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Insurance
By Barry Flagg

New standards for managing life insurance as a fiduciary

Life insurance remains the last, largest, most-neglected asset on clients' balance sheets. Neglect breeds poor performance, and life insurance is no exception. It has been the worst-performing asset relative to clients' expectations for decades, and is now in desperate need of a fiduciary-oriented management process. I can think of no one better for that job than NAPFA advisors.

Similarities to 1980s financial marketing

The marketing of financial products in the 1980s, when I started my career in the pension investment advisory business, left a lot to be desired. Working in a fiduciary environment, I had a front-row seat to the conflicts between marketing and the prudent process for serving clients' best interests.

For instance, 1980s-vintage investment contracts paid commissions of 50 percent or more, similar to the way the compensation is structured in life insurance products today. Back then, mutual funds were sold by representatives of the fund companies in much the same way life insurance products are still sold by agents of the insurers today. And investment products like tax shelters were often sold based on hypothetical projections, again in the same way life insurance products are sold using hypothetical illustrations today.

Which insurer offers the best products?

In this environment, advisors and consumers lack the information necessary for prudent decision making. As a result, the question I get asked more than any other is: "Which insurer offers the best products?" However, this question is just as silly as: "Which mutual fund company offers the best mutual funds?"

There are thousands of mutual funds, and yet no mutual fund company offers the highest-rated funds for all clients in all situations. Some offer highly rated equity funds. Others offer funds highly rated for their fixed-income performance. Still others are highly rated for their international, or small cap, or high-yield-bond fund performances. Some charge sales fees, while others don't. Some are passive, while others are highly rated for their active management.

Even with all these variables, there's no single best mutual fund company. The situation is even more complex with life insurers because they offer many more products, each with upward of 10,000 pricing combinations and permutations.

For those who find that hard to believe, let's do the math starting with a different price for every age (e.g., from 20 to 85). That's 65 different prices right there, times two different prices for gender; times three to five for the different health-risk rate-classes; times two to three more for smoker, non-smoker, or never-smoked rates; times four to six for volume breakpoints on larger face amounts; times three different prices for single-pay, abbreviated-pay, and level-lifetime-pay premium payment plans; times at least four different prices for different commissions discounts offered or not offered by different brokers. Altogether, that's well over 10,000 prices for each and every product.

And, unlike many mutual funds that remain similar in form and fees over time, life insurance products work more like closed-end mutual funds where there's a limit on the amount of investment that can be accepted. Likewise, insurers are limited on the amount of insurance they can place in each product because they typically co-insure a portion of each death benefit with reinsurers, but only up to a certain aggregate amount of risk. When that aggregate amount of insurance is placed, that product is no longer available, and the primary insurer negotiates a new reinsurance treaty and introduces a new product with another 10,000 new pricing combinations and permutations.

With such complexity, it's easy to see how pricing combinations and permutations for all products from all insurers mean millions of different prices. And while costs are certainly not the only consideration in the selection or recommen-

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dation of any product, knowing the costs charged inside life insurance products is particularly important because they can vary by as much as 80 percent, and are too often overlooked or hidden by hypothetical illustration comparisons now considered "misleading," "fundamentally inappropriate," and unreliable by financial, insurance, and banking industry authorities.

In addition to cost considerations, the prudent selection or retention of any life insurance product also involves qualitative considerations like the financial strength and claims-paying ability of the insurer, the stability of the insurer's pricing representations, access to or restrictions on policy account values, and actual historical performance of invested assets underlying policy cash values. Altogether, the answer to the question of which insurer offers the best product for a given client depends on many more cost and quality considerations than the answer to the same question for mutual funds.

With such complexity, it's at least implausible, and more likely impossible, that any agent or broker can know which insurers offer the "best" products for a given client or prospect without researching the question in the same way that investment advisors use research services like Morningstar.

Needed: a fiduciary process

Life insurance needs to get out of the 1980s so it can be managed using a fiduciary-oriented management process. Examples of fiduciary-oriented decision-making processes include ERISA for retirement plans, the Uniform Prudent Investor Act (UPIA) for private trusts, and fiduciary standards for investment advisors, trustees, and investment committee members.

The elements of such an established and proven decision-making process generally include 1) defining roles and responsibilities for members of the planning team, 2) analyzing goals and objectives, 3) strategizing the most prudent solutions sets (i.e., product types), 4) formalizing the search criteria for the product within the optimal solution set, 5) searching for and implementing the vehicle(s) offering best-available rates and terms, and 6) monitoring performance relative to both original expectations and peer-group alternatives.

