

**What Fiduciaries
Should Know and Ask
about Life Insurance**

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Executive Summary

- 1. Irrevocable life insurance trusts provide an effective wealth preservation device for trust customers and an effective means of augmenting the long-term assets that trustees will retain for their management. However, life insurance is a complex trust investment with unique characteristics that require special attention.**
- 2. Permanent life insurance products (e.g., whole life) are not fungible. Their rates of return vary substantially one from the other, as does the financial strength of the companies offering them. Expert and objective help is needed to sort out these differences.**
- 3. Reliance on policy illustrations as the basis for choosing between insurance companies is misplaced. The choice should be based on a combination of an insurer's financial strength, the historic rate of return that its policies have offered, and a proven record of treating its policyholders fairly (pages 4-7). A 1996 actuarial study revealed that only 2 of 28 companies projecting the most favorable results satisfied current regulatory requirements for illustration integrity.**
- 4. Policy performance depends on four factors: gross investment returns, mortality charges, expenses, and policy persistency (lapse rates). Even for products with similar investment results, differences in the other variables dramatically affect long-term rates of return.**
- 5. Looking at the variable of mortality charges alone, a recent Society of Actuaries study found that the difference between the best results from one company vs. the mean results for 22 other leading companies improved long-term rates of return by 90 to 140 basis points depending on the age of the insured.**
- 6. It is often possible to structure the components of a permanent insurance product to reduce the traditional agent's commissions by approximately 85 percent. This, too, can improve the long-term rate of return of a policy by 1 percent or more, and trustees have a duty to reduce such investment expenses.**
- 7. A low-load life insurance policy with the most competitive mortality and expense charges offers an attractive investment opportunity in comparison with similar taxable**

investments. Removing 85% of the commission cost and obtaining top mortality results can improve rates of return by 200 basis points, or 43%, over the returns from an average policy with a standard commission (pages 14-15; see charts on pages 16-17). With such a policy, even if the dividend interest rate were to decline by 1 percent below the current rate and the insured were to live to age 95, the tax-free rate of return would be 6.5 percent. With combined federal-state tax rates of between 30% and 40%, the taxable equivalent rate of return for this low-risk, fixed income investment would range between 9 and 11 percent.

8. With both existing and new policies, it is possible to “reverse engineer” policy illustrations to analyze and gauge the credibility of their projections. This process enables a forecast of a policy’s range of potential outcomes and a comparison with alternatives that might offer better returns.
9. A high percentage of existing “permanent” life insurance policies will self-destruct before the death of the insured, wreaking havoc with estate and business planning that assumes the continuation of this coverage. Many of these policies were sold with “lowball” premiums designed to beat the competition that are insufficient to deliver the expected death benefit, in light of lower interest rates and higher insurance charges than those used in the original policy sales illustration. Corrective action, which may include the replacement of the original policy, is required to keep these policies alive and, perhaps as well, to obtain much better returns for the premiums paid.
10. Increasing capacity in the reinsurance market has raised the likelihood that those with health impairments can obtain insurance on a favorable basis from the best insurance companies. Informal underwriting inquiries can be made to determine the likelihood of acceptable results.
11. A fee-only life insurance consultant should have the following qualities and capabilities in addition to life insurance experience: (1) objectivity (the firm should be fee-only with no commission-based compensation); (2) independent analysis of the reliability of insurance company policy illustrations and projections; (3) a conservative bias in favor of assuring the durability of insurance policies intended to provide permanent, rather than term, coverage; and (4) a fee structure consistent with fees charged for irrevocable life insurance trusts and capable of easy explanation to trust customers.

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The failures of several large life insurance companies within the last decade – most notably, Mutual Benefit and Executive Life in 1991 and Confederation Life in 1994 -- sent tremors throughout the life insurance industry and caused those who work in an advisory capacity with life insurance products to take a closer look at both the strength of the companies and the nature of the policies.

A less obvious but more widespread problem affecting the life insurance industry is the extent to which many policies sold in the last 20 years have failed to come close to matching the projections made in the illustrations used to sell them. The combination of lower investment earnings and higher internal policy charges than those assumed in the original policy illustrations makes it likely that many “permanent” insurance policies will not last as long as the insureds. This is especially true of policies purchased based on the perception that they were the cheapest.

These ominous developments in the life insurance industry have important, and potentially dire, implications for trustees of irrevocable life insurance trusts. While trust documents are often designed to exculpate the trustee from any potential liability for the choice and performance of the life insurance investment, it is questionable, at best, whether such provisions can offer an effective shield, especially where the trustee has purchased the policy in the first instance.

Those who have considered the potential liability of trustees for the poor performance of trust-owned insurance have not sited any legal support for an argument that the fiduciary responsibilities for the oversight of trust investments are somehow diminished when the investment takes the form of life insurance. To the contrary, commentators have noted that “(i)n order to properly discharge its obligation to exercise due diligence in making an investment in life insurance, a trustee must extend that exercise to the selection of an insurance company and product and the periodic review of the investment.”¹ The consensus view is that trustees must either develop the necessary expertise internally to review investments in trust-owned life insurance policy investments or delegate that task to outside experts, as permitted more broadly under the new Prudent Investor Rule.

The perception that trust-owned life insurance presents undue complexity and risk for trustees of irrevocable life insurance trusts has caused a number of banks to avoid this role altogether. Some who had eagerly and routinely accepted this business in the past no longer will, and some of the banks that refuse new insurance trust business have also resigned as trustees of existing trusts.

¹ James B. Bertles and Joel H. Yudenfreund, “Limiting Fiduciary Liability for Investing in Insurance,” *Journal of Taxation of Investments*, Spring, 1994, 239, at 246. See also Howard M. McCue III, “Fiduciary Liability: A Little Shop of Horrors for the ‘90’s,” Presentation to the Chicago Estate Planning Council, at 26-28, 1993.

This attitude and approach represent an overreaction to a genuine problem. Insurance trusts do contain distinct complexities and risks compared to trusts invested wholly in marketable securities. However, they also present a significant opportunity in two common situations – first, where the eventual insurance proceeds will remain under the management of the trustee or, secondly, where the added liquidity in the hands of the trustee will increase, by a similar amount, the eventual value of the assets that the trustee will retain to manage, once estate taxes are paid. Declining to serve as trustee of an irrevocable insurance trust will likely reduce the value of the assets that the trustee retains after the death of the insured. Worse, it may mean the complete loss of all long-term trust business from the insured’s family.

The twin premises of this article are that trustees should welcome a role as trustee of an irrevocable insurance trust where the two opportunities described above are present, but, at the same time, they need to appreciate the significance and relative complexity of this oversight function. For those trustees with the foresight to recognize the value of future business from irrevocable life insurance trusts, the following due diligence guide should be helpful. It is intended both as a guide to purchasing new insurance and to reviewing the performance of existing insurance. Ultimately, trustees may seek to delegate the responsibility for reviewing insurance proposals and performance to outside advisors, as few, if any, trustees have a volume of insurance trusts that can justify hiring someone with this niche expertise. Whatever course trustees follow, they should understand the following insurance questions and problems that need ongoing attention.

Comparing Companies

All insurance companies are not alike. Both in their financial strength and rate-of-return performance, they are very different. It is therefore important for trustees to be armed with the basic information necessary to distinguish the good from the bad and even the best from the good and, in the case of existing insurance, to spot problems with current policies. Policy ratings and probable rates of return are readily measurable and capable of comparison, one against the other, and, to the extent your trust customers are in a position to do so, there is no reason not to choose the best alternative available.

Life Insurance Company Ratings and Rating Agencies: Any analysis of a new or existing policy should begin with a review of the financial strength ratings of the company in question. Today, there are five rating agencies: A.M. Best, Standard & Poor’s, Moody’s, Fitch (previously Duff & Phelps), and Weiss Research. For years, A. M. Best had the field to itself. However, as large pension funds investing in the “guaranteed investment contracts” of life insurance companies sought additional means of tracking the safety of their investments, S&P, Moody’s, and Fitch -- all firms with a history of issuing credit ratings -- entered the insurance rating business as well. Weiss is the most recent addition to the group and is known for its critical and wholly quantitative approach.

A.M. Best and Weiss rate all life insurers of any meaningful size. A company has to choose to be ranked by the other three agencies. Because it takes the time of top management to undergo interviews with and respond to requests for information from the examiners and perhaps because there may be a reluctance to face the additional scrutiny, some choose to forgo a review by one or more of this group of three. The absence of a rating, however, makes it more difficult for a company to compete with insurers who have favorable grades from all of the agencies.

The number of companies reviewed and the number receiving the top rating from each of the agencies is as follows, according to the September, 2001 edition of The Insurance Forum: A.M. Best: 1,353, 65; Moody’s: 200, 12; Standard & Poor’s: 852, 38; Fitch: 219, 41; Weiss Research: 1,158, 6. That publication contains a table similar to the one on the next page.

Moody's and Weiss are often considered the toughest graders because of the small number of companies receiving their highest rating, and one should look to them to discriminate between those that simply make the top tier and those that are truly the most solid. These two agencies did the best job of forecasting possible trouble for Executive Life and Mutual Benefit in 1991, as Moody's did again with Confederation Life, the fourth largest Canadian company, which was taken over by regulators in 1994 (Weiss does not follow Canadian companies).

The Rating Agencies and Their Grades

| | | | | |
|-----|------|------|------|----|
| A+ | Aa1 | AA+ | AA+ | A |
| A | Aa2 | AA | AA | A- |
| A- | Aa3 | AA- | AA- | B+ |
| B++ | A1 | A+ | A+ | B |
| B+ | A2 | A | A | B- |
| B | A3 | A- | A- | C+ |
| B- | Baa1 | BBB+ | BBB+ | C |
| C++ | Baa2 | BBB | BBB | C- |
| C+ | Baa3 | BBB- | BBB- | D+ |
| C- | Ba1 | BB+ | BB+ | D |
| D | Ba2 | BB | BB | D- |
| E | Ba3 | BB- | BB- | E+ |
| F | B1 | B+ | B+ | E |
| | B2 | B | B | E- |
| | B3 | B- | B- | F |
| | Caa1 | CCC | CCC+ | |
| | Caa2 | CC | CCC | |
| | Caa3 | R | CCC- | |
| | Ca | | CC/C | |
| | C | | DDD | |
| | | | DD/D | |

If one is shopping for new insurance, it is relatively easy to identify the company or companies that the rating agencies judge to be the strongest, and, if historic rate of return has also been first-rate, there is no reason not to choose the best. When viewing inadequate ratings as a possible reason to replace a policy, however, it is more difficult to mark clearly the threshold below which replacement action ought to be taken. For one thing, all of the large companies mentioned above which became insolvent in recent years had top ratings from one or more of the agencies within a relatively short time -- a year or less -- of being taken over by the regulators. However, they did not have top ratings from all of them and certainly not from Moody's and Weiss.

