

THE DECISION TO REPLACE TRUST OWNED LIFE
INSURANCE POLICIES

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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,ⁱ 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 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.ⁱⁱ

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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 statutesⁱⁱⁱ 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.^{iv} 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.’^v

QUANTITATIVE ANALYSIS AND THE CASE FOR POLICY REPLACEMENT: SPURIOUS CONCLUSIONS

There may be many valid reasons to consider policy replacement.^{vi} 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?”^{vii} 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.

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.^{viii}

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.^{ix} 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?”^x

Based on this somewhat single-minded view of the role of the life insurance trust^{xi}, the authors 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].^{xii} Even if the conclusions of the authors are correct (although most regulators and academic commentators suggest that replacement is usually not warranted),^{xiii} 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.^{xiv} 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.^{xv} 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.^{xvi} 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.

QUANTITATIVE ANALYSIS AND THE CASE FOR POLICY REPLACEMENT: AN ALTERNATIVE APPROACH

A recent study suggests that marginal yield analysis is an appropriate analytical tool for making insurance policy replacement decisions.^{xvii} The authors point out that, despite the fact that the NAIC Model Regulations caution policyowners to “make a careful comparison of the costs and benefits of your existing policy or contract and the proposed policy or contract,”^{xviii} the policyholder is not provided with “a financial framework for measuring the performance of the existing policy, upon which insurers, financial service professionals, and consumers can base the policy replacement decision.”^{xix}

After reviewing commonly used policy cost measures, they conclude that traditional measures (primarily, Linton Yield and Yield Comparison Indexes) are not well suited to provide guidance regarding replacement decisions. At the heart of the problem lies the inescapable fact that traditional policy cost measures must rely on projected, non-guaranteed values that span long periods of time. Such projections are found on computer-generated policy illustrations (in-force illustrations for existing policies and sales illustrations for proposed replacement policies), the assumptions of which remain opaque to most trustees and the credibility of which is far from perfect. As the authors state: “...the issue of *illustrated* policy performance versus *actual* policy performance remains a vexing problem when trying to compare policies.”^{xx}

Their proposed solution is to base the quantitative aspects of the policy replacement decision on the outcome of a marginal annual yield analysis. In essence, the methodology treats all past cash flows (i.e. premiums and dividends) as “sunk costs.” As such, they become irrelevant for ascertaining how additional, forthcoming benefits of a continued commitment to the current policy compare to benefits generated by making premium commitments to a replacement policy. In effect, the marginal annual yield calculation “collapses” the applicable decision-making horizon to just the next one year (or, at most, the next few years). The assumption is that near-term policy cost and benefit projections are more credible than long-term projections.

The trustee is asked to determine the policy’s marginal yield by calculating the value of a fraction, the numerator of which is the projected benefits for the forthcoming policy year (Cash Value plus Dividends) and the denominator of which is the monetary commitment to the policy less average yearly cost for the equivalent net term insurance death benefit. Monetary commitment, in this case, is both the previous year’s cash value (which remains in the policy and, therefore, is unavailable for other uses), as well as any scheduled out-of-pocket premiums. Thus, marginal yield analysis is a year-by-year mortality-adjusted determination of the return the policyholder can expect to receive given a continued commitment to stay the course. Increases in policy cash benefits divided by cost of maintaining coverage equals marginal yield for the year in which the calculation is made. As such, the rate of return methodology is comparable to that proposed originally by Joseph Belth in 1968 (although Belth’s formula requires input of an assumed interest rate, while the Carson-Forster formula solves for the rate).^{xxi}

In this case, however, the authors employ the marginal annual yield methodology with an eye towards creating a framework to measure the economic effects of policy replacement. The decision rule is as follows: if the replacing financial instrument cannot provide a rate of return over, e.g., the next year, that is sufficiently high, the original policy should not be replaced. Thus, the trustee’s replacement decision is one that must be revisited each year to determine when, or if, the marginal annual yield of the replacement policy can overcome the “hurdle rate” as defined either by the forthcoming year’s marginal annual yield on the existing policy, or, by some other suitable rate determined by the trustee. Interestingly, at a five percent hurdle rate, the methodology indicates that, given the sample of historical Universal Life policy returns over a ten-year period ending in 1998, approximately 90% of existing policies are “non-replaceable.” Intuitively, this result is

satisfying because it conforms to the admonitions of regulators and unbiased academic studies, and because it stands in contrast to the previous market-oriented assertion that over 70% of ILIT policies are candidates for replacement.

