

## THE DECISION TO REPLACE TRUST OWNED LIFE INSURANCE POLICIES

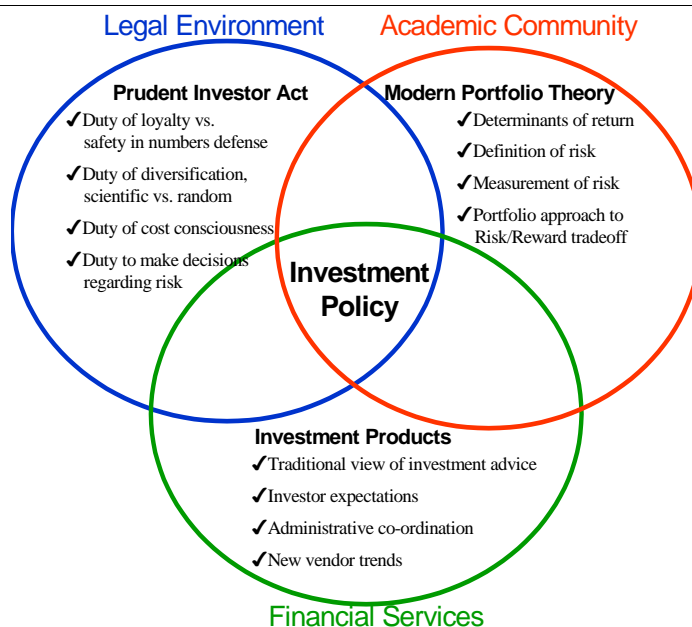
We note that the Life and Health Insurance Foundation for Education (LIFE), a non-profit arm of the U.S. life insurance industry, has designated September as "Life Insurance Awareness Month." The organization plans to commit \$2.5 million to a radio and print advertising campaign that will include an eight-page special section in *Newsweek* magazine. Following in the spirit of this designation, *Fiduciary Forum* presents an insurance-related discussion that, for many trustees, may be both topical and timely. The discussion consists of a series of excerpts from a working paper authored by Patrick Collins, principal at Schultz Collins Lawson Chambers, Dieter Jurkat, manager of information technology and actuarial consultant at Firemans Fund Insurance Company; Michael McGovern, partner at the Washington, D.C. law firm of Hanson & Molloy; and Ashley Wiggins, attorney at the Washington, D.C. law firm of Griffin, Farmer & Murphy. A complete text of the preliminary draft should be available in early December.

### Introduction

Irrevocable Life Insurance Trust [ILIT] administration occurs along a spectrum of trustee arrangements extending from family trustees (selected for their loyalty to the grantor, knowledge of family dynamics, and willingness to serve without compensation); to professional trustees and commercial fiduciaries advertising special expertise and experience in asset management. Although a comprehensive discussion of prudent administration of life insurance assets is beyond the scope of this paper,<sup>1</sup> it is important, for at least three reasons, to consider a trustee's decision to replace an existing life insurance contract:

- 1) Trust owned insurance policies are often a cornerstone for estate plans that contemplate the availability, upon the death of the insured, of large sums of insurance proceeds for asset protection, estate transfer liabilities, business continuity, etc.;
- 2) Insurance replacement transactions may incur substantial costs; but, a failure to replace a financially unsound or underperforming asset may violate the duty to make trust property productive; and,
- 3) Trustees failing to discharge the duties of their office without requisite care, skill, and caution may be personally liable should they be found to be in breach of their fiduciary duties.

In this article, the term "trustee" means either a professional trustee (or co-trustee) such as an attorney or CPA, or a commercial fiduciary such as an independent trust company or bank trust department. The presumption is that the trustee assumes fiduciary responsibilities for asset management (or, if



delegating asset management responsibility, retains control over the terms of the delegation), for which the trustee receives monetary compensation. For convenience, the term "expert trustee" describes individuals and institutions holding themselves out as having special asset management skills, and providing compensated trust services. It is instructive to limit discussion to the expert trustee portion of ILIT asset management arrangements for a number of reasons:

- 1) Examination of reasonable ILIT asset management practices can provide grantors, beneficiaries, and courts with a more clear notion of 'best practice' standards; and,
- 2) Helpful guidelines (including, for example, the American College of Trust & Estates Counsel's "Guide for ACTEC Fellows Serving as Trustees; ALI-ABA's "Fiduciary Accounting Guide," and The Office of the Comptroller of the Currency's Regulation 9, etc.) already shape the legal, administrative and regulatory environment in which the expert trustee operates. Where the expert trustee's organization includes Certified Financial Planners (CFPs), Chartered Life Underwriters (CLUs), or Chartered Financial Analysts (CFAs), the trust settlor, beneficiaries and other interested parties may also reasonably expect that the standards of practice promulgated by such professional organizations will also inform the ILITs asset management strategies.<sup>2</sup>

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*...some insurance agents or financial advisors (frequently) employ inappropriate methodologies that lead to incorrect conclusions.*

The term “replacement” means the surrender or exchange of an existing life insurance contract for its full cash surrender value. The trustee uses the net surrender value, all or in part, to fund a new life insurance contract. This definition differs from the more comprehensive definitions of life insurance policy replacement found in, for example, Regulation No. 60 of the New York State Insurance Department, or, Model # 613 (Life Insurance And Annuities Replacement Model Regulation) promulgated by the National Association of Insurance Commissioners [NAIC]. The New York and NAIC documents include in their definition of replacement a wider variety of transactions such as partial surrenders or benefit reductions, election of policy loan options or non-forfeiture benefits, use of accumulated or projected future dividends, or a reduction or stoppage of premiums on an existing contract in contemplation of acquisition of a new policy. The more broad-scope replacement definition touches on issues of “twisting,” “suitability,” and other possibly fraudulent market practices that lie outside the scope of this article. Likewise, this article does not consider trustee decisions to replace life insurance policies for other investment-oriented financial instruments (a buy-term-and-invest-the-difference approach to asset management).