In spite of some necessary subjectivity in using ratings as a reason for replacement, it is at least possible to suggest some guidelines.

A.M. Best: While Best has the longest history of rating insurance companies, its heavy dependence on the insurance industry for the sale of its publications has led to some criticism that it has been too lax in its ratings. Perhaps as a result, it added a highest A++ rating, which is currently given to 65 companies, to differentiate somewhat more clearly among the stronger companies. The absence of this rating does not necessarily justify replacement, but advisors should at least be aware of the large number of companies that are financially stronger, and recognize that some well-known companies that had Best's old top grade of A+ became insolvent within one year of having this rating.

Moody's: Because it gives the most stringent scrutiny, along with Weiss, it deserves special attention. One should therefore be looking at all ratings that are given, and not just those from

one or two rating agencies. A “double-A” rating is thought to assure a general level of comfort and, in the absence of an uncompetitive return, does not warrant a replacement.

Weiss: Although viewed as an upstart maverick by some and criticized by others for relying solely on data filed in insurance company annual reports and not at all on interviews with company management, Weiss has the best record, as well as Moody’s to an almost equal extent, of withholding top ratings from companies that have gone insolvent. For that reason, it has gained credibility, and its rating should be part of any analysis.

Look At All Ratings: Because companies with some top ratings have developed liquidity problems, it is important to review all ratings, with a special eye on Moody’s and Weiss, and not just on one or two ratings. If a company is not rated by one or more of the agencies among Moody’s, Standard & Poor’s, and Fitch, it is fair to ask why, especially if the tough standards of Moody’s have been avoided.

For a more complete idea of the range of ratings used by the five agencies, the table on the previous page is provided.

Comparing Products as well as Companies

Other than reviewing a company’s ratings with the rating agencies, life insurance analysis involves a comparison of products as well as research on the companies themselves. This is true whether the contemplated purchase is term insurance or some form of permanent coverage. Because of the greater number of term insurance products today and its importance in the marketplace, we should give some attention to term insurance before moving to a more in-depth analysis of permanent insurance.

Term Insurance Analysis: The main point to be made with regard to term insurance, other than the importance, in any case, of the quality of the company, is that the policy that appears to be the cheapest may not be.

Term insurance generally comes in two basic forms: the increasingly popular level premium product and the traditional “yearly renewable term,” in which case the premium starts lower but increases a little each year. In either case, your customers should focus on long-term needs and costs.

With level premium term, it is a common mistake to shop for a 10-year level premium product when the need is likely to last beyond ten years, at which point the premium will increase to some unaffordable level. Therefore, if a level premium product is preferred, customers should choose a long enough level premium period that it will extend through the years that they might need term insurance. Otherwise, they should opt for the yearly renewable term alternative that will enable them to keep the insurance as long as they need it without a requirement that they requalify for it by passing a new medical exam.

In the case of yearly renewable term, they should check out the future annual premiums, and not be misled by a low-ball initial premium when the longer-term rates will greatly exceed the premiums of a policy with a higher first-year cost.

Finally, if there is any possibility at all that customers will want to convert all or a portion of their term insurance to some type of permanent insurance policy in future years (recognize that only 1 percent of term insurance policies ever pay a death benefit; the rest are converted to permanent insurance or are dropped before death), trustees should be aware of the companies that offer the best rates of return on their permanent insurance policies. They will want to know whether the term

insurance policy can be converted, the period of time during which they have this right, and the historical performance of the company and product into which the term insurance might convert. These considerations lead logically to the following more detailed discussion of how to determine what company might offer the best rate of return on permanent insurance.

Permanent Insurance: Reviewing Its Rate of Return: In analyzing a policy's present and future rate of return, and comparing it to possible alternatives, there are a number of fairly reliable indicators which are discussed in some detail below. However, it is first important to understand how inherently unreliable and potentially misleading is the most common method of analysis -- the policy illustration prepared by the company or agent.

The Fallacy of Relying on Insurance Ledgers: Sellers of life insurance policies, including products with an investment component, are allowed to do that which is illegal for the seller of securities -- to project into the future the likely rate of return of a particular policy and to represent that the illustration is a sound basis for selecting the product.

To even pretend that the illustration accurately portrays how the policy will perform is potentially even more misleading than if similar sales materials were allowed to be used in the sale of mutual funds, since the life insurance policy is more complicated than a mutual fund, and its future rate of return is therefore more difficult to predict. While the mutual fund's performance depends only on the gross rate of return of the investment and money management expenses, the life insurance policy's return is tied to four factors -- investments, mortality experience, expense charges, and lapse rates of policies (how long they stay on the books). Does it make sense that projecting the future performance of the relatively uncomplicated product (the mutual fund) is illegal, while doing the same thing for the more complex product (the life insurance policy) is not only legal but is the primary basis upon which agents sell and consumers and their advisors (including trustees) choose among competing products? Obviously not. Indeed, the practice defies logic and invites deception.

How well a policy performs and how close it comes to meeting or exceeding its illustrated rate of return depends on the non-guaranteed performance of the company and policy in all of the areas affecting rate of return, and the current results do not always justify the manner in which these factors are implicitly shown to play out in the future in a policy illustration. In other words, the future forecast may look much brighter than the past, and the experience of the life insurance industry makes clear that there is no very close correlation in most cases between companies that illustrate most optimistically and those which have performed well.

For companies and agents to obscure this essential truth is a great disservice. For sophisticated investors and their other advisors to ignore it and allow, or even encourage, a choice of insurer based on the untested assumptions underlying a policy illustration compounds the problem.

It is not unusual for agents and brokers to provide a series of policy illustrations purporting to show which company and product offers the best cash value and death benefit rate of return based on certain premium payments and assumed ages of policy surrender or death. The fact is that, even if the agent is experienced and acting in good faith, this seemingly sophisticated analysis is not worth the paper on which it is printed, at least as a basis for choosing the company or product offering the best buy.

As a useful general guide for the role of the policy illustration, the advice contained in this report from a leading accounting firm should be taken to heart:

“...Illustrations are helpful in understanding plan structure, but have little value in comparing policies and companies...We focus on past insurer performance, current

operating statistics, and the insurer's demonstrated willingness to focus on 'old' policyholders versus potential future buyers..."

Detecting Hidden and Overly Optimistic Illustration Assumptions: Illustrations are a relatively poor basis for choosing a company or policy even if the illustration is honestly based on current performance. The problem is made worse by undisclosed assumptions that may bear no relation to existing experience -- for example, the unjustified use of a continually improving trend in life expectancy or of "lapsed-supported pricing," which uses the unreasonable and unhealthy expectation of profits from premature policy terminations to offer the non-guaranteed promise of additional returns and reduced expenses for long-term policyholders.

Needless to say, it can be difficult to tell whether a policy's illustration is based on something other than the company's and product's current experience. However, an increased focus in recent years on the potentially misleading nature of illustrations and in-depth questioning of the practices of insurers and agents has shed new light on the problem.

Using the Illustration Questionnaire of the American Society of CLU and ChFC (now the Society of Financial Service Professionals): Recognizing that the problem of misleading illustrations has resulted more from company than agent practice, the American Society of CLU and ChFC, the organization representing the most highly-trained agents, directed a series of questions to companies, which, if answered honestly and thoroughly, were designed to reveal the extent to which illustrations are based on past and current experience. At one count, 84 insurers, representing 71 percent of company assets, had responded. Some companies have now submitted a second response, perhaps as a result of more critical self-analysis or changing company practices and economic conditions.

The American Bar Association's Life Insurance Counselor Series: Also helping to provide badly needed insight into the illustration practices of companies and agents has been the Life Insurance Counselor series of the ABA's Real Property, Probate and Trust Law Section, in particular its first publication: Life Insurance Products, Illustrations, and Due Diligence, first released in 1989 and revised in a much-expanded second edition, Life Insurance Due Care, in 1994. This project is an acknowledgment of the need for a deeper understanding of life insurance on the part of those with the greatest responsibility for reviewing large life insurance purchasing decisions, and it is also a major help in providing additional insight.

Regulatory Efforts of the National Association of Insurance Commissioners: As the inherently misleading nature of life insurance illustrations has drawn legislative fire from some in Congress, state officials charged with the lead role in regulating insurance have struggled with ways to standardize ledgers. The National Association of Insurance Commissioners' Working Group on Life Disclosure Standards ultimately recommended some standards to control, if not end, the abuses.

Under the proposed NAIC regulations, companies may only base their illustrations on their current experience, and they have to designate an "illustration actuary" to certify that illustrations have this integrity. The actuary is required to disclose any difference in treatment of old and new policyholders -- equality of treatment among policyholders being one of the characteristics of a consumer-friendly company.

Such regulations, if they were truly implemented and enforced, could help make life insurance illustrations a more useful predictor of future product and company performance. But there are still other criteria that one can use for more reliable guidance? Even more objective and analytical benchmarks discussed below are available.

The Tillinghast-Towers Perrin Analysis of Life Insurance Illustration Abuses:

Confirming the widespread abuses in life insurance policy illustrations is the 1996 Tillinghast-Towers Perrin study of the subject. According to their analysis of the illustrations from 114 companies, only 50 percent met the standards proposed by the National Association of Insurance Commissioners (NAIC) (see below). Most revealing, only 2 of the 28 illustrations purporting to show the best future projections passed the NAIC test. What this means, quite obviously, is that, in spite of good faith regulatory efforts, life insurance illustrations are almost certain to be a hopelessly flawed basis for choosing the company and policy that will likely perform most competitively in the future.

