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Are Advisors Neglecting Their Fiduciary Responsibility With Life Insurance?

Joseph W. Maczuga, LIC, Executive Director, Fee Planners Network

Are we sitting on a litigation time bomb with a short fuse? At the FPA Success Forum in Philadelphia, I was invited to speak on the topic of bringing value-added service through the use of no-load life insurance on a fee-transaction platform. Since my handout material did not arrive in time, I took the opportunity to integrate some of my concerns about the lack of awareness and fiduciary responsibility into the area of life insurance planning. The transition from the old paradigm of insurance selling to the new paradigm of insurance planning brought to the universe of life insurance practice a fundamental change that was so subtle that most of us didn't recognize it: **Fiduciary Responsibility**. This paradigm shift occurred with the introduction of a new concept in life insurance design, that being universal life and later, variable universal life.

Over the years, my contact with advisors, financial planners and insurance agents has brought to light an interesting dynamic that I recently referred to as the "cookies of the mind." In technological terminology, a cookie is a little bit of information that is stored in your computer when you visit a web site. This mechanism allows you to revisit the web site without reloading the basic information needed to bring up the page (subject matter). The human brain functions in a similar manner. Initial data and information flows through the neocortex which assimilates and sorts data, establishes the intellect, and feeds the limbic system. The limbic system stores the habits, perceptions and reflexive functions (cookies). These mindsets are often the most inhibitive distractions to the progressive movement of any profession. Great advancements are only achieved when individuals remove the cookies (clear the cache) and refresh their thinking process through the neocortex (often referred to as "thinking out-of-the-box"). I reference this subject so that there is a foundation as to why we are in such a serious climate of exposure today.

THE TRANSITION FROM THE OLD PARADIGM OF INSURANCE SELLING TO THE NEW PARADIGM OF INSURANCE PLANNING BROUGHT TO THE UNIVERSE OF LIFE INSURANCE PRACTICE A FUNDAMENTAL CHANGE THAT WAS SO SUBTLE THAT MOST OF US DIDN'T RECOGNIZE IT: FIDUCIARY RESPONSIBILITY

Old Paradigm/ New Paradigm

In the old paradigm of Insurance Selling, the agent did not have to be concerned about policy performance. Whether the client bought term or whole life, the issuing companies were responsible for policy development, premium strategy and policy continuance. The company had the fiduciary responsibility in these matters.

The economic elements of the policy (i.e., premium, death benefit and cash value) were guaranteed. Premiums were easily found in the rate book. This rate book established the responsibility of the underwriting company to the risk management of the policy. It was the agent's/planner's job to develop the client's need for insurance coverage, then quote the established rate book premium for the selected amount of coverage and policy style (term or whole life).

With the creation of universal life (UL) and later, variable universal life (VUL), the insurance companies, for the first time, made a transfer of significant importance that went unrecognized. Transferred to the client was risk exposure, and transferred to the financial planning community was the fiduciary responsibility of premium design. Guarantees were diminished, and non-guarantees became the focal point of attention. What the consumer didn't know – and most advisors didn't recognize – is that premium and policy cost is not the same thing (cookie). Premium is a designed strategy of integrating the cost of policy maintenance with the deposits of capital and anticipated return on capital. This process should also

consider the economics of the client's objective. The rate books of the old paradigm were replaced with the illustration software of the new paradigm. Now, from a fiduciary standpoint, it became the advisor's responsibility to design the premium strategy for the client, using the parameters of the issuing company and the confinements of IRS formulas.

Back to the Cookies

1. There has been universal acceptance that illustrations have credibility (cookie). The primary value of a policy illustration is in the first year only. Each year after the first becomes more and more hypothetical and without basis.
2. Another accepted premise is that life insurance is a long-term planning vehicle (cookie). Persistency figures show that between 35% and 50% of policies do not go beyond five years, and that 72% to 80% of policies issued do not continue beyond ten years. This is intermediate term planning, not long term. Note that surrender charges in commission policies are usually in the range of 8 to 15 years. It isn't difficult to imagine where the graph of terminations intersects the surrender period time line.
3. If the assumed return on equity is the same, there is a level playing field to analyze policy illustrations (cookie). Our content exposes the error in this concept, as one cannot determine the cost assumptions and enhancements buried in the software. Return on equity is a secondary consideration.
4. If a company has a good dividend paying history, then an illustration with a highly leveraged term rider-to-base policy is acceptable (cookie). Illustrations promoted by participating whole life companies that use a highly leveraged term-to-base rider may be facing some major issues soon. One of the primary areas of concern is that they are not required to illustrate the two basic elements that are mandated with UL illustrations: assumed and guaranteed. All one has to do is review the footnoted caveats to find that the additional term benefit has a limited time duration of guaranteed premium. However, nowhere to be found are the guaranteed rates that explode after the initial rates expire. There are other omissions in these illustrations that place the client in harms way and require full disclosure and analysis.
5. The primary debate between a commission policy and a no-load policy has centered on the practitioners preference between a commission practice and a fee-based practice (cookie). The theory behind UL and VUL is to pay for coverage so that excess premium deposits create equity with a tax-advantaged wrap. Equity is a fully liquid and accessible account. Fee-based life insurance provides the client and advisor full disclosure and transparency of premium allocation, whereas the commission policy uses a "bundled" premium approach. Compare the functionality between the two approaches and see which one works in year one, year two, etc. Hence, the debate should focus on disclosure and functionality, not the preference of practice remuneration.

