

Steve Leimberg's Financial Products Planning Email Newsletter Archive Message #7

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Subject: Richard Weber - Are You in Good Hands?

“Recent regulations intended to moderate the calculation and display of non-guaranteed benefits projected in IUL policy illustrations have largely backfired, inspiring what objectively appears as unachievable promises of future performance. How should insurance and non-insurance professionals react and respond? This newsletter goes beyond just the potential for misusing policy illustrations and delves into the suitability and fiduciary issues of serving a client’s best interest.”

Richard Weber provides members with important commentary that examines the suitability and fiduciary issues of serving a client’s best interest that can arise when evaluating life insurance policies.

Richard Weber, MBA, CLU, AEP, is President and primary consultant for **The Ethical Edge, Inc.**, providing fee-only insurance analytics and consulting services to family offices and high net worth individuals. Dick holds an M.B.A. from the Haas School of Business at the University of California at Berkeley with a specialty in Insurance and Finance. He was designated a Chartered Life Underwriter in 1974 by the American College. Among his various teaching activities, Dick served for 11 years as an Instructor of Insurance at the University of California at Berkeley's Program in Personal Financial Planning and from 1993 through 1998 served as Adjunct Professor of Ethics at the American College in Bryn Mawr, Pa. He currently serves as Senior Adjunct Professor of Risk and Insurance in California Lutheran University’s MBA program and is on the faculty at Texas Tech University’s Personal Financial Planning degree program.

Life Insurance as an Asset Class - A Value-added Component of an Asset Allocation was co-written with Christopher Hause, FSA, MAAA, - and was honored with a 2008 Best Paper Award from the Academy of Financial Services. Hause and Weber published a second volume in the Asset Class series - “Managing a Valuable Asset” - in 2010. Dick Weber was the Society of Financial Service Professional’s Kenneth Black, Jr. Leadership

Award recipient for 2008 in recognition of his "... exemplary leadership qualities and significant contributions to the fulfillment of the Society's core values of ethic, education, and relationships."

In 2009, Dick was elected to the NAEPC Estate Planning Hall of Fame and selected to receive the Distinguished Accredited Estate Planner award and designation for "... significant and outstanding lifetime achievements and contributions to the practice and profession of estate planning." In 2012, Dick served as national President of the Society of Financial Service Professionals.

Here is his commentary:

EXECUTIVE SUMMARY:

Long associated within the financial practitioner community for addressing and attempting to overcome policy illustration abuse, Dick Weber began his decades-long exploration of these issues when assuming the Chair of the Society of Financial Service Professionals (FSP)'s *Illustration Questionnaire* (IQ) Committee. IQ emphasizes that the "illustration is not the policy," and educates its members about the responsible use of policy illustrations. Yet Indexed Universal life insurance (IUL) products have created new challenges for professionals seeking to apply a customer-focused standard of care to their recommendations for policies designed for a lifetime. IUL is most often characterized as giving owners the best of both worlds by offering investment upside potential, a minimum guaranteed growth feature and underlying life insurance protection. These features, along with the (largely incorrect) slogan "Zero is the Hero" has made IUL the fastest growing permanent life insurance product of the past decade.

Recent regulations intended to moderate the calculation and display of non-guaranteed benefits projected in IUL policy illustrations have largely backfired, inspiring what objectively appears as unachievable promises of future performance. How should insurance and non-insurance professionals react and respond? This newsletter goes beyond just the potential for misusing policy illustrations and delves into the suitability and fiduciary issues of serving a client's best interest.

COMMENT:

Let's open the discussion with an example. Indexed Universal Life products introduced into the marketplace in the last few years are *off the rails* relative to illustration regulations. Policy illustrations are ideally supposed to differentiate that which is guaranteed from non-guaranteed - and to demonstrate with a set of assumptions (highly unlikely to mimic in reality) about how the policy works. But when a prominently displayed 5.76% illustrated crediting rate somehow is leveraged into illustrated account values that actually increase at a rate of 14% or more starting in the second year - the issue isn't so much "who has the best policy?" The real issue is "... are you kidding me?!"

The intention of this narrative is to draw the attention of insurance professionals as well as those who are often financial gatekeepers to the acquisition, management, or disposition of policies - non-insurance professionals, including Certified Financial Planners (CFP®), attorneys, investment managers, and CPAs.

Processes and Procedures

Consider the premise that when suitability and fiduciary processes and procedures are being followed - illustrations shouldn't even be necessary! This should almost always be true if the agent/advisor starts with a credible suitability process rather than the 50+ pages of streaming numbers often incomprehensible to the client. While the NAIC's 1995 Model Illustration Regulation - as enacted by each State legislature - requires a signed illustration no later than delivery of the policy, ideally the signature on the illustration should simply be an acknowledgment of a *process* leading the client to an appropriate selection of policy style and funding levels that meet her needs. It is an entirely different conversation than "my numbers are better than their numbers!"