Dividend or Net Cost History: A fair basis for predicting the possible future performance of an investment portfolio and comparing it to its peers has always been its track record, assuming there is one. So it is in the life insurance industry, which uses a standard known somewhat interchangeably as net cost or dividend history.

Net cost can actually mean one of three things: (1) the traditional net cost method, which adds cumulative premiums and subtracts dividends and ending cash value but ignores the time value of money; (2) the interest-adjusted payment cost, which measures the annual net premiums -- premiums less dividends, adjusted for interest using a 5 percent discount rate -- but overlooks the guaranteed cash value; and (3) the interest-adjusted surrender cost, which uses the same discount rate to calculate premiums less dividends less guaranteed cash value.

While the National Association of Insurance Commissioners uses both the interest-adjusted payment cost and surrender cost, the latter is a fairer measure of rate of return, since it includes all cash value and not just the portion that comes from dividends. The interest-adjusted surrender cost also forms the basis of “dividend histories” compiled by A.M. Best.

Comparing Dividend Histories: For companies willing to participate in its survey (only 59 chose to subject themselves to this scrutiny in one recent year), A.M. Best publishes annual reports of dividend histories covering a company’s policy over the previous 10 and 20 years. It selects what policy to use and the policy issuance age of the insured. Because permanent insurance only makes sense for those planning on keeping it for longer than 10 years and closer to 20, the 20-year dividend history comparisons are most instructive.

To obtain the best idea of a company’s past and possible future performance over a long period of time, it is useful and important to check its 20-year dividend history over many years, rather than just for the current year. This most effectively winnows the field. For example, in a recent 20-year period, only 27 companies have finished in the top 10 of 20-year dividend histories at least once.

Those companies that illustrate most aggressively but have not compiled competitive dividend histories should be asked how they can expect to do so much better in the future, relative to other companies, than they have in the past. This lack of close correlation between those companies that have performed well and those that appear to promise the most underscores again the peril of heavy reliance on policy illustrations as a means of choosing between companies, including in the context of deciding for or against replacing a policy.

The Four Factors Affecting Rate of Return: A company’s and a policy’s performance depends on the cost of insurance and, in the case of a permanent insurance policy, the return on investment dollars after insurance costs are paid. Investment results tend to be the focal point of most rate of return analyses. However, these rankings may vary between periods and can easily overlook or

misrepresent the important distinction between gross and net returns. It is especially important to recognize also that a company's consistency in providing products with a competitive return is as much a function of the cost factors – (1) good mortality experience, (2) modest expense charges, and (3) low policy lapse rates -- as it is of strong investment performance. Investment results may be the attention-getting quarterback of the team, but it is the three factors governing the cost of insurance that do the essential blocking and tackling.

To use another athletic metaphor, competition among life insurance companies is also like the triathlon. Consistently superlative performance in each area should be the benchmark, not just impressive investment returns.

Any review of new or existing insurance should therefore examine a company's record in each of the four categories of life insurance performance -- investments plus the three areas relating to insurance costs: mortality, expenses, and lapse rates -- to see how the company compares to the competition. Let's examine these four factors in more detail.

Questions To Ask About The Four Factors Affecting Rate of Return: For those interested in having a greater ability to analyze insurance companies and products and to separate fact from fiction, a more detailed look at the four factors determining a company's and product's rate of return may be of interest and should be helpful.

Investments: The investment return from the assets supporting the particular policy in question is the most important of the four variables, although a stellar investment record cannot fully compensate for even mediocre performance in any of the other three areas. Most traditional whole life policies credit the same interest rate on all policies based on the total portfolio return. With universal life and some whole life policies, carriers segment investment income by policy year and, in addition, sometimes apply both a "new money" rate for newer premium dollars and an "old money" rate for investment returns from dollars paid in previous years. Variable life investment returns depend on the performance of the underlying investment fund chosen by the policyholder and the level of investment management expenses.

Numerical comparisons of "dividend scale" interest rates for whole life policies or "crediting" rates for universal life policies can be misleading. Some companies might use a gross rate, some may use some kind of net rate, and some practices may fall somewhere in between. Even the "net yield" figures used by A.M. Best are not reliable indicators of investment acumen since their exclusion of capital gains and inclusion of policy loan interest understates performance.

Most companies apply a lower interest rate to a policy to the extent there is borrowing against it and to the extent the policy loan interest rate which the company receives in repayment is lower than the gross investment rate earned on the rest of its portfolio. This practice is known as "direct recognition."

Special Questions About Investment Returns: Does the company use a gross or net interest rate or something in between? Northwestern Mutual's dividend scale rate, for example, includes capital gains, excludes policy loan interest, and is net of taxes and investment expenses. In the case of universal life, the gross rate is relatively meaningless, since higher than normal expense and mortality charges could reduce the effective interest rate credited below that of a company with a lower gross rate but which also offered lower mortality and expense deductions. Because it is often difficult,

if not impossible, to know what variables are included and excluded in the statement of interest rates, excessive reliance on interest rates in a comparative analysis is a mistake.

Does the company use a portfolio or investment period allocation method for crediting interest earnings to policies? The portfolio method generally involves somewhat longer-term investments and therefore higher average investment returns than the shorter-term and more interest-sensitive investment period allocation method used with universal life and some whole life policies?

Does the current dividend or interest-crediting rate appear to be justified by the current earnings of the company? It is possible that a company might be overly aggressive in its rate relative to its current earnings, although, again, that could be due to the use of a gross rate that appears misleadingly high. Otherwise, one should inquire as to whether the relatively high rate can be sustained, or whether its use comes at the expense of proper contributions to company surplus.

Does the interest rate vary by policy duration with a non-guaranteed enhancement for older policies or for those with higher cash values? If it is guaranteed, are reserves set aside to support it? Seeming to offer additional returns may be an indication of “lapse-supported pricing,” which uses a rather cynical, and perhaps faulty, assumption that the premature termination of policies will be profitable to a company and that a portion of those profits can be used to fund the enhancements. What happens if the lapses do not materialize as expected?

Are interest rates and any interest-related policy enhancements the same on old and new policies, at least where the portfolio interest crediting method is used? If not, the company may be punishing existing policyholders with a lower rate in order to lure in new business.

Especially if the carrier’s investment return is unusually high, but even in general, it is a good practice to inquire about the nature of a company’s investments. Are there any unusual risk characteristics in its portfolio? These should be reflected in the company’s standing with the credit rating agencies, but their track record has not been perfect, as has been noted. Insurers are somewhat limited by investment laws in how they can invest, but there is still potential for trouble for those which are overly aggressive. Possible problem areas have included one or more of the following: defaults on below-investment-grade (junk) bonds, delinquent mortgages, differences between book and market values for real estate, and, in general, an investment portfolio that does not maintain sufficient liquidity to match the insurer’s possible obligations to meet demands for cash. The rating services should, but may not, call attention to potential problems in any of these areas.

Mortality Experience: Differences in mortality results between life insurance companies can influence the rate of return on a permanent insurance policy just as much, or more, as differences in investment returns. A company’s mortality experience is measured by A.M. Best by the rate at which death benefits are paid compared to the company’s own actuarial expectations used to price the premium. The results can vary substantially even among well-recognized companies.

Those factors which influence a company’s mortality experience in general are the quality of the underwriting process; the demographics of the insureds; the amount of individually underwritten business vs. group insurance, which has no underwriting, or small policies which do not require it; and the amount of new vs. old business. Increasing amounts of new business are helpful because it means that the pricing of more policies is based on the current health of policyholders as opposed to health conditions that may have changed since an old policy was issued.

Special Questions about Mortality Experience: Is the company or an illustration projecting mortality results better than those experienced in the past or currently? Is the company, for example,

predicting a continued improvement in mortality based on recent trends? Mortality has improved about 1 percent per year over the last twenty years, but it is questionable whether this pattern will continue.

Do mortality rates vary by product, and, if so, is there justification for doing so, or will one group of policyholders be subsidizing another?

In the case of a group product with either no or minimal underwriting, are illustrated mortality charges higher, as they should be, than for the company's individually underwritten policies? Surprisingly, some large group universal policies marketed to large firms of professionals and offering substantial death benefits without medical exams appear to offer lower mortality charges, at least initially, than policies from the same insurer that require full underwriting. At the same time, the guaranteed maximum mortality charges are, as one would expect, lower with the full-underwriting product. One can only fairly, if somewhat cynically, assume that the mortality expenses for these group policies will be increased to more realistic levels once the plans have been in place for a period of time.

Is there a policy enhancement in the form of a refund of or reduction in mortality charges for policies of a certain duration or over a certain size? If so, the company should be asked if it is guaranteed, and, if it is, whether reserves are set aside to support it. Because a policy's mortality costs should increase for older policies, since the lapse of time after the underwriting medical exam leaves greater uncertainty regarding current health, a mortality charge refund offer for older policies makes no sense. In most cases, there is actually a mortality expense surcharge of some kind on older policies, which may be more than offset by a reduction in administrative expenses for the policy as it ages.

Unfortunately, in spite of extensive efforts cited above to regulate and reform misleading policy illustrations, a recent article by leading actuary noted widespread projections of unrealistically low mortality charges "rooted more in science fiction than science."² He cited the example of several companies using mortality rates in future years that would require improvements in life expectancy 300% to 400% greater than those experienced over the last 15 to 20 years.

The Society of Actuaries' Study of Mortality Results: Perhaps the most telling evidence of the extent of rate of return differences between even the best and largest companies comes from a recent private study of mortality results by the Society of Actuaries.

It involved a review of the results of 22 leading companies, looking at policies issued over the previous 15 years with deaths occurring in the prior 5 years. It revealed that the impact on the dividend interest rate (roughly equivalent to the impact on rate of return) of differences between the best results from one company and the mean performance of these 22 companies was a full 100 basis points (1 percent) for policies issued at age 45, 140 basis points at age 55, and 90 basis points at age 65.

These differences are so great that they may be hard to believe. Indeed, they suggest that, given the same investment performance and non-mortality expense charges among insurers, differing mortality results between companies are a compelling basis to choose one company over another where the underwriting results make such a choice possible. Low mortality charges for a particular carrier may even make it the company of choice where the underwriting rating it offers is somewhat less favorable than another company's.