WE CAN NO LONGER PRACTICE ON AN ASSUMPTION THAT, ONCE PURCHASED, THE POLICY WILL CONTINUE WITHOUT OUR SUPERVISION

Unfortunately, too many planners still carry over the old paradigm mindset (cookie), sometimes referred to as "hit and run." We can no longer practice on an assumption that, once purchased, the policy will continue without our supervision. It is imperative that we understand the pricing relationships of the features in the policy, the interactive relationships between the economic elements and implement annual reviews with the client. If you look back at history, you find that class action litigation became an active and growing phenomenon in the new paradigm era. Policies were failing due to poor premium strategies and unrealistic projections. Although the named defendants in this plethora of litigation were the insuring companies, I don't believe that it will take long for litigators to see that we now have the front line of fiduciary responsibility. We failed to realize that software is NOT a rate book.

Financial Planning vs. Marketing Sizzle

Over the last two decades, we have witnessed another dynamic that has battered the unsuspecting consumer. Labeled as "sophisticated advanced planning techniques," the insurance industry, with the assistance of some creative marketing minds, have developed numerous "techniques" that are attractive to the consumer, often the high net worth client. These impressive presentations are seldom at the disposal of the fee-advisor or the planner who is focused on AUM. Developed for the "big hitters" of the insurance industry, the initiative behind the design was to increase sales by appealing to the greed and ego of the client. Over the last two decades, a combination of law suits and IRS challenges have brought such planning techniques into question. It is interesting that, when reviewing the attached "legal opinion," many of these strategies incorporate into their presentation for credibility, there is an obvious omission that, if challenged, the law firm will represent the client and pay any fines and penalties should they lose the case.

In a recent article entitled "When Estate Plans Go Bad," the author provided some insight as to what may be in our future. This presentation on a high-profile lawsuit uncovers a number of issues that we should note. First, there is the exposure of a sophisticated "plan" that mandated a large amount of life insurance. Too often, we do not separate the merits of a plan from the sale of a product. Does the plan have a basis of its own, or is it a result of integrating product marketing to generate commissions. In this case, we have a high profile attorney, two marketing groups, a well-recognized insurance company and several "sophisticated planner" agents. Involved is a $60 million policy on an 80-year-old female with annual premiums of $25 million. Commissions were $4.4 Million.

As one expert commented, "Sometimes it's clear that these deals were commission motivated and just won't work …." The suit focuses on other issues, with life insurance playing a

major part. This is where it gets interesting. One statement refers to the responsibility to ensure that policies are competitive in terms and price. Another statement relates to the fact that certain associated costs were omitted from the policy illustration. (This is nothing new.) The following paragraph adequately describes what I often see in the insurance planning arena: that policy performance is not in sync with illustrated projections and/or values. A key phrase used throughout is that of full disclosure. And finally, the closing statement of the article: "... it is not an attorney's responsibility to evaluate insurance policies …. If an agent doesn't do it, then I think the valid claim is against the agent." (Although I feel that if the attorney concurs with the recommendation, he shares in the responsibility.

Problems Facing the Advisor/Planner

Illustrations have become a "point-of-sale" marketing tool and have no substance to validate future policy performance. This is due to the fact that there are two economic components involved. One is the assumed return on equity, which has been the primary focus of sales and analysis. The other is related to policy costs and the actuarial techniques used in development. This becomes the "X" factor that skewers the playing field. If one were to do a little research on the history of policy performance, illustrations and class action litigation within the insurance industry, it would not take long to validate the fact that illustration software is corrupt in its projections.

Case-in-point is the recent fiasco with the Conseco Lifestyle policy. Conseco did not calculate monthly mortality charges under the normal method but employed a concept referred to as the R-factor. This concept artificially increased the account value, which then allowed the calculation of the monthly mortality charge to be decreased by about two-thirds. The R-factor was not disclosed in sales illustrations or in-force illustrations. By simply removing this factor, mortality rates tripled. The safety net of defense for the company is the footnoted caveat that illustrated values are not guaranteed. Most advisors relate that statement to the interest rate return, not the charges and costs in the contract. There are numerous examples, which would mandate a book of enormous proportion.