New York Department of Financial Services' *Regulation 187* will shortly put into effect a "best interest" requirement on all agents selling insurance in the state. And an apparently infrequently enforced "agent is a fiduciary" requirement has existed for a number of years in nearby New Jersey. But can you hold an insurance license in New York - and sell a policy to a client living in Connecticut - with a different standard of care than will be imposed in New York effective August 1, 2019 for annuities and the following February for life insurance? It's an inherent violation of the concept of

fiduciary (and the underlying “client’s interest above my own”) to follow one standard of care because it’s required in New York or New Jersey, but a lesser standard in jurisdictions not yet enlightened by a focus on the client. And of course, there are other ways to be held to this high standard than just jurisdictional regulation. For example, CFP® certificants - as well as credentialed members of the Society of Financial Service Professionals (FSP) - have a membership-imposed commitment to integrity and “client’s interest above my own,” regardless of the advice or products they provide their clients - and regardless of how they get paid for their recommendations. For these professionals, it doesn’t matter where they live or what they sell or the advice they give. Professionals must adhere to the standard. FSP’s professional pledge states “... in all my professional dealings, I pledge myself to the following rule of ethical conduct: I shall, in the light of all conditions surrounding those I serve, which I shall make every conscientious effort to ascertain and understand, render that service which, in the same circumstances, I would apply to myself.”¹ It’s a practical expression of client’s best interest.

The CFP Board of Standards will begin enforcing a heightened fiduciary standard on its members, effective October 1, 2019. Its rules are enhanced beyond the original 2008 standards in the following manner:

- The fiduciary standard applies to all advice - not just planning advice;
- To the extent there’s a material conflict of interest (e.g., the receipt of commissions), the certificant must make full disclosure and obtain the consent of the client before providing any financial advice regarding which there is a material conflict of interest.
- Where appropriate, the certificant must consider and analyze one or more potential alternative courses of action, including the material advantages and disadvantages of each alternative, whether each alternative helps maximize the potential for meeting the Client’s goals, and how each alternative integrates the relevant elements of the Client’s personal and financial circumstances.²

This poses a significant challenge for Registered Investment Advisor firms promoting themselves as providing broad planning advice, but which may have limited expertise to delve into risk management and insurance advice (and possibly) products - appropriately and in the client’s best interest.

It All Starts with *Suitability*

It would seem inconsistent with a standard calling for a “client’s interest before my own” for an agent to merely present an illustration of non-guaranteed returns on behalf of an indexed universal life insurance policy without knowing the client’s tolerance for risk inherent in those non-guaranteed elements. It would similarly be inconsistent for the agent to not thoroughly understand the policy and its risks.

For example, unless addressed and determined before considering the type of policy to propose, the “client’s interest before my own” cannot be served with many of today’s complex and largely non-guaranteed insurance products if it turns out her natural inclination is to avoid risk and places importance on “... a return of my money before considerations of a return *on* my money.” Yet in many instances, the prospective client may receive an aggressively illustrated proposal with little disclosure other than the proverbial “your mileage may vary” to inform the client there might be inherent risks associated with the proposed policy. The dilemma, of course, is that since indexed policies are not considered a security and the sale technically not subject to Financial Regulatory Authority’s (FINRA) suitability admonition to its Broker-Dealer members (and in turn to its Registered Representatives), there is no outright regulation directing the agent’s recommendation and subsequent sale to be suitable.

FINRA Rule 2111 states that firms and their associated personnel “must have a reasonable basis to believe that a transaction or investment strategy involving securities they recommend is suitable for the customer. This reasonable belief must be based on the information obtained through the reasonable diligence of the firm or associated person to ascertain the customer’s investment profile. The rule requires firms and associated persons to seek to obtain information about the customer’s ...

- age;
- other investments;
- financial situation and needs, which might include questions about annual income and liquid net worth;
- tax status, such as marginal tax rate;

- investment objectives, which might include generating income, funding retirement, buying a home, preserving wealth or market speculation;
- investment experience;
- investment time horizon, such as the expected time available to achieve a particular financial goal;
- liquidity needs, which is the customer's need to convert investments to cash without incurring significant loss in value; and
- risk tolerance, which is a customer's willingness to risk losing some or all of the original investment in exchange for greater potential returns.”³

In the securities world, this information is supposed to lead to a reasonably appropriate (i.e. suitable) product recommendation.

“Mapping” the Client’s Risk Tolerance to Policies

Chief among the suitability factors as it relates to a long-term investment in life insurance should be the client's risk tolerance. Delineated into the classic labels of conservative, balanced, and aggressive, we can imagine risk tolerance statements related to the purchase of a life insurance policy being “mapped” or correlated to certain types of policies:

- “I’m intolerant of volatility and seek guarantees” is indicative of a conservative risk tolerance that can readily be mapped to policies that are guaranteed - such as **whole life**, **guaranteed death benefit universal life**, and even **term life** insurance for its initial guaranteed timeframe.

- or -

- “I’m tolerant of modest volatility and willing to accept fewer guarantees in favor of *premium payment flexibility*” indicates a more balanced approach in the context of paying for life insurance and would be the classic statement in favor of simple **universal life**. In this style of UL, the insurance company provides a minimum guaranteed crediting rate and, when possible and at its discretion, may credit to the policy a rate that is higher than its guarantees.

- or -

- “I’m tolerant of volatility and willing to do without guarantees in favor of *premium investment opportunity*” is indicative of an aggressive risk tolerance - and could map to the suitability of **variable life** insurance, in which the policy owner has the right and the obligation to determine how her premiums will be invested amongst an array of proprietary as well as institutionally offered mutual fund-like sub-accounts.