The extent to which courts will resolve fiduciary breach actions against professional trustees and commercial fiduciaries by looking towards ERISA prudent expert standards, local or bright-line standards of practice for ILIT administration, or to “Third Restatement / Prudent Investor Rule” asset management standards as embodied in state statutes<sup>3</sup> may vary. However, there appears to be an increased expectation that ILIT trustees should discharge the duties of their office in a manner that is academically sound, administratively reasonable, and legally defensible. The actions of trustees holding themselves out as having special skills, experience, and expertise may be subject to close scrutiny should the trust fail to achieve its financial objectives; and, it remains to be seen how effective broad-scope exculpatory provisions embedded in the enabling trust instrument can protect the expert trustee from liability when, presumably, a grantor pays for both administrative services as well as for advertised expertise in asset management.<sup>4</sup> The Plaintiff’s Bar may well have cause to pursue legal action not only in terms of seeking remedy for breach of fiduciary duties; but, also, in terms of deceptive trade practice if discovery indicates that a commercial trustee’s ILIT asset management strategy is merely ‘benign neglect.’<sup>5</sup>

### Quantitative Analysis and The Case for Policy Replacement: Spurious Conclusions

There may be many valid reasons to consider policy replacement.<sup>6</sup> However, the focus here is on recommendations, based primarily on quantitative analysis, to replace an existing life insurance contract with a new contract that, allegedly, provides superior financial results. In other words, the trustee is taking replacement action based on the expectation that the new policy offers a financial instrument better suited to the terms, purposes, distribution requirements, and other circumstances of the trust. For example, some commentators recommend evaluating trust-owned life insurance policies relative to other policies by calculating projected rates of return. If the rate of return on an existing policy is unsatisfactory, the trustee, according to this advice, may want to consider exercising the option for policy surrender in favor of acquiring a replacement policy. The implication is that a rate of return calculation is a satisfactory way to document a prudent decision-making process; and that the quantitative nature of the analysis provides strong evidence that the trustee employed the requisite levels of care, skill, and caution.

When using quantitative analysis, however, it is important to use appropriate calculation methods—i.e., methods with sufficient integrity and explanatory power. This is a particularly troubling area because of the propensity of some insurance agents or financial advisors to employ inappropriate methodologies that lead to incorrect conclusions. A good example of a faulty quantitative policy evaluation methodology is one that emphasizes the relationship of projected death benefits to premiums paid. In policy replacement sales pitches, this often takes the form of a question along the lines of “if I could obtain a policy that offers 40% more death benefit for the same premium, would you be interested?”<sup>7</sup> The replacing agent proceeds to calculate the policy’s death benefit Internal Rate of Return (IRR) statistic. The IRR expresses the premium-to-death benefit relationship in a single number. The IRR is the rate at which money committed to the insurance policy (and remaining in the policy) compounds to the projected amount of death benefit. As such, it is comparable to the rate earned on a savings account. If beneficiaries receive an early death benefit after payment of only a few scheduled premiums, the IRR will be very high. If they must wait many years for receipt of policy proceeds, the interest rate that equates premiums paid to benefits received will be lower.

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Despite the fact that trustees are sometimes told that policies can be compared and evaluated based on the calculated IRR, with respect to a life insurance policy, the IRR measure is *inappropriate* because it ignores both the scale of premium commitment as well as risk of future policy lapse due to underperformance. To a great extent there is an *inverse* relationship between a high IRR and the cash-value base upon which the contract depends for its future integrity. Therefore, the higher the IRR, (i.e., the more death benefit per premium dollar that the policy must support), the more likely the policy will lapse because future interest or dividend credits are insufficient. Furthermore, changes in premium inputs and time horizons sometimes lead to widely varying IRR results. It is possible that inferior products may actually replace adequately performing policies simply because sales illustrations are manipulated by agents.<sup>8</sup>

Reductions in scheduled premiums will, all else equal, enhance the death benefit IRR. Although premium reduction simultaneously increases the risk of lapse due to insufficient cash value, the increased lapse risk is not captured by the internal rate of return calculation. Indeed, the 1985 report of the Yield Index Advisory Committee of the National Association of Insurance Commissioners stated that calculating a death benefit internal rate of return in order to determine the value of a life insurance contract was misleading.<sup>9</sup> However, although potentially misleading and inappropriate, the death benefit IRR calculation is sometimes the primary basis for a recommendation to dump policies that are, allegedly, outdated and underproductive. For example, the following commentary on managing trust-owned life insurance (TOLI) policies notes: “few trustees have provided the requisite review and management.” It continues:

*“...the primary purpose of an irrevocable life insurance trust is to maximize the death benefit. Cash value accumulation is only a premium financing decision which should closely be considered and documented by the trustee.... For an existing TOLI policy, grantors, beneficiaries and their legal advisors expect the trustee to address two obvious questions through the annual monitoring function:*

- ◆ *Can more death benefit be purchased for the same premium outlay?*
- ◆ *Can the same death benefit be purchased for less outlay?”<sup>10</sup>*

