FSRA
Financial Services Regulatory Authority of Ontario

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Observed Practices in the Distribution and Sale of Universal Life Insurance

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Section 1

Executive Summary

Consumer protection is at the heart of everything the Financial Services Regulatory Authority of Ontario (FSRA) does, which includes ensuring those who are looking to buy life insurance are getting products that best meet their needs.

In light of recent concerns regarding the selling of potentially unsuitable life insurance, FSRA undertook a deeper review into 24 client files from agents contracted with three managing general agencies (MGAs) that operate under a tiered-recruitment model.

In the majority of instances, a Universal Life (UL) Insurance policy was sold. UL is a unique and complex insurance product often designed for individuals to meet very specific goals. When such policies are sold to consumers for whom the product is not a good fit, there is a significant risk of poor outcomes. In fact, the review revealed several troubling patterns involving the fair treatment of customers as it relates to the sale of UL. These instances may be leading to poor consumer outcomes.

Notably, 80 per cent of the files did not demonstrate that UL policies sold were aligned with the customers' needs or circumstances.

FSRA's detailed review:

- assessed whether it appeared customers had been treated fairly in each case;
- evaluated the apparent product fit to the customer's circumstances; and
- assessed the risk of poor consumer outcomes in cases where customers may have been sold products unsuitable to their needs and circumstances.

The review uncovered several common concerning themes related to the sale of UL. These included:

- no specific life insurance need identified, or a trivial needs analysis;
- boilerplate recommendations;
- incomplete or inaccurate retirement planning advice; and
- unrealistic and/or misleading policy illustrations.

This client file review was part of a six-point action plan that FSRA is implementing to help correct troubling business practices in the life and health insurance sector. The plan includes an enhanced approach to sector supervision, a new regulatory framework, industry guidance, enforcement, whistleblower protection, and a consumer education campaign.

By taking this action and addressing these problems head-on, FSRA believes it will improve the conduct practices of life insurance agents, MGAs, and insurers, and ensure people who contravene the *Insurance Act* face consequences. FSRA's ultimate goal is enhanced protection and fair treatment for consumers.

Section 2

Introduction and Background

In 2011, the International Association of Insurance Supervisors (IAIS), of which FSRA is a member, adopted Insurance Core Principles (revised November 2019)[1] (comprised of Principle Statements, Standards and Guidance, and collectively referred to as "ICP") as a globally accepted framework for insurance supervision and regulation.

Specifically, ICP 19[2] requires that insurers and intermediaries treat their customers fairly throughout the lifecycle of a product (conceptually referred to as "FTC"). These principles are intended to ensure customers receive ethical, competent service and advice and are served with the right products and solutions to meet their needs.

In 2018, stemming from ICP 19, CCIR and Canadian Insurance Services Regulatory Organizations (CISRO), (collectively, "the Regulators") jointly published Guidance Conduct of Insurance Business and Fair Treatment of Customers (FTC Guidance)[3], for the purpose of *"laying out a framework of expectations relating to business conduct in the insurance industry with the end goal of achieving FTC."*[4]

As a further step, on January 1, 2021, FSRA announced that it would use CCIR/CISRO's FTC Guidance, which applies to all intermediaries, to supervise the conduct of insurers and other entities FSRA regulates under the *Ontario Insurance Act*, R.S.O.1990,c.I.8 (the Act) However, while the Guidance lays out expectations that FTC principles be followed by insurers, MGAs, and agents, enforcement of these principles can be challenging in nature.