- or -

- “I’m intolerant of volatility but drawn to the idea of an *upside opportunity with no downside risk*.” This somewhat convoluted risk statement best applies to the newest (and currently most popular) form of universal life - **Indexed universal life**. In contrast to the classic risk tolerance category of “aggressive” in terms of comfort with risk, I (somewhat tongue-in-cheek) refer to the risk tolerance associated with Index UL as Passive Aggressive. To the initial confusion of all but the most experienced investor, these policies are extremely complex, yet offer the seemingly simple assurance of upside opportunity when referenced stock market indices are positive, with no downside risk when indices are negative. Yet it is generally not well understood that ongoing policy expenses exert downward pressure on the account value. This is most dramatically demonstrated in newer IUL policies, which typically assess significantly higher expenses that in turn diminish account values when the index credit is low or “0” when reflecting negative returns in the measured index.

What approach to recommendations amongst an array of these policy choices could be more sensible than correlating risk tolerance to an initial consideration of policy style? While financial planners normally recommend the customized allocation of resources in a portfolio of investment categories by addressing their client’s *conservative, balanced,* or *aggressive* risk tolerance, it is rarely seen in the life insurance sales process.

Consideration of Risk Tolerance Within Policy Types

There are further considerations of risk that might not be obvious within each category of insurance policy and the client's assessed risk tolerance:

1. **Whole Life (Conservative):** premiums, cash value, and death benefits are guaranteed, and cash values "lock in" as soon as they are credited. Dividends are not guaranteed until paid. Premiums are not flexible and in order to receive the substantial guarantees of the policy, the premium must be paid every year.
2. **Guaranteed Death Benefit Universal Life (Conservative):** while these policies typically develop little or no long-term cash value, premiums and death benefits are guaranteed as long as all scheduled premiums are paid on time. While both whole life and guaranteed death benefit policies have the advantage of requiring little or no active management, it must be pointed out there is a minimum premium indicated that guarantees (if paid timely) continuing coverage to a specific age such as 95, 100, even 110 or older. It is possible to change the paid premium once the policy is in effect, but that will almost certainly change the duration of the no-lapse guarantee. Still, the client has flexibility to some extent to pay more or less than the scheduled "no lapse" premium, which in most recently issued policies will accordingly drive the no-lapse age up or down.
3. **Universal Life (Balanced):** the insured with this risk style accepts policy elements that are not guaranteed, and buyers should be made aware that policy illustrations cannot reasonably predict ongoing planned premiums, potential cash value accumulation, or future policy loans - for more than a year or two at a time. As stated by the Society of Actuaries, "Most illustration problems arise because illustrations create the illusion that the insurance company knows what will happen in the future, and that knowledge has been used to create the illustration."⁴

Hence, unlike policies whose main elements are guaranteed for the life of the policy, there is inherent risk in universal life policies in exchange for payment and timing flexibility. For traditional universal life, the major risk arises due to the initially illustrated planned premium turning out to be insufficient to maintain the policy over the insured's lifetime because anticipated crediting rates are not realized and/or policy expenses are raised higher than assumed in the original sales illustration.

4. **Variable Universal Life** (Aggressive/Very Aggressive): similarly, individuals with this risk style accept policy elements that are not guaranteed, and for which there are *no* guarantees as to cash value accumulation. This is the one form of universal life in which the policy owner has both the privilege and the obligation to choose from mutual fund-like sub-accounts and inform the insurance company how she wants her premium payments “invested” across a wide spectrum of returns - from guaranteed to aggressive. Yet, variable policies are not - as many critics have suggested - inherently risky. Sub-accounts may be deployed as an expression of the buyer’s risk tolerance and materialize into a sophisticated asset allocation appropriate to that buyer. Again, those for whom variable policies are suitable should be made aware that policy illustrations cannot reasonably predict ongoing planned premiums, potential cash value accumulation, or future policy loans for more than a year or two at a time.

Similar to its traditional UL cousins, there is inherent risk in the variable form of universal life. But because there is no floor to the crediting rate of the policy (i.e. when sub-account values are “down” - the crediting rate is negative), VUL policies will not likely cover a normal life expectancy for which the initial planned premium was calculated at (constant) rates of return in excess of 7%. Yet federal regulation of such policies allows projection rates as high as 12% and there is no practical impediment to the agent/Registered Representative using such a high assumed crediting rate with which to correspondingly project a low planned premium. This is unfortunately consistent with the insurance purchasing paradigm emerging from early universal life sales in which PRICE (planned premiums driven down by the assumption of high initial crediting rates persisting forever) became the sole determinant of VALUE.

It bears mentioning there can be a significant disconnect between the assumed crediting rate in the VUL sales illustration (projecting a constant 8% or 10% or 12%) and the returns in the sub-accounts designated by the policy owner that are *actually* deployed on behalf of the policy. A best practice approach to illustrating VUL is to address in advance the risk tolerance/asset allocation issues *before* any attempt to run a sales illustration, and of course the assumed crediting rate in the illustrated sales illustration must reflect a reasonable expected return from the assumed allocation. Further, as it is likely the insured’s risk

tolerances will change as he/she grows older, it is equally important to *manage* the VUL policy as to asset allocation adjustments and, in turn, an assessment of the need to increase the planned premium to compensate for a lower return expectation from less volatile (but reduced return) sub-accounts.

