Casting Blame In The Wrong Direction

Robert Barney

A recent article in *The Globe and Mail* entitled, "Through Canada's Insurance Loophole", reasons that consumers are being swindled by life insurance brokers who are out of control. The ultimate blame for the problem is directed at life insurance distributors called "Managing General Agents" (MGAs). The article argues that MGAs are unregulated and are failing to exercise any oversight of broker conduct. The solution, according to the article, is for regulatory control of MGAs.

I would happily support such regulations if I thought that they would address the problem, but sadly they won't. Discussing such regulations draw attention away from the real problems that face consumers and such regulations lay the groundwork for another level of bureaucracy that will exist for the sake of bureaucracy alone. Of course, as often occurs, regulators may be more concerned with the appearance of solving a problem than actually solving the problem.

The premise of the lengthy *Globe and Mail* article is so flawed on so many levels that it is difficult to know where to begin. Rather than try to pick apart the article point by point, let's begin with the real problems that ultimately impact consumers, and steps that the government can take to address the problems.

Are there people who are being swindled by life insurance brokers and agents? Absolutely, there is no doubt about it and it goes on too often. But such swindles are not new and they have existed for many years. These swindles predate the evolution of the way that life insurance is sold by life insurance companies. The root problem is not with the sellers of life insurance products, but the manufacturers of the product.

As the article notes, there was a time when the majority of life insurance sales people were agents who were sponsored by a single life insurance company. Those agents could only sell the products of a single company. The article reasons that during this period life insurance companies maintained a strict control over these agents because the companies were ultimately responsible for the conduct of the agent.

That reasoning was and is akin to the foxes being in charge of the hen house. While life insurance companies may long for the good old days when they dictated what agents could or couldn't sell, that had little to do with protecting consumers.

In case anyone forgot, there was a time, over 30 years ago, when life insurance companies sold high-priced life insurance endowment policies as Registered Retirement Savings Plans. By contrast to the other investment options at the time, those endowment products were over-priced life insurance policies that provided consumers with abysmal investment returns versus other products available in the market. And what did life insurance companies do about it in order to assist consumers? They offered exorbitant commissions to their agents to sell those policies. Why did the companies pay such high commission? The products were highly profitable cash cows for the companies. Those products finally died when regulators stepped in and ended the practice.

And lest we forget, what happened to all the vanishing premium whole life insurance policies that were sold a few years later by those same single company life agents? Unfortunately the premiums never vanished and the whole thing blew up. Consumers were out huge amounts of money as demonstrated by the successful litigation that followed. Who was to blame for that mess? Did life insurance agents design and build those flawed products? Did agents hold guns to the heads of life company executives and force them to set the overly high commissions to sell those products? Of course not. Those products were highly profitable cash cows and the life companies wanted their agents to sell them.

And that problem continues to this day. Universal Life (UL) insurance policies, the "flavour of the day" that represents the greatest profits for life companies, and the biggest problems facing consumers in the near to mid-term are much more profitable for life companies than term insurance policies. Guess which products offer the highest commissions to insurance agents and brokers?

As most will know I am a great believer that the vast majority of consumers are best served by buying term life insurance. Term insurance is cheapest when you need it the most and premiums go up later when you are much less likely to need life insurance. By comparison to permanent life insurance products, such as UL, term premiums are a fraction of the cost. But when you look at a comparison of the commission offered to sell term versus UL, it's little wonder that agents and brokers prefer to sell UL policies.

In many cases total commission rates for Universal Life are half again as high as the commission rates paid on term. And that's just the commission "rates". Consider that it is the premium that determines the commission, and the difference between the commission paid for Term and Universal Life can be enormous.

Here's a quick example.

A Canada Life, $500,000, 10-year term policy for a 40-year-old, male non-smoker in preferred health is $370 per year. The basic commission rate for that policy is 40% with typical bonuses of 190% added to that. The total commission for the sale of that policy is $429.

By comparison, the minimum premium for a UL policy from the same company is $2,878. Basic commission for that policy is 60% (half again as much as for the term product) with the 190% bonus generating a payday for the agent of about $5,007.

Now I am not trying to single out Canada Life. It should be noted that a number of companies offer very similar commissions and they are quite typical in the market.

So, if the agent sells the 40-year-old a term insurance policy, he/she makes $429 versus a UL plan that pays a commission of $5,000 plus, more than 10 times as much.

And if the agent is able to get the consumer to put more premiums dollars into the UL policy, over and above the minimum required, dollars which go into the investment side of the UL product, additional commissions of 8 percent plus 190% bonus apply. For example, if the consumer puts in an additional $5000 in the first year, commissions to the agent are increased by $1,160 (23%).

Why are consumers being talked into UL products that they don't need? Do you think the commission might have something to do with it? And who determines the commission levels for these products?

If life insurance policies all paid the same commission rates, and those commissions were based upon face amounts rather than premiums, you can guess which products agents and brokers would prefer to sell.

How do life agents manage to convince consumers to buy life insurance products that are much higher in price and not suitable? Easy, they argue that the product is not insurance; it's an investment. As I said over and over again, be wary of life agents who argue life insurance is an investment. When you buy life insurance the number one assumption is that you need the insurance protection. If you don't need the insurance, and all you want is an investment, then life insurance is the wrong thing to buy.

But I also consider regulators highly culpable for the practice of life insurance agents and brokers being able to swindle consumers into giving up huge amounts of money for products that they should not be buying.

First, you can't sell the stuff without a license. And who issues the license? That's right, the regulators. They determine what the agent can and cannot do.

Second, many life insurance agents are "dual licensed". Not only are they allowed to sell life insurance, they are also allowed to sell investment products. Who allows this? That's right, the same regulators.

Many agents, who are dual licensed emphasize that they are investment providers and then like to slip in those UL life insurance products as great investments that allow investors to avoid income taxes. And while life insurance products enjoy some special tax breaks, the cost of admission is very high-priced insurance that makes no sense buying unless you really need it.

And which product would an agent prefer to sell you, a mutual fund or a UL policy? The $8,000 in our example UL policy would pay a commission of $6,160. The same investment in a mutual fund might yield a commission up to $440 the first year. (See "Mutual Fund Loads, Fees and Other Expenses" by Ken Kivenko on page 7.)

So, if regulators want to do something that will end many swindles, they can do two simple things:

1. Force down the compensation paid for permanent life and/or require that term insurance compensation go up. Require compensation to be based upon the pure insurance cost component of a premium, whether it's term or UL.
2. Eliminate the ability for life insurance agents or brokers to sell investment products and require that all life insurance agents and brokers clearly identify themselves as sellers of insurance.

Those changes would do a great deal to reign in the temptations motivating swindlers into peddling life insurance policies as investments, and allow the consumer to know if they are dealing with an investment provider or an insurance salesperson. Incidentally, this is why I oppose other entities, such as banks, from selling insurance products.

And finally, when it comes to catching the crooks, provinces that issue life insurance licenses need to find a way to communicate with each other. When one province finds an agent or broker swindling the public, other provinces should be able to pull or not issue that same person a license.

Bob Barney, President, Compulife Software Inc., Kitchener, ON (888) 798-3488, barneyrl@compulife.com, www.compulife.com