Basing the quantitative aspects of a replacement decision on marginal annual yield analysis, however, may still leave the trustee with the problem of employing overly myopic planning strategies. That is to say, long-term financial instruments are compared over short-term intervals rather than over the applicable planning horizon. Furthermore, even when appropriate rate of return methods are used, the trustee seeking to make a valid long-term policy analysis still confronts at least two problems:

- 1) How credible are policy projections that provide the data for the return calculations?
- 2) How credible are the results of calculation methodologies based on point estimates rather than range estimates?

The most precise calculations cannot assist the trustee to make good decisions if they utilize unreliable data. As the authors freely admit, to the extent that illustrated policy values do not accurately reflect actual future premiums and benefits, all types of yield analysis methodologies lack credibility.

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.^{xxii}

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. 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.^{xxiii} 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."^{xxiv} 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."^{xxv} 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 eliminate illustration abuses is producing underwhelming 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."^{xxvi}

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 determinates of return (increase or decrease in lapse rate, interest credits, and so forth). Additionally, the variable of interest is usually changed in a predetermined fashion with all other variables held constant.

Even if "what if" methodologies could yield useful insights, they may fail when applied to insurance policy illustrations. The determinates 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.”^{xxvii}

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.^{xxviii} 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.^{xxix} 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.

QUANTITATIVE ANALYSIS AND THE CASE FOR POLICY REPLACEMENT: BENCHMARK ANALYSIS

Generally speaking, the traditional quantitative methods for determining life insurance policy costs divide into:

- 1) event specific methods; or,
- 2) group average methods.

The quantitative methods discussed above are examples of event specific methods. Event specific methods are commonly used by salesmen to calculate life insurance costs because they focus on the customized and specific insurance illustration prepared for the policyholder. Generally, event specific methods seek to determine the cost of an insurance policy (and, by implication, to compare competing policies) by taking illustrated dollar benefits at their face value. Examples of event-specific methods include the Death Benefit IRR and the Yield Comparison Index methods as well as Linton Yield (implied rate of return on projected cash values); Equivalent Level Annual Dividend method (for participating whole life contracts); and net present value calculations.^{xxx} The key point, however, is that event specific methods can determine the true cost of life insurance only if every assumption underlying the product illustration (sales proposal or inforce policy illustration) occurs exactly as predicted. This method generates financial expectations that trustees should never expect.

A Group Average method does not measure the insurance cost for individual insureds; but, rather, calculates the average cost for the group of consumers electing to purchase the policy. As a consequence, the method generates average numbers that do not provide the exact cost of insurance for any individual. This said, however, group average methods may be superior to event specific methods for a variety of important reasons. When considering, over time, the total experience of a group of policyholders, the method incorporates critical dynamic variables such as lapse ratios, survival probabilities, non-forfeiture values, etc. Thus, a group average method includes multiple ‘discounting’ operations for interest, policy retention, and mortality experience. The dimension of time incorporates factors for time value of money (similar to the Yield Comparison Index method), and can provide a more comprehensive year-by-year picture of insurance policy costs and benefits.

An insurance policy’s future performance is a random variable dependent upon the interaction (joint distribution) of results from several stochastic processes (including the date of the insured’s death). The purpose of a benchmark model is to help the trustee understand the degree to which any policy is subject to

mispricing risk. If an insurance company fails to collect premiums sufficient to fund projected (non-guaranteed) benefits, the trust will be faced with the necessity of additional out of pocket premiums in order to maintain coverage. Failure to charge a sufficient premium means that the contract is mispriced.