Based on this somewhat single-minded view of the role of the life insurance trust,<sup>11</sup> the au-

thors assert that up to “74 percent of single life policies and 85 percent of Survivorship policies” are candidates for replacement. As the line of thought is pursued to its end, the authors give professional trustees the “good news” that a replacement campaign can be a marketing tool to expand the trustee’s business. A new standard of prudent asset management, based on the morals of the marketplace, emerges: “Properly structured, TOLI management is a *marketing program* bringing multiple services to the client while documenting procedural prudence” [emphasis added].<sup>12</sup> Even if the conclusions of the authors are correct (although most regulators and academic commentators suggest that replacement is usually not warranted),<sup>13</sup> there is the possibility that a marketing-oriented trust administrative system might leave trustees vulnerable to a perceived failure to uphold the duty of loyalty because of collusion or self-dealing sales activities.<sup>14</sup> This is an emerging and important liability issue for commercial trust operations created by the merger of banking, trust services, and insurance carriers.

Many of the common methods of measuring insurance policy costs are based on solving equations to calculate either rates of return or present values of costs and benefits.<sup>15</sup> The calculations rely on point estimate values (a precise dollar value projected in a specific future year). For example, the Yield Comparison Index method (Surrender Cost Index) found on policy illustrations calculates an equivalent yield (i.e., rate of return) on insurance policy cash value assuming that the contract is surrendered in a designated future year. Such a calculation requires an estimate of cash surrender value many years into the future; and relies on the assumption of a deterministic interest rate (flat yield curve) throughout the applicable calculation period. Not only is a flat yield curve an unrealistic assumption, the likelihood of accurate dollar-value estimation becomes increasingly poor as the time horizon of the analysis expands.<sup>16</sup> Furthermore, calculation methods such as the Yield Comparison Index method or the Litton Yield method (a comparison of a cash value policy with term insurance and an investment fund) demand static assumptions regarding realized returns or the applicable planning horizon over which the trustee will maintain the insurance contract. Such long-term, purely deterministic methods cannot comfortably accommodate prudent decision making in a dynamic environment.

*[The article continues with a discussion of more appropriate forms of quantitative analysis]*

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### The Quandary of the ILIT Trustee

As noted, the ILIT trustee is faced with a daunting task. Some commentators suggest that the trustee should periodically compare trust-owned insurance policies with alternative contracts to assure that trust beneficiaries are not shortchanged by a failure to acquire policies projecting superior values. The implication of many sales pitches is that the trustee has a duty to maximize return by finding the best deal; or, alternatively, has a duty to minimize cost by funding death benefits at the lowest possible premium. Absent specific directions in the trust instrument, however, it is doubtful that there is a common law duty to maximize return or that such a duty exists either in statutory form or in judicial precedent. Certainly, it is not a *per se* breach if trustees fail to buy the hottest performing stock during an up market, if they fail to put all assets in 30-day U.S. treasuries during a down market, or if they fail to establish equity positions via the lower-cost derivatives markets rather than by transacting in higher cost cash markets. Despite the fact that maximization of return is the mantra of policy sales and replacement activities, this is a form of treasure hunting that is achievable only by concentrating assets in a single insurance policy issued by a single carrier. Only one carrier will have the top performing policy twenty or thirty years from today; but the odds of the trustee correctly identifying the future winner are remote. Today's frontrunner may become tomorrow's Executive Life. Many policy replacement campaigns envision the trustee hopping from carrier to carrier (while maintaining extreme asset concentration risk by placing all coverage in the company marketing the most aggressive benefit projections) in the attempt to maximize returns. Over the long run, such an asset management strategy may incur heightened risks and increased costs with the result that the attempt to maximize return minimizes the probability of a long-term successful outcome.<sup>17</sup>

Fortunately, projections for new insurance coverage must depict the worst-case scenario in the guaranteed values column of the sales illustration. Additionally, most insurance carriers illustrate guaranteed values for existing policies on inforce illustrations. However, the financial and actuarial assumptions that underlie policy illustrations are proprietary information. Without knowing the underlying assumptions for product pricing, it is difficult for trustees to determine how changes in a single variable (e.g., credited interest rate) illuminate actual policy risks. Decision making becomes one-dimensional in the sense that the trustee is tempted to ignore risk while encouraged to focus on projected reward.

Actuaries are trained to focus their attention on the risk that the assumptions underlying product development and insurance policy pricing are misspecified or incorrectly determined. Actuaries term the risk that a pricing model's flawed assumptions will lead to a failure to meet insurance company financial objectives "pricing risk." If there is a high degree of pricing risk, there is a high probability that the insurance contract will fail to deliver adequate return on equity to the carrier (meet the company's cost-of-capital "hurdle rate"); and will fail to deliver projected values to the policyholder absent additional premiums.

In an attempt to restrain the rampant gamesmanship in the projection of policy costs and benefits, the NAIC approved the Model Regulation of Life Insurance Illustrations in 1995. It provides for the appointment of an Illustration Actuary responsible for certifying the reasonableness of the non-guaranteed elements in the company's product illustration.<sup>18</sup> The regulation specifies rules for construction of a "Disciplined Current Scale" and requires a set of testing procedures to determine the viability of the product illustration. Actuarial Standard of Practice #24 governs the methodology that the actuary must use to determine that the product illustration is self-supporting. Actuarial assumptions must be based on "recent historical experience."<sup>19</sup> Thus, a reasonable assumption is merely one that corresponds (i.e., can be no worse than) current experience for the product line being illustrated. With the continuous creation of new product lines backed by segregated investment portfolios, and, with little long-term lapse experience history, illustrations based on current experience may bear little reality to actual future outcomes: "Life insurance contracts usually extend over many years, and it is impossible for the issuing company to predict the actual cost of insurance on a reasonably accurate basis."<sup>20</sup> Additionally, regulations for allocation of expenses ("fully allocated" vs. "marginally allocated") permit great latitude in illustrating the future dollar values of an insurance contract.