² Tom Fitch, "Low Mortality Assumptions Could Hurt Buyers' Confidence in Life Industry," National Underwriter, July 16, 2001, p. 54.

Differences in mortality charges between an existing policy and a proposed new one may also make a policy replacement economical. If the health of a client with existing insurance is good, the possible long-term savings may also make it advantageous to replace an existing policy of a company with relatively high mortality charges with one with substantially lower costs.

Expense Charges: The impact of insurance company expenses – other than mortality costs – also varies significantly from company to company. As in other industries, some companies are simply more efficient than others. These differences in overhead are reflected in A.M. Best’s “renewal expense ratios.” A company with lower expenses is obviously going to be able to offer a higher return than one that consumes a larger portion of its gross investment yield on overhead. Relative ability to control expenses may also be the best indication of the quality of management and the culture of the company.

Several factors influence the level of a company’s renewal expenses. Because of the relatively high expenses of selling life insurance, due to the fact that the product has traditionally been “sold and not bought,” the efficiency of a company’s distribution system is a key element in controlling expenses. Companies with the best career agency forces have tended to have some of the lowest expenses. At the same time, because of the cost of training new agents, a company’s ability to recruit and retain new agents is important.

Product mix also has an impact on expenses. Whole life, a long-term product, has a higher persistency and therefore lower expenses than term or universal life. The uneven and less predictable cash flows of universal life, coupled with some flexibility in varying the death benefit, lead to relatively high ongoing administrative costs.

Company growth is another key ingredient. While new business is expensive to put on the books, an ever-expanding base of existing policies achieves economies of scale and helps to defray the cost impact of writing new business.

The Question of First-Year Expenses and Agent’s Commissions: First-year expenses, especially the payment of a standard first-year agent’s commission, can detract significantly from the long-term performance of a permanent insurance product. Commissions have by far the largest impact on the short-term performance of an insurance policy, and, under most premium and commission structures, they result in almost no cash value accrual within a policy in the first year or two of a new policy (see the last chart on page 17).

The typical first-year agent’s commission is largely responsible for this drag on product returns. Including portions of commissions paid to general agents and amounts paid as “expense allowances,” commissions can often exceed 100% of the first-year premium. They typically range between 5% and 10% of the premium for the next 5 to 10 years.

At one time, inflexible premium structures on whole life insurance policies gave the consumer no choice. This is no longer the case. Today, the agent and policy applicant have considerable discretion in structuring a policy and premium so as to reduce the standard commission by 80% or more. This is done by designing a policy with a maximum amount of term insurance and a minimum amount of permanent insurance and then having most of the annual premium payments take the form of “additional premiums” or “dump-ins” on which the commission may run about 3 percent, or a mere 5 percent of the standard first-year agent’s commission.

The difference between the full commission and the low-load commission falls straight to the bottom line, builds immediate cash value within the policy, and substantially enhances long-term returns from the policy.

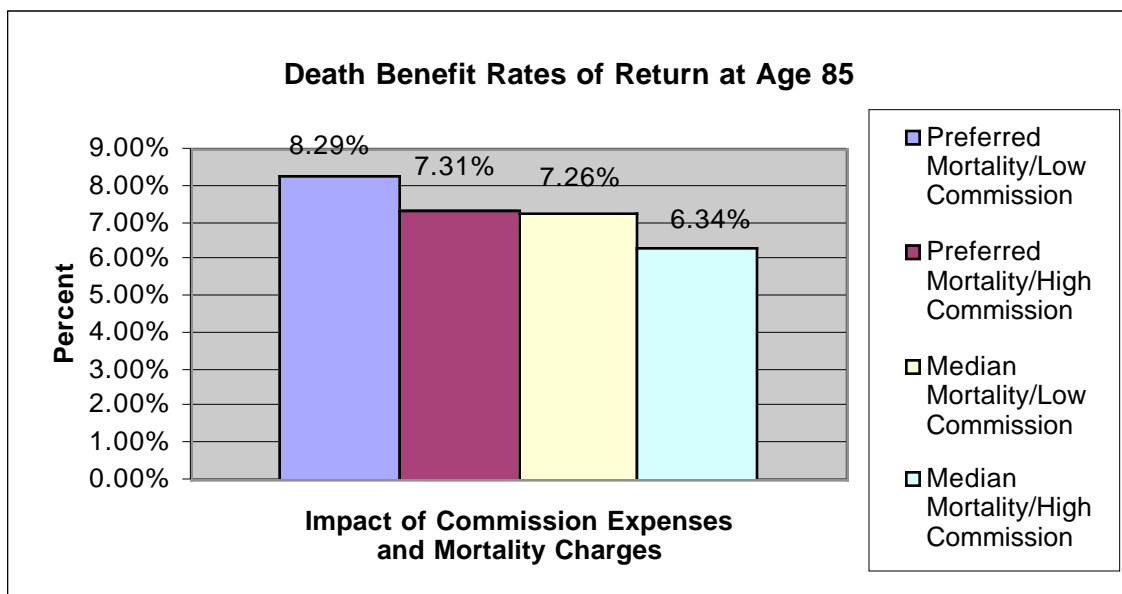
The ability to achieve these savings and to increase policy values in the process is not limited to special products with very large premiums, such as private placement and offshore life insurance policies. Premiums can be structured to eliminate most of the commission for most any permanent insurance policy – whole life, universal life, or variable life – offered by the best companies. The process simply requires objective expertise and oversight in applying for the policy to be sure that the premium is structured to minimize commissions.

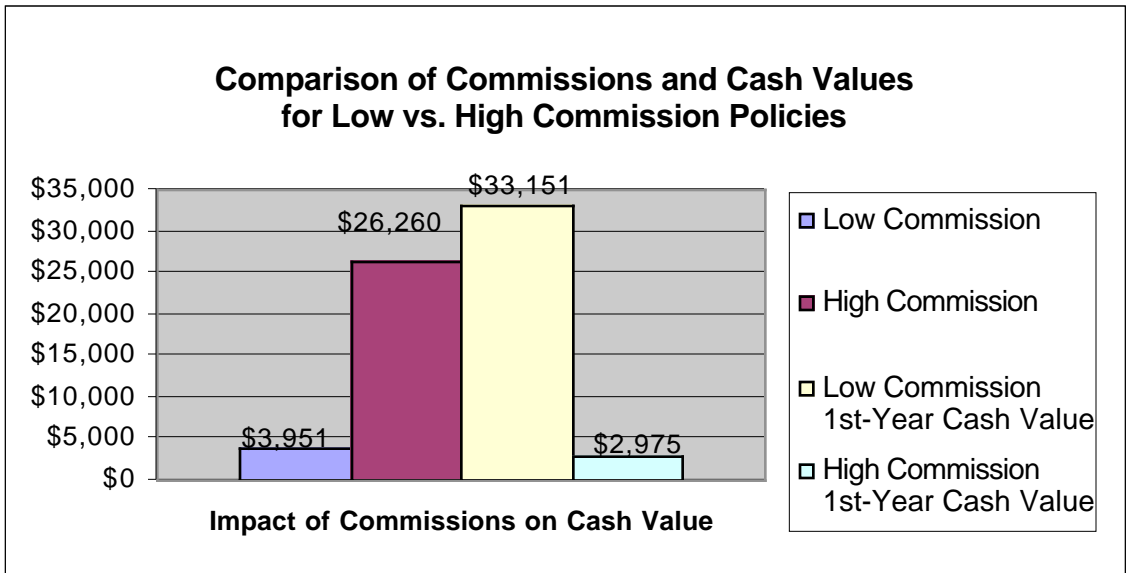
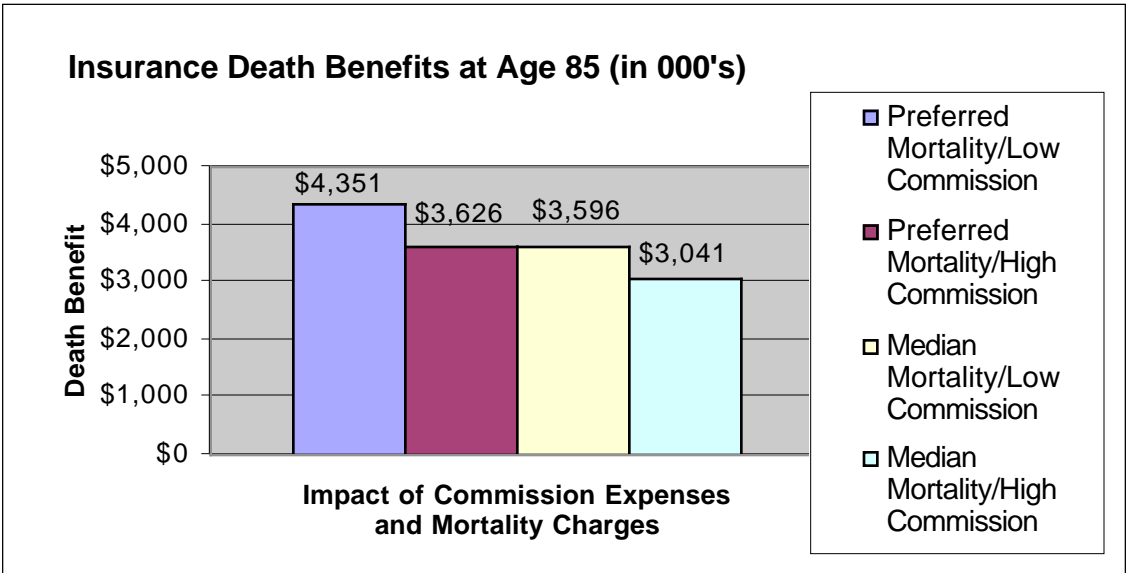
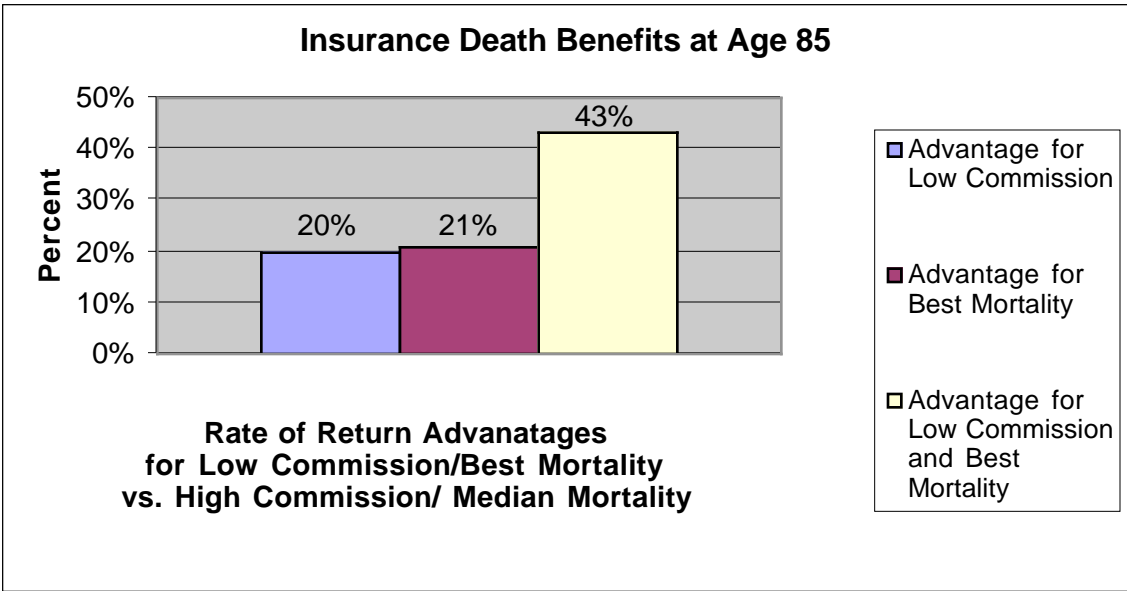
Consider the example illustrated in the charts below. It involves a \$1 million permanent insurance policy for a 56-year-old male with an annual premium of \$36,685. With a low commission of only \$3,950, the death benefit rate of return at age 85 is about 100 basis points, or 20% higher, than with a standard commission (\$26,260) based on 55% of the first-year premium and an “expense allowance” of 30% of first-year commissions. The low commission is only 15% of the higher commission, a striking example of the ability to reduce commissions on today’s flexible insurance policies to enhance long-term returns.