As with all forms of universal life, insurers may assess policy expenses that are higher than assumed in the original sales illustration, creating an additional impact on illustration expectations.

5. **Indexed Universal Life** (Passive Aggressive): especially as to a recent, second “generation” of product development within indexed UL policies, there is a high likelihood that illustrated projections cannot be met with respect to planned premiums, accumulated cash value, and the potential for large, illustrated cash value loans to supplement retirement income. Future imposition of policy expenses greater than implied in the sales illustration - and adverse movements in future index crediting rates, participation rates and caps - are also an element of uncertainty.

Additionally, there is a great deal of complexity beneath the surface of IUL in how these policies are managed by the issuing insurance company. The insurer deploys hedging techniques to enable a “capped” crediting rate of 10 or 11% in an “up” stock market year, yet the investments underlying the policy’s guarantees are not in stocks, but rather in high grade bonds and mortgages. Also, there is an almost total conceptual disconnect between the simplicity of the illustrated promise of “zero is the hero” (reflecting the guarantee that the crediting rate will not be less than 0%), and the amount of risk the buyer is taking to achieve the illustrated result. Net surrender values *can* be negative even when the segment credit is 0% because expenses will *always* be subtracted from account values, and enhancements and/or multipliers may also have specific expense that will be subtracted from account values regardless of the segment’s crediting rate.

As is the case for all styles of universal life, it is important to assess the client’s risk tolerance when it comes to selecting a *funding* level. Because the dominant benefit of universal life is “pay what you want / when you want,” we must also assess the client’s level of discipline when it comes to the discretion of paying flexible premiums. This is different from risk tolerance as to the basis on which policy credits will

be earned, but the ability to commit to a specific planned premium is equally critical to the successful management of life insurance for its ultimate objective of death benefit and/or future cash flow from the policy.

The Second Generation of Indexed Policies

These new policies add to an already financially complex design wherein an insurance company continues to invest in high quality, fixed return assets to meet its obligations, yet credits equity-like returns of 10% or more in a favorable 365-day period of the measured index. To accomplish this, a variety of enhancers and/or multipliers are deployed by “doubling down” on the insurer’s options budget. The hoped-for favorable results of this investment strategy are in turn optimistically (and constantly) reflected within the complex calculations underlying the sales illustration. Yet, *these factors are almost entirely subject to the insurance company’s discretion*, notwithstanding a minimum guaranteed multiplier of 1.0. Current illustrations indicate the use of seemingly conservative illustration crediting rates (often less than 6% as a reflection of an historic annual average of the 1-year S&P500 Index) - and yet in at least one example, an analysis of account value growth reflects a year-after-year increase of 14% beginning as soon as the second year. These policies are “Not your Mother’s Oldsmobile!” Further, are clients sophisticated enough to even marginally understand what is going on under the hood?

The potential for substantially increased returns are not “free,” and in fact may represent a significant cost to the policy owner, and certainly represent additional risk that neither the agent nor the policyholder has any means by which to estimate or evaluate. In one popular version of enhanced IUL policies, the total expenses charged in the first 20 years significantly exceed the total planned premium paid. The typical illustration does *not* break out the expense factors (or if an expense detail is available, it is an optional report rarely chosen by the agent) and instead are disguised by the illustrated 14% increases in value each year. Yet those expenses will be charged regardless of the applied index-driven crediting rate, and crediting rates may be little or none during periods of market declines or significant volatility.

While there certainly exists a wide range of options and policies responding to a consumer’s specific risk tolerance, in my opinion the use of enhanced

options to inflate (non-guaranteed) illustrated results is unacceptably aggressive and likely to fail. I am *not* suggesting these are bad policies or bad design, and there may well be a relatively small number of insurance buyers whose risk tolerance is a good match. But because of the highly technical basis on which the policies are designed - and the fact that they can be sold by agents and brokers who are neither skilled nor *licensed* to discuss or sell securities - the typical buyer may be hard-pressed to understand the degree of risk taken when choosing such policies based on the illustrations and whatever representation is made by the agent. Again, I am not suggesting the typical IUL policy will fail, but that it may not achieve the anticipated outcome (demonstrated herein in Appendix A under certain economic scenarios) - which outcome, in most cases, is based on a projection of substantial, tax-free policy loans taken by the policy owner for many years in retirement.

Analysis of Illustrations for Current Generation IUL Policies

Because policy illustrations assume a constant crediting rate to compute account values after expenses have been debited, and to more specifically illustrate the concern over unfulfilled expectations, the analysis in Appendix A examines the current projected premiums and retirement cash value loans under two simple scenarios of a constant 6% return and a constant 4% return. Neither scenario can possibly be predictive because sequences of returns will dictate the actual outcome, but it provides a first-tier assessment of “what ifs” that can practically inform the buyer of what happens if year-by-year returns are less than optimistically projected.

