

SUITABILITY IN THE SALE OF FIXED LIFE AND ANNUITY PRODUCTS

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On Tuesday June 11, 2002, the last day of the June NAIC meeting in Philadelphia, the Life Insurance and Annuities (A) Committee held a long-awaited hearing on the Life Insurance and Annuities Suitability Model Act and Model Regulation. The Model Act and Regulation had been drafted and recommended to the A Committee after nearly two years of work by the Life and Annuities Suitability Working Group. The Committee heard a number of comments from the Working Group and interested parties. Commissioner Stewart of Utah, Chairman of the A Committee, ended the hearing by announcing that additional comments would be accepted in writing if submitted by August 1, 2002. Any action on the models would be deferred until the Fall meeting.

It is not clear at this point what action the A Committee will take at the Fall meeting in New Orleans. For anyone attending the hearing it seems unlikely that the A Committee will vote to adopt the models as proposed. Both industry and consumer groups opposed the models, and no one outside the Working Group spoke in favor of their adoption. In face of this opposition, it is difficult to believe that the A Committee would vote to adopt the models which would then face opposition in the various states where the models would need to be enacted.

What do we mean by suitability? How did we get to where we are? Why are both the industry and consumer groups opposed to the models in their present form? Does the rejection of these models mean that the issue of suitability is dead? What is the future for suitability?

When discussing suitability it is important to distinguish disclosure from suitability. Disclosure is a requirement to provide full and accurate information about a particular product so consumers can decide whether the product is appropriate to their needs. Suitability requires the seller to obtain personal information regarding the purchaser's insurable needs and financial objectives, and then recommend or sell to that consumer only those products that are suitable for those needs.

In the late 1980s and early 1990s, there were a number of instances of improper sales activities on the part of some insurers. Some of these practices included the sale of life insurance policies as retirement or pension products, and either misrepresenting or not disclosing that the product was actually a life insurance policy. There were policies sold as vanishing premium policies based on then current interest rates. More recently there have been abuses in the sale of annuities to the very elderly with deferred payouts and long-term surrender penalties. Other examples of improper sales, due to misrepresentation or non-suitability, include excessive amounts of life insurance sold to persons of limited income or to persons with little or no life insurance needs.

One of the early responses to the publicity concerning these sales practices was the recommendation that insurance should be sold in the same manner as securities. There have been suitability requirements in the sale of securities and registered products for over forty years.¹ The argument was that the same suitability standards applicable to the sale of securities should be applied to the sale of insurance products. In June 2000 the NAIC released a white paper discussing this issue.² The white paper concluded by recommending: "The working group recommends that rules be developed requiring that suitability be determined by the producer and carrier in the sale of non-registered life insurance and annuity products."³ It was in response to this recommendation that the Life and Annuities Suitability Working Group was formed and subsequently drafted the Model Act and Regulation.

After two years the Working Group drafted the Suitability Model Act and Regulation considered by the A Committee. The Model Act states:

Prior to making a recommendation for the purchase, sale or exchange of a fixed life insurance or annuity product, an insurer or an insurance producer shall obtain relevant information from a

consumer and shall make reasonable efforts to determine the insurable needs or financial objectives of the consumer and recommend insurance transactions which are suitable in assisting the consumer to meet those needs or objectives.

On its face this statement seems reasonable, so why is there so much opposition? While the above statement seems relatively simple, the corresponding Model Regulation goes into great detail as to what constitutes a “recommendation,” “relevant information” and “suitable recommendation.” The industry has a number of objections, some of which include the fact that the securities industry is regulated by one single regulator with a uniform suitability standard. The NAIC Model Act and Regulation would have to be enacted in all 50 states and, given prior history, the odds of uniform adoption is remote. The American Council of Life Insurers (“ACLI”) also points out that the insurance industry is already subject to the Unfair Trade Practices Act, Replacement regulations, Disclosure requirements and Advertising rules. There are no corresponding laws applicable to the sale of securities.

Looking back on examples of improper sales, the activities tend to fall into several categories, i.e. misrepresentation, fraud and unsuitable sales. The sale of life insurance policies for retirement purposes without disclosure that the policy is a life insurance policy is misrepresentation, if not fraud. There are arguably circumstances where a life insurance policy might be suitable in funding a portion of a retirement program. The sale of vanishing premium could also be considered more of a disclosure issue. This raises an issue which gives rise to the argument both for and against suitability standards. Inevitably, after interest rates dropped and the insured might be required to make additional premium contributions, the insured would claim that they were never informed that additional premium contributions might be required, i.e. the term vanishing premium was a misrepresentation. The agent, on the other hand, would claim that this possibility was fully disclosed. If interest rates had not dropped or had remained high enough that additional premium contributions were not required, the issue of suitability would likely not be raised. As a result, some in the industry fear that suitability standards will be applied whenever there is an unfavorable outcome irrespective of any disclosures made at the time of sale. As stated by Scott Cipinko of the Life Insurance Council (“LIC”) at the A Committee hearing, “When people look back on earlier purchases, some products that were sold did not turn out to be so suitable.”

