

WHERE'S THE RISK?

SAFEGUARDING INSURANCE PORTFOLIOS – DOCUMENTING ACTIVE STEWARDSHIP

The fastest growing division of trust companies is the litigation department due to the groundswell of lawsuits surrounding fiduciary responsibilities. When it comes to life insurance trusts (LITs), litigation is rampant because the interests of the grantor are not typically in concert with the fiduciary responsibilities of the trust company and the trustee, or the interests of the beneficiaries.



500 Lake Cook Rd.
Suite 270
Deerfield, IL 60015
Tel: 847 943 0800
Fax: 847 943 0801
www.idc-llc.com

Whether or not fiduciaries and other advisors wish to deal with the reality of policy failure or poor performance, they must be aware that life insurance is a financial instrument that has evolved into a new asset class. Unfortunately, the fiduciaries and advisors often do not possess the specific expertise now required to serve clients with significant capital entrusted to the life insurance industry. Most are equally wary of the liability they perceive exists in making recommendations. **Inaction does not mitigate this potential liability.**

Creating a life insurance portfolio has some similarities to building a house. Even with close oversight and professional review, problems arise. Routine inspections and ongoing maintenance are needed and, over time, you are likely to find problems you didn't know were there. As with a house, a life insurance portfolio is likely to require modifications as a person's needs change.

Where is the long-term risk? What you don't know about the "moving parts" within life insurance contracts will increase the risk of a buy and hold philosophy dramatically.

Fiduciaries and financial advisors need to understand the potential liability of inertia –

- Rates of return on death benefits can be surprisingly high
- Trust cash flow is rarely limited by gifting restrictions

THE CONTENT COVERED IN THIS PRESENTATION IS FOR INFORMATIONAL PURPOSES ONLY. ALTHOUGH MANY OF THE TOPICS PRESENTED MAY ALSO INVOLVE TAX, LEGAL, ACCOUNTING OR OTHER ISSUES, NEITHER THE INSURANCE DESIGN CENTER LLC, NOR ANY OF ITS CONSULTANTS, ADVISORS, EMPLOYEES OR INSURANCE AFFILIATES ARE IN THE BUSINESS OF OFFERING SUCH ADVICE. THE INSURANCE DESIGN CENTER, LLC IS LICENSED WITH THE STATE OF ILLINOIS DIVISION OF INSURANCE AND PROVIDES SERVICES IN THE CAPACITY OF AN INSURANCE CONSULTANT ONLY. THE INFORMATION CONTAINED HEREIN IS NOT INTENDED TO CONSTITUTE AN OFFER TO SELL OR A SOLICITATION IN CONNECTION WITH ANY PRODUCT OR STRATEGY.

- Capital that is locked up in life insurance contracts is not necessarily illiquid
- The preconception that people over 70 are locked in to the insurance they own is a fallacy
- Cash-value life insurance is likely to fail. Even policies that are heavily funded have the potential to fail
- Policies are worth far more than you think
- Existing plans can often provide opportunities
- Surrender is rarely the best answer – it is like walking away from the equity in your house
- What happens when the contract actually fails? The death benefit is gone forever
- Why would anyone worth \$50 million ever buy life insurance? Because it is a phenomenal capital management tool.

Identifying Risk

To benefit insureds and their beneficiaries and to avoid liability suits, trustees and advisors should develop best practices for managing life insurance assets that put these assets on the same footing as other capital.

At the very least, policies should be reviewed annually to identify risk and determine whether they are meeting goals. Fiduciaries who conduct such a review today will find that in many cases, the insurance is not only falling short of targets, but is likely to fail unless significant changes are made. Insurance companies as “manufacturers” are clearly focused on product sales. They provide little incentive to support such vital functions as monitoring ongoing policy performance.