Generally speaking, a benchmark is an objective model of insurance costs and benefits that incorporates reasonable assumptions regarding the timing, probability, magnitude, and risk of all cash flows. James C. H. Anderson, in a seminal work published in 1959, lists the relevant variables that a valid life insurance benchmark must address:

- The probability of collecting premiums;
- The interest earned on accumulated funds;
- The benefits paid upon death and policy termination (lapse, surrender, or maturity);
- Policy Expenses;
- Charges assessed for contingencies; and,
- The basis for calculating reserve liabilities established for future benefits.^{xxxii}

The interaction of the critical components within a well-constructed benchmark allows for a richer level of insight into the likelihood that a policy's actual assumptions are, in fact, reasonable. Some models act like generic asset share pricing models while other models utilize a probability-adjusted net present value analysis. Regardless of how the model is constructed, however, the model user can control underlying assumptions regarding mortality, expenses, lapses and other variables of interest to assure a comfortable degree of conservatism. A benchmark cannot predict how any single insurance policy will perform. Rather it provides insight into the relative pricing risk of the policy or policies under evaluation.^{xxxiii} To the extent that the benchmark suggests that there is a funding shortage, the trustee can logically infer that the assumptions underlying the illustrated benefits are, in fact, more aggressive than the known assumptions incorporated into the benchmark.^{xxxiii}

Interestingly, the value of using independent, objective benchmarks has long been recognized for judging performance within the investment industry. Failure to use benchmarks often results in a high level of "gamesmanship" in order to construct a jerry-rigged performance track record. The moral hazard of gamed track records in the securities industry is similar to the hazard of gamed illustrations in the insurance industry. Indeed, many naive investors still succumb to sales pitches based on 'horse-race' analogies. The investment manager with the best rate of return is the winning horse. A superlative track record may, in fact, be masking levels of risk that are intolerable. Without careful statistical analysis, the investor may not be aware that the winning horse is just one lap away from a catastrophic breakdown. Benchmark comparison avoids many of these difficulties and is a particularly powerful tool because it allows for policy comparisons and evaluations on a level playing field. The benchmark assumptions produce risk-adjusted data that can help trustees make defensible and academically sound judgments.

Several decades ago, the professional money management industry in the United States was plagued by extensive gamesmanship in the calculation, reporting, and presentation of investment returns. Consumers of investment services found it particularly difficult to determine which managers added value after fees and expenses. Although money managers attract clients primarily on the basis of performance track record, evaluating investment track record from the single dimensional perspective of return can lead to flawed judgments regarding manager skill. Capital market theory suggests that, in the long-term, the manager that earns the greatest return is the manager that assumes the greatest risk; and managers may be tempted to form high-risk portfolios in hopes of winning the rate of return horse race. The investment community, however, recognized that risk was also a critically important dimension for determining managerial skill. Outperforming the S&P 500 stock index by assuming greater risk is no more an indication of skill than underperforming the index with a lower risk portfolio indicates a lack of skill. A valid benchmark re-calibrates manager returns to reflect the degree of risk to which they expose their clients' money. The performance metric changes from "what return did the manager earn," to "what return should the manager have earned

given the degree of risk in the investment strategy.” Today, prudent investment performance evaluation uses customized benchmarks to make accurate measurements of both skill and risk.

The critical point to note is that prior to the employment of modern portfolio risk-adjusted performance evaluation methods, it was particularly difficult to compare investment managers. Each manager had a unique product to offer in the sense that no two portfolios manifested similar holdings, volatility, factor exposures, etc. Any manager could make the case that he or she employs a superior investment strategy; and, those managers who, either by skill or luck, generate high rates of return use circular reasoning as a proof of such skill. But this is comparable to the competing claims of insurance agents who aspire to make the case for the products and companies that they represent. One company has superior mortality experience, one has higher asset yields, one has lower loan utilization rates, one has low lapse and surrender rates, one has higher dividend or interest crediting rates, one has a better financial strength rating, and so forth. This is an endless parade of marketing claims few of which can provide helpful information to the trustee seeking to acquire new insurance or to evaluate an existing policy. Many of the insurance company performance characteristics touted by marketing departments are amalgams of various actuarial and expense factors which differ markedly from company to company and thus make it impossible to determine the true cost of their products.^{xxxiv}

The analogy between the competing and difficult-to-verify claims of money managers and the claims of insurance agents suggests a solution to the vexing problem of comparing insurance products either by means of computer-generated illustrations, or by reason of marketing claims based on selectively presented financial information. If the agent-produced illustration/financial data for company A cannot nor should not be compared to the illustration/financial data for company B, how is the trustee to make an informed and prudent decision with respect to either? Just as use of appropriate benchmarks levels the playing field between investment managers and facilitates accurate measurement of investment skills and risks; so, also, benchmarks can put competing insurance products on a level playing field to generate meaningful risk/reward insights and comparisons.

