



THE INSURANCE DESIGN CENTER, LLC

ADVISOR ALERT

JULY 2007

WHAT HAPPENED TO POLICY PERFORMANCE?

Would an investor leave a \$5 million, \$10 million, or \$20 million dollar investment portfolio in a drawer and never check to see how it is doing? The answer is NO, but in fact that is what many investors have been doing with their life insurance.

The insurance industry, undergoing change, now transfers more capital to shareholders than to policyholders. Clients and their advisors must take a proactive approach to **prudently manage** their life insurance capital. Trustees have special liability (and fiduciary responsibility dictated by the Uniform Prudent Investors Act) for relative performance and value.

According to a study conducted by Prince and Associates Inc., nearly 70% of ILITs have not undergone a review in over 5 years. It's not just trust-owned policies that are improperly managed - many of the estimated 13 million individual policies in force in the United States, providing some \$9.7 trillion in coverage as of the end of 2004, are also unmanaged¹ (whether they are trust, bank, corporate or individually owned). Unmanaged life insurance is defined as policies that are not receiving adequate reviews in a timely manner and/or on a regular basis.

What is most troubling about this lack of life insurance management is insurance policy performance issues are on the rise. Interest rates are lower today than they were several years ago. As a result, most carriers have reduced their interest crediting rates. In 1981 rates were at a near historical peak of 16.39% and, while they have recovered from their historical lows near 3.5%, they still provide only modest returns in the 5% range. While lower rates are helpful for those looking to reduce mortgage payments, interest rates have an adverse effect on cash value life insurance performance.

As such, the baseline assumptions many policies were sold under no longer exist, causing many policies to fall short of their original projections. Traditional cash value policies, both universal life and whole life, rely largely on fixed instrument rates of return. What this means for many insureds is their policies are beginning to fail without the knowledge that there is even a problem, or that premium payments must be increased to allow the coverage to remain in force. Below you will find a few brief case studies which demonstrate these policy performance issues.

LET'S REVIEW SOME EXAMPLES:

First, a policy purchased in 1996 on a 64 year old with a death benefit of \$10 million, originally projected an annual rate of return of 8.5%. If a review was done today, it would reveal a cash value shortfall, and could help the advisors and the client determine the appropriate premium to retain the coverage based on current rates of return and insurance costs.

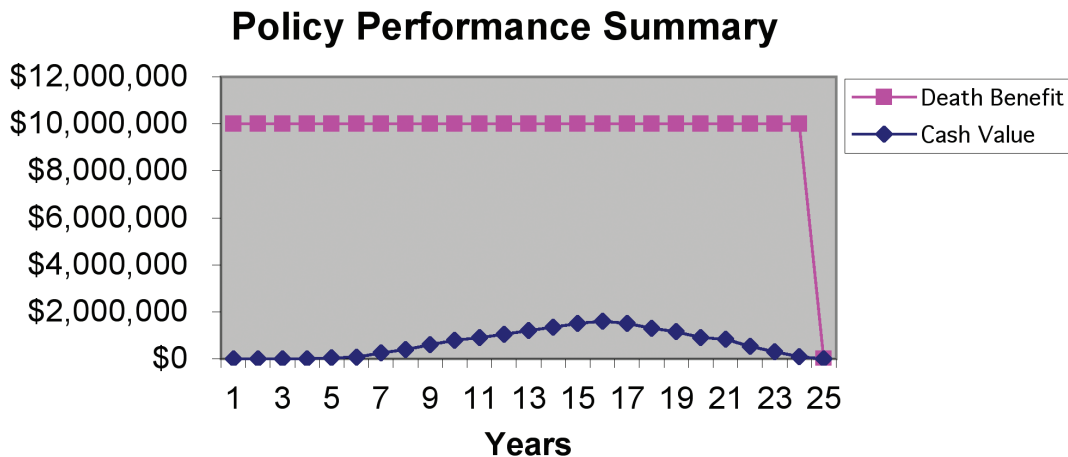
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Current illustrations, assuming today's crediting rate remains unchanged, would show in policy year 25 (at the insured's age 89) the cash value and death benefit **would be gone** due to policy performance that could not meet the original projections.



Second, we have a \$7.5 million dollar policy with a premium of \$40,000 per year originally payable until age 100. Today, the premium would need to be increased to \$120,000 per year to cover the policy performance shortfall.

Not only is there cause for concern for lack of oversight, many clients are leaving money on the table! One statistic receiving a lot of press is that, based on today's life insurance rates, 85% of existing trusts could obtain a 40% reduction in premium costs for the same amount of insurance or, conversely, obtain 40% more death benefit for the same premium cost.² To illustrate this let's use the following case example:

The client is 79 years old and has two policies in place within her trusts, paying a total of \$288,160 in premiums per year for \$10 million of death benefit. The current cash value is \$6,313,000. A 1035 exchange of this cash value, and continuation of the same premium, could provide \$21,482,274 of death benefit for this client.

The above examples illustrate the importance of treating one's life insurance as an asset, not just a rainy day insurance policy. Remember, if a policy is purchased in a steadily declining interest rate market it has very little capacity to meet its original projections; however, insurance companies are constantly working on new alternatives that might provide better solutions within their target markets.

With projected increases in life expectancy, many new policies provide either lower premiums or larger death benefits in exchange for older coverage. Their competitive efforts provide opportunities for astute advisors to determine whether or not their clients would benefit from an objective analysis of their existing insurance portfolios when compared with current alternatives.

As advisors, we should not only be looking out for policies that are underperforming against projections, but also be aware of market dynamics that may provide opportunities to save our clients money, and give them additional peace of mind.

¹ American Council of Life Insurers, 2005 Life Insurer's Fact Book, at 81.

² John E. Mayer, CFP, MSFS, CLU, AIFA "Fiduciary Duties for Trust Owned Life Insurance under UPIA," *Michigan Lawyer Weekly* (July 2, 2001).

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