The initial impact of this difference in commissions on policy performance is dramatic. It is revealed by the disparity in first-year cash values between the low commission and standard commission policies - \$33,000 vs. \$3,000. With the low commission approach, more than 90% of the first-year premium goes to work immediately within the policy to build long-term values. With the standard commission, almost all of the first-year premium is siphoned off to pay the agent’s and other commissions (to the general agent, brokerage manager, etc.) and expenses.

If, on top of this differential from commission savings, one gains a further edge by obtaining the policy from the company with the best mortality results, rather than one with average mortality charges, that results in an additional rate of return advantage of almost 1 percent. Indeed, the combined

**Impact of Commissions and Mortality Charges on Insurance Policy Rates of Return
\$1 Million Policy for 56-Year-Old Male with \$36,685 Annual Premium**





benefit of a low commission and low mortality charges, as opposed to a standard commission structure and average mortality charges, increases the age 85 death benefit rate of return by almost 200 basis points – 8.29% vs. 6.34%. This difference translates into a death benefit from the low commission/low mortality policy that is 43% higher than that produced with the alternative. In short, these substantial variations in commissions and mortality costs have a profound impact on long-term policy results. One is simply throwing away large sums of money by ignoring these differences. The charts above help to illustrate this point.

In addition, a company with low operating expenses (other than for commissions and mortality charges) and top risk-adjusted investment results can offer further advantages. Considering these additional factors widens the rate of return gap between average companies and the best returns likely available from life insurance policies.

Trustee’s Duty to Minimize Insurance Commissions: Restatement Third of Trusts and the associated Prudent Investor Rule impose an obligation on trustees to reduce investment-related commissions and expenses. “Prudence” dictates that “trustees have a duty to avoid fees, transaction costs and other expenses that are not justified by needs and realistic objectives of the trust investment program.”³

In the life insurance context, where high commissions have been common but can usually be avoided, the duty to minimize fees and expenses has clear and potentially serious implications. Consider the consequences for a trustee, which, in the exercise of reasonable care, should know that two identical permanent insurance products can be purchased, one with a commission six times greater than the other. The trustee purchases the high-commission alternative, resulting in a 100 basis point reduction in rate of return. This scenario is very common today, and trustees need to avoid it, perhaps by retaining outside expertise to oversee the purchase of such products on a low-cost basis at a fraction of the expense of standard insurance commissions.

What about No-Load Life Insurance? If commissions were the sole determinant of comparative rates of return, then the few no-load life insurance products available today would offer a compelling alternative. Yet, thus far, the failure of the no-load companies to achieve top mortality results and to reduce non-commission expenses to the most competitive levels appears to keep them from offering the most competitive long-term returns in spite of the absence of commissions. In addition, it is often possible today, as in the above example, to reduce the standard commission to such an extent that it barely detracts from a policy’s long-term rate of return. Looking for a company that excels in limiting mortality and non-commission expense charges and then reducing commissions in the manner suggested above can provide the best returns. As products and companies change in the future, the possibility that the no-load alternative might become more competitive in these basic ways will bear watching. For now, it does not appear to offer an advantage.

Other Questions About Expense Charges: Are expense charges consistent for new and existing policies of the same type? If they are not, this is an indication that old policyholders are subsidizing the company’s attempt to capture new business.

³ McCue, *op.cit.*, at 5.

Do expenses vary by product or underwriting class? This is only reasonable if justified by a company's actual or reasonably anticipated experience. It is otherwise an indication of overly aggressive marketing and subsidization of the product with the lower expenses.

Are expenses in an illustration that discloses them adequate and realistic? If not, it is likely they will be subsidized by higher charges for mortality or a lower interest-crediting rate. Conversely, an unrealistic and overly aggressive projection of mortality charges could be offset by higher expense charges, or, again, a lower interest rate.

Lapse Rates: Several factors in addition to commissions influence a company's expenses. One important variable is the rate at which policies lapse – i.e., are terminated by insureds before they die. Writing a new policy is an expensive proposition for a company. Paying for agents' commissions, doctors' fees, underwriting personnel, reinsurance (in some cases) and policy reserves that must exceed the initial premium all cause a company to draw down its surplus. For a policy to become profitable for the company, it must stay on the books for an average of seven years. Companies with poor policy persistency will therefore have the most difficulty recouping their upfront expenses.

A relatively high lapse rate adversely affects not only an insurer's expenses, as one would expect, but also its mortality results and investment returns. Mortality experience suffers with higher lapse rates because, at least to some meaningful extent, healthier policyholders are most likely to let their policies go. Companies with lower lapse rates have better overall risk characteristics among their insureds than those with higher lapse rates. As more policies have gone off their books, companies with more lapses have thereby lost more of their better risks, leaving a less healthy pool of remaining policyholders.

As for their impact on investments, lapses interfere with long-term investment strategies. High lapse rates require greater liquidity in the insurer's portfolio, leading to shorter-term investment vehicles, forced and untimely asset sales, missed investment opportunities, and capital losses.

Questions To Ask About Lapse Rates: In spite of the negative effects of high lapse rates on all aspects of an insurer's operations, "lapse-supported pricing" -- a carrier's assumption not only of relatively rapid policy turnover but also that this high lapse experience will be profitable -- is all too common. To make these projections, a company must price and structure its products with unusually high surrender charges, which are then used to fund non-guaranteed interest and/or mortality enhancements limited to policies of a certain duration or size. When the ability to deliver the non-guaranteed elements is dependent on lapses being profitable to the carrier, it is highly questionable whether any policies will actually qualify for the enhancements.

As a possible way to detect lapse-supported pricing, companies should at least be asked whether, if lapse rates are lower than assumed, that would impair the company's ability to meet its non-guaranteed projections or, if it does pay these amounts, its profitability will suffer. Unusually high surrender charges in a policy's first years or unusually low mortality charges in the "out years" of an illustration may also indicate the use of lapse-supported pricing.

Insurance as an Investment with a Low Commission, High-Performing Product: One of the clear implications of the substantial variation in insurance policy rates of return based on the factors discussed above and the charts above is that the best performing products are good investments. That is especially true where (1) the policies are held until death so that insurance proceeds are received free of income taxes, or policy values are otherwise withdrawn or borrowed during life without tax

consequence; and (2) the comparative after-tax or tax-free returns are compared to investments with similar risk characteristics.

In fact, if, as noted above, it is possible to add 200 basis points or more to the returns of the standard life insurance policy by taking out most of the commission cost and obtaining the benefit of low mortality and expense charges, the tax-free returns of a life insurance policy can look very attractive compared to similar investments. If, for example, one considers the possible returns from the most competitive whole life policy in the context of other fixed income investments, a tax-free yield of 6.5%, or more, should have great appeal compared either to tax-free municipal bonds or taxable corporate, U.S. Treasury or other government issues.

To test this thesis, consider the best performing policy (as the result of a low commission and low mortality charges) from the charts above and assume that the 8.29% death benefit rate of return at age 85 declines because the assumed dividend interest rate falls by 100 basis points and higher mortality costs are incurred because the insured lives to age 95 rather than 85. Even in that situation, the projected death benefit rate of return is 6.5 percent. That tax-free return is equivalent to an after-tax return from a taxable investment of 9.3%, assuming a combined 30% tax rate, 10% with a 35% tax rate, and 10.8% with a 40% tax rate. These are clearly very attractive returns for a low-risk, fixed income investment.

The investment appeal of life insurance should be greatest for those who will most likely hold the policies until death, to take advantage of the income tax-free treatment of the death benefit, and who can afford to forgo the cash flow that an equivalent investment would produce. Avoiding the taxable income from the alternative investment is an additional benefit. However, even where the insured, or the beneficiaries of a trust created by the insured, would like to have the flexibility to obtain access to the cash value of the policy, they can do so, if necessary, on a tax-free basis by withdrawing cash value through the surrender of "additions" purchased with dividends up to the tax basis in the policy and then borrowing portions of the cash value beyond that point.