Academic research suggests that it is not possible to compare directly policies in different companies, and that it is not possible to project accurately the future performance of any policy from a computer-generated sales illustration. It is, however, possible to build a benchmark insurance policy pricing model with assumptions that are known and that have a comfortable degree of conservatism. It is a straightforward task to compare policy A to the benchmark and to compare policy B to the same benchmark; and, by mathematical inference, to generate a valid comparison of A with B. The benchmark informs us about the degree of pricing risk in each of the illustrated policies. The benchmark cannot tell us how each of the policies will actually perform in the future (only a crystal ball can do this); but it can provide information regarding the likelihood that the insurance carrier can provide the projected benefits without asking for premiums greater than those illustrated.

The benchmark approach changes the nature of the discourse by eliminating sales pitches based on funding maximum benefits for the lowest premium costs, or on maximizing rates of return without regard to underlying risks. The benchmark approach allows the decision making process to shift to a consideration of the likelihood that the insurance program can discharge successfully the economic objectives of the settlor. The life insurance evaluation process can profitably and comfortably incorporate many of the tools and techniques developed by the investment management industry to cut through the gamesmanship that plagues the insurance industry and to put the stewardship of ILIT policies on a more firm basis.

BENCHMARK PRICING MODELS

Just as there is no single, inflexible or monolithic standard for prudent administration of ILITs, there is no single correct way to build benchmark insurance pricing models (although there are many ways to build them incorrectly). An examination of the literature shows several models that may be adopted by ILIT trustees and that lend themselves to straightforward calculation platforms such as Microsoft Excel. One example is the

Cost/Benefit Ratio model developed by finance professor D. Cho.^{xxxv} Following an evaluation of traditional event driven measures of insurance costs such as the interest-adjusted cost index methods, Cho concludes that such measures provide only point estimates for time intervals that may not be relevant for consumers (i.e., consistent with policyowner or beneficiary utility), and that may be subject to various manipulations by product manufacturers. His model is a group average model that conforms to modern portfolio theory methods of evaluation in that it is an 'expected value' model. That is to say, it adjusts all projected cash values and death benefits in terms of the probability of their receipt; and, projects all premiums in terms of the probability of their payment. Thus, his model incorporates liquidity risk (for early lapses and surrenders), retention probabilities (survivors electing to continue coverage), mortality risk (risk of living beyond the date at which the present value of the insurance death benefit exceeds the present value of premium costs) and other relevant variables (e.g., joint probabilities for mortality and lapse risk, time value of money, etc.).

Cho's list of the advantages of his group average insurance pricing model is especially noteworthy because it encompasses many of the major asset administration issues faced by ILIT trustees who must evaluate, presumably on an annual basis, the merits of policy retention, lapse, surrender or replacement options. Cho specifically compares the C/B [Cost/Benefit] Ratio to the traditional point-estimate SCI [Surrender Cost Index] measure of insurance value:

- 1) "Unlike the SCI, the proposed index is founded on expected utility theory, and is therefore theoretically superior. Although the cost of whole life insurance exceeds its benefit, some people buy it because it reduces fear and worry and provides more utility.
- 2) The C/B ratio makes more sense to unhealthy people who may not survive the planning period because death protection is counted in this ratio.
- 3) The C/B ratio is also useful to the policyowners who may terminate the contracts before the planning period, because the probability of policy lapse is considered in this ratio. The insureds may wish to replace present policies with new products offering better policy terms or options. Also, they may terminate them early if the market interest rate rises dramatically, in which case the CV [Cash Value] with a low fixed rate becomes less attractive.
- 4) The C/B ratio is good for the insureds who may keep the policies beyond the time horizon. In the SCI, only the ending CV and TD [Terminal Dividend] are counted; therefore, if the policy is kept beyond the period, the SCI will drop substantially below the original index value, because the CV builds up at an increasing pace over time. However, in the C/B ratio, the intermediate CVs and TDs are adjusted for the probability of lapse, and hence it should not change dramatically even if the policyowner goes beyond the period."^{xxxvi}

Although Cho intends the model to function primarily as a tool for disclosing the expected future costs of life insurance protection, it can be generalized for use in comparing new policies that the trustee contemplates adding to the trust estate; in comparing an existing policy to a replacement alternative; or, in comparing the future economic consequences of exercising current policy options to repay loans, increase or decrease premiums, elect policy non-forfeiture rights, evaluate split-dollar termination strategies, etc.