A 2004 study estimated that 75% of cash-value policies are not performing as originally illustrated¹. This is not a new phenomenon. Studies performed in the early 1990s found that 80% to 90% of cash-value policies would not perform as originally illustrated without “restorative action,” i.e., additional premiums.² Insureds don’t know it, their trustees don’t know it and their insurance companies aren’t telling them, but drastic steps will need to be taken to restore these insurance policies.

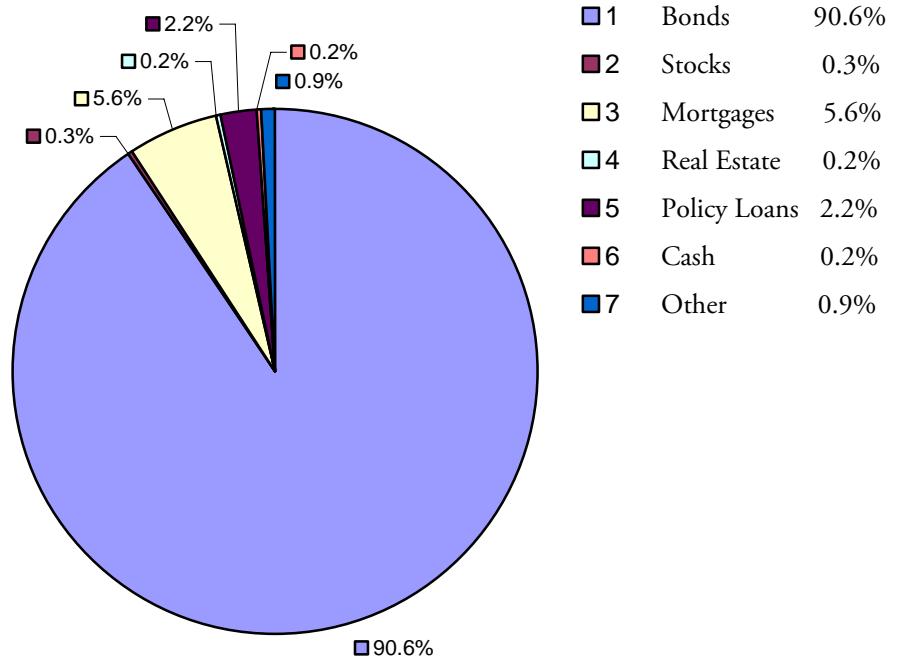
THE CONTENT COVERED IN THIS PRESENTATION IS FOR INFORMATIONAL PURPOSES ONLY. ALTHOUGH MANY OF THE TOPICS PRESENTED MAY ALSO INVOLVE TAX, LEGAL, ACCOUNTING OR OTHER ISSUES, NEITHER THE INSURANCE DESIGN CENTER LLC, NOR ANY OF ITS CONSULTANTS, ADVISORS, EMPLOYEES OR INSURANCE AFFILIATES ARE IN THE BUSINESS OF OFFERING SUCH ADVICE. THE INSURANCE DESIGN CENTER, LLC IS LICENSED WITH THE STATE OF ILLINOIS DIVISION OF INSURANCE AND PROVIDES SERVICES IN THE CAPACITY OF AN INSURANCE CONSULTANT ONLY. THE INFORMATION CONTAINED HEREIN IS NOT INTENDED TO CONSTITUTE AN OFFER TO SELL OR A SOLICITATION IN CONNECTION WITH ANY PRODUCT OR STRATEGY.

Why are so many life insurance policies on life support?

The active climate of mergers, acquisitions, consolidations and demutualizations has had a profound effect on the life insurance industry in recent years. After going public, insurance companies aggressively seek methods to enhance their value on Wall Street, trading policy values for stock values.

Remember that insurance companies base their projections on insureds' anticipated mortality rate and on the expected rate of return from the premiums they charge. Premiums are invested in the general portfolio of the life insurance company, which typically is heavily weighted with fixed-income securities, such as bonds and Treasury bills.