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[1] Insurance Core Principles and Common Framework
[2] ICP 19 - Conduct of Business
[3] Guidance - Conduct of Insurance Business and Fair Treatment of Customers
[4] Guidance - Conduct of Insurance Business and Fair Treatment of Customers

In October 2021, CCIR published a Consolidated Observations Report[5] resulting from cooperative FTC reviews of insurance companies undertaken between 2017 and 2021 and of individual CCIR member reviews of insurance companies based on FTC principles. The observations from these reviews cited 14 FTC deficiencies across seven areas of review, demonstrating that much work still needs to be done to fully achieve the objectives of FTC.[6]

Further, in an effort to identify FTC issues specifically with respect to life insurance distribution and sales, FSRA undertook comprehensive reviews of the relationship between insurance companies and the MGAs that distribute their products,[7] as well as a thematic review of three MGAs that utilized a tiered-recruitment model[8]. Consistent with the Consolidated Observations Report, these reviews also uncovered FTC deficiencies, including:

- a general lack of adherence to ICP and FTC;
- deficiencies in insurers' oversight of their distributors and the agents they contract with;
- little agent monitoring by insurers and distributors;
- insufficient agent training with respect to regulatory requirements and best practices;
- compensation models that tie compensation to agent recruitment;
- lack of clear lines of responsibility between insurer and distributor for oversight of agents; and
- business models that are driving the sale of UL over potentially more appropriate products.

As a result of these concerns, FSRA recently took the additional step of assessing in greater depth the life insurance sales activities of agents associated with the three MGAs previously reviewed, with the express purpose of determining if they were driving appropriate consumer outcomes. The ultimate goal of this report is to raise awareness

[5] CCIR Cooperative Fair Treatment of Customers (FTC) Review – Consolidated Observations Report
[6] CCIR Cooperative Fair Treatment of Customers (FTC) Review – Consolidated Observations Report
[7] FSRA Insurer-MGA Relationship Review Report, July 28, 2021
[8] CCIR cooperative MGA-focused thematic review - Consolidated observations report

regarding the questionable sale of complex insurance products (overfunded UL insurance in particular) in specific circumstances, and to commence a broader discussion regarding specific actions that can be taken to increase adherence to FTC/ICP 19 and to mitigate the potential risk of poor consumer outcomes in the future.

Section 3

Review and Analysis of Agent Practices and Client Outcomes

In undertaking an analysis of the agent/client files in question, FSRA sought to assess whether the customer/agent interactions and resulting sales were in keeping with FTC/ICP 19, whether the life insurance being recommended demonstrated sufficient knowledge and understanding of the customer's specific circumstances, whether the insurance was being sold in an appropriate manner, and, if not, whether there was significant risk of negative consumer outcomes as a result.

FSRA's file reviews included gaining an understanding of the client's personal circumstances (age, dependents, etc.), financial picture (income, assets, debts, etc.) and stated goals, if any; determining whether the client was utilizing Tax Free Savings Accounts (TFSAs) and/or Registered Retirement Savings Plans (RRSPs) before purchasing and overfunding UL insurance policies; determining whether the agent had performed a needs analysis, and if so, if it appeared accurate and reasonable; ascertaining the amount, type and premiums of insurance purchased; reviewing policy illustrations provided and the underlying assumptions used; and understanding the rationale (if any) for the product recommendations (regardless of whether there was a "Reasons Why" letter on file.)

The files were further analyzed to gather as much information as possible as to the product's fit given the client's specific circumstances, and the corresponding risk of negative client outcomes.

The reviews uncovered the following common themes:

1. UL insurance was generally sold on the premise that it is appropriate for almost everyone, without regard to risk, and regardless of client need, financial sophistication, or personal circumstances;
2. lower cost, lower risk strategies, specifically the use of TFSAs and RRSPs, were generally not considered or discussed as alternatives to overfunded UL;
3. needs analyses were either performed incorrectly or not at all, or the products recommended not well-matched to the clients' stated need;

4. recommendations for the type (UL) and amount of insurance were based on specious, incomplete, or non-existent reasoning, and often used boilerplate wording;
5. policy illustrations were either missing entirely or misleading, including the use of selective or aggressive assumptions and/or ignoring TFSAs or RRSPs in comparative analyses;
6. agents were recommending overfunded UL without consideration to a client's existing high-interest personal debt;
7. underlying investment recommendations for overfunded premiums were given little attention, and did not consider investment risks;
8. critical illness riders, and corresponding additional premiums, were automatically added to policies, with no discussion or documented options presented to the customer; and
9. existing permanent insurance policies were replaced with new UL policies, without clear rationale or benefit to the customer.