The benchmark insurance policy pricing model developed independently by Collins and Jurkat incorporates additional functionality that easily encompasses many broad-scope asset management issues faced by ILIT trustees.^{xxxvii} The model employs a group average analytical methodology similar to the Cho model. It incorporates all of Cho's adjustments for mortality and lapse expectations; and, additionally, adjustments for health status, and policy expenses (commissions and other costs generally associated with the policy type, premium and face amount). Rather than evaluating the cost/benefit ratio, its focus is on the expectation of underfunding when using the benchmark model; and on the magnitude of the possible underfunding.

The methodology does not project actual performance for a specific policy (this task remains a statistical impossibility); but, rather, shows the expected average underfunding, if any, implied by the benchmark model. The model does not test for the risk that the insurance carrier will fail to achieve its profitability targets.^{xxxviii}

Trustees managing trust-owned life insurance have several options available to them. They can:

- 1) Continue to maintain the coverage under the current schedule of benefits and premiums;
- 2) Add additional funds to the contract (or, equivalently, pay down policy indebtedness including repayment obligations under split dollar financing arrangements);
- 3) Reduce the face amount of coverage; or,
- 4) Exercise their “non-forfeiture” options or the option to surrender the contract.

Thus, for a new insurance policy purchase decision, or for an asset administration decision with respect to existing insurance, a benchmark model provides insight into the range of probable outcomes over multi-year planning horizons. Benchmark pricing models based on group average methodologies, because they do not warrant the actual future performance of any specific contract; and, because they provide ILIT trustees with a broad range of important information into expected rewards and risks of the trust’s insurance portfolio, appear to represent an especially promising avenue for achieving prudent asset administration at a reasonable level of administrative resources.