For the analysis in the appendix, we selected 12 of the most popular policies currently being sold in the current generation of enhanced IUL policies. We assume a 45-year-old male, Preferred Nonsmoker, paying \$25,000 annually for 20 years. The illustration goes on to “solve” for maximum annual policy loans beginning at age 65 and taken for the next 20 years - through age 84. The illustration specifications target \$100,000 of account value at age 121 and then calculate the minimum possible death benefits to avoid taxable events with an increasing death benefit to age 65 - leveled thereafter.

Our conclusion for these 12 enhanced IUL policies is that, as seen in Appendix A, “Product A” and “Product B” – with the appearance of

substantially greater retirement cash flow benefits than most of its “peers” at or near 6% – do not “perform” nearly as effectively as their peers when the crediting rate is reduced to 4%. The retirement policy loan expectations in today’s sales illustrations calculated at a constant rate at or near 6% are unlikely to be achieved. Will the average ultimately be 5.5%? Or 5%? Or 4.5%? We don’t know, and it is difficult to perform our customary volatility testing because the real driver of illustrated performance is *not* the crediting rate (for which we could make volatility models), but rather the multipliers and enhancers that are in the sole control of the insurance company.

Note that in contrast to VUL where the market is in control of the returns, the non-guaranteed multipliers, enhancers, participation rates and caps are all controlled by the insurance company on behalf of second generation IUL. Indeed, the behavior of the index is almost secondary to the degree of the insurance company’s ability to manage these policies to achieve its profit margins regardless of varying market conditions.

Because IUL is often sold for its presumed tax-free policy loan benefits beginning at retirement (or some other date in the future), it is important to point out that if the policy is not able to provide the amount of cash flow via policy loan - for the length of time suggested by the sales illustration - it is possible the policy could lapse for insufficient account value to maintain the expenses of the policy until death of the insured. Current tax law requires any gain over basis in the policy to be subject to ordinary income tax in the year the lapse occurs - and the calculation of basis is reduced by the amount of the prior cash value loans (and accrued interest). In the referenced analysis, if Product Illustration “A’s” illustrated cash value loan of \$100,193 is processed year after year with no regard to *actual* year-to-year account credits and its effect on net account values, the policy could lapse prior to death and the resulting tax impact could be significant. We also have to consider how unlikely it will be the retiring – or retired – policy owner would have any way of knowing until a lapse is imminent the policy may be “out of whack” and their retirement plan is in peril. And then what? “Who do I sue?!”

We note that recent IUL policies often contain “Overloan Protection Riders” that attempt to eliminate the problem of tax recapture by preventing the lapse in the first place. This is accomplished - when very specific and not necessarily easy-to-meet conditions are met - by essentially transforming

the policy into a “reduced paid-up” policy with no further premiums or loans - thereby fending off the lapse. However, as a typical policy illustration warns, “... The potential tax consequences of the Overloan Protection Rider have not specifically been ruled on by the IRS or the courts. Consult your tax adviser.” The issue addressed here is that the reduction of the death benefit to accommodate the remaining account value and sustain the policy until death could be deemed an elimination of debt (the cumulative policy loans plus accrued interest), and such debt forgiveness could be construed as taxable income. Proceed at your own risk! But don’t expect the typical financial or tax advisor to be particularly knowledgeable or very comfortable about how this technical tax issue will eventually be resolved. And, even if the Overloan Protection Rider is activated, it does not fulfill the expectations of a much higher level of cash value loans in the face of possible meager-to-middling account value performance.

It’s Time to Consider the *Fiduciary Overlay to Suitability*

All client-focused processes must start with suitability. But what is the “value add” of the *fiduciary* standard of care over that of suitability? Let’s consider the commonly agreed upon elements of the fiduciary duty:

1. Put the client’s best interest ahead of your own;
2. Act with prudence; that is, with the skill, care, diligence, and good judgment of a professional;
3. Do not mislead clients; provide conspicuous, full, and fair disclosure of all important facts;
4. Avoid conflicts of interest;
5. Fully disclose and fairly manage, in the client’s favor, any unavoidable conflicts.

Clearly the *client’s interest above my own* standard enhances the underlying suitability standard. In the most practical assessments of the “value add” of fiduciary, an assessment of suitable options does not specifically require the non-fiduciary advisor to be skilled or diligent or to exercise good judgment. As long as the presented options are suitable, the disclosure of commissions is rarely required (yet is a defined *conflict of*

interest in consideration of fiduciary duties), and disclosure of many forms of conflicts of interest in general are not required of the suitability standard. A purely dispassionate “robo” process might mechanically calculate and display suitable options, but it still takes someone to provide context and help the client make choices and decisions they can subsequently self-proclaim were in their best interest. In fact, the evolution from salesperson to fiduciary is one we might describe as becoming “... an expert facilitator of decision making” on behalf of their client - otherwise known as the ideal financial professional. We call her *Advisor 2.0*.

The common law definition of *profession* is an occupation, such as law or medicine (or financial services), that:

1. encompasses a body of knowledge beyond the common understanding of the general public;
2. requires considerable training or specialized study to master;
3. has a competency examination or some other barrier to entry into the profession ...
4. ... which is maintained by a self-regulating guild or society that ...
5. ... imposes a code of ethics on the members of the profession obligating them to take action which is in the best interest of those they serve in their professional capacity.⁵

We observe most consumers have an innate expectation their financial professional will naturally interact with them as a fiduciary. Thus, the financial professional who takes “... action which is in the best interest of those they serve in their professional capacity” *should be* synonymous with the intent, spirit, and execution of a fiduciary.