The trustee purchases a contract that promises only the guaranteed values. Additional benefits are forthcoming if the assumptions that underlie the pricing model unfold, as predicted, over time. The likelihood that such additional benefits will unfold exactly as predicted is remote; and, this is a reason why some quantitative rate of return methods are not as helpful in policy evaluation as might be expected. One commentator sums up the current state of policy illustration credibility in the following terms: "...the NAIC's attempt to elimi-

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nate illustration abuses is producing overwhelming results...the regulations apparently can be interpreted to allow companies to continue the game of illustration liar's poker by making unsupported exaggerated policy values promises."<sup>21</sup>

Can the trustee test the credibility of illustrated values prior to inputting them into a yield calculation formula? Academic studies provide a caution to trustees who must carefully evaluate projected dollar benefits either on new policy sales illustrations or on inforce policy illustrations. The trustee is faced with a seemingly insurmountable task because it is impossible to obtain a road map through the myriad of assumptions underlying such illustrations; and, therefore, impossible to know which direction you are moving towards if you make changes in individual assumptions. Conventional wisdom regarding the value of and the strategies for testing product illustrations appears to be largely inadequate from the standpoints of both methodological correctness and legal defensibility.

Most of the illustration testing procedures consist of multiple scenarios or "what if" analyses. What if the credited interest rate dropped by one percent; what if the cost of insurance coverage rose to the maximum guaranteed level? This type of testing provides only limited information to the trustee. Insurance policy dollar values are generated by the dynamic interaction of all relevant variables operating in an environment of interactive complexity and tight coupling. Such environments are characterized by conditional probabilities and non-linear results. Thus, a "what-if" analysis may miss the mark. A "what if" analysis takes an illustration and examines changes in dollar values resulting from changes in isolated determinants of return (increase or decrease in lapse rate, interest credits, and so forth). Additionally, the interest variable is usually changed in a predetermined fashion with other variables held constant.

Even if "what if" methodologies could yield useful insights, they may fail when applied to insurance policy illustrations. The determinants of projected dollar values cannot be disentangled. The trustee cannot, for example, assume that the interest rate crediting component in a universal life policy illustration reflects only interest earnings on underlying assets. The crediting rate may reflect both interest earnings and a variety of policy expense factors and insurance costs. Although clear disclosure regarding important policy elements was a marketing promise made by insurance carriers when Universal Life products first appeared, "not only are high early expenses now covered by a surrender charge, but mortality charges may frequently

include expense or income tax, and interest rates credited may even be reduced by expense costs other than investment expense."<sup>22</sup>

Conversely, the fact that an insurance carrier can demonstrate a superlative historical track record may be merely a form of statistical bias. A track record reflects a single sample of economic history during which the insurance company has not yet encountered a unique pattern of risks that puts its survival into question. Statistical bias, however, does not guarantee the absence of risks; just that they have not yet manifested themselves. A naive reliance on historical results is not a substitute for intelligent quantitative analysis, prudent risk assessment, and asset diversification.

Thus, the trustee's dilemma. Insurance policy cost/benefit measures rely on inputs from policy illustrations; but illustrations cannot be used for policy comparisons.<sup>23</sup> If the trustee executes a replacement, the trust may be subject, on the one hand, to substantial surrender costs or lost opportunity costs by exercising the option to abandon the existing program, and, on the other, to significant new policy acquisition expenses.<sup>24</sup> However a trustee that fails to execute a replacement may be in breach of the duty to make the trust property productive. This outcome is especially likely should the retained policy subsequently fail to deliver the benefits expected by trust beneficiaries; or, should the funding of projected benefits require higher premium outlay.

*[The article continues with practical suggestions regarding how best to resolve the trustee's dilemma]*

### Conclusion

The landscape of the insurance industry is rapidly changing. Attorneys and accountants are, in some states, expanding their service set by acting as agents in life insurance transactions, often as part of an estate planning process in which they participate as counselors, advisors, draftsmen, and trustees. Common ownership between banks and insurance companies is becoming more frequent. Mutual fund companies as well as life insurers are launching trust companies. However, the office of trustee demands that the trustee forsake opportunities to generate financial gains at the expense of beneficiaries either because of the advantages provided by asymmetric information or because of exploitation of trust presumed by the fiduciary relationship. Commercial fiduciaries or professional trustees advertising special expertise in asset management may be held to higher standards of care, skill and caution.

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Most policy replacements will, according to both insurance industry regulators and independent academic research, not be in the best interest of the policyowner. Therefore, when an expert trustee either recommends or facilitates policy replacement, or when the expert trustee considers a sales pitch from an unaffiliated insurance agent, there may be a heavy burden of proof to evidence a prudent decision making process. Indeed, given the weight of objective and credible academic evidence, there may be a presumption that policy replacement is not in the interest of the trust; and, the plaintiffs' bar may seek to allege a fiduciary breach, measure damages by reference to the projected death benefit, and simultaneously shift the burden of proof onto trustees to demonstrate that they followed a substantively prudent decision making process.