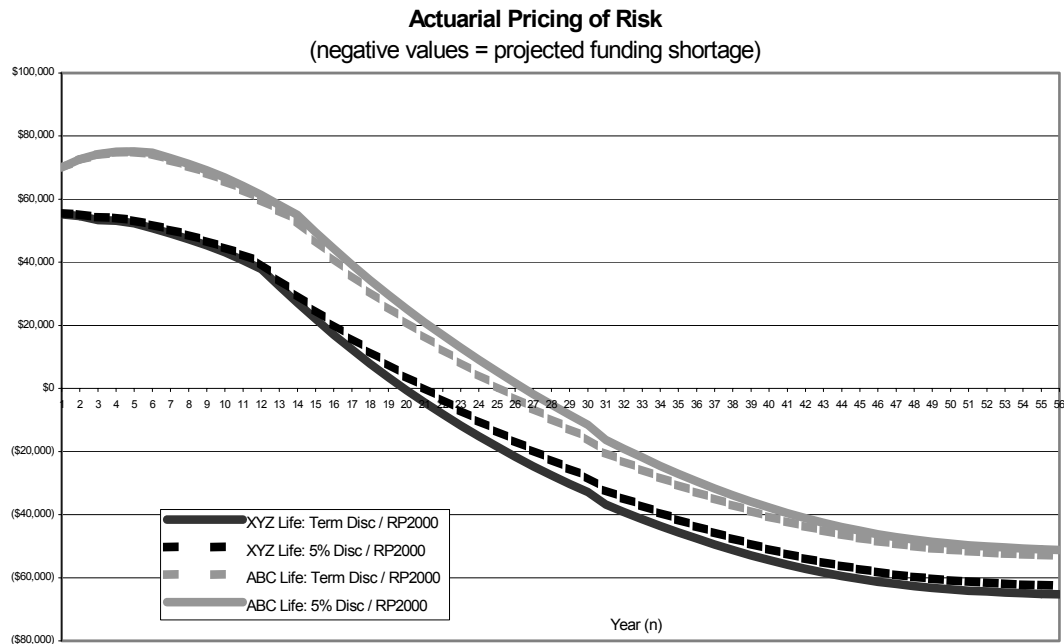
EXAMPLE

The following example outlines a sales presentation advocating policy replacement. The example’s fact pattern is as follows: The ILIT currently owns a participating whole life policy issued in 1994 on a preferred risk/non-smoker basis by ABC Life. The policy, originally issued at age 35, provides a \$2 million death benefit on a female insured currently age 44. The policy cash surrender value is \$70,521. The original policy illustration’s non-guaranteed projections indicated that payment of an annual premium of \$10,108 for a period of thirteen years would fund projected future benefits without necessity for further out of pocket payments. The replacement agent purports that the ABC life policy currently has a dividend interest crediting rate of 6.04%. At the current dividend scale, however, the inforce policy illustration projects that out-of-pocket payments must continue for another fourteen years.

The replacing agent encourages the trustee to replace the underperforming ABC contract with a new, better-designed, Universal Life contract with an equivalent amount of initial death benefit. The new contract, issued by the XYZ Insurance Company, consists of a base amount of \$1,000 Universal Life; a single premium rider for a face amount of \$200,000; and a level annual renewable term rider for a face amount of \$1,799,000. The new contract’s sales illustration indicates that it assumes a 7.1% interest crediting rate in policy year one and a 6.7% rate thereafter. After transferring the existing cash value by means of an IRC §1035 exchange in year one, the XYZ sales illustration projects an out of pocket cost of \$9,910 in years two through twelve, and a final payment of \$424 in year thirteen. Finally, the new contract has a “no-lapse” guarantee rider that is in force for the initial twenty policy years provided that the owner adheres to all applicable terms and conditions. Beyond twenty years, the rider is no longer in force. All else equal, it appears that the trustee may be able to maintain a safer, no-lapse insurance program at a reduced cost by replacing the existing contract in favor of the new policy.^{xxxix} Indeed, if the XYZ policy illustration is to be believed, the total cost savings generated by the policy replacement amount to \$22,168.

The savings hypothesis, however, is not confirmed by a benchmark comparison of the existing and proposed policies. This should not be surprising given the fact that the new policy must finance not only the projected insurance and policy surrender benefits, but also a new set of policy acquisition expenses.^{xl} The following chart indicates that, relative to the comparative benchmark, each policy exhibits a high degree of

sensitivity to mispricing risk; but that the XYZ policy has a greater likelihood of requiring additional future premiums in order to fund projected values.



Each policy is compared to a group average benchmark that uses the Society of Actuaries RP 2000 mortality table. Future values are discounted according to two methods: (1) the term structure of interest rates as interpolated from the spot rate curve of US Treasuries as of September 15, 2003;^{xli} and, (2) a fixed 5% interest rate (flat yield curve) factor. The chart suggests that the existing policy has less mispricing risk (i.e., has a higher likelihood of satisfactory future performance) than the recommended replacement policy. On a present value basis, exercising the option to replace ABC by acquiring XYZ generates a negative value to the trust of slightly more than \$12,000 over the applicable planning horizon. Given the results of the quantitative analysis, it is unlikely that a trustee can conclude that the replacement agent has met a reasonable burden of proof.

Furthermore, the time line that unfolds on the horizontal axis, suggests that the twenty-year no-lapse policy design is of little value. The guarantee rider is in force during the period when policy funding appears sufficient, and not in force during the time when it may prove valuable.^{xliii} Needless to say, at this point in time, it is obvious that some action need be taken to preserve the integrity of the trust's insurance portfolio. The quandary of the trustee reappears; and the ILIT trustee may benefit greatly from consultation with a knowledgeable advisor who can suggest a variety of reasonable planning alternatives.

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.