Tools for the Financial Professional Addressing Risk and Insurance as a *Fiduciary*

When it comes to assessing a client’s need for life (and disability and annuities and long-term care) insurance, many non-insurance financial professionals are at a disadvantage with respect to addressing those

needs. While fully accustomed to translating a client's risk tolerance into a recommendation of portfolio options via an Investment Policy Statement, there is only a haphazard toolkit of processes for the financial professional to address the client's five key questions/issues about the aforementioned products sold by life insurance companies - but here focused on life insurance:

1. How *much* life insurance do I need?
2. For how *long* will I need it?
3. What *kind* of policy would be in my best interest?
4. What's the *best price* to pay for it - I don't want to pay more than I have to!
5. With *which insurance company* should I make this commitment?

Taking these one at a time, we can start considering and assessing “**how much do I need**” from the standpoint of its purpose. Throughout most of the 260-year history of the life insurance industry in America,⁶ the purpose of life insurance has been to replace the lost income and financial support of a breadwinner. Solomon S. Huebner, Professor of Insurance at the Wharton School of the University of Pennsylvania and founder of the American College in 1926, believed that “... because an individual has the ability to create economic wealth and because his life has value in relation to other lives, ... the individual has a ‘sacred duty’ to provide for his dependents in the event of his death or incapacitation.”⁷ Life insurance and disability insurance are the only financial assets that can immediately and completely fulfill that sacred duty, and there are any number of calculators available to advisors that can address “how much” life insurance.

There are two main schools of thought for determining “how much:” 1) *Needs Analysis* focuses on helping the family to continue to manage their ongoing need to meet the normal expenses of living (and not to overlook such mundane but necessary consideration of children's allowances and the occasional family vacation); or 2) *Human Life Value* places a value on the future ability of the breadwinner to earn her or his lifetime income and simply replaces that value with life insurance death benefit. Each approach has its advocates and appropriate use in responding to “... how much do I need?”

However, a much more recent orientation *away* from the need for death benefit has emerged in a focus on the income tax-free nature of cash value

accumulation and the consideration of policy loans as inherently tax-free. The only requirement to assure the tax advantages are not *recaptured* - as previously described in terms of “overloan” protection - is for the policy to remain in effect until the insured dies. Therefore, one of the factors that should be determined within “how much do I *need*?” is the follow-up question “what’s the *purpose* of this inquiry into life insurance?”

Addressing “**how long will I need it**” requires an unbiased perspective. Agents and advisors will probably have a different view of the amount, length of the client’s need - and appropriate type of life insurance - to fulfill the need. Agents generally get paid by commissions on the sale, typically as a percentage of the premium paid in the first few years, and a logical resource for those premiums may come from an investment portfolio. Financial/Investment Advisors often get paid on the basis of assets under management (AUM) and there could be a concern about an outflow of premium dollars from AUM accounts on behalf of a life insurance policy. Obviously, the issues discussed herein must be addressed from the client’s standpoint and not the self-interest of agents or advisors.

Closely tied together are the considerations of “**how long will I need it?**” and “**what kind of policy is best for me?**” In most instances of a short-term protection need (i.e. 20 or fewer years), term life insurance will be the most appropriate type of policy. Such uses include insuring for outstanding mortgage durations, loan guarantees, and “until the kids are out of the house.” Longer needs for life insurance - typically spanning a lifetime - require a different type of policy than term, since term is neither mathematically nor actuarially designed to be affordable for a lifetime that reaches to or beyond “average life expectancy.” The section in these remarks associating policies designed for a lifetime with risk tolerance will be a useful guide in exploring “what kind is best for *me*?”

“**What’s the *best price* to pay for it - I don’t want to pay more than I have to!**” Consider the essential premise of *any* kind of insurance: a means through which the financial consequences of a future loss can today be shifted to a financial entity with a broad enough base of similar risks to set a reasonable premium in exchange for a promise to reimburse – under the terms of the policy and elected features - a covered loss. In so doing, insurance brings peace of mind for having the coverage, whether as “good neighbors” or in “good hands.” It’s called risk shifting and it is a vital part of modern life, without which most commerce would quickly grind to a halt.

First referred to as “indeterminate premium” policies (but quickly re-labeled “universal life”) when introduced in the late 1970s policies, most universal life policies essentially shift the risk from the insurance company *back to the policyholder* through the appeal of a low initial premium based on optimistic assumptions for timeframes far in the future – with the insurer’s right to come back and ask for more money to continue to sustain the death benefit. And sometimes it comes back for a *lot* more money. Few consumers are as risk tolerant as this explicit explanation would suggest, and yet that’s exactly what they’re buying into.

I have no problem with the different variations of universal life - except when the buyer doesn’t understand the fundamental fact they have accepted the appearance of a lower *current* price in lieu of a higher *guaranteed* price - in exchange for the insurance company’s right to increase the cost in the future. When the reality hits home, the policy owner is typically surprised, upset, and litigious when receiving a “five-figure” demand from the insurance company because their illustrated and expected premium is no longer sufficient to sustain the policy. This is perhaps the most controversial aspect of buying life insurance, because the majority of policies designed for a lifetime are actually some form of indeterminate premium universal life, with a substantial shift of the risk back to the policy owner whether the policy will “pay off.”

