Insurance Product Innovation And Suitability

by Scott N. Sherman and Wendy B. Hart

Introduction

Since long before the McCarran-Ferguson Act was enacted in 1945, insurance products have been regulated primarily by the individual states rather than the federal government. However, recent statutory proposals and enactments, along with new innovations in variable insurance product designs, may soon lead to a massive overhaul of the insurance industry and — in particular — changes to its regulatory environment. Some industry experts argue that a regulatory overhaul is necessary due to the increasing complexities of the insurance business; other experts argue, instead, that federal regulation is crucial to protecting consumers and guarding against the insurer insolvency concerns that arose at the height of the recent economic crisis. One thing, however, is certain: with the insurance industry becoming more globalized each year, both domestic and foreign insurers are feeling added pressures to increase their competitive stance in the marketplace, to develop innovative insurance product solutions for investors, and to distinguish themselves from a rapidly-changing field of insurance providers.

This article briefly outlines a variety of forces currently at work in the insurance industry, including recent insurance-related legislation; newly-implemented FINRA rules affecting insurance products; revised recommended disclosures for deferred products; and updated guidance on indexed annuities, life settlements, and niche products.

Recent Legislation Impacting The Insurance Industry

Perhaps the most significant legislative impact on the insurance industry comes from the recently-enacted Dodd-Frank Wall Street Reform and Consumer Protection Act (the "DFA"). The DFA, which was signed into law on July 21, 2010, has had (or ultimately will have) a significant impact on the insurance industry. From an industry perspective, the DFA will affect both the structure of insurance products and an adviser's suitability considerations in offering those products (particularly annuities) to new or existing clients. Further, because of certain DFA provisions, the SEC, under a proposed "Uniform Fiduciary Standard," will likely soon require broker-dealers who provide personalized financial advice to use the same or similar fiduciary standards of care that investment advisers are already required to use when offering securities, including variable annuities and variable insurance products (both of which are regulated by the SEC as well as other state and federal regulators), to their clients. Because of the anticipated uniform fiduciary standard, the SEC will probably further tighten its standard of care requirements for sellers of variable products.

FINRA Rule 2330: Its Impact On Deferred Products

Other nationwide changes to the insurance industry derive from newly-implemented FINRA rules. For example, FINRA Rule 2330, implemented on February 8, 2011, addresses "Member's Responsibilities Regarding Deferred Variable Annuities." Rule 2330 applies to recommendations concerning the purchase or sale of deferred variable annuity products and to the recommended initial sub-account allocation within a policy. However, the Rule does not apply to either the sale or surrender of an existing contract that will not be exchanged for another contract or to reallocations made between a product's sub-accounts after the product's initial purchase or exchange. The Rule also does not apply to deferred variable annuities offered through tax-qualified, employer sponsored retirement accounts unless a member firm or its associated person makes specific recommendations to individual plan participants.

Rule 2330 identifies several items for advisers to consider prior to recommending the purchase or exchange of a variable annuity. For variable annuity exchanges, in particular, Rule 2330 emphasizes the importance of weighing the proposed exchange's overall benefits and potential downsides to the client, which includes comparing the existing and offered products' living and death benefits, explaining new surrender charges and periods, disclosing the forfeiture of already accrued living or death benefits, and addressing whether the financial condition of the existing issuer is in apparent decline. In particular, FINRA will continue its heightened focus on annuity recommendations made to senior investors.

Rule 2330 also imposes a new requirement for variable annuity sales and exchanges: namely, a principal's review of the proposed transaction and his determination as to whether to approve a customer's annuity application. The principal's review must occur before the application is transmitted to the issuer but not more than seven days after the principal receives the application packet from the adviser. Rule 2330 further requires member firms to have supervisory procedures in place to determine whether advisers are engaging in inappropriate or excessive variable annuity exchanges and to appropriately address variable annuity exchanges that principals believe may be inappropriate. Finally, Rule 2330 requires member

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firms to create training programs for insurance-licensed representatives who sell deferred variable products, as well as for the principals who review annuity transactions.

Additional Deferred Annuity Considerations And Disclosures

State and federal insurance regulators continue to carefully monitor the deferred annuity marketplace because deferred annuities, whether fixed or variable, are not appropriate for all investors. Insurance industry critics are quick to disapprove of deferred annuities, particularly regarding investors' need to wait - in most instances - until the end of the deferral period before excess interest is credited to an annuity account. While certain products in the marketplace address this concern better than others, the benefit of crediting interest more frequently often comes at the expense of lower long-term growth. Nevertheless, some in the industry believe deferred annuities reward individuals who are willing to sacrifice a small portion of guarantee in the short-term for a larger potential return in the long term.

Guaranteed Minimum Withdrawal Benefits:

Certain features of deferred annuities lend themselves to higher levels of regulatory scrutiny than others. While guaranteed minimum withdrawal benefits ("GMWB") have not been the subject of recent legislative or regulatory guidance, per se, they nevertheless remain a primary focus of industry regulators (due to both their high fees and relative complexity). GMWB options give policyholders the ability to protect their tax-deferred investments against downside market risk by providing the annuity owner the right to withdraw a percentage of his initial investment each year until his entire principal has been recouped. After being exercised, the GMWB protects an annuity owner against any investment losses that his account might otherwise incur, without forfeiting the benefit of future upside gains. If an annuity experiences poor performance due to market conditions, the GMWB (usually offered as a policy rider) ensures that the annuity owner will still receive the full return of his principal, spread out over a period of years in accordance with the rider's terms. The remaining principal remains invested so, should distributions begin and market performance subsequently improve, the principal remaining in the contract will benefit from future appreciation. In most cases, the insurer resets the principal's "high water mark" annually, so future distributions under the GMWB never fall below the initial payout amount, yet may increase depending on market performance.
It is important to note, however, that the GMWB "switch" usually works just one way: once withdrawals begin, they cannot later be suspended (yet another example of why advisers must understand the offered products' "bells and whistles").