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.^{xiii} 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 insight 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.^{xiv} 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 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.

i 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.

ii 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."

iii 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.

iv 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."

v 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.

vi Moyses, 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); Weber, Diane, "When - and when not - to replace life insurance policies," Medical Economics (May 13, 1996), pp. 94-99; and, Moyses, John S., "The Ethics of Replacement," Journal of the American Society of CLU & ChFC, (November, 1991), pp. 76-81. Moyses, in his 1991 article, discusses a Canadian court's ruling (*La Mutuelle du Canada Cie d'assurance-vie c. L'Excelsior Cie d'assurance-vie et autres*, R.J.Q.1866-1901 C.S. 1988) that "as a general rule, replacement in the majority of cases is not to the advantage of the policyholder."

vii 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 insurance 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.

viii 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.

ix NAIC Proceedings, Vol. I., 1986, p. 647.

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

xi 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.

xii 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 [Op Cit: “Life Cost Disclosure: Prospects for True Reform”] 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.

xiii 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).

xiv 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.

xv See, for example, Alexander, Neil, “Understanding Life Insurance Illustrations,” Journal of Accountancy (February, 2003) Online Issues www.aicpa.org/pubs/jofa/feb2003/alexand.htm.

xvi 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.

xvii Carson, James M., & Forster, Mark D., “Suitability and Life Insurance Policy Replacement,” Journal of Insurance Regulation (Volume 18, 2000), pp. 427-447.

xviii NAIC Model Regulation §613-12.

xix Op. Cit., Carson & Forster, pp. 428-429.

xx Ibid., p. 432.

xxi Belth, Joseph, M., “The Rate of Return on the Savings Element in Cash-Value Life Insurance,” Journal of Risk and Insurance (1968), pp. 565-581.

xxii 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.

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

xxiv Easton & Harris, Op. Cit., pp. 226-227.

xxv Easton & Harris, Op. Cit., p. 135.

xxvi Katt, Peter, “Deciphering Cash Value Life Insurance Illustrations” Journal of Financial Planning, p. 33.

xxvii Easton & Harris, Op. Cit., p. 17.

xxviii 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 (§613-12) cautions: "Illustrations should not, however, be used as a sole basis to compare policies or contracts."

xxix 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."

xxx Mehr, Robert I. & Gustavson, Sandra G., Life Insurance Theory and Practice Fourth Edition (Business Publications, 1987) pp. 135-143. See also, Bohannon, David, "Methods of Evaluating Life Insurance," Journal of Financial Planning (April, 1996), pp. 20-22.

xxxi Anderson, J.C.H., "Gross Premium Calculations and Profit Measurement for Nonparticipating Insurance," TSA (Vol. XI, 1959), pp. 357-394. Anderson was interested in finding a method for calculating the gross premium for nonparticipating insurance contracts. His formula, therefore, has an additional factor for the carrier's profit objectives. The insurance purchaser, however, is interested in knowing the likelihood that the benefits credited to the policy after the insurance carrier has realized its profit can be supported by the illustrated premium schedule. If a policy fails, it is not because the carrier fails to make a profit on it; rather, it fails because the after-profit funding is insufficient to support the illustrated values.

xxxii Op Cit., Collins "Is it Prudent and Suitable? Estimating the Value of Trust Owned Life Insurance," California Trusts and Estates Quarterly.

xxxiii Consulting actuaries sometimes use commercially available product pricing software programs. These programs are primarily designed for insurance company profit testing but can raise interesting and important questions regarding the likelihood that the carrier will be able to provide projected benefits. There are several insurance advisory services that use benchmark analysis. Peter Katt and Glenn Daily are independent insurance advisors that jointly developed an asset share like model (The Beacon Model). Peter Katt can be contacted at www.peterkatt.com; Glenn Daily can be contacted at www.glendaily.com. Schultz Collins Lawson Chambers, Inc [SCLC] is Independent Investment Counsel specializing in assisting trustees of both qualified retirement plans and non-qualified trusts [www.schultzcollins.com]. SCLC utilizes the Collins/Jurkat benchmark model that is designed on the classical actuarial model used to calculate net level premium reserves. That is to say, it employs a mortality table that increases monotonically with age; and either a single interest rate that serves as a prospective discount factor, or the term structure of interest rates as derived from spot rates on risk-free government bonds or on risk-free securities plus a credit (corporate bond rate premium) spread. However, the benchmark incorporates both lapse and expense factors. Illustrated benefits are what remain after the carrier has determined its targeted profit. The model subtracts the (probability adjusted) present value of future benefits from the (probability adjusted) present value of future premiums. Actuarially, reserves (the funds that the insurance carrier must place on the liability side of their balance sheets in order to fund promised benefits) calculated prospectively through the use of a discount factor are equal to reserves that are calculated retrospectively by subtracting accumulated benefits paid in the past from accumulated premiums plus interest earnings).