More specifically, the analysis revealed:

- **Misaligned, Misleading, or Incomplete Retirement Planning Advice**
  - In 33% of these instances, the customer was sold overfunded UL with the expressed or implicit purpose of helping to fund retirement or grow the value of the client's estate, yet in 75% of those cases the client did not appear to have a TFSA or RRSP.
  - In all these instances the client was a single person in their 20s or early 30s, with no dependents and only modest income.
  - In fact, in 70% of the instances the insured stated an annual income of $60,000 or less.
  - Further, in 83% of the files reviewed there was no indication that the client had any TFSA or RRSP, and in almost 30% of the cases the client was carrying high interest personal debt, which was not factored into the recommendations.

- **No Life Insurance Need Identified, and/or Boilerplate Needs Analysis or Recommendations**
  - 80% of the files did not demonstrate a specific life insurance need, or the stated need was boilerplate in nature and not specific to the customer's circumstances.
  - In 50% of the files, there was no needs analysis performed. In 70% of the cases where there was a needs analysis, it was often fundamentally flawed (e.g., incorrect calculations or financial analysis, or no consideration as to whether anyone is actually dependent on the client's income) or boilerplate, and/or the actual insurance being purchased did not match the perceived need.
  - In almost 90% of the cases, there was either no rationale provided for the specific insurance being recommended, or it was boilerplate in nature, even though "Reasons Why" letters were on file in more than half the cases.
- **Misleading or Unrealistic Assumptions**
  - In at least two instances, UL was sold to fund an *Insured Retirement Plan* ("IRP"), and in both these cases the assumptions used in the policy illustrations were misleading, unrealistic, and did not sufficiently highlight the underlying risks of this strategy.
  - Where alternative illustrations were shown, they never included TFSAs, even if the client had no TFSA savings; the rate of return on taxable or RRSP investments was never adjusted upward to reflect the additional costs inherent in UL investments; and the underlying income tax rate assumption used for comparison to taxable investments was often too high, and/or overstated the amount of investment income that would be fully taxable as interest (vs. capital gain, for example).
  - Risks related to market volatility, performance of the selected investment products or borrowing rates were never adequately highlighted to the client, and lower risk alternative insurance protection and/or future savings strategies were never documented.

Potential for Poor Consumer Outcomes

The files reviewed once again confirmed a failure to meet FTC/ICP 19, and demonstrate a real and significant risk of poor consumer outcomes, including:

i. **Opportunity Cost**

Money otherwise available to grow savings or pay down high interest personal debt spent on overfunded UL insurance premiums.

As mentioned, in 80% of the files reviewed, the client's need for life insurance was not clearly identified or explained. Given that many of these cases involved young people with modest means, no savings and carrying high interest debt, the money being used to overfund UL premiums under the guise of helping them grow their savings may well have otherwise been put to better use through investment in TFSAs or by reducing their personal debt, among others.

ii. **Catastrophic Loss Due to Policy Lapse**

Complexity and risk of overfunded UL is leading to unaffordable premiums and/or policy lapses.

In all these instances, customers were purchasing relatively complex UL policies on the basis of boilerplate needs analyses and recommendations, in the absence of genuine financial planning or analysis as to whether the product was right for the customers' specific circumstances or goals. Specifically, the sales of overfunded UL lacked any substantive consideration of the significant risks of erosion of cash value or future increases in policy premiums, raising concerns regarding high policy lapse rates and corresponding loss of all the customer's overfunded premiums.

