



# Life Insurance Reviews: What Trustees Should Know (and Do)

Trustees should evaluate life insurance policies held by the trust to determine their appropriateness in light of current financial conditions and industry developments.

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Someone serving as a trustee of a life insurance trust may not have examined trust-owned policies with the same scrutiny as used with respect to other trust assets. The role of trustee may have been taken on as a favor to a client or, if a bank or financial institution, because someday there may be an opportunity to manage life insurance proceeds. The trustee may not know how the policies are really performing. After all, an attorney likely cannot bill the client for the time an in-depth review will take. The old adage of “no good deed goes unpunished” is often true when it comes to trustees who hold life insurance policies in trust.

Someone in this situation is not alone. The following are findings of a recent survey:<sup>1</sup>

- 71% of personal trustees had not reviewed their trust’s life insurance policies in the past five years.

- A surprising 83% had no directions from the grantor about how to handle life insurance investments: how often, or what to review, who to report to, etc.
- 95% had no investment policy statement for trusts that own life insurance.

Flexible premium policies now account for 35% to 40% of in-force trust-owned life insurance policies.

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These policies permit premiums to be higher, or lower, than originally scheduled to maintain the death benefit. (That is why they are called flexible premiums.) More than 50% of those are “underperforming” (i.e., actual results compared to original projections). In addition, over 90% of trust-owned policies are “orphans” without an assigned servicing agent, meaning there is no “go-to” person for questions. The insurance company’s customer service department may be more frustrating than helpful.

Therefore, trustees often lack the skills to manage life insurance policies, have no directives from the grantor, and usually do not have an agent or broker to assist with a review.

While a trustee may be inclined to hope things turn out for the best, the trustee should not be naïve. Under the Uniform Prudent Investor Act (UPIA), trustees have a fiduciary responsibility to review trust-owned life insurance policies.<sup>2</sup> The

UPIA requires trustees to produce reasonable returns for beneficiaries. A failure to review life insurance can reduce returns for beneficiaries (on life insurance assets) and ultimately lead to litigation.

A trustee who asks his or her friendly life insurance broker to provide a review is more likely to get a replacement proposal (i.e., the broker will report that the old policy is not competitive and therefore, it should be replaced with new coverage—bearing a new sales charge). While this may be true, the trustee has a responsibility to explore all the options before taking this path.

### Why do trustees hesitate?

Many trustees have little understanding of the mechanics of life insurance policies, and the assumption is most policies of the same generic type are alike. The details are a black box a trustee cannot decipher. Many clients name relatives or friends as trustees, with little understanding of their fiduciary responsibilities for the insurance investments. They have no sense that a beneficiary could challenge the propriety of an insurance purchase, or the continued holding of a particular policy in the future, or if they do consider that possibility, they take false comfort in the donor's assurance that his or her children would never sue their uncle or the family's accountant. The most common misperception is that a trustee of an insurance trust has no responsibility until life insurance proceeds are received at death.

Trustees and the donor-insured may worry that they will not be able to evaluate whether the review is independent, or whether the information provided is motivated by the agent's desire to sell more, or different, insurance—as a new product is always available. Many life insurance salespeople mass

market life insurance reviews for trust-owned life insurance precisely as a sales tool. The ability to obtain thoughtful professional analysis seems unattainable. Agent compensation may also affect product recommendations because two products may have very different compensation structures (e.g., private placement variable universal life vs. traditional universal life). In some instances, a broker may become comfortable with one type of product and recommend that product in most situations—many times because the broker does not understand other products or features. Before replacing a policy, a trustee should ask the broker to disclose compensation associated with different proposals.

**At a minimum, a trustee should order an in-force re-projection each year from the insurance company and compare it to original projections provided when the policy was issued.**

Trustees who do understand the need to perform a periodic review are overwhelmed by the volume of paperwork supplied by the insurance companies. The projections provided by the insurance companies are voluminous and confusing to even the most knowledgeable lay person. Often, the initial reports received are non-responsive to the question asked, such as:

- Will the policy continue to perform as intended assuming ongoing level annual contributions and no change in the interest crediting or dividend schedule?