AIG Life Insurance Company



Pie Chart for a Traditional Insurance Co. Portfolio Mix

THE CONTENT COVERED IN THIS PRESENTATION IS FOR INFORMATIONAL PURPOSES ONLY. ALTHOUGH MANY OF THE TOPICS PRESENTED MAY ALSO INVOLVE TAX, LEGAL, ACCOUNTING OR OTHER ISSUES, NEITHER THE INSURANCE DESIGN CENTER LLC, NOR ANY OF ITS CONSULTANTS, ADVISORS, EMPLOYEES OR INSURANCE AFFILIATES ARE IN THE BUSINESS OF OFFERING SUCH ADVICE. THE INSURANCE DESIGN CENTER, LLC IS LICENSED WITH THE STATE OF ILLINOIS DIVISION OF INSURANCE AND PROVIDES SERVICES IN THE CAPACITY OF AN INSURANCE CONSULTANT ONLY. THE INFORMATION CONTAINED HEREIN IS NOT INTENDED TO CONSTITUTE AN OFFER TO SELL OR A SOLICITATION IN CONNECTION WITH ANY PRODUCT OR STRATEGY.

Unfortunately, bond rates have been declining, sometimes precipitously, for 25 years. Rates for 10-year government bonds fell from a peak of 15.32% in September 1981 to 3.33% in June 2003³. Insurance purchased at any time during that period was purchased when rates were significantly higher for a fixed portfolio than they are today. The decrease in interest rates has resulted in lower returns than projected.

Illustrations used by insurance companies are based on a constant rate of return- this never happens in the real world. The longer the period covered by the illustration, the less accurate it is likely to be. Given that life insurance illustrations project out over a very long term, the likelihood of the projection being accurate is low at best. Other factors also contribute to under-performance. For example, regular payment of premiums is optional for owners of universal life insurance; when premiums aren't paid, the original projections are no longer accurate.

Charging More For Poor Performance

Insurance companies have begun using “mortality and expense” charges to compensate for under-performing assets. People are living longer and other expenses are not increasing, so these charges should be decreasing. Yet in some cases, they are rising. Insurers have two sources of income – return on investments and premiums. When companies have lowered their projected rate of return to the minimum contractually guaranteed rate and are still having trouble meeting profit projections, they are limited to raising mortality and expense charges in order to improve the profit picture.

The only way insurance companies can make more money is by increasing mortality and expense charges. The limits on mortality and expense charges are set at the state level. Current charges are typically well under the maximum charges. Some insurers are now using the opportunity to pass on the costs of their inaccurate projections.

Conseco is just one example of a company that has followed this practice. Among its acquisitions was Massachusetts General, which was selling a large amount of insurance at highly competitive premiums. This under-priced insurance was paying higher interest rates than it should have. Even when dropping rates to the minimum guaranteed rates,

THE CONTENT COVERED IN THIS PRESENTATION IS FOR INFORMATIONAL PURPOSES ONLY. ALTHOUGH MANY OF THE TOPICS PRESENTED MAY ALSO INVOLVE TAX, LEGAL, ACCOUNTING OR OTHER ISSUES, NEITHER THE INSURANCE DESIGN CENTER LLC, NOR ANY OF ITS CONSULTANTS, ADVISORS, EMPLOYEES OR INSURANCE AFFILIATES ARE IN THE BUSINESS OF OFFERING SUCH ADVICE. THE INSURANCE DESIGN CENTER, LLC IS LICENSED WITH THE STATE OF ILLINOIS DIVISION OF INSURANCE AND PROVIDES SERVICES IN THE CAPACITY OF AN INSURANCE CONSULTANT ONLY. THE INFORMATION CONTAINED HEREIN IS NOT INTENDED TO CONSTITUTE AN OFFER TO SELL OR A SOLICITATION IN CONNECTION WITH ANY PRODUCT OR STRATEGY.

TRADEMARK & COPYRIGHT © 2006 INSURANCE DESIGN CENTER, LLC

Conseco was not making the necessary profit on the policies, so it raised mortality charges. An argument could perhaps be made that Conseco's mortality was at stake.