Variable Product Recommendations and Disclosures:

As noted above, with the offer or sale of any insurance product, an adviser should provide his clients with appropriate disclosures. If an adviser has software that can run illustrations, the reports it generates can show clients how their principal and distribution amounts may be impacted by various marketplace and withdrawal scenarios. The adviser should ensure that his client understands the offered product and is comfortable with its potential risks and limitations. It is helpful for licensed advisers to speak with insurance company personnel, including external wholesalers, to ensure that the advisers' understanding of the insurer's variable products (and their costs and limitations), is accurate.

Before making a variable annuity recommendation to a customer, an adviser can consider the following:

• Does the product offer an appropriate mix of solidly-performing investment choices?
• How difficult will it be to explain the complexity of the subaccount offerings to a prospective contract owner?
• If the product offers a GMWB rider, does the insurer have the sole ability to dictate any investment options/limitations/restrictions?
• How difficult will it be to explain the complexity of a product's income riders and death benefits?

Indexed Annuities

Regulators also remain concerned with what they call the "confusing features" of indexed annuities, including how providers calculate the gains in the indexes to which their equity indexed annuities ("EIAs") are linked. EIAs are hybrids, possessing certain characteristics of both fixed and variable annuities. They typically offer a minimum guaranteed interest rate coupled with an interest rate tied to a (usually broad) market index. Because of the products' guaranteed interest rate, EIAs have less market risk than variable annuities but, because of the index-linked interest rate, EIAs also have the potential to earn higher returns than traditional fixed annuities when the underlying index(es) are rising.

EIAs are regulated as insurance. In December of 2008, the SEC issued Rule 151A to regulate indexed annuities as securities under the SEC's jurisdiction rather than as insurance products. Rule 151A was to become effective on January 12, 2011, but several insurers filed a lawsuit in opposition to its implementation and, in July 2010, successfully argued to the D.C. Circuit Court of Appeals that the status quo should be maintained and that indexed annuities should continue to be regulated as insurance products. Furthermore, DFA's Title IX ("Investor Protections and Improvements to the Regulation of Securities") currently maintains state regulation of indexed annuities exclusively as insurance products, so long as such products satisfy applicable standard non-forfeiture laws and suitability requirements, including model insurance acts and regulations promulgated by the National Association of Insurance Commissioners. Notably, FINRA continues to focus its attention on EIAs and to raise questions regarding EIAs in its routine audits of member firms.

Life Settlements And Regulatory Notice 09-42

Life settlements also remain at the forefront of insurance industry regulation. For example, FINRA Notice 09-42 reminds firms of their obligations regarding life settlement activities. Namely: variable life settlements are securities transactions subject to federal securities laws and applicable FINRA rules; if member firms seek to enter the business of variable life settlements, they must file an application for approval of a “material change in business operations” under NASD Rule 1017; firms must present balanced and fair information regarding life settlements in their advertising and communications with the public; and firms must adhere to FINRA’s guidance on both suitability and fair and reasonable commissions and fees when offering variable life settlements.

Of note, the DFA’s rules only apply to the aspects of the life settlement business that are considered the “business of insurance” rather than “securities products.” For purposes of the DFA, the “business of insurance” means writing insurance or reinsuring risk. In a recent Court of Appeals decision, the Court in *Life Partners Inc. v. Morrison*, 484 F.3d 284 (4th Cir. 2007) held that the purchase and sale of a life insurance policy constituted the “business of insurance.”

However, that side of the life settlement business involved settlement brokers in transactions where a policyholder sold a policy directly to a life settlement provider, not a third party. This area is still untested in many jurisdictions and likely will evolve.

Marketing/Suitability Considerations For Niche Products

FINRA Rules 2090 and 2111, both currently slated to become effective July 9, 2012, further address FINRA’s suitability expectations of member firms.

FINRA Rule 2090 — “Know Your Customer” — modifies NYSE Rule 405(1) and requires firms to obtain and maintain “essential facts” concerning its customers and the authority of any persons acting on behalf of its customers. FINRA contends this suitability information is necessary to effectively service customers’ accounts, act in accordance with special handling instructions, monitor the conduct of persons acting on behalf of customers with prior authorization, and comply with all industry laws, rules and regulations. This fact gathering obligation arises when an account is opened, regardless of whether a recommendation has been made.

FINRA Rule 2111 — “Investment Strategies” — applies a suitability standard not only to recommended transactions but also to recommended “investment strategies” involving securities. It has three separate suitability requirements: Reasonable Basis (firms must have reason to believe that a recommendation is suitable for at least some investors), Customer-Specific Basis (firms must have reason to believe that a recommendation is suitable for a specific investor), and Quantitative Basis (firms must have reason to believe the number of transactions recommended to a particular customer during a certain period is not excessive (i.e., that the investor’s account is not being churned)).

Conclusion

In light of recent legislative changes concerning the insurance industry, new FINRA rules affecting insurance products, and updated guidance regarding deferred and variable products (as well as anticipated product initiatives that may impact the insurance industry in the near-future), it is likely that additional product innovations and new approaches to the offer, sale, and use of variable insurance products will soon be forthcoming. It will be interesting to monitor these, and related, changes and their impact on the industry in the years ahead.