These six steps are incorporated in the West Point Draft of Best Practice Standards for Life Insurance Stewardship, which applies to life insurance this universal decision-making framework already widely accepted in the investment business. The document was created in 2013 by a group of financial services leaders. Let's look more closely at the six elements of the standards.

6-step process

To prudently select, retain, and management life insurance, follow the six steps in the West Point Draft of Best Practice Standards.

Step 1. Define: Just like the investment advisor is a member of the planning team, life insurance advisors distinguish themselves from agents/brokers by first discussing their role on the planning team. Too often, conversations about life insurance start with some "flavor of the day" product or planning idea or tax scheme. NAPFA advisors are already having client-centric conversations, and expanding them to include life insurance can lead to better results for clients, more assets under management, and better relationships and more referrals from the client's CPA, attorney, and related professionals.

Step 2. Analyze: In the same way that the investments for clients seeking income will differ from the investments for clients seeking growth, some life insurance products are designed for defined contributions and maximum accumulation, whereas others are designed to minimize premiums for a defined death benefit. Different life insurance products are also designed for different risk profiles. As such, advising clients about the prudent selection and proper management of life insurance starts with an understanding of their circumstances, goals, and objectives instead of some "flavor-of-the-day" product.

Step 3. Strategize: The rate of return reasonable to expect from any financial strategy is most influenced by its underlying asset allocation. Most universal life (UL) and whole life (WL) products are required by regulation as a practical matter to invest assets' underlying policy cash values predominantly in high-grade bonds and government-backed mortgages. On the other hand, variable products (VUL) allow for allocation to various asset classes. Product type is, therefore, a function of the **r**isk tolerances of the client, corresponding **a**sset class preferences, the **t**ime horizon and **e**xpected outcomes (remember R.A.T.E.), as follows:

Risk Profile	Asset Allocation (Equities/Fixed-Income)	Product Type	Rates of Return Reasonable to Expect
Conservative	20% / 80%	UL/ Guaranteed UL/WL	5% - 6%
Moderate-Conservative	40% / 60%	Indexed UL	6% - 7%
Moderate	60% / 40%	VUL	7% - 8%
Moderate-Aggressive	80% / 20%	VUL	8% - 9%
Aggressive	100% / 0%	VUL	9% - 10%

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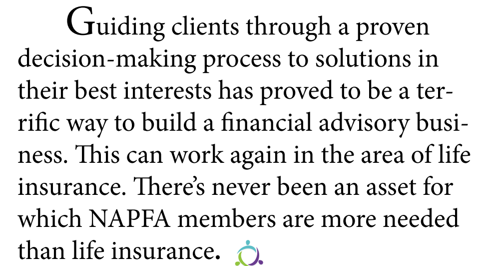
Step 4. Formalize: The life insurance industry is full of constraints and conflicts (not unlike the investment business of decades ago). With 10,000+ pricing combinations and permutations for every product, cost of insurance charges (COIs) being the largest expense (not commissions), and as much as an 80 percent variance between best-available rates and terms (BART) and worst-available rates and terms (WART), it's safe to say that no insurer, product, compensation model, distribution system, nor proprietary product is inherently "better" for all clients or all situations. Understand the universe of products for the product-type peer group identified in Step 3, and discuss constraints and conflicts.

Step 5. Implement: A search for BART considers, at a minimum, the financial strength and claims-paying ability of the insurer, the competitiveness of internal policy charges, the stability of the insurer's pricing representations, accessibility to/restrictions on policy cash values, and the historical performance of invested assets underlying policy cash values. Additional considerations can include underwriting capabilities and ongoing service and reporting. A BART search is one of the easiest ways to distinguish your advice from misleading product sales practices using illustration comparisons.

Step 6. Monitor: Life insurance has been the most disappointing asset type relative to client expectations for decades, due partly to lack of monitoring, reporting, and management. Advising about the prudent selection and proper management of life insurance involves periodically checking on changes in the health, risk tolerance, time horizon, performance expectations and/or planning objectives of the client, changes in the financial stability and claim-paying ability of the insurer, and/or changes in internal costs, investment performance, and/or the funding adequacy of policy holdings.

Guiding clients through a proven decision-making process to solutions in their best interests has proved to be a terrific way to build a financial advisory business. This can work again in the area of life insurance. There's never been an asset for which NAPFA members are more needed than life insurance.



Barry D. Flagg is the inventor and founder of Veralytic®, the only patented online publisher of life insurance pricing and performance research and product suitability ratings. Veralytic is the product of his unique background as a CFP® and life insurance practitioner.

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