Even though bond rates that had trended downward for many years are now heading up, trailing indicators are so deeply entrenched, they have been artificially supporting interest rates in the insurance market for years. Insurance companies, in many cases, continued reporting 7% to 8% rates of return from their underlying portfolio. That can't go on much longer. Those insurance companies that didn't ignore the problem have, in some cases, taken actions that made a bad situation worse. Some tried to compensate for declining bond rates by investing in junk bonds. Rather than improving performance, the outcome of these investments was a very negative impact on these insurance companies' ratings.

Put the Policies in the Safe Deposit Box

Lawsuits against trustees are increasing, and may result from negligence in maintaining policies, poor or inappropriate investment decisions, or selection of an inappropriate insurance carrier or agent⁴. Agents who consider themselves representatives of the insured often create friction or even lose clients for trust companies by restricting policy reviews to performance issues, rather than following a holistic review process that considers trust goals as the primary objective. The first responsibility is to the facts, always. Step one must be an objective assessment of policy and company performance, to determine if planning goals are supported. This appraisal will provide the basis necessary for validating objectives and examining alternative solutions.

For TOLI, failure to properly manage life insurance assets violates the Uniform Prudent Investors Act (UPIA) and can result in lawsuits against trustees or others with responsibility for managing the life insurance. The UPIA, which in some form has been adopted by 46 states, sets standards for managing trust-owned assets, including life insurance.

In spite of the potential liability, recent studies show that trustees are woefully negligent when it comes to managing TOLI. A 2003 survey of nonprofessional trustees, who are

THE CONTENT COVERED IN THIS PRESENTATION IS FOR INFORMATIONAL PURPOSES ONLY. ALTHOUGH MANY OF THE TOPICS PRESENTED MAY ALSO INVOLVE TAX, LEGAL, ACCOUNTING OR OTHER ISSUES, NEITHER THE INSURANCE DESIGN CENTER LLC, NOR ANY OF ITS CONSULTANTS, ADVISORS, EMPLOYEES OR INSURANCE AFFILIATES ARE IN THE BUSINESS OF OFFERING SUCH ADVICE. THE INSURANCE DESIGN CENTER, LLC IS LICENSED WITH THE STATE OF ILLINOIS DIVISION OF INSURANCE AND PROVIDES SERVICES IN THE CAPACITY OF AN INSURANCE CONSULTANT ONLY. THE INFORMATION CONTAINED HEREIN IS NOT INTENDED TO CONSTITUTE AN OFFER TO SELL OR A SOLICITATION IN CONNECTION WITH ANY PRODUCT OR STRATEGY.

often family members, found that 71.2% had not reviewed the TOLI in the trusts they managed in at least five years⁵. The same study found that professional trustees are also lax – 83.5% have no guidelines for managing TOLI and 96.3% have no policy statement guiding how life insurance investments should be handled.

It shouldn't be surprising that clients, trustees and sometimes even their advisors fail to take life insurance seriously. It is, after all, "insurance," which automatically puts it in a category of "things you need," rather than "things you want." And who can get excited about a product that reminds us of our mortality? Or that, in the end, pays out a "death benefit?"

Yet life insurance may be one of the most useful capital-management tools on the market. If properly constructed, regularly maintained and carefully managed, a life insurance portfolio can have a profound impact on a person's ability to pass wealth along to heirs, keep a business operating, benefit a charity or supplement retirement income. It also provides a number of tax benefits, as well as liquidity.

Policy Review and Portfolio Restructuring

Although many trustees have experience managing trust-owned investment capital, few institutional trustees – and almost no private trustees (wives, friends, parents, siblings) – feel qualified to navigate the fiduciary territory of managing all of the "moving parts" at risk when analyzing policy and carrier performance. The trustees in the 2003 study previously referenced also reported that they had no procedures for review and no exit strategy for under performing policies.