In any case, in light of the ability to improve upon the traditional returns of standard life insurance products, the investment merits of life insurance deserve much closer attention in a variety of situations. The point made here largely involves only a discussion of whole life insurance in comparison with fixed income alternatives. The comparisons could be equally or more compelling when considering the possible investments available through a range of variable life products, including those that high net worth investors may wish to explore in the private placement or offshore life insurance markets with investments of their own choosing. With a sufficient amount of money to invest (generally, \$2 million and up), insurance companies will often agree to allow the insured substantial discretion in recommending their own investments, including hedge funds, which, inside of a life insurance policy, can reap tax-free returns. In this context, the investment potential of life insurance expands even further.

Comparing the Rate of Return of Whole Life and Universal Life: It is probably fair to say that in all four of the rate of the rate of return categories -- investments, mortality, expenses, and lapses -- the performance of universal life, other things being equal, will lag behind whole life policies. To understand why, the basic differences between the two products need to be explained.

Universal life, which is now about twenty years old, came into being at an unusual time when the interest rate yield curve was inverted, as short-term interest rates reflected in those policies' rates of return were higher than the longer-term whole life dividend interest rates. Because of those interest rate differences, universal life was sometimes sold in its first years as an opportunity to borrow out of

an old whole life policy at the low loan interest rate guaranteed in the policy, or to surrender the old policy altogether, and to reinvest the proceeds at what was then, albeit temporarily, a much higher yield offered in the universal life contract. As the yield curve reassumed its normal upward slope in subsequent years, this turned out to be a poor strategy.

Today, the lingering appeal of universal life for some is its greater flexibility in the timing of premium payments than whole life offers. Unlike whole life, which requires annual premium payments calculated to yield the guaranteed cash value and death benefit based on conservative assumptions, universal life sets a target premium designed to produce the desired benefit based on current policy experience. It then lets policyholders skip or vary premium payments, provided that there is money inside the policy sufficient to pay, not the full target premium, but the lower current insurance costs of the policy, which increase each year with the age of the insured. Whole life allows somewhat similar flexibility in that, if the cash value in the policy is sufficient, an automatic premium loan will fund the premium payment. But it must be the full whole life premium that is paid, rather than only the pure term insurance costs of the policy as universal life permits.

In addition to permitting irregular premium payments, many universal life policies allow some increases in death benefits without additional medical underwriting.

This somewhat greater premium paying and death benefit flexibility of universal life appeals to some life insurance buyers, but it carries a price in its impact on all four rate of return factors. The investments of universal life policies are, of necessity and by policy design, intended to be relatively short-term and interest-sensitive. The unpredictability of cash flows, due to the lack of an annual premium requirement, forces a shorter-term, lower-return investment yield than the better whole life policies offer.

Mortality experience is likely to be worse with universal life because of the adverse selection stemming from the death benefit flexibility that many policies offer and the greater tendency of healthier insureds to let their policies lapse when, because of having missed past premium payments or due to deteriorating policy performance, they would otherwise have to pony up large premium payments to keep them going.

Expenses are higher because of the higher administrative costs associated with policy flexibility and higher lapse rates, which, in turn, result from the freedom to skip and underpay premiums until it is perceived as too costly to pay enough back premiums to maintain the policies.

The higher lapse rates also adversely affect investments (forcing them to be shorter term to maintain sufficient liquidity for the high turnover of policies), mortality (because of the adverse selection involved in the decisions to lapse policies), and expenses (because the policy's acquisition costs are not recovered as readily as they are with higher persistency whole life policies). In addition, the negative impact of high expenses and lapse rates on the universal life insurer's profitability and company surplus is apt to be reflected in its grades from the rating agencies.

Where universal life is already in place, all of these factors are reasons to consider its replacement with the best whole life product, if the flexibility of universal life is not clearly needed and the other implications of policy replacement outlined below are fully understood. In any case, the flexibility of universal life requires that it be monitored especially carefully because of the high probability that a policy, though designed to be permanent, will lapse without adequate funding.

A Comparative Analysis Involving Variable Life: If variable life is either the existing policy or the potential replacement policy, it is important to recognize how it differs from a regular portfolio product. Its chief distinguishing feature is the range of investment choices it offers, usually including a

variety of equity accounts. Its appeal, therefore, is its potential on the investment side of the equation to achieve a higher gross rate of return than traditional whole life because of the different and riskier nature of its more aggressive investment funds in comparison with the general portfolio behind a whole life or universal life policy.

Because insurance companies are limited by law to fairly conservative investments that consist largely of fixed income assets – e.g., bonds and mortgages – their portfolio products will not likely match the average historic returns from equities. However, variable life incurs higher expenses than a portfolio product from the same company because of the cost of SEC compliance and investment management expenses. As a general rule of thumb, variable life costs 50 to 150 basis points more in expenses than a traditional product from the same company, depending mostly on investment management expenses.

While the hope and reasonable expectation is that the 3 to 4 percent difference in historic rates of return between equities and bonds will overcome the higher expenses of variable life, its greater costs and risks pose at least offsetting considerations. In addition, from an investment diversification standpoint, there is a place in every portfolio for some fixed income-oriented investments, and it would be a mistake to get rid of those that are of the highest quality and, because they are contained in a life insurance policy, the most tax-advantaged. Any suggestion to switch from a traditional product, especially one that is the best of its kind, to a variable policy should, therefore, not be pursued without careful consideration and recognition of the potential risks and expenses.

The Impact of Fluctuating Investment Returns: One of the difficulties of analyzing variable life insurance proposals is that investment returns within the policy fluctuate considerably from year to year. Policy illustrations assume a consistent return of, say, 10 percent or perhaps even 12 percent. They do not show the effect of very different returns from one year to the next.

The proprietary “reverse engineering” program mentioned below takes these fluctuating returns into account. Using historic returns for the asset class similar to the insurance investment, the program projects a range of probable results based on a random sequence of historic annual returns, life expectancy, and reasonable assumptions for mortality and expense charges based on the carrier’s experience. What this exercise reveals is that variable life is riskier than insurance company illustrations would suggest. This is especially true when the plan is designed to minimize the premium for a given level of permanent death benefit. For that reason, minimally funded variable life policies should be avoided, and all such plans should be carefully monitored on an annual basis.

The “Reverse Engineering” Analysis of Life Insurance Policies: With the assistance of more powerful personal computers, it is now possible to calculate the assumptions underlying life insurance illustrations, to make educated forecasts of their ability to deliver on their representations, and to compare the likely performance of a policy against competitive industry benchmarks. These standards are developed from a study of information from various sources of policy mortality and expense charges. Given an assumed rate of return in a policy illustration, it is readily possible to back into the insurance costs of a policy (the mortality and expense piece). Conversely, with an assumed level of mortality and expense charges, one can determine whether the resulting net investment return corresponds with the rate in the policy projection.

The use of certain known or assumed variables to calculate others and, thereby, to project in a more realistic way the likely overall performance, or range of possible outcomes, of a policy is referred to here as “reverse engineering.” Using this process, it is possible to determine whether an illustration has integrity, or whether it is based on unrealistic expectations about mortality and expense charges, on

the one hand, or investment rates of return, on the other, or possibly both. With this kind of multiple variable spreadsheet analysis, one is also able to vary interest rates, mortality charges, or expenses by various percentages and to determine the impact on the long-term performance of the policy.

Varying Interest or Investment Assumptions: With regard to investment results, as mentioned above, a more realistic view of possible policy performance can be observed using a variable or random-ordered application of historic investment or interest rates. By linking the investment returns or interest rates to the historic returns of the stock market, in the case of variable life, or to a company's past dividend or interest-crediting rates in the case of portfolio products, a range of probable results is developed. Since the variability of investment returns and the order in which they will be experienced will yield not one sure outcome but a broad range of possible results, it is this range of potential returns that is most realistic. In the discussion below, we will see how this method of analysis has direct application to a process for determining whether thinly priced new or existing permanent insurance policies are likely to last the lifetime of the insured.

The "Reverse Engineering" Process Detects a Flawed Policy Illustration: An example of how the reverse engineering process uncovers a misleading policy projection is well illustrated in a recent case involving a 52-year-old male considering the purchase of \$2 million of variable life insurance. The agent's illustration from a company that is generally well regarded and well rated indicated that a \$25,000 premium would be adequate to fund the \$2 million of coverage on a permanent basis. However, when put through the reverse engineering process, with appropriate assumptions made about the policy's likely mortality and expense charges and 1,000 random tests using historic investment returns and life expectancy outcomes, the policy was found to have a 40% chance of failure (i.e., of lapsing before the insured's death). To reduce the failure possibility to 5% would have required a premium of \$54,000, or more than twice the premium that the agent had suggested.

This example illustrates the pitfalls, especially for one charged with fiduciary responsibilities, of simply relying on an insurance illustration as a reasonable prediction of a policy's performance. Not all illustrations are unreliable, but many of those from brand name companies are. Trustees, or those acting on their behalf, need to look "beneath the hood" to detect unreliable assumptions regarding the performance of both new and existing insurance. They need to be especially alert to policies which, like the above example, have been or will be funded insufficiently to assure the permanent death that their trust customers expect.

What To Do About Existing Coverage

The kind of insurance policy and company analysis discussed above is often most important when examining existing insurance and determining whether it will deliver what seemed to have been promised. In these situations, trustees frequently encounter the following issues and problems.

Salvaging or Replacing Underperforming Policies: Two types of overly aggressive illustration practices at the time of policy sale, coupled with a general decline in interest rates in recent years and frequent increases in mortality and expense charges, now raise many questions about the present status and future performance of old policies. It may be that adjustments to the old policies' premiums or death benefits are required. Quite possibly, they should be replaced, if possible, with coverage from a more financially solid carrier with a better track record of offering the most competitive returns. Whether or not the replacement of existing policies is warranted, it may be that any additional insurance may be obtained from a much better insurer in the future.

The Non-Vanishing or Reappearing Vanishing Premium: The first example of overzealous sales practices is the “vanishing premium” illustration used to project the point at which policy dividends, perhaps coupled with a surrender of dividend additions (the additional insurance that has been purchased with dividends) will be sufficient to pay premiums. The reliance on continuing high interest rates and perhaps other overly optimistic assumptions in making the rosy projections that were used to sell the policy now, when these assumptions have proven unfounded, causes premium payment obligations to continue for many more years. In some cases where premiums had previously vanished, they are now reappearing, sometimes in much larger amounts than the original supposedly “vanished” premium.