- Will the policy perform if assumptions change in the future, and what additional contributions might be required to maintain performance?

Trustees fear they will not be able to understand, or have the time to devote to reviewing, the analysis. A significant impediment to the process is the simple fact that many insurance trusts do not have funding, above the amounts needed to pay life insurance premiums, which would enable the trustees to pay for assistance in the review process. Family and friends often do not charge trustee fees, and corporate trustees are reluctant to charge more than a nominal trustee to cover the responsibility for premium payment and preparing the annual *Crummey* withdrawal notices.

Trustees may be hampered in their wish to pursue a review by an insured who is reluctant to participate in a process that may involve analysis of whether comparable insurance would be available at better pricing as the insured's health may have deteriorated since the original policies were purchased. In addition, if new policies are recommended, there may be a need for the insured to increase periodic funding to the trust for increased premiums due to the current age of the insured or changes in health. Older policies often have maturity dates that do not reflect current mortality experience, and the cost to extend the maturity date on the existing policy is more than the cost to purchase new (and often better) insurance.

A review may uncover split-dollar funded life insurance that has not been administered properly or simply needs to have the split-dollar funding arrangement terminated, which may require addi-

<sup>1</sup> Steve Leimberg's Estate Planning Newsletter, #891, 11/16/2005.

<sup>2</sup> Uniform Prudent Investor Act, section 2(a) through (d).

tional funding to the trust. The donor-insured may have no tolerance for increased contributions to the trust, but that does not necessarily mean the trustee has no planning options. The death benefit may need to be reduced in order to maintain coverage for the intended duration of the policy.

Trustees and insureds sometimes want the attorney or accountant to participate in the review process, and their own lack of familiarity with life insurance may make these advisors reluctant to do so. Their clients may assume they are knowledgeable, and they risk exposing their lack of knowledge, or worse, assuming liability for advice they are not competent to provide. The advisors' reluctance to participate in the review may be perceived by the trustee and insured as discouragement from engaging in a review of the insurance altogether.

Finally, and perhaps most importantly, the agent who placed the original policies may be a friend of the insured, the attorney, or the accountant so that there is a relationship in addition to the business relationship. This can make one or more of the individuals reluctant to "rock the boat" on the assumption that not much can be different between policies. Sometimes that trust is misplaced and the cost to the trust from owning inappropriate insurance might be extraordinarily expensive. Without a review, the trustee would never know that alternatives might be available.

All of these issues need to be considered and addressed thoughtfully, but should not be reasons to avoid review of the life insurance.

### **Necessary information and where to obtain it**

At a minimum, a trustee should order an in-force re-projection each year from the insurance company and compare it to original projections provided when the policy was issued. This is the only way to know how a policy is performing. The re-projection illustrates how the policy may perform (not guaranteed), based on current cash values and crediting rates. This will help the trustee determine if the current premium is sufficient, or if the premium needs to be increased.

A life insurance review should address at least the following areas:

1. Original goals and policy design.
2. Historical performance.
3. Options to reduce policy charges.
4. Insurer financial strength.
5. Replacement coverage alternatives.

### **Original goals and policy design.**

Consider what the original goals were when the policy was purchased and what has changed since then. In making that analysis, consider these questions:

- How was the policy designed to meet those goals?
- What were the loads and charges?
- What mortality table was used?
- Were initial assumptions about policy charges and expenses aggressive?

If assumptions have not been realized, the trustee should determine why. A trustee who does not have the original illustration can request an "as sold" policy illustration from the company. Mortality tables have changed over time, as life expectancies have increased. An older policy would have used what are now outdated

mortality rates, which caused policy charges to be higher than today's products, based on longer life expectancies.<sup>3</sup>

**Historical performance.** These questions should be considered in evaluating historical performance:

- Has the policy lived up to expectations?
- How has the policy actually performed versus how it was projected to perform when acquired?
- Is there is a discrepancy (typically in cash values)?
- How much is needed to shore up the policy, and what will be the source of funds to fix the problem?
- Have interest crediting rates on universal life policies declined (see Exhibit 1), causing frustrations for policy-owners?
- Have dividends (on whole life policies) been reduced?