A reasoned approach to managing life insurance assets provides a defensible framework that benefits trusts, grantors and beneficiaries, as well as trustees and other fiduciaries.

Following is a list of the issues an objective review or restructuring should address:

- 1) What is the logic behind the original insurance acquisition? Should or can the policies be modified through renegotiation with the insurance companies?

THE CONTENT COVERED IN THIS PRESENTATION IS FOR INFORMATIONAL PURPOSES ONLY. ALTHOUGH MANY OF THE TOPICS PRESENTED MAY ALSO INVOLVE TAX, LEGAL, ACCOUNTING OR OTHER ISSUES, NEITHER THE INSURANCE DESIGN CENTER LLC, NOR ANY OF ITS CONSULTANTS, ADVISORS, EMPLOYEES OR INSURANCE AFFILIATES ARE IN THE BUSINESS OF OFFERING SUCH ADVICE. THE INSURANCE DESIGN CENTER, LLC IS LICENSED WITH THE STATE OF ILLINOIS DIVISION OF INSURANCE AND PROVIDES SERVICES IN THE CAPACITY OF AN INSURANCE CONSULTANT ONLY. THE INFORMATION CONTAINED HEREIN IS NOT INTENDED TO CONSTITUTE AN OFFER TO SELL OR A SOLICITATION IN CONNECTION WITH ANY PRODUCT OR STRATEGY.

- 2) What are the current insurance needs? This must be framed in the context of total net worth, current and projected estate requirements, and estimated return on investment.
- 3) Are the policies appropriate for the risk profile of the grantor or settlor?
- 4) Should new or additional coverage be considered to meet current objectives and/or to take advantage of favorable actuarial assumptions and the underwriting environment?
- 5) Should capital be recovered and reapplied through a life settlement?
- 6) What structure and funding options are available to most effectively manage the life insurance capital?

In spite of the industry's problems, insurance policies are generally worth far more than most people would guess. One survey estimates that 85% of policies can be restructured to provide 20% to 40% greater value to the insured¹. This restructuring could involve a variety of strategies combined in unique ways to best utilize the available capital.

Selling, or arranging for a life settlement of existing policies, though, makes sense only if the coverage is no longer required or if new insurance can be put in place with better benefits, a larger death benefit or a lower premium. Even term insurance has value if it's convertible to a cash-value contract. If any health changes have occurred for the insured, the policy can be converted to a cash-value contract and then sold. The availability of life settlement options for policies that are surrendered or lapsed can create a fiduciary liability whether or not the fiduciaries are educated in these alternatives.

Contrary to popular opinion, life insurance is available even for individuals over 75. We have secured life insurance for people in their mid to late 80's. If replacement coverage is desired, a broad range of contracts is currently available because of the strong competitive market among companies.

Following a bidding or auction process that seeks the best outcome from a life settlement, the resulting funds can be exchanged to buy an immediate annuity. The annual payment from the annuity can then be used to pay for new life insurance

THE CONTENT COVERED IN THIS PRESENTATION IS FOR INFORMATIONAL PURPOSES ONLY. ALTHOUGH MANY OF THE TOPICS PRESENTED MAY ALSO INVOLVE TAX, LEGAL, ACCOUNTING OR OTHER ISSUES, NEITHER THE INSURANCE DESIGN CENTER LLC, NOR ANY OF ITS CONSULTANTS, ADVISORS, EMPLOYEES OR INSURANCE AFFILIATES ARE IN THE BUSINESS OF OFFERING SUCH ADVICE. THE INSURANCE DESIGN CENTER, LLC IS LICENSED WITH THE STATE OF ILLINOIS DIVISION OF INSURANCE AND PROVIDES SERVICES IN THE CAPACITY OF AN INSURANCE CONSULTANT ONLY. THE INFORMATION CONTAINED HEREIN IS NOT INTENDED TO CONSTITUTE AN OFFER TO SELL OR A SOLICITATION IN CONNECTION WITH ANY PRODUCT OR STRATEGY.