Twenty years ago, actuary Chris Hause and I began seeking a better way to appreciate the difference between a policy illustration calculated with a constant return assumption - and one using stochastic analysis⁸ to infer a *probability of success*. Members of the Society of Financial Service Professionals (FSP) have had exclusive use through their member benefits of a calculator that will estimate such a probability of success based on the illustrated assumptions of variable universal or first generation indexed universal life illustration. However, as useful as stochastic analysis may be, the newer generation of indexed policies utilizing enhancers and/or multipliers defies conventional volatility testing.

Regardless of the assumptions made regarding planned premium calculation, when the buyer asks “how much is it gonna cost” regarding a product recommendation that includes universal life, our answer is speculative at best, and a fiduciary standard of care compels a thorough discussion with the client to make certain she understands the

opportunities and the risks. To be clear, there is a place for flexible premium/universal life-type policies. But without comparisons such as the 6% / 4% demonstration - *and a year-by-year schedule of projected policy expenses* - the policy owner is almost always going to be disappointed between the reality and the illustrated expectation, especially if pursuing the popular pricing paradigm of “lowest price *wins*.”

As to “**with which insurance company should I make this commitment?**” The buyer who recognizes he is buying a promise that he hopes won’t need to be kept for another 30 - 40 - 50 - 60 or more years will want to pause and consider the financial and service reputation of the company making the promise. While it is not within the scope of this narrative to delve into financial strength issues of the insurance industry, it is certainly advisable to request financial strength ratings and to read at least the summary of what those ratings imply.

The fiduciary’s consideration of *buying* life insurance So far, the focus has been on the suitability of the sale of life insurance with the possible overlay of a standard requiring client’ interest above that of the licensed agent or advisor. But there is a category of *buyer* of life insurance who in almost all instances will be considered to have a fiduciary duty - to the beneficiaries of trusts established for their benefit and for which the trustee has a significant obligation of care with respect to those beneficiaries. What are the considerations of a fiduciary duty when it comes to buying life insurance (typically) on the life of the grantor - for the benefit of the trust’s beneficiaries? The following are suggested best practices:

- Acquire a policy (or policies) that are suitable and appropriate for the resources of the trust - typically through annual cash gifts with which the trustee may pay premiums - as well as being suitable to the risk tolerance most appropriate for the benefit of the beneficiaries. Time horizon will be an important suitability factor;
- For policies that don’t have guaranteed pricing, avoid “best price” attraction and instead focus on the planned premium necessary to have a high likelihood of sustaining the policy for the insured’s entire life, with a generous eye toward longevity;

- Diversity: when the total death benefit need exceeds \$5 - \$10 million, consideration should be given to a diversity of insurance carrier and policy style;
- Ongoing management: few personal trustees have the natural skill to manage some of the more sophisticated life insurance policies available in the marketplace. The trustee will want to perform a periodic review of the policy and of the issuing insurance company, and will often need to enlist the services of the insurance agent and/or an advisor who is specifically skilled in such management;
- Periodic review of options: does the life insurance policy asset continue to serve the best interest of the beneficiaries? If the estate tax exemption now exceeds the purpose of the insurance in the first place, should the policy be continued? What are the disposition options - including the possibility of a life settlement - that would be expected of a fiduciary in this situation?

When They're Running You Out of Town, Get at the Head of the Line and Make It Look Like a Parade!

The financial services industry has been confronted with on-and-off pressures to upgrade to the level of a fiduciary the standards of care between advisor/agent and consumer. Few know what that means. In fact, in 2015 when the Department of Labor issued its tentative rules regarding the duties required of any advisor offering advice or products for retirement plans (including IRA and Roth), it was widely assumed by some to be the end of the insurance industry as we know it. "Fiduciary means I can't earn a commission!" Or "Fiduciary means I must sell the 'best' policy - and how do I keep track of the thousands of products that are out there?" Or "I work for a company with a limited number of life insurance products, and I cannot sell away." How will I make a living?" All of these concerns turned out to be a misunderstanding of what it really means to put the client's interest above that of the advisor/agent. Earning a commission is not specifically contrary to a fiduciary standard; the method and amount simply must be disclosed. And obviously there's no such thing as a "best" product in virtually any industry. And, once again, disclosure "cures" the problem of limited product availability.⁹

When the U.S. Court of Appeals for the 5th Circuit vacated the DOL fiduciary rules in March 2018, many agents were relieved and expected to return to “business as usual.” But not the Certified Financial Planners®, and not the multi-disciplinary professionals belonging to the Society of FSP. These professionals have long adopted their own higher standards of care, and more states have entered the fray with new or existing rules (New York, Nevada, and New Jersey) with other jurisdictions such as Massachusetts introducing legislation on behalf of “best interest” requirements between agents and their clients. The SEC and FINRA are also expected to throw their regulatory hats into the ring as well, and the one great concern is that there will be a hodgepodge of inconsistent rules that could inspire endless litigation.