In these situations, it is overwhelmingly likely that, when the policy was sold, the non-guaranteed nature of dividends, which is typically mentioned only in an insurance ledger’s footnotes, was not emphasized. As attention focused on the year in which the figure in the premium column first read zero, the distinction between a policy with a vanished premium, where dividends or policy values are projected to be sufficient to cover it, and a paid-up policy, on which no future premiums are ever due, was almost certainly not explained.

Compounding the incomplete understanding of these points at the time of sale has been the companies’ and agents’ general absence or insufficiency, in most cases, of an early warning to their policyholders of the consequences of declining interest rates -- for example, that a premium designed to “vanish” in year 10 in the original illustration, will, at the current dividend or interest-crediting rate, need to be paid until year 18.

Especially if a whole or universal life policy was purchased within the last 10 to 20 years with the expectation, based on an illustration at the time of purchase, that the growth in policy values would permit premium payments to stop in a particular year without losing the coverage, check again. The news may be very upsetting to insureds and their policy beneficiaries.

The Danger of Underfunded, Vanishing Policies: Worse than the abuses of overly optimistic vanishing premium illustrations are policies sold with “lowball” premiums that are insufficient to sustain them, especially against reduced interest rates or higher than assumed mortality charges, expenses, or lapse rates. These underfunded policies usually take the form of either whole life/term insurance hybrids where the term portion is maximized or universal life with a minimally priced target premium based on optimistic assumptions. In either case, the policies, because they were priced as low as possible, are completely dependent on the non-guaranteed assumptions behind the illustration, which often have little chance of proving accurate.

Both types of policies have lots of term insurance mixed into them, and the non-guaranteed returns from the policy are required to replace the term portions of the policy with permanent insurance. When this does not happen because of declining interest rates and perhaps other unmet projections, three related developments threaten the future of the policy. Reduced non-guaranteed returns leave fewer investment dollars inside the policy to generate additional dividends and cash value growth. With poorer investment results and lower dividends, additional permanent insurance, which must be acquired with these dividends, is not purchased at a fast enough rate to replace the term insurance on the planned schedule. In turn, the continuing presence of too much term insurance as the insured ages increases the policy’s mortality charges and leaves less money left over to accumulate as the cash value reserve inside the policy. As that reserve fails to build fast enough because of reduced investment returns and is, at the same time, depleted with higher than projected insurance costs, there is a good chance that the policy will fall apart before the insured dies.

Some policies from what are generally regarded as reputable companies have gone so far as to offer step-rated or “graded” premiums that depend on dividends to avoid an additional out-of-pocket cost to the policyholder when the future premium increase occurs. In some cases, the premiums do not increase for the first ten years. However, when interest or dividend rates fall or insurance costs go up, dividends will be insufficient to pay the increased premium, and the risk of policy lapse is especially high. This is just an example of the lengths to which life insurers will go to try to appear price-competitive.

The Special Peril of Underfunded Second-to-Die Policies: Nowhere are the hazards of underfunded policies greater, or is the problem more widespread, than in the second-to-die market. Because of the large amounts of insurance often involved, the central importance of these policies to the ultimate success of estate plans, and the gift tax considerations that influence the choice of policies and premiums, an aggressively priced policy with a heavy mix of term insurance is especially risky and, in many cases, irresponsible.

Sad to say, there are many of these types of policies among those already purchased. They may even comprise the majority of existing coverage. Overheated competition among insurers and agents in the big case market, unfiltered by a second opinion from a knowledgeable advisor, has fed the natural tendency of purchasers to focus on perceptions of lowest price rather than on proven and probable comparative rates of return among insurers, based on their historic track records and current performance. Consumers have been apt to fall into the trap of paying too little for insurance, not realizing that this may well mean the policy gives out before they do.

As a result, a number of existing “low-priced” policies now suffer from the serious impact of declining interest rates since the time of their sale, possibly coupled with mortality and expense charges that are higher than those illustrated when the policy was sold. Dependent on the originally assumed dividends to carry them forward, these policies are imperiled by the unfavorable deviation from illustrated values. Without immediate and major corrective action, these thinly-priced policies will likely lapse before the death of the insureds, leaving no residual value. Estate and business planning, which is based on the assumption that these policies will provide the necessary liquidity, will collapse in the process.

It is likely that, in almost all of these situations, trust customers have no clue that their insurance policies may collapse. It is not likely that they receive copies of the premium and other notices from the insurance company that are directed to trustees as owners of the policies. Trustees, however, cannot afford to turn a blind eye to these problems or to wait to be told that there may be a problem before undertaking their own independent analysis of policies.

What To Do With An Underfunded Policy: In reviewing an existing policy, it is first important for trustees to figure out whether a policy is vulnerable to underfunding or has otherwise failed to measure up to the original projections upon which a client’s plans have been based. This can be determined by asking the carrier or agent for an “inforce ledger” showing a policy’s current status and projecting its performance into the future.

Ask for an illustration that shows the insured living to a very advanced age – even beyond age 100, as some policies are designed to lapse at advanced ages, such as 95 or 100. In the case of a second-to-die policy, ask for the same thing for one of the insureds and ask that it also show the younger, healthier insured dying prematurely. At the same time, ask that the current dividend or interest crediting rate be reduced by one percent. If the mortality and expense charges of the policy are also

honestly projected, this ledger will expose underfunded policies and show the point at which, without corrective action, the policies will collapse if the insured has not died sooner.

Recognize that inforce policy illustrations may be just as unreliable a basis for decisions about an existing policy as they are in the case of a ledger for a new policy. The “reverse engineering” process described above can help to detect projections that appear misleading or unrealistic in comparison to competitive industry benchmarks. Using the policy’s stated dividend or interest-crediting rate can reveal the assumed mortality and expense charges. Appropriate adjustments to these mortality and expense charges implicit in the illustration can then demonstrate the impact of higher charges, including the odds that the policy will fail before the death of the insured (or both of the insureds in the case of a second-to-die policy).

If what appears to be a policy’s disappointing performance results only from a general decline in interest rates affecting all life insurers and similar policies, and the current performance of the policy is otherwise competitive with similar products, and the company has enjoyed and retains high solvency ratings, there is probably no reason to replace the existing policy. It can be maintained either by lowering the death benefit or increasing the premium if the policy is underfunded, or simply by paying premiums for a longer period of time if the policy has failed to live up to a vanishing premium projection. The policy may also be adjusted or updated by the existing insurer to a more competitive current product, perhaps including a guaranteed death benefit, without the need for additional medical underwriting.

However, if the policy has experienced a low rate of return compared to similar products or if the insurer’s ratings are questionable or have recently been downgraded, there is a good case for replacement, assuming the replacement precautions noted below are observed.

Precautions in Replacing Policies: Even where solvency concerns or rate of return considerations seem to call for a policy’s replacement, there are several precautions to observe. Those responsible for reviewing a life insurance policy that has experienced a disappointing performance should understand that:

- Policy performance may actually be quite competitive if the factors adversely affecting this performance have been experienced by all insurers. In particular, the dramatic fall in interest rates over the last 20 years has lowered the returns of all traditional whole life and universal life policies to one degree or another. Rather than replace the competitive policy of a well-rated insurer, whose returns have only gone down to some extent with the broad decline in interest rates, it may be more appropriate to make any necessary adjustments to assure the continuation of the policy by raising the premium, paying it for a longer time, reducing the policy’s death benefit, or seeking an adjustment with an updated policy from the same insurer.
- A worsened health condition since the first policy was issued may cause a new policy to have an inferior health rating and therefore a higher mortality cost, meaning a greater expense for basic insurance coverage. In any event, the old policy should not be surrendered until the new one is issued on satisfactory terms.
- A new policy would have contestable and suicide provisions applying anew that could result in a claim, that would have been payable under the old policy, being denied in the first two years of the new policy in the event of a suicide or commission of fraud in the application process. These are highly unlikely events, but the applicant for the replacement policy should at least be aware of them.

- The agent's commission and possible surrender charges on the new policy could lower the rate of return on the new policy, at least in the first few years of the new policy, in comparison with the old policy. The commissions can be substantially reduced, as pointed out above, but they would, in any case, impose some cost that would detract somewhat from the initial rate of return on the new policy. Attention needs to be paid to the point at which a higher rate of return on the new policy may surpass the rate of return of the old one, after incurring the costs involved in effecting the replacement. Remember again that policy illustrations – both the “inforce ledger” of the existing policy and the projections for a new policy - are not, by themselves, a reliable basis for making this comparison.
- Differences in the underlying investments of the old and new policies may make rate of return comparisons difficult or misleading, especially if the proposed new policy is variable and equity investments are contemplated in place of the old insurer's fixed income-oriented investment portfolio. Investment returns obviously need to be adjusted for risk for comparisons to be meaningful, and the other factors affecting product performance -- mortality, expenses, and lapse rates -- need to be considered as well.
- Some replacement proposals attempt to increase the death benefit for an existing premium or to lower the premium for an existing death benefit by guaranteeing a death benefit – but only to a certain advanced age, such as age 95 or 100. Purchasers of “permanent” insurance want their policies to be “permanent” and not to expire before they do if they happen to live to an especially long time.

Tax-free Policy Exchanges: When a policy is replaced, caution is required to avoid taxation of the investment gains inside the old policy if they exceed the policy's tax basis, which consists of premiums paid by the owner less any cash permanently withdrawn. With a policy replacement, the cash value from an existing policy is used as an initial deposit for the new policy. If the cash value exceeds the tax basis of the policy, income taxation on this difference between cash value and basis can be avoided with a tax-free exchange of one contract for another pursuant to IRC Section 1035.

It is important to note that the 1035 exchange rules do not function like the more commonly known IRA rollover rules in that policy owners cannot, themselves, surrender the existing policy, take its cash value, and then apply it towards the new policy. Rather, with the application for the new policy, ownership of the old policy is assigned to the new insurer, which then surrenders it after the new policy is issued. Within these limitations, one policy can be exchanged for another on the same insured, or one annuity for another, or a life insurance policy can be traded for an annuity equal to its cash surrender value, in which case the distributions from the annuity may even be deferred. In addition, multiple policies on the same insured can be exchanged for one new contract.