The likely answer to this last question is "yes" (Exhibit 2). The impact can be significant because lower dividends (on whole life) and lower crediting rates (on universal life) often mean additional premiums. A trustee may need to have a conversation with the grantor (and adult beneficiaries) about the need for additional premium payments or reducing the death benefit of the policy; otherwise, the policy may lapse with no value.

### **Options to reduce policy charges.**

What has the trustee done to have the current policy become more competitive? Today's policies often have 2-3 categories of "preferred" ratings (e.g., super-preferred, preferred-plus, and preferred), and each category results in a significant difference in the policy's mortality charges. A trustee can submit medical information to the

<sup>3</sup> "Mortality Improvements: Analysis of the Past and Projections of the Future" 8 Actuary Magazine 20 (August/September 2011), available at: <http://www.soa.org/library/newsletters/the-actuary-magazine/2011/august/act-2011-vol8-iss4.pdf>.

## EXHIBIT 1 Historical UL Interest Crediting Rate and Rolling Average Benchmark



**Source:** Moody's published bond yields and carrier published crediting rates

in-force company and request an upgrade on the current policy; this could lower charges and improve performance.

The trustee should consider reducing the death benefit. An underperforming policy will do better with a lower death benefit due to lower mortality charges. In light of current unified credit amounts, and estate tax brackets, the trustee should consider whether the grantor-insured still needs the level of life insurance coverage that was needed a few years ago. Before any death benefits are reduced, consider seeking agreement from the beneficiaries.

**Insurer financial strength.** Recent history offers a reminder of the

importance of an insurer's financial strength. Many sources of information provide insight into an insurer's financial strength. The most common sources are the major rating agencies (A.M. Best, Fitch, Moody's, and Standard & Poor's). While it is common to focus on the actual ratings, each agency also prepares a detailed report explaining the fundamentals underlying their analysis of the company. These reports can help provide additional insight and highlight areas that warrant additional investigation. Trustees holding policies issued by insurers with ratings in the "vulnerable" category should evaluate the insurer's outlook (i.e., whether financial strength is expected to

improve) and closely review the options for replacing the policy with a higher-rated carrier.

**Replacement coverage alternatives.** This is the "what is possible" question and may lead to replacing current policies. Before existing policies are surrendered, the trustee should explore whether a sale of the existing policy makes sense from an overall planning perspective. In all cases, it will be important to understand the competitive landscape to know what products (and at what costs) are available. Current products have a range of fully or partially guaranteed cash values and death benefits with dif-

## EXHIBIT 2 Whole Life Insurance Dividend History (1991–2011)



Source: Moody's published bond yields and carrier published dividend rates

ferent costs based on the level of guarantees in the product.

The trustee should also explore an internal exchange with the company that issued the current policy as a way to reduce or eliminate charges on a new policy that may have better pricing than the original policy. Bear in mind this caveat: A replacement requires new underwriting and new medical exams, so before proceeding, the trustee should determine if the insureds are still insurable—and at what categories.

A real life insurance review provides an opportunity to communicate with beneficiaries, manage expectations, and build relation-

ships. This is likely to be one of the reasons the trustee agreed to take on the position of trustee in the first place.

### Crediting rates and rolling average benchmark

Along with declining interest rates, crediting rates on older policies have also likely declined as the insurance company's portfolio of bonds and mortgages has experienced a decline in interest income. The reduced crediting rates (to the trust-owned policy) will likely require premiums to be paid for several years longer than originally planned or additional amounts to be paid to maintain

the policy's death benefits. Exhibit 1 illustrates how universal life crediting rates have declined over the past 20 years.