We have considered the complex task of insurance policy comparison from a quantitative analysis perspective. How should the expert trustee demonstrate the requisite level of care, skill and caution? Trustees compensated for their asset management expertise should strive to follow best practice standards. Thus, it seems reasonable to expect the trustee to reference such documents as the Life Insurance And Annuities Replacement Model Regulation which the NAIC promulgates "to protect the interests of life insurance and annuity purchasers by establishing minimum standards of conduct to be observed in replacement or financed purchase transactions." New York State Insurance Department's Regulation 60 provides a set of required disclosure and policy comparison worksheets that are aimed at the skill level of insurance agents licensed in the state.<sup>25</sup> The Society of Financial Services Professional (American College of CLU & ChFC) provides policy replacement questionnaires for life insurance agents to complete and present to their customers.

The above referenced documents are designed for use in the retail insurance marketplace; and, without question, the trustee should document that they have evaluated the policy replacement issue according to these *de minimus* standards. Additionally, professional standards of conduct as developed through organizations like state Bar Associations or the American Law Institute-American Bar Association may either prescribe or recommend additional standards of conduct or professional expertise. Likewise, many trusts are administered through institutions regulated by state or federal oversight agencies like the Office of the Comptroller of the Currency, and must conduct trust operations in a manner that does not impair required capital by exposing the institution to litigation risk. Obviously, local statutes also provide in-

sight and guidance into the standards of practice expected of those who discharge the duties of a trustee. California Probate Code §16040(a) [The California Prudent Investor Act], for example, requires a trustee to administer assets under an ERISA-like standard.<sup>26</sup> The trustee must use "...reasonable care, skill, and caution under the circumstances then prevailing that a prudent person acting in a like capacity would use in the conduct of an enterprise of like character and with like aims to accomplish the purposes of the trust as determined from the trust instrument." It remains to be seen how courts will interpret this language and whether they will presume that

**APPEALS COURT UPHOLDS RIGHT TO SUE INSURANCE COMPANY FOR FRAUD**

Former participants of Computer Business Service Inc.'s terminated 401(k) plan sued American United Life Insurance Co. (AUL), the plan's service provider, alleging that AUL fraudulently misled them by claiming that annuity investments were the only method for obtaining tax deferrals through a 401(k) plan, and by not properly disclosing that plan assets were invested through a group annuity contract. AUL moved for summary judgment, claiming that the employees had admitted at trial that there was no "redundant" tax deferral by using an annuity contract to fund the plan. Further, AUL argued that since they were not a fiduciary to the plan, they could not be sued for fraud.

The trial court denied AUL's motion, finding that the 401(k) plan itself provided tax deferral benefits, that it was not necessary to purchase a deferred annuity to achieve tax deferral, and that AUL failed to make the plaintiffs aware of this fact. Thus the basis for the employees' complaint "is clear and unequivocal". Further, the trial court found that AUL could be sued without any fiduciary relationship. By positioning itself as a "specialist" in retirement plans, AUL established a trust relationship that could lead to fraud.

The Indiana Court of Appeals upheld the lower court's decision to deny the motion for summary judgment, allowing the suit to continue. The case is American United Life Insurance Co. v. Douglas, Indiana Court of Appeals, #29A02-03-04-CV350. Whether participants will successfully recover anything from AUL is yet to be determined.

Fiduciaries should note that insurance companies may position themselves as experts, but later attempt to duck responsibility for their "expert" advice. Further, insurance companies may attempt to use their non-fiduciary status as a litigation shield. It's heartening to note that these strategies appear to be unsuccessful, at least in Indiana.

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the expert trustee has demonstrated the requisite knowledge, experience and expertise with respect to management of life insurance assets. Courts may well agree that there is a reasonable expectation on the part of the ILIT's settlor and beneficiaries that financial decisions will be made only after rigorous analysis, and that an expert trustee should be able to quantify the economic advantages and disadvantages of the options under consideration.

ance commissioner; and he provides a life insurance policy evaluation service under the auspices of The Consumer Federation of America. Mr. Hunt prefers a "Yield Index" method of cost disclosure comparable to the "Linton Yield" method of calculating the investment return on the cash value component of life insurance. Although this method has the advantage of ease of communication, it relies on an uncritical acceptance of projected insurance values and, therefore, may not be an appropriate substitute for a more in-depth analysis.

<sup>1</sup> A forthcoming monograph authored by Patrick Collins, Dieter Jurkat, and Kathryn Ballsun provides a more general treatment of Trustee Administration of Life Insurance. The authors argue that there is not a single "path to prudence," but that there exist useful tools, procedures and administrative options for trustees with varying skill sets. It outlines a history of advice to trustees charged with management of life insurance assets, a critical analysis of the advice, and a discussion of evolving standards of care, skill and caution for trustees. Sample Life Insurance Investment Policy Statements (providing guidelines for unsophisticated trustees) and sample Fiduciary Reports (a tool appropriate for commercial fiduciaries and professional advisors) are among the items that the authors present and evaluate.

<sup>2</sup> Rounds, Charles E., Loring A Trustee's Handbook (Aspen Publishers, New York) 2004 edition p. 394: "...the professional trustee would be well advised to have all marketing brochures and other promotional materials carefully reviewed before they are disseminated to the public to make sure that he, she or it is able and prepared to perform as advertised. It is a certainty that should a disgruntled beneficiary file suit against the trustee for breach of some fiduciary duty, those materials will be discovered and made part of the litigation record."

<sup>3</sup> In some states, ILIT trustees have a limited exemption from liability. See, for example, Collins, Patrick J., "Statutory Exemption from Fiduciary Liability for Trustees of Life Insurance Trusts," Maryland Bar Journal (January / February, 2000), pp. 54-58. The reader is cautioned that several typographical errors entered the article during the publication process; and that some errors may change the intended meaning of sentences. See, also, Collins, Patrick J., "The Lawyer as Trustee: Do Exculpatory Provisions Mitigate Liability Under the Prudent Investor Standards?" The Maryland Bar Journal (January / February, 2003), pp. 48-50.