A much easier example of illustrated illusion is the variable universal life concept. One of the mandated return-on-equity assumptions that must be illustrated is that of 0%. In other words, we are showing the consumer how the policy would function if the market was flat and we achieved no return. This scenario implies that the market will never have a negative year. In addition, any assumed rate-of-return always illustrates a static compounding result, which is very different than an annual average. However, it is the hidden "X" factor that must be reviewed. One of the exercises we use at our conferences is one that you also can employ to prove this point. Run an illustration on a client and select the sub-account with the maximum annual administration charges. Then re-run the illustration selecting the sub-account with the least annual administration charges. There will be a substantial difference in the projected cash value, even though you used the same assumed rate-of-return (the so-called level playing field). Hence, you can create an artificially superior policy be tweaking the internal costs.

Another technique that is used by some companies to be "more competitive" is that of lapse-based premium assumptions. This approach projects very nicely, but if policyholders stay and the company experiences better than expected persistency, the company starts to lose money. The result will be a heavy increase in policy expenses and COI's, which will erode equity and require additional premiums.

I also find it interesting that many advisors ask about the ratings of a company – a good question to ask – but a better question would be this: "How many versions of this product have you brought to the market in the last five years?" As a producer (an experience that most fee-only advisors have never had), we are constantly getting new product updates, each one better than the last. Well, what about my clients who bought the last version two years ago. Will they get these new cost advantages? NO!!!

My preference to use no-load and low-load (fee-based) life insurance is based on several factors:

1. I believe that full disclosure and transparency is crucial in educating the client to the pricing and cost relationships of the policy;
2. Isolating the minimum premium requirements allows me to integrate premium strategies that correlate to the specific objectives of the client, including the leveraging of capital;
3. Full cash value liquidity insures maximum control and flexibility in the event of unforeseen contingencies; and
4. Policy implementation in a fee-based advisor relationship eliminates any future challenges to my initiative as that being driven by commissions.

However, when a fee-only advisor orders a home office illustration or refers the client to a no-load insurance provider, such action may not relieve the advisor/planner of their fiduciary responsibility. Although it is important to work with a well-trained and knowledgeable home office staff when designing a fee-based policy, it is important that the advisor understands the make-up and components of the policy for the purpose of designing premium strategy. The client should not be led to believe that there is an actual "level premium to endow," or a targeted level annual premium that will obtain a projected cash value. The advisor must educate the client on how a UL or VUL works: the concept, the variables of costs, the need for annual reviews and adjustments (to stay on track to the planned objective) and the need for liquidity. Fee-only advisors that do not engage in this activity will still be held to their fiduciary responsibility.

THE ADVISOR MUST EDUCATE THE CLIENT ON HOW A UL OR VUL WORKS: THE CONCEPT, THE VARIABLES OF COSTS, THE NEED FOR ANNUAL REVIEWS AND ADJUSTMENTS (TO STAY ON TRACK TO THE PLANNED OBJECTIVE) AND THE NEED FOR LIQUIDITY

As a profession, we may have unconsciously abandoned our fiduciary responsibility to comprehensive financial planning and life insurance integration, as few advisors subscribe to the conclusions discussed. Turning over the task of premium design to home office staff via illustrations, without your input and premise for the designated strategy, does not exempt you from this frontline position of litigation. I feel that UL and VUL are very dynamic planning tools, when properly designed.

It is time we reflect on our approach. Will it be "Hit and Run," "Ignore," or will it be "Design and Advise"? ■

About the Author

Joseph W. Maczuga is a life insurance counselor in the State of Michigan and president of Capital Planning Strategies, Inc., a comprehensive financial planning firm. Entering the insurance and securities industry in 1973, he was recognized as a top producer by such companies as Western Reserve Life, Mariner Financial, First National Life, American Skandia, American Investors, Kansas City Life, First Commonwealth and ProEquities.

His personal practice is concentrated in the area of corporate and business planning, executive enhancement benefits, estate planning, tax advantaged engineering, wealth accumulation and asset protection strategies.

Mr. Maczuga also conducts seminars for financial planners and advisors, and is a nationally registered instructor for CPE, ChFC, CLU, and CFP CE (Continuing Education) Credits, including registration in many states as an insurance instructor for Insurance CE Credits. His consulting services are retained by several independent broker/dealer and advisory firms, and he has served as a consultant to an international financial conglomerate for product development.

Presently, as executive director of the Fee Planners Network, Mr. Maczuga's responsibilities include training and assisting financial planners and advisors across the country, providing a resource of expertise to independent advisors. Since 1983, he has been engaged in comprehensive fee planning with low-load life insurance and has become a nationally recognized expert on the concepts and strategies of such planning techniques.

For more information, contact Mr. Maczuga at 888-854-0931 or vist Fee Planners Network's web site (www.feeplanners network.com).

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SENIOR CONSULTANT

1457 Crystal Springs Lane
Richmond, Virginia 23231
Ph 804-643-1075 ■ Fax 804-643-1544
WWW.SRCONSULTANT.COM