**Whole life dividend rates.** Dividends on whole life policies have declined as well (see Exhibit 2), also causing premiums to be paid longer (or in higher amounts) than planned. Because whole life dividend rates tend to lag interest rate changes, these trends are expected to continue even if interest rates level out or start to increase. Therefore, communicating with grantors and beneficiaries is important so expectations of

**EXHIBIT 3**  
**Pricing for Mortality Risk 2001-2008; Male, Non-Smoker, Issue Age 55**



**Source: Society of Actuaries 2001 and 2008 Valuation Basic Tables**

grantors (who will likely fund with additional gifts) and beneficiaries (who expect to receive death benefits) can be best managed.

Each 50-basis-points decline in a dividend scale is estimated to require an additional 5% to 7% of additional premium.

Furthermore, variable life policies, which experienced declines in cash values in 2008 of 30% or more, are in the same predicament of needing additional premiums to shore up cash values and maintain policy death benefits.

**What does this mean for policyholders and for trustees?**

In general, expect to pay more premiums for in-force policies than

was originally planned. This obviously has implications for a grantor who may have other plans for annual exclusions or unified credit gifts.

Do not overreact and surrender one policy for another—and then find that the result is reduced flexibility or the loss of policy features that later look attractive.

Carefully consider replacement options. If the grantor/insured is relatively healthy, new pricing opportunities may offset negative investment results (bonds, mortgages, equity). If clients are insurable, consider restructuring and taking advantage of current insurance pricing. As outlined in Exhib-

it 3, a recent mortality study shows improvements of as much as 25% or more since the prior 2001 study.

**What about life insurance "pricing improvements"?**

Life insurance pricing is dynamic, not static. The insurance industry is evolving. As it evolves, new products (often with lower costs) become available. Furthermore, high net worth clients have access to better medical care, have generally healthier lifestyles (which promotes longevity), and therefore are better risks from a life insurance perspective. A trustee should seek out products designed (and priced) for the high net worth segment of the population because those products

are generally 20% to 30% less expensive than products offered to the general population.<sup>4</sup> As an analogy, consider how prices (and features) of computers have improved over the past 20 years.

A trustee should look for products that contractually require future pricing improvements (by the insurance company) to be automatically shared with existing customers. Most insurance companies use mortality and expense improvements to improve the pricing on new products (to attract new business). An insurance company should treat existing policyholders as well as they do their new customers. Sharing pricing improvements (in the future) with existing policyholders is one way to avoid having to replace existing policies (with new sales charges and limitations).

Insurance company medical directors are often at the forefront of understanding improvements (and risk) in medical diagnoses, treatments, and prognoses—which are reflected in underwriting decisions. For example, heart attack patients 10 to 15 years ago were uninsurable. Today, heart attack patients may be insurable within one month of a heart attack, and may be a standard risk. Cancer survivors (e.g., prostate or breast) who in the past would have been uninsurable may now (five years from end of treatment) be standard risks.

### Case study

A universal life policy was issued in 1995 with a \$2.5 million death benefit. The insured was a standard risk class, age 60 (now age 76). The annual cost was \$52,000 payable for lifetime. The crediting rate assumed at the time the policy

was issued was 8% (all years) from 1995 through date of death. Based on the (non-guaranteed) assumption of an 8% crediting rate, the policy would endow at age 95; that means the cash value would equal the \$2.5 million death benefit at age 95.

**A trustee can submit medical information to the in-force company and request an “upgrade” on the current policy; this could lower charges and improve performance.**

The policy’s cash value (in 2011) was \$711,000 (after 16 years of premiums of \$52,000/year), and the current crediting rate was 4.45% (not the 8% projected in 1995). Because the premiums have not been adjusted (upward) and the crediting rate is about one-half of what was originally projected, the policy will now lapse at age 90 unless premiums are increased to \$90,000 annually. In other words, the current premium needs to increase by 72%. This is not what a trustee wants to tell a client/insured.

The existing company would reconsider the underwriting category only if the client surrendered the current policy and acquired a new one (with new underwriting and new sales charges). However, if the 76-year-old can qualify as a standard risk (different company, comparable product features and guarantees), a new \$2.5 million policy (with new mortality tables), would cost \$45,000 annually, and the coverage would last to age 100 (as originally envisioned).