<sup>4</sup> See, for example, Weidenfeld, Edward L., "Professional Liability Issues for Estate Planning Attorneys Working With Life Insurance Products," Tax Management Estates Gifts and Trusts Journal (November 11, 1999), p.9: "The UPIA [Uniform Prudent Investor Act] may actually impose the duty on a trustee to perform portfolio analysis, which is beyond the normal scope of the average estate planner or insurance broker."

<sup>5</sup> For a commentary on bank liability for trust owned insurance programs, see Arnold, William M. & Harper, Jeffrey C., "Counsel's Corner," The Banking Law Journal (September, 1998), pp. 824-827. The same authors discuss litigation risk from the perspective of Errors & Omissions claims in "Trusts Pose Hidden Catastrophic Exposures," National Underwriter (June 22, 1998), pp. 3 and 23.

<sup>6</sup> Moyse, John S., "Right & Wrong Reasons for Policy Replacements," National Underwriter (January 10, 2000), pp. 11-12. See, also, NASD Investor Alert, "Should You Exchange Your Life Insurance Policy?" (September 23, 2002).

<sup>7</sup> One actuary estimates: "the cannibalizing of existing whole life policies reached a zenith in the mid-1980s when one in every two sales of a cash value policy was a replacement." Hunt, James, H., "Life Cost Disclosure: Prospects for True Reform," Journal of Insurance Regulation (Summer, 1995) p. 406. Hunt is a former insur-

<sup>8</sup> An excellent review of quantitative methods of insurance cost measurement is found in Bartlett, Dwight K., "Life Insurance Cost Disclosure: A Regulatory Viewpoint," Journal of Insurance Regulation (Summer, 1995), pp. 432-439. Bartlett describes the history of cost disclosure calculation methods as well as several common and egregious methods used to manipulate them.

<sup>9</sup> NAIC Proceedings, Vol. I., 1986, p. 647.

<sup>10</sup> Whitelaw, C. Markham & Ries, William C., "Managing Trust-Owned Life Insurance Revisited," Trusts & Estates (April, 1999), pp. 38-45

<sup>11</sup> By contrast, Donato & Benesh list eight rationales for establishing and maintaining an ILIT. See, Donato, Linda F. & Benesh, Bruce K., "Irrevocable Life Insurance Trusts," The Tax Adviser (July, 1994), pp. 395-396.

<sup>12</sup> Whitelaw, & Reis, p. 43. There may be emerging a cottage industry of "independent advisors" offering their services to trustees based on the pitch that policy reviews can generate additional commission sales for banks affiliated with life insurance carriers. See, for example, Barney, Austin D., "TOLI Due Diligence Can Yield Sales," National Underwriter (April 13, 1998). Many states have adopted versions of the NAIC Model Replacement Regulations which direct that the replacing agent must provide the policyowner with a Replacement Notice warning of possible disadvantages, must notify the carrier of the policy to be replaced, and, in some states, must provide a Comparative Information Form projecting the relative performance of each policy. Hunt, James, H., "Life Cost Disclosure: Prospects for True Reform," Journal of Insurance Regulation (Summer, 1995) characterizes replacement regulations as "How-to-do-it Kits" for agents and brokers, p. 406. For a review of litigation issues surrounding policy replacement activities as well as other "market misconduct" allegations against the life insurance industry, see Egler, Frederick N. & Malak, Paul J., "The Individual Life Insurance Sales Practice Case: A Litigation Primer," FICC Quarterly (Fall, 1999), pp. 1-28.

<sup>13</sup> The NAIC "Life Insurance And Annuities Replacement Model Regulation" legislative history section, for example, states, "although in some instances it may be to the advantage of the policyholder to lapse or surrender an existing policy of permanent life insurance and replace it with new life insurance, ordinarily it is not in the interest of the insured." (613-21). Likewise, New York's Reg. 60 cautions: "As a general rule, it is often not advantageous to drop or change existing coverage in favor of new coverage, whether issued by the same or a different insurance company" (Appendix 10C).

<sup>14</sup> Although constraints on trustee self-dealing and other conflicts of interest vary from state to state, OCC regulation 12 CFR §9.12 prohibits self-dealing between national banks and their subsidiaries and affiliates including insurance corporations. See also, Moore, Donald F., "The Duty of Loyalty and the Responsibility of the Fiduciary—A Regulator's Perspective," Trusts & Estates (May, 2000), pp. 40-41 & 79.

<sup>15</sup> See, for example, Alexander, Neil, "Understanding Life Insurance Illustrations," Journal of Accountancy (February, 2003) Online Issues [www.aicpa.org/pubs/jofa/feb2003/alexand.htm](http://www.aicpa.org/pubs/jofa/feb2003/alexand.htm).

<sup>16</sup> Collins, Patrick J., "Is It Prudent and Suitable? Estimating the Value of a Trust-Owned Life Insurance Contract," California Trusts and Estates Quarterly (Winter, 1998), p. 6.

*Many European no-lapse contract issuers fell into severe financial difficulty as adverse market conditions forced them to honor provisions for which they did not adequately charge. Ironclad guarantees evaporated as insurance carriers disappeared from the marketplace.*

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<sup>17</sup> See, for example, Collins, Patrick J., "Diversification, Due Care and Duties of an ILIT Trustee," *California Trusts and Estates Quarterly* (Summer, 2001), pp. 8-15.