The argument for a suitability standard under these circumstances is that in addition to a prohibition against misrepresenting that the premiums will vanish under all circumstances, an analysis should be made as to whether the risk that additional premium contributions may be required is consistent with the purchaser's insurable needs or financial objectives. In other words, what is the purchaser's risk tolerance that additional premiums may be required?

Based on the testimony at the A Committee hearing, the consumer group's objections seem to fall into two categories. First, the Model Act and Regulation places too much responsibility on the producers and not enough on the companies. In the opinion of the consumer groups, the primary responsibility for suitable sales should rest with the insurance companies. In addition, the consumer groups object to the exclusion of certain products such as credit life and health insurance. Furthermore, in the opinion of some consumer groups some products are inherently unsuitable.

Assuming the A Committee does not vote to adopt the Model Act and Regulation at the Fall meeting, is the issue of suitability in the sale of fixed products dead? In the opinion of this author, for a variety of reasons, I think the answer is no.

First, even if the A Committee does not vote to adopt the presently proposed suitability models, the models could be referred back to the Working Group for additional modification or amendment. In addition, there are existing suitability requirements applicable to the sale of fixed products in a number of states. The standards for suitability, as well as the products for which suitability standards apply, vary among the states that have adopted suitability standards. The following are examples of some existing state requirements for the sale of fixed products:

Iowa – Administrative rule Section 191-15.11. The rule generally provides that a producer shall not recommend a product without reasonable grounds to believe that the transaction or recommendation is not unsuitable for the person. The rule applies to, “the purchase, sale, or exchange of any life insurance policy, annuity or any rider, endorsement or amendment.” The rule requires that suitability

be determined, “based upon reasonable inquiry concerning the person’s insurance objectives, financial situation and needs, age, and other relevant information known by the producer.” Group policies are included, but the relevant person is defined as the policyowner.

Kansas – Administrative rule Section 40-2-14(c)(5). The rule prohibits recommending to a prospective purchaser the purchase of a product “with reasonable grounds to believe that the recommendation is unsuitable for the applicant.” The rule applies to the purchase or replacement of any life insurance policy or annuity contract. Under the rule, a recommendation to purchase or replace a policy that a producer believes is “unsuitable for the applicant based on information furnished by this person, or otherwise obtained” is an unfair or deceptive practice under the Unfair Trade Practices Act.

Minnesota – Statute Section 60K.14. This statute requires that an agent must have reasonable grounds for believing the recommendation to purchase a product is suitable for the customer. The statute provides some detail as to how to judge suitability, requiring that the agent “must make reasonable inquiries to determine suitability” and prescribes the following suitability standard: “The suitability of a recommended purchase of insurance will be determined by reference to the totality of the particular customer’s circumstances, including, but not limited to, the customer’s income, the customer’s need for insurance, and the values, benefits and costs of the customer’s existing insurance program, if any, when compared to the values, benefits and costs of recommended policy or policies.” The statute applies to all life, endowment, individual accident and sickness, long-term care, annuity, life-endowment and Medicare supplement insurance.

South Dakota – Regulation Section 20:06:14:03(7). This rule governs the suitability of the sale of individual life and individual and group health insurance and requires that the agent determine the appropriateness of the sale by examining the totality of the consumer’s circumstances including his financial condition and need of insurance at the time. South Dakota has other rules pertaining to other insurance products: South Dakota statute Section 58-17-87 covers health benefit plans, Section 58-18B-35 for stop loss, multiple employer trusts, and MEWAs and additional regulations 20:06:13 43 to 20:06:13:43.02 for Medicare supplemental insurance.

Vermont – Statute Title 8 Section 4724. This statute defines as an unfair or deceptive practice “soliciting, selling or issuing an insurance policy when the person soliciting, selling, or issuing the policy has reason to know or should have reason to know that it is unsuitable for the person purchasing it.” The statute applies to all insurance products. The statute provides no guidance as to how to judge suitability.