It doesn't have to be this complicated. Put the client's interest first. Use suitability considerations to develop two or three insurance options that are consistent with the client's needs, resources, time horizons and risk tolerance - and learn to become an expert facilitator of decision making so the client can ultimately point to what *she* knows to be in her best interest. And as a result, a “best price/best outcome” policy illustration will have had a very small role – if any - in the decision about “what's the best policy *for me?*”

Appendix A

The following analysis assumes a 45-year-old male, Preferred Nonsmoker, paying \$25,000 annually for 20 years. The illustration goes on to “solve” for maximum annual policy loans beginning at age 65 and taken for the next 20 years - through age 84. The illustration specifications target \$100,000 of account value at age 121 and then calculate the minimum possible death benefits to avoid taxable events with an increasing death benefit to age 65 - leveled thereafter.

IUL Illustration Results at 6% (or Current Maximum Rate if Less than 6%) Ranked with Illustrated Retirement Cash Flow Expectation

Product	Assumed 6% Illustration
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<u>Illustration</u> <u>policy loans</u>	<u>Rate - or rate noted here</u>	<u>Assumed Age 65</u>
A		\$100,193
B	5.76%	\$ 90,839
C		\$ 89,047
D		\$ 79,476
E	5.76%	\$ 78,024
F		\$ 76,212
G		\$ 75,662
H		\$ 75,511
I		\$ 74,772
J		\$ 72,830
K		\$ 71,564
L		\$ 70,120

Caution: these numbers derive from illustrations and are not a promise or even a prediction. *We cannot assume these numbers will actually come true!* It is unfortunate that some producers act as if the numbers are going to be true (or at least their relative order will be true when answering the question “who has the best policy?”). The producers selling Product A may be excited for having the hottest product on the street, but “it ain’t necessarily so,” and indeed the likelihood is extremely small. As soon as the reality of sequence of returns sets in - and if/when caps continue to decline - the perceived promises will change. Is it only downhill? Could the numbers in these illustrations turn out to be as good or better? Perhaps, but our 20 years of volatility assessing non-guaranteed illustrated results points to a low probability of “better” in policies with underlying volatile elements.

Further, notwithstanding the 30% difference in projected retirement cash value loans, it should not be inferred that the policy behind Illustration A is inherently superior to that of Illustration L. No two illustrated policies are designed or managed exactly the same. As is true with illustrations in general, the information contained in this analysis is a simple “what if” between 6% and 4% calculation rates *only* as it relates to the *same* product being illustrated for the purpose of revealing calculated effectiveness at two different crediting rate assumptions. When we recalculate results at 4%

(the only parameter changed in each illustration), we get some interesting changes:

IUL Illustration Results Ranked with Illustrated Retirement Cash Flow Expectation

<u>Product Illustration Change</u>	<u>4% Recalculation Assumed Age 65 policy loans</u>	<u>6% Original Assumed Age 65 policy loans</u>	
G	\$50,882	\$75,662	-33%
E	\$50,208	\$78,024	-36%
D	\$49,740	\$79,476	-37%
H	\$48,514	\$75,511	-36%
C	\$42,478	\$89,047	-52%
J	\$42,177	\$72,830	-42%
F	\$40,512	\$76,212	-47%
L	\$36,646	\$70,120	-48%
I	\$35,808	\$74,772	-52%
K	\$29,736	\$71,564	-58%
A	\$21,728	\$100,193	-78%
B	\$20,541	\$90,839	-77%

As can be seen, with a 33% drop in constant assumed crediting rate, some policies via their illustrations “held their own” with a proportionate drop in illustrated policy loan value. Some accomplished this with low anticipated charges, others with a flat 75% persistency credit instead of a multiplier that gets cut by 1/3 in this methodology.

Of note are the two policies at the top of the annual policy loan potential under the 6% scenario – but falling close to 80% when projected at an illustration rate of 4% when seeking accessible policy loans beginning at age 65. And, in fact, based on the illustrated assumptions which vary only in the applied crediting rate of 4%, the insured may get back in future policy loans barely 80% of the \$500,000 in premiums paid in earlier years.

HOPE THIS HELPS YOU HELP OTHERS MAKE A POSITIVE DIFFERENCE!

Richard Weber

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- ⁴ Executive Summary of the Society of Actuaries (1992) Final Report of the Task Force for Research on Life Insurance Sales Illustrations Under the Auspices of the Committee for Research on Social Concerns: "How credible are any non-guaranteed numbers projected 20 years into the future, even if constructed with integrity? How does a consumer evaluate the credibility of two illustrations if they are from different companies or even from the same company if different products with different guarantees are being considered? Most illustration problems arise because illustrations create the illusion that the insurance company knows what will happen in the future, and that knowledge has been used to create the illustration."
- ⁵ "Living in the Second Circle: A Seminar on Ethics," Burke A. Christensen, JD, CLU.

⁶ The first insurance company in America was formed in 1759 - “The Corporation for Relief of Poor and Distressed Widows and Children of Presbyterian Ministers.”

⁷ “1994 Frank M. Engle Lecture in Economic Security” delivered at The American College.

⁸ A stochastic analysis (also referred to as Monte Carlo analysis) uses random return assumptions representing various historical scenarios. This can predict a probability of success under a variety of circumstances

⁹ These issues were specifically addressed in the landmark *Wall Street Reform and Consumer Protection Act* (“Dodd Frank”) passed by Congress and signed into law in 2010.