<sup>18</sup> Easton, Albert E. & Harris, Timothy F., *Actuarial Aspects of Individual Life Insurance and Annuity Contracts* ACTEX Publications (Winsted, CT, 1999) pp. 150-151.

<sup>19</sup> Easton & Harris, Op. Cit., pp. 226-227.

<sup>20</sup> Easton & Harris, Op. Cit., p. 135.

<sup>21</sup> Katt, Peter, "Deciphering Cash Value Life Insurance Illustrations" *Journal of Financial Planning*, p. 33.

<sup>22</sup> Easton & Harris, Op. Cit., p. 17.

<sup>23</sup> Miller, Walter N., "Special Report: How Companies Are Answering the IQ," *Journal of the American Society of CLU & ChFC* (March, 1996): "...illustrations by themselves should never be used to compare policies in different companies (or even worse, the companies themselves). P. 82. See also the American Society of Actuaries Actuarial Standard of Practice No. 24 which states: 'Since a sales illustration is simply an extension of the current scale of non-guaranteed elements into the future assuming current assumptions hold to that point, actual non-guaranteed elements will almost certainly vary from those illustrated. Different companies will experience different variances from illustrated values.' Several recent studies confirm the perils of relying on values projected on computer illustrations. One study of policy yields on Universal Life contracts [Carson, James M. & Forster, Mark D., "An Analysis of Life Insurance Illustrations," *Journal of Insurance Regulation* (Summer, 1997), pp. 480-501] concludes that: "even after the Life Insurance Illustration Model Regulation (1995), illustrations do not provide adequate disclosure of the non-guaranteed nature of life insurance...." Another recent research paper evaluating the effectiveness of insurance product and price disclosures [Kirsch, Larry, "Do Product Disclosures Inform and Safeguard Insurance Policyholders?" *Journal of Insurance Regulation* (Spring, 2002) pp. 271-295] concludes that disclosure messages on sales illustrations do not provide clear and accurate disclosure and that "insurers may manipulate consumers to their detriment." The NAIC Model Regulation on Life Insurance Replacement (p. 613-12) cautions: "Illustrations should not, however, be used as a sole basis to compare policies or contracts."

<sup>24</sup> Babbel, David F. & Santomero, Anthony M., "Risk Management by Insurers: An Analysis of the Process," *Investment Management for Insurers* (Frank J. Fabozzi Associates, 1999), P. 24: "Perhaps the area of greatest concern in the area of actuarial risk is the misalignment of incentives between owners of the insurance firm and its sales and marketing staff....The typical arrangement is to pay commissions for sales of new policies, with the commissions on a multiperiod contract heavily front-loaded....This creates a tremendous incentive for agents to sell as much business as possible, whether it is profitable for the company or not. It also creates strong incentives to replace existing policies, whose commission rates have dwindled to the low single digit percentage range, with new policies that pay commissions ranging from 20 to 100% of the first year premiums. Sales managers and marketing personnel are also often rewarded based on volume of sales. Even senior management may sometimes have their compensation tied to sales growth."

<sup>25</sup> Interestingly, New York State Regulation 60 asks the replacing agent to provide information sufficient to complete the following statement: "The advantages of continuing the existing life insurance policy or annuity contract without changes are:\_\_\_\_\_."

<sup>26</sup> ERISA §404(a)(1)(B): a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and with the care, skill, and prudence that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character with like aims.

## IS A "NO-LAPSE GUARANTEE" A "NO-BRAINER"?

*The following discussion is excerpted and adapted from "Trustee Administration of Life Insurance." Kathryn Ballsun, Patrick Collins and Dieter Jurkat are authors of this Working Paper.*

From time-to-time it is suggested that the purchase of a contract with a "no-lapse" guarantee obviates the need for in-depth critical analysis. No-lapse guarantees shift risk back to the insurance firm issuing these types of contracts.<sup>1</sup> Although such contracts are relatively new in the U.S. market, they have a troubled history in European and Asian life insurance markets: "Over the years, more than a few life insurance companies have become insolvent when interest rates fell and they were no longer able to earn interest rates high enough to support long-term guarantees."<sup>2</sup> Many European no-lapse contract issuers fell into severe financial difficulty as adverse market conditions forced them to honor provisions for which they did not adequately charge. Ironclad guarantees evaporated as insurance carriers disappeared from the marketplace. In the North American market, no-lapse guarantees may not be adequately reserved and it may be difficult to identify assets backing them. This has prompted some commentators to draw comparisons between no-lapse guarantees currently offered by some U.S. life insurance companies and the lapse-supported term-to-age 100 policies once offered to Canadian consumers. Canadian insurers withdrew from this market when they determined that continued policy sales would create untenable financial obligations.<sup>3</sup>

In certain respects a premium sufficiency guarantee is a grant of an option to the policyowner (the option to pay a premium to continue the policy death benefit despite cash value insufficient to support the benefit). The correct pricing of options, however, may be elusive: "...the cost of most options is never quantified and never explicitly reflected in pricing."<sup>4</sup> In the U.S., some underwriters have longer-term experience with guaranteed minimum death benefits (GMDBs) on variable life and annuity products. These products must be priced using stochastic modeling or option pricing methods. However, "theoretical costs have usually been higher than the costs assumed by most companies offering variable annuities with GMDBs."<sup>5</sup> Just as a corporate bond indenture "guarantees" timely repayment of principal and interest, the guarantee is only as good as the ability of its maker to discharge its financial obligations. Nevertheless, there is strong anecdotal evidence suggesting that agents are using no-lapse guarantees as a lever to replace policies lacking this "attractive" policy provision.