Therefore, the trustee might be able to reduce annual costs from \$52,000 to \$45,000. If the 76-year-old individual can qualify as a pre-

ferred risk, the savings are greater; the annual cost would be \$35,000.

Life insurance pricing is not static, so trustees should review their pricing options regularly. As noted above, a company should be sought that automatically shares pricing improvements with policyholders, without requiring them to surrender their existing policies.

### Universal life product trends

Universal life and variable life products continue to be the product of choice due to their greater flexibility (to increase or skip premiums), lower cost structure (as compared with whole life), and transparency (disclosure of product charges).

**Equity indexed universal life.** Just as pricing for life insurance products change, products change as well. The newest product is *equity indexed universal life*; this is a universal life product with interest crediting rates based on one or more equity indexes, such as the S&P 500. These products provide flexibility, with guaranteed cash values; an interest rate floor of 0% (even if the index declines as the S&P did in 2008); and a ceiling that can range from 12% to 14%. Equity indexed universal life sales have more than doubled between 2003 and 2010, making up over 20% of universal life sales in the fourth quarter 2010.<sup>5</sup>

**Private placement variable universal life (PPVUL).** PPVUL is gaining greater awareness among advisors. PPVUL’s institutional pricing, and sophisticated investment choices (e.g., hedge funds and actively managed/customized portfolios) can be attractive as a tax-deferred investment strategy, especially in grantor trusts when the grantor is responsible for taxation of trust income. SEC requirements that the policy owner be a qualified purchaser (to purchase PPVUL, which invests in

<sup>4</sup> M Proprietary Life and Disability Insurance Products brochure, Favorable Experience Fundamentals, 8/2010

<sup>5</sup> Annuity Specs News Release, 11/15/2010 and LIMRA 4th Quarter 2010 Sales report.

unregistered securities like hedge funds), however, may limit a trustee's ability to purchase PPVUL in a typical irrevocable life insurance trust.

Furthermore, variable life insurance products are long-term investments and may not be suitable for all investors. An investment in variable life insurance is subject to fluctuating values of the underlying investment options, and it entails risk, including the possible loss of principal.

#### *No-lapse guarantee universal life.*

These products are still popular and appeal to trustees due to their fully guaranteed death benefits. Pricing in these products has risen as much as 20% or more in the past two years as the cost of holding reserves for these guarantees has increased. This has caused some companies to withdraw this product from the market. The disadvantages of this product (which trustees may learn too late) are that the sales loads and surrender charges are extremely high. As a result, these products do not provide the same flexibility as other life insurance products for restructuring

or moving to a less expensive product in the future.<sup>6</sup>

#### **Choosing someone to do the review**

When evaluating who to hire for an insurance review, ask potential candidates for the following information:

- Years of experience the broker has in the life insurance business.
- Number of support staff in the firm, or per insurance broker. (More support staff per broker indicates dedication to ongoing policy support and maintenance.)
- Is the firm (or broker) an "independent" or a "captive"? In other words, what percentage of the firm or broker's business is with one company?
- Percent of business that is replacement.
- Mix of products placed. (This is relevant in determining how comfortable the broker is with different product types. Many insurance brokers understand one product type very well and recommend it

for all situations, regardless of suitability.)

- Access to products priced specifically for high net worth individuals.
- Access to products with in-force improvements.
- What kind of relationship does the firm have with insurance carriers and what leverage does it have to advocate effectively on behalf of its clients?

In addition, request a sample report and find out whether annual reports (i.e., updates) are available at a reduced cost.

#### **Conclusion**

The life insurance review can be a helpful tool, but it needs to be updated at least every two years. A trustee cannot afford to ignore one of the more important assets in a trust account. ■

<sup>6</sup> Passero, "Has No-Lapse Universal Life Been Oversold?," Life Insurance Selling Magazine (December 2010), available at: <http://www.lifehealthpro.com/2010/12/01/has-nolapse-universal-life-been-oversold>.