TRADEMARK & COPYRIGHT © 2006 INSURANCE DESIGN CENTER, LLC

coverage. The immediate annuity provides additional leverage to fund the life insurance contract.

The key, though, is to know what's available and to perform an in-depth competitive analysis. Big, brand name insurance companies aren't always the best source of life insurance. Just because a company markets aggressively doesn't mean it has quality products. A piece of the rock or a walk with Snoopy may not be the optimum alternatives for many people.

When negotiating a contract, think long term. Most insurance companies have little motivation to keep old policies in the same competitive arena as their new offerings. A select group of companies takes a different approach. When they improve new products, they apply the same adjustments to their existing book of business. Without a broad and educated review process these fine points of carrier quality will be overlooked.

The best insurance planning includes gifting strategies that are completely neutral with acceptable levels of risk. In a portfolio where insurance is acquired *ad hoc* over many years, gifting is obviously not considered strategically. Restructuring with oversight, extensive market analysis and complete integration into the existing and proposed estate and business planning strategies benefits fiduciaries, clients and beneficiaries.

What can be done when you have a strategy and know the market is best shown by example. Consider a few real-life cases from The Insurance Design Center, LLC:

Case #1 - An \$800,000 Windfall: A 78-year-old male client had \$12 million in underperforming universal life contracts that were 10 years old. Based on current premiums, we projected that two thirds of the insurance would lapse in nine years and one third would lapse in seven years. We negotiated with three life settlement brokers representing roughly forty different settlement funders. The life insurance policies had a cash value of \$700,000, yet we were able to sell them for \$1,575,000 – 225% of cash value.

The trust used half of the proceeds to buy single-premium annuities and retained the balance. As a result, the trust increased its funds to pay premiums and also has the

THE CONTENT COVERED IN THIS PRESENTATION IS FOR INFORMATIONAL PURPOSES ONLY. ALTHOUGH MANY OF THE TOPICS PRESENTED MAY ALSO INVOLVE TAX, LEGAL, ACCOUNTING OR OTHER ISSUES, NEITHER THE INSURANCE DESIGN CENTER LLC, NOR ANY OF ITS CONSULTANTS, ADVISORS, EMPLOYEES OR INSURANCE AFFILIATES ARE IN THE BUSINESS OF OFFERING SUCH ADVICE. THE INSURANCE DESIGN CENTER, LLC IS LICENSED WITH THE STATE OF ILLINOIS DIVISION OF INSURANCE AND PROVIDES SERVICES IN THE CAPACITY OF AN INSURANCE CONSULTANT ONLY. THE INFORMATION CONTAINED HEREIN IS NOT INTENDED TO CONSTITUTE AN OFFER TO SELL OR A SOLICITATION IN CONNECTION WITH ANY PRODUCT OR STRATEGY.

TRADEMARK & COPYRIGHT © 2006 INSURANCE DESIGN CENTER, LLC

money coming out of the single-premium annuity. We used annual payments from the annuity to support the purchase of new coverage with the same \$12 million in death benefits, but the new insurance is guaranteed for life – and there's roughly \$800,000 left in the trust.

Case #2 - A Bigger Benefit: Two co-owners of a business, aged 50 and 54, each owned 10 different whole life and term insurance policies on each other with a total death benefit of \$10 million. After reviewing their insurance portfolio, we found that we could consolidate all of these policies into a single policy at the same premium level and 150% of the death benefit they previously had.

Case #3 - A "Home" Run: There are many ways to use life insurance in a trust to circumvent gifting limits. Grantor retained annuity trusts (GRATs), charitable lead trusts and back funding of guaranteed contracts are just a few examples. Another example is the Qualified Personal Residence Trust (QPRT), which was recently used for a woman who was approaching her gifting limits and still wanted to pass on more assets to her children.