*“Moody’s believes that the focus at many companies has been more on meeting market demand for products that sell than appropriately managing the risks from these products.”*

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## “NO-LAPSE GUARANTEE” A “NO-BRAINER?”

Trustees should exercise caution when faced with this type of policy replacement decision especially if the agent recommends concentrating all coverage in a no-lapse policy. The July 21, 2004 edition of the Wall Street Journal (online) reports: “A competitive frenzy led insurers to offer generous guarantees on some business lines, but insurers may well have underestimated the costs of those guarantees.... Often called ‘no-lapse guarantee’ policies, or sometimes ‘term for life,’ the guaranteed universal-life policies provide both a death benefit and a savings account.... Such policies are all the rage among life-insurance agents. Agents say they are busy replacing existing policies—particularly among older policyholders—with the new, guaranteed ones. But concerns are mounting that insurers’ current reserves are based on unrealistic assumptions about investment returns or about ‘lapses’—policies that expire unpaid, usually because holders stopped paying premiums.... Moody’s Investor Service warns that the implications of any pricing problems or erroneous lapse-rate assumptions ‘will become apparent sometime during the next five to 10 years’ without changes by insurers. Even a one percentage-point error in assumed lapse rates, Moody’s notes, ‘can have a material impact on product profitability.’”<sup>6</sup>

A distinction should be drawn between an insurance guarantee and a financial guarantee. The insurance policy offers the former, while a no-lapse rider is a secondary guarantee of the latter. The guarantee is, of course, only as strong as the company that sells it. But insurance guarantees are priced much differently than financial guarantees. Pricing of insurance guarantees assumes (1) a large number of individual insured events; (2) independence of events both within a single period and across all periods; and (3) predictable risk measurement. Insurance guarantees have measurable risks (the face amount of the policy) and predictable claims (independence of trials assures that the actuary can apply the central limit theorem). In the case of a financial guarantee, at the limit, either all of the policyholders within a certain group will present a valid claim against the resources of the insurance carrier, or none will present such a claim. This destroys pricing assumptions based on the independence of claims events. Furthermore, the distribution of variables leading to a claim may not be close to multivariate normal. For example, claims for continued coverage when cash values are depleted may become more probable in a prolonged regime of low interest rates or in the face of certain lapse rate assumptions. If these two variables (among many possible variables) are correlated, the resulting distribution is comonotonic. This means that the magnitude of claims presented to the insurance carrier may

be more severe than allowed for through normal reserving. It is as if the insurance company sells a put option against the value of underlying assets and hopes that it can invest the put option premium so that it has sufficient funds to pay potential future claims. However, if all claims appear at once, the likelihood that the financial guarantee (i.e., put option) is “deep in the money” is also the measure of the bankruptcy risk for the carrier because the claims reserves are calculated on the insurance guarantee pricing model rather than on the financial guarantee pricing model.

A guarantee is an uncertain proposition in the face of counterparty risk. Moody’s is especially concerned that certain companies are using unrealistic, aggressive and insupportable pricing assumptions and that these carriers may not have efficient risk measurement and control systems in place. The report concludes: “Moody’s believes that the focus at many companies has been more on meeting market demand for products that sell than appropriately managing the risks from these products.” Trustees seeking the comfort of no-lapse guarantees may inadvertently be increasing the idiosyncratic (carrier solvency) risk of the insurance portfolio. A no-lapse guarantee should not be a substitute for prudent portfolio diversification.<sup>7</sup>

<sup>1</sup> However, most no-lapse-guarantee products require premium payments on a fixed and inflexible schedule. If a payment is missed, the guarantee may be voided and the policy may suddenly become grossly underfunded.

<sup>2</sup> Atkinson, David B., & Dallas, James W., *Life Insurance Products and Finance* (Society of Actuaries, 2000), p. 172. See also, Giraldi, Claudio, Susinno, Gabriele, Berti, Giacomo, Brunello, John, Buttarazzi, Silvia, Cenciarelli, Gianluca, Daroda, Carlo & Stamegna, Giuseppe, “Insurance Optional,” *Risk* (April, 2000), pp. 87 – 90.

<sup>3</sup> See, for example, Belth, Joseph M., “Secondary Guarantees, Marketers, Actuaries, Regulators, and a Potential Financial Disaster for the Life Insurance Business,” *The Insurance Forum* (March/April, 2004), pp. 21-30.

<sup>4</sup> Atkinson & Dallas, Op. Cit., p. 911.

<sup>5</sup> Atkinson & Dallas, Op. Cit., p. 790.

<sup>6</sup> “Life Insurers Face A Profit Squeeze,” *Wall Street Journal* (online). The authors wish to thank John E. Mayer (Fiduciary Review Services www.fiduciaryreview.com) for providing assistance on the topic of secondary life insurance guarantees.

<sup>7</sup> For a more in-depth discussion of this topic see, Wendt, Richard Q, “An Actuary Looks at Financial Insurance,” *Financial Engineering News* (November/December, 2003), pp. 7 & 12; D’Alene, J., Denuit, M., Goovaerts, M.J., Kamas, R. & Vyncke, D., “The Concept of Comonotonicity in Actuarial Science and Finance: Applications,” *Insurance: Mathematics & Economics* (April, 2002), pp. 1-44; and “Beware of What You Price For: Credit Implications of UL Secondary Guarantees for U.S. Life Insurers,” *Moody’s Investors Service Report #87150* (July, 2004).

