-force policy illustration. Almost two dozen of our member firms now offer this service for policies that they place through us. Now five years in operation, we can prove results that are 60% better for clients in terms of policies that are on track for their goals. We measure this by comparing the blocks of thousands of policies that we bring under management that were unmanaged or informally managed vs. ones that annually have a written policy review. In late 2017, we cast a vison on how these consumer-oriented systems when put together could radically improve results for the client and published a book entitled *Life Insurance 10X*.

No doubt meeting these new standards will be difficult. It will likely drive some companies and agents who are unwilling or unable to meet these new standards from the market. But we believe that these standards will bring life insurance into the modern financial world with standards that are on par with other financial products. The best companies will adapt their products and sales materials so that more clients will truly benefit from the policies recommended.

ABOUT THE AUTHOR

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Lawrence J. Rybka is Chairman and Chief Executive Officer of Valmark Financial Group, which includes a broker dealer, an investment advisor and Executive Insurance Agency (the nation's first producer group). Valmark serves 120 premier independently-owned and run wealth management/transfer firms in 31 states and has helped place over $60 billion of life insurance death benefits while managing insurance policies with a cumulative cash value of over $8 billion. Valmark's affiliated RIA, Valmark Advisers, has over $6 billion in assets under management, including approximately $3 billion in variable sub-account assets within its TOPS® funds.

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[1] 11 N.Y.C.R.R. § 224.

[2] General Account products are products not regulated by FINRA or the SEC. Examples include Whole Life, Universal Life, Indexed Universal Life, Term Life, Immediate Annuities, Fixed Deferred Annuities, and Fixed Indexed Annuities.

[3] There currently is a subset of life and annuity contracts that are subject to the higher standard of suitability requirements and provide greater disclosure to clients via prospectus; these are commonly known as variable life and annuity products and are regulated under the 1933 and 1934 Acts SEC. These sales must also be principal approved by broker-dealers under FINRA regulatory standards. In addition, they meet normal filing and licensing requirements of state insurance law.

[4] "Beyond Illustrations – The Importance of Contract Language", Thomas R. Love, Journal of Financial Services Professionals, July 2017.

[5] The Ledger Lie" Lawrence S. Rybka, Best's Review, Volume 90 No. 4, August 1989.

[6] 11 N.Y.C.R.R. §§ 224.3(g) and 224.4.

[7] If the contracts in question are separate account variable products, there are additional duties owed to the client. The broker-dealer has an obligation to approve the use of the product in question, the recommendation must be suitable for the client's specific situation, sales materials and correspondence are reviewed by a firm principal and each transaction is subject to principal review.

[8] "Beyond Illustrations – The Importance of Contract Language", Thomas R. Love, Journal of Financial Services Professionals, July 2017, "The Elephant in the Room", Lawrence J. Rybka, March 2017.

[9] 11 N.Y.C.R.R. § 224.0(c).

[10] "DFS Issues Final Life Insurance and Annuity Suitability and Best Interests Regulation Protecting Consumers From Conflicts of Interest" [Press Release], Richard Loconte, Department of Financial Services (July 18, 2018). Retrieved from https://www.dfs.ny.gov/about/press/pr1807181.htm

[11] "NAIFA Files Second Lawsuit Against NY Best-Interest Rule", John Hilton, insurancenewsnet.com, November 26, 2018. Retrieved from https://insurancenewsnet.com/innarticle/naifa-files-second-lawsuit-against-ny-best-interest-rule#.XKX5G_ZFw2w

[12] Other insurance departments are considering similar standards and the Maryland Senate is considering a bill that would create a fiduciary standard for life insurance and other products in that state. Nevada and New Jersey have pending regulations that would impose fiduciary standards on some additional financial transactions.

[13] 11 N.Y.C.R.R. § 224.4(c).

[14] 11 N.Y.C.R.R. § 224.3(g).

[15] 11 N.Y.C.R.R. § 224.3(h).

[16] 11 N.Y.C.R.R. §§ 224.4(b)(3)(i) and 224.5(b)(2).

[17] 11 N.Y.C.R.R. § 224.4(i).

[18] 11 N.Y.C.R.R. § 224.6(a).

[19] 11 N.Y.C.R.R. § 224.8.

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