Section 4

Universal Life Insurance (UL) Overview

UL is a unique, relatively complex product. It combines a tax-free, flexible self-directed investment component and a flexible permanent insurance component into a single product, the types and amounts of both which can be adjusted based on the client's needs and changing circumstances. Further, Canadian tax laws allow policyholders to overfund their policies by paying higher premiums than required into the investment component of the policy on a tax-free basis. The resulting accumulated cash value can be used to fund the Cost of Insurance and policy fees, or as collateral to borrow against in the future, and/or can ultimately be paid out to the beneficiaries tax-free. These unique features are what set UL apart from other life insurance products. And while a major feature of UL lies in its flexibility and in the ability to overfund the premiums, this unique feature is also what makes UL a potentially risky product if sold and/or utilized inappropriately.

In addition, the introduction of TFSAs in 2009, coupled with changes to the tax rules in 2017 that significantly limit the amount that can be invested tax-free within permanent insurance policies, has reduced the attractiveness of UL for most Canadians. In fact, FSRA's conversations with multiple insurance companies in 2023 confirmed that for the various reasons listed above, UL insurance is generally sold as a niche product for the vast majority of their customers.

Further, many UL policies may be sold under the guise of creating an "IRP" or "Insured Retirement Strategy", where the policyholder borrows against the cash value of the policy to supplement their retirement income. While these plans/strategies can be effective for the savvy consumer, they require even greater analysis before being implemented and carry significant additional inherent risks.

Finally, even in situations that may seem ideal for UL, the complexity of such products can make them confusing, difficult to understand and at risk of undermining the reason most Canadians buy (and need) life insurance in the first place – to provide peace of mind and financial security for surviving dependents in the eventuality of one's death.

In summary, while there are always exceptions, there is wide-ranging consensus that UL is generally most appropriate for clients who:

a) have a genuine need/purpose for permanent insurance;

b) are already maximizing other tax advantaged accounts, such as TFSAs (and/or RRSPs or Registered Education Savings Plans (RESPs) as applicable), and who do not need access to their overfunded premiums in the short-to-medium term;

c) are prepared to carefully monitor and adjust their policy on an ongoing basis; and

d) have sufficient means to support increased premiums in the case of future poor investment performance or volatility.

In light of these factors, it is also accepted that for a UL strategy to work:

- the agent selling the product must be ethical and thoroughly knowledgeable about UL and all its components, and able to customize the product to fit the customer's overall financial picture, risk tolerance and overall financial plan;
- the customer must be savvy, understand their policy options and the inherent pros, cons, risks, and benefits of each; and
- the policy must regularly monitored by the agent and/or customer to ensure it continues to meet its intended purpose and that it is adjusted in a timely manner as appropriate, to avoid policy lapse.

Without these fundamental pieces, the effects can be catastrophic, resulting in policy lapse and a corresponding loss of all premiums paid into the plan, including overfunded amounts.

Section 5

Conclusions and Next Steps

Summary and Conclusions

As a result of concerns raised by previous reviews, including a targeted examination of three MGAs using a tiered-recruitment model (also referred to as multi-level-marketing, network-marketing, or recruitment-focused) business models, FSRA took the additional step of undertaking a deep dive into 24 client files randomly selected from each of those MGAs to assess whether the customer/agent interactions and resulting sales were in keeping with FTC/ICP 19, whether the life insurance being recommended demonstrated sufficient knowledge and understanding of the customer's specific circumstances, and whether the insurance was being sold in an appropriate manner. This deeper review demonstrated concerns most specifically regarding the sale of overfunded UL, leading to significant threats of resulting poor consumer outcomes.

Next Steps

As a result of the recent file reviews, action is needed to stem the tide of poor consumer outcomes related to the sale of complex life insurance products – overfunded UL in particular.

FSRA will be considering a number of measures, including working with industry to enhance ongoing competency and performance standards for agents and distributors, and to ensure FTC objectives are ultimately achieved and consumers are better-protected against poor outcomes.

Appendix

Footnotes and References

1. Insurance Core Principles and Common Framework
2. ICP 19 - Conduct of Business
3. Guidance - Conduct of Insurance Business and Fair Treatment of Customers
4. CCIR Cooperative Fair Treatment of Customers (FTC) Review – Consolidated Observations Report
5. FSRA Insurer-MGA Relationship Review Report, July 28, 2021
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