Wisconsin – Administrative rule Ins. 2.16(6). The rule provides that no insurer or intermediary may recommend to a prospective buyer the purchase of a product “without reasonable grounds to believe that the recommendation is not unsuitable to the applicant.” The regulation provides the following guidance on judging suitability: “The insurer or intermediary shall make all necessary inquiries under the circumstances to determine that the purchase of the insurance is not unsuitable for the prospective buyer.” The rule applies to “the purchase or replacement of any individual life insurance policy or annuity contract.”

Other states have more limited suitability standards or standards that apply only to certain products.⁴

Historically, the sale of fixed products has been disclosure driven and there are a number of existing laws that regulate disclosure in the sale of fixed products. These include, Life Insurance and Annuities Replacement Model Regulation,⁶ NAIC Life Insurance Illustrations Model Regulation, Model Advertising Rules, Life Insurance Disclosure Model Regulation, Annuity Disclosure Model Regulation, Buyers Guides and Unfair Trade Practices Act. These laws all mandate either full and accurate disclosure and/or bar misrepresentation in the sale of insurance products.

Presently, variable products constitute in excess of 50% of new product sales. As stated earlier, the sale of variable products is regulated by NASD suitability standards as well as state suitability rules in some jurisdictions.⁷ In addition, the Insurance Marketplace Standards Association (“IMSA”) requires insurers that seek IMSA certification to have procedures in place to obtain relevant information to determine

customers' insurable needs and financial objectives and to be sure that the company enters into transactions that assist customers in meeting their financial needs or financial objectives.⁸ While IMSA does not call this a suitability standard, it bears a strong resemblance to one. Presently there are over 200 IMSA member companies representing approximately 68% of the life insurance and annuity premiums written in the United States.⁹

For a variety of reasons, it appears that the sale of fixed products is moving towards some type of suitability standard whether imposed by regulators or adopted by the industry voluntarily. One of the problems will be determining what suitability standard will apply to fixed products. The NASD requires the member to have reasonable grounds for believing the recommendation is suitable based upon facts, if any, disclosed by the customer. The proposed NAIC Model would require the person making a recommendation for a purchase to make reasonable efforts to determine insurable needs and financial objectives and to make only recommendations that assist with those needs. The various states cited earlier in this article range from requiring a producer to recommend a product that is not unsuitable to having reasonable grounds for believing that the product is suitable. IMSA requires companies to have policies and procedures designed to reasonably assure determination of customer's insurable needs and financial objectives in the marketing of covered products.

One can debate which is a tougher standard: the affirmative requirement that the insurer sell only a suitable product versus a prohibition against a sale of an unsuitable product. There are also issues as to whether the standard should be applied to the sale, a recommendation that results in a sale, or any recommendation to the consumer. In addition, there is the question as to what liability the company or producer has if the prospective purchaser refuses to provide or misrepresents needed information. There are related concerns with products that are purchased over the internet where the contact is initiated by the consumer. These are all matters that need to be resolved if uniform suitability standards are to be applied to fixed products.

Irrespective of the issues to be resolved and whether the A Committee adopts the recently proposed Model Act and Regulation, the days of life insurers selling the same product to everyone on a one-size-fits-all basis have ended. Insurers now ignore customer needs at their peril. Companies can no longer ignore

information indicating that a sale is unsuitable and most companies are taking affirmative steps to conduct some suitability review.

Endnotes

1. SEC – Rule 10b-5 anti-fraud provisions. NASD – Members Conduct Rules, Section 2310.
2. NAIC – Suitability of Sales of Life Insurance and Annuities – June 2000.
3. *Ibid.*, p 23.
4. New Mexico Administrative Rule Title 13 Sec 10.8 50. Ohio Bulletin (92-1).
5. Utah Statute Section 31A-23-303.
6. NAIC Life Insurance and Annuities Replacement Model Regulation: The most recent version adopted in 2000 places additional requirements on producers and insurers when replacement is involved. It requires insurers to maintain a system of control over producers and monitor replacement levels. It also contains elements of suitability requirements in that the producer is required to gather certain customer information, i.e. a complete inventory of existing insurance. There are additional disclosure requirements to assist a purchaser in making an informed decision. There is no affirmative requirement for a suitable recommendation or that the sale be suitable.
7. For an excellent discussion of variable suitability requirements *see*, “Covering All the Bases: An Integrated Approach to Suitability,” by Carl B. Wilkerson, Chief Counsel, Securities and Litigation, American Council of Life Insurers, May 2, 2002.
8. Insurance Marketplace Standards Association – Principle 1 Code A.
9. Don Walters IMSA presentation to NAIC Insurance Marketplace Standards Working Group, June 10, 2002.