She owned a lake house worth \$3 million. Several years ago, the house had been put in a QPRT, which will now mature in two years. The required premium for the insurance she has in place is greater than her current gifting limits. For a few years she can use her remaining lifetime exemption to augment her gifting program. Once the QPRT matures, in the third year, she will begin paying rent to her children for her use of the lake house. This will more than adequately pay the annual insurance premiums. Should she choose to, she will now be able to make her annual gifts for other purposes. She will also avoid using up her lifetime exemption and will not ultimately be forced to pay gift tax.

Insurance policies are put in place in the context of family philosophies, expectations and circumstances. This context shifts continuously, requiring not only a review of the policies relative to the family framework, but also in light of the array of planning options that have become available in the last few years.

THE CONTENT COVERED IN THIS PRESENTATION IS FOR INFORMATIONAL PURPOSES ONLY. ALTHOUGH MANY OF THE TOPICS PRESENTED MAY ALSO INVOLVE TAX, LEGAL, ACCOUNTING OR OTHER ISSUES, NEITHER THE INSURANCE DESIGN CENTER LLC, NOR ANY OF ITS CONSULTANTS, ADVISORS, EMPLOYEES OR INSURANCE AFFILIATES ARE IN THE BUSINESS OF OFFERING SUCH ADVICE. THE INSURANCE DESIGN CENTER, LLC IS LICENSED WITH THE STATE OF ILLINOIS DIVISION OF INSURANCE AND PROVIDES SERVICES IN THE CAPACITY OF AN INSURANCE CONSULTANT ONLY. THE INFORMATION CONTAINED HEREIN IS NOT INTENDED TO CONSTITUTE AN OFFER TO SELL OR A SOLICITATION IN CONNECTION WITH ANY PRODUCT OR STRATEGY.

TRADEMARK & COPYRIGHT © 2006 INSURANCE DESIGN CENTER, LLC

Where's the risk? The risk lies in ignoring the opportunity to discover the structure and funding options that could most effectively manage the life insurance capital.

¹Stewardship of Trust-Owned Life Insurance," The Insurance Design Center, LLC.

²"Managing Trust-Owned Live Insurance Revisited," *Trusts & Estates*, April 1994

³E. Randolph Whitelaw and Richard M. Weber, "Trust-Owned Life Insurance: Risk Management Guidance for Fiduciaries," *Estate Planning*, September 2005

⁴Mark A. Teitelbaum, JD, LLM, CLU, ChFC, "Trust-Owned Life Insurance: Issues Trustees Face; Decisions Trustees Need To Make," *Journal of Financial Service Professionals*, June 2005.

⁵Richard L. Harris and Russ Alan Prince, "The Problem with Trusts Owning Life Insurance," *Trusts & Estates*, May 2003.

THE CONTENT COVERED IN THIS PRESENTATION IS FOR INFORMATIONAL PURPOSES ONLY. ALTHOUGH MANY OF THE TOPICS PRESENTED MAY ALSO INVOLVE TAX, LEGAL, ACCOUNTING OR OTHER ISSUES, NEITHER THE INSURANCE DESIGN CENTER LLC, NOR ANY OF ITS CONSULTANTS, ADVISORS, EMPLOYEES OR INSURANCE AFFILIATES ARE IN THE BUSINESS OF OFFERING SUCH ADVICE. THE INSURANCE DESIGN CENTER, LLC IS LICENSED WITH THE STATE OF ILLINOIS DIVISION OF INSURANCE AND PROVIDES SERVICES IN THE CAPACITY OF AN INSURANCE CONSULTANT ONLY. THE INFORMATION CONTAINED HEREIN IS NOT INTENDED TO CONSTITUTE AN OFFER TO SELL OR A SOLICITATION IN CONNECTION WITH ANY PRODUCT OR STRATEGY.

TRADEMARK & COPYRIGHT © 2006 INSURANCE DESIGN CENTER, LLC