The fact that the second policy inherits the tax basis of the initial policy can minimize eventual taxation. This is true where the first policy, at the time of replacement, had a tax basis greater than cash value. The basis carryover at replacement means less exposure to taxation if and when cash is eventually withdrawn from the second policy. As a practical matter, the second insurer may not always account for the impact of the carryover basis from the old policy. Even the best insurers are often unsuccessful in their attempts to track this information. If they cannot obtain it, the reported basis of the policy on surrender will not include the premiums paid on the original policy. Therefore, to take advantage of the carryover basis rule, it is important that good records be kept and that, at the time of the exchange, every effort is made to attempt to obtain tax basis information from the old insurer.

If policy tax basis is greater than the investment gain, such that there would be no immediate tax due if the old policy is surrendered rather than exchanged, an exchange may still be preferable if the new policy may eventually be surrendered. The carryover basis rules mean that the portion of the cash value in the new policy that would be shielded from taxation upon withdrawal will increase by the basis of the old policy. However, if it is overwhelmingly likely that the new policy will never be surrendered, such as with the purchase of a new second-to-die policy intended only for estate liquidity purposes, the relative ease of surrendering the old policy, as opposed to the somewhat more cumbersome and protracted exchange procedure, will make the surrender alternative most appealing.

How to Approach Insurance Underwriting with a Health-Impaired Applicant: Quite obviously, not every insurance applicant is a “select” or “preferred” risk. With age comes an increase among insurance applicants who have health issues of one kind and degree or another, and the percentage of those who can be underwritten on the most favorable basis naturally declines (though not nearly as much as one might think).

Impaired risk underwriting can be a specialty by itself, and there are only a few national brokers who can legitimately claim it. Does that mean that those who might fall into the impaired risk category should be contacting the impaired risk broker directly? Probably not, unless the broker is local and is clearly one of the national specialists in this field.

In the first place, do not conclude too quickly that the underwriting verdict from the company of first choice will be negative. As the result of increasingly favorable arrangements with reinsurers, a top company may be willing to accept the risk on terms that are favorable to the applicant. In these situations, it is best to be dealing with an advisor with a broad understanding of the industry and the possible sources of the most favorable offer in these situations. In this way, your trust customers will obtain the best underwriting outcome available in all circumstances. Informal inquiries can be made to insurance companies to determine the likelihood of acceptable underwriting results (and premium costs) without actually applying for the coverage.

Reviewing the Performance and Projections of Trust-Owned Life Insurance: Whether a trustee seeks to develop procedures for monitoring trust-owned life insurance policies or chooses to delegate this assignment to an outside consultant, the process should follow certain basic steps.

In the case of new insurance, obtain it, where underwriting results permit, from the company that appears to offer the best combination of solid ratings from the rating agencies and most competitive long-term rate of return based on historic performance. When measuring historic performance, pay especially close attention to mortality and expense charges, remembering that differences in mortality charges alone, given the same underwriting results (i.e., “preferred” or “select”), can account for a 100 basis point difference in rate of return. Once identifying the chosen company, structure the premium to minimize the commission in order to further enhance the policy’s values. Commission savings can also add 100 basis points or more to a policy’s rate of return.

Do not choose between policies based on comparative projections in insurance company illustrations. A sound analysis depends upon the sort of “reverse engineering” process discussed above and a comparison of illustrated mortality and expense charges thereby detected in an illustration and then matched against competitive industry benchmarks.

In general, do not select one policy over another based on guarantees. Policy guarantees do not offer a sound target benchmark for a competitively performing life insurance policy. In most cases, the company that offers the most attractive guarantees is not likely to achieve the best rate of return. A

trustee should seek the best risk-adjusted return on insurance it owns, using reasonable assumptions for investment returns and mortality and expense charges and looking at various possible ages of death at and beyond actuarial life expectancy.

If the new insurance that the trust will own is term insurance, determine the maximum period of time for which the settlor will want to keep the insurance. Do not participate in the purchase of a term insurance policy that only offers attractive rates for a shorter duration. If there is any possibility that the settlor will want to convert the policy to permanent insurance, do not simply buy the least expensive term insurance. Use the criteria suggested above to purchase the term insurance that could be converted into the most competitive permanent insurance product. In the process of conversion to permanent insurance, make sure that the product and premium structure are designed to minimize the commission and, thereby, to augment long-term returns.

In the case of existing insurance policies that were purchased with the expectation that they were permanent, the trustee should first examine them to determine the probability that the policies will last as long as the insureds, or the survivor of two insureds in the case of second-to-die policies. Trustees must consider the distinct possibility that any policy lapse of a policy intended to be permanent, thus resulting in a total loss of invested premium dollars, will lead to very unhappy and possibly litigious beneficiaries.

Evaluating the existing policy's possible future performance should begin by requesting an in-force ledger from the insurance carrier or by authorizing such a request from the trustee's designated insurance consultant. Using the reverse engineering analysis to determine the assumed level of mortality and expense charges used in the illustration, these rates should then be compared to benchmark standards with upward adjustments made, if warranted, based on the carrier's historical performance. Depending on the results of this analysis, it may also be appropriate to run a series of reiterative tests that apply the variables of investment earnings, mortality and expense charges, and life expectancy in random order. This exercise will yield a range of possible rates of return for the policy and the percentage risk of policy failure, e.g., policy lapse before the insured's death.

Where existing rates of return have proved disappointing or the financial strength of the insurance company is questionable, consideration of a policy replacement may be justified. If so, trustees should follow the guidelines outlined above on the policy replacement question. Either the health of the insured(s) or their unwillingness to participate in the consideration of a policy replacement may limit the available remedial alternatives to restructuring the existing premium or product with the same company, thus avoiding the need for new health underwriting.

The Role of the Fee-Only Insurance Consultant: Even the largest personal trust departments would likely encounter difficulty developing the necessary in-house knowledge of the life insurance industry and product analysis capabilities to perform the functions suggested above without outside assistance. It is also unlikely that any trust department has a sufficient number of insurance trusts to justify employing someone with such a specialized background on its staff.

Even identifying and obtaining such a service from a firm with the necessary expertise and objectivity may not be easy. As in all areas where a trustee delegates its responsibilities to choose and monitor trust investments, special care and caution is required in the selection of agent, and the trustee bears a continuing responsibility for the quality of the agent's work. On the other hand, when the trustee lacks sufficient knowledge of specialized investment assets it owns, it is reasonable to suggest that there is a duty to delegate if outside expertise can help to review and monitor these assets.

Desirable Qualities of the Consultant: Foremost among the qualities that a trustee should seek in an insurance consultant, beyond the requisite experience with the life insurance industry and its products, are:

1. **Objectivity.** Does the consultant operate on a fee-only basis, or is some of its income derived from commissions on life insurance sales?
2. **Independent Analysis Capabilities.** Does the consultant base its recommendations on illustrations from the insurance companies, or does it have a methodology for independently testing the reliability of these projections and for making any necessary adjustments to them to make them more realistic?
3. **Conservatism.** Does the consultant have a bias in favor of assuring that insurance policies that were or are intended to provide permanent coverage are structured to achieve that result? With increasing longevity, permanent insurance policies must be designed for the possibility that the insured, or the survivor of two of them, will live to a very advanced age. A guaranteed death benefit to age 95, or even age 100, is not sufficient. One existing “fee-based” (not fee-only) firm markets its services to trustees with claims that in a typical portfolio of trust-owned insurance, it can increase the average death benefit by 98% without an increase in premiums. It appears to suggest that this is possible with universal life policies guaranteed to certain older ages, but not necessarily guaranteed to be permanent no matter when death occurs. This prescription is a recipe for future litigation.
4. **Reasonable fee structure.** Is the consultant’s fee structure consistent with a cost that the insured will bear for the services provided, and can the fees and the rationale for them be effectively explained to the trust customer? To state what may be obvious, the extent of services and the fees incurred will not be the same in each instance. Every policy should be inventoried and its nature and purpose analyzed. Short-range term insurance policies with no possibility of conversion need only a relatively cursory review. Permanent insurance policies should undergo a basic reverse engineering analysis unless it is apparent that their permanence is assured and that they are issued by a company with the most competitive historic rate of return performance. Any permanent insurance policy that, through a reverse engineering analysis, appears threatened by a policy lapse before the death of the insured should have the more rigorous random variable test applied to it to determine the percentage possibility of policy lapse. Various levels of service and fees are appropriate. The basic reverse engineering analysis can be provided for a cost consistent with fees traditionally charged by corporate fiduciaries of irrevocable life insurance trusts. More extensive analysis and policy restructuring and replacement services would involve additional fees, but the cost of such services and the need for them in selective situations should be apparent to trust customers from the results of the basic policy evaluation.

Conclusion

With proper oversight, irrevocable life insurance trusts can offer good current business and an even more valuable inventory of long-term investment management trust accounts for the future. Corporate fiduciaries can ill afford to turn this business away. Encouraging the creation of life insurance trusts and

indicating a willingness to serve as trustee will likely result in more assets under the trustee's management upon the death of the trust grantor than if the trustee takes a passive approach.

At the same time, the acceptance of new business and retention of existing trusts owning life insurance requires a vigilance that few trustees have yet exercised. Trustees will need to monitor these trusts with the same caution and care that they bring to other trust investments. For the reasons mentioned, they will likely need outside help in this process.

The opportunities are plentiful for trustees who appreciate the possibilities of future business created by irrevocable life insurance trusts but who also understand the need for a regular review of insurance company and policy performance. Trustees who facilitate wealth preservation with insurance while also minimizing their liabilities with the steps outlined here will serve the interests of both themselves and their customers.

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An estate planning lawyer prior to joining NML, Barkhausen is a member of the American, Illinois, and Chicago Bar Associations and served for 14 years on the National Conference of Commissioners on Uniform State Laws. He has written for and spoken to these organizations on estate planning and life insurance topics, and he has also conducted Continuing Professional Education seminars for the Illinois CPA Society on the business and estate planning applications of life insurance.

Barkhausen graduated with high honors from Princeton University in 1972 and in the first class of the Southern Illinois University School of Law in 1976. He and his wife, Sue, live with their sons, Wicks and Billy, in Lake Bluff, Illinois.