xxxiv Op Cit., Miller “Special Report: How Companies Are Answering the IQ”: “The frequency of this practice provides strong evidence for the proposition that any attempt to make a meaningful comparison of cost of insurance charges between companies is almost certainly doomed and will probably produce misleading results.” P. 83.

xxxv Cho, Dongsae, “The Cost/Benefit Ratio: An Ex-Ante Life Insurance Cost Disclosure Index,” The Journal of Insurance Issues (Fall, 1997), pp. 160-180.

xxxvi Ibid., pp. 169-170.

xxxvii Op Cit., Collins “Estimating the Value of Trust Owned Life Insurance,” California Trusts and Estates Quarterly

xxxviii As indicated, the Collins/Jurkat benchmark model is, in some respects, similar to pricing models using the Net Level Premium Reserve calculation methodology with prospective actuarial formulae (Reserve = Present Value of Benefits – Present Value of Premiums). However, it adjusts for mortality, expense, and interest factors to bring the benchmark more into line with actual experience. Therefore, it differs from mandated statutory valuations for reserve calculations. For example, the model eliminates use of expense reallocations according to preliminary term methods of reserve valuations in favor of matching costs (projected benefits to insureds) and revenues (premiums collected from the surviving and non-lapsing policyowners) as they unfold over the applicable planning horizon.

For statutory accounting purposes, the Net Level Premium Reserve calculation is a purely computational device wherein the future benefits are not the actual contract benefits and the future premiums are not the actual “gross premiums” charged to the policyowner. It is designed to provide regulators with a measure of capital required for safe operation of an insurance company. Bartlett, Dwight K. & McGill, Dan M., “History of the Development of Preliminary Term Methods of Valuation of Life Insurance Policies in the United States,” Journal of Insurance Regulation (Spring, 1997). Pp. 382-401. Rather than solving the equation for required Reserve, the Collins/Jurkat benchmark model cumulates, given reasonable assumptions, the differential between PV of Benefits and PV of Premiums to determine the extent of expected average shortfall or surplus.

xxxix Although the replacement agent provided accurate information regarding the respective interest crediting rates, equating a dividend interest crediting rate on a whole life policy with the interest crediting rate on a universal life policy may be misleading without additional clarification and explanation. The example assumes that the trustee assigns little or no probability of needing to access cash values of the contract; and, therefore, is not particularly concerned about increased liquidity risk should the insurance program be terminated during the period when the XYZ cash values projections are lower than the ABC projections. In discussing this example, we do not opine on the prudence of making such a probability assessment. Generally, however, liquidity risk is an important consideration when evaluating financial alternatives.

xl The decomposition of the replacement policy into base coverage combined with relatively low cost single premium and level term riders tends to mitigate policy acquisition costs. For this example, we assume initial acquisition costs equal to 20% of initial premiums paid. Acquisition expenses include commissions, medical examinations, and administrative expenses.

xli Data source is 'www.bloomberg.com/markets/rates/index.html.

xlii The issue of long-term policy guarantees is complex and is beyond the scope of this study. Suffice it to say that guarantees are only as sound as the company that issues them. The National Underwriter (Vol. 106, Issue 5) of February 4, 2002 reports that there is a risk that insurance companies may be subject to “compressed margins” because they cannot earn returns greater than or equal to minimum rate guarantees. A prolonged negative spread environment in a declining interest rate environment may result in the economic difficulties for some insurers. William Ziemba, a well known authority in the creation of stochastic models for financial management, opines: “Many insurance companies in Japan, the United States, Europe, and elsewhere write insurance policies in which a certain investment return is guaranteed over time. This practice is risky and dangerous and frequently leads to disaster.” Ziemba, William T., The Stochastic Programming Approach to Asset, Liability, and Wealth Management (The Research Foundation of the Association for Investment Management and Research, 2003), p. 85.

xliii 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:_____.”

xliv 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.