WHEN PERMANENT ISN'T FOREVER:

WHY MANY "PERMANENT" POLICIES HAVE SHORTER LIFE EXPECTANCIES THAN THOSE THEY PROTECT

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OVERVIEW

Many life insurance policies are underperforming original projections and are forecasted to terminate sooner than anticipated.[1] This may come as a surprise to many policyowners since 70% of inforce policies have not been reviewed in the past five years.[2] With the extended ultra-low interest rate environment, even policies labeled as "permanent" may be at risk. Advisors can provide value and security to their clients by being aware of this situation and offering assistance in reviewing inforce policies to prevent surprises. Rest assured, life insurance is not rocket science and understanding the basics will take you a long way in helping your clients make sound decisions.

ANALYZING INFORCE COVERAGE

Insurance can be a valuable component in a well-designed financial plan. It's important for the policy to perform as originally intended or for proper adjustments to be made along the way. If the insurance policy is owned by a trust, the trustee must monitor the policy.[3] Unfortunately, policies are rarely reviewed[4] and over the past few decades, many policies have fallen short in meeting original projections.

But wait…haven't insurance agents been monitoring these policies? Where are the agents that sold the policies? Simply put, they're gone. It's estimated that 70 to 95% of trust-owned life insurance policies have no agent assigned to help service the policy.[5] Very often, the original agent who sold the original policy is no longer in business – she may have retired, left her firm or changed careers altogether. In fact, research shows there are simply less insurance agents available to help.[6] Clearly, insurance is no good if it's not around when needed so what can be done to better understand how a policy is performing?

MANY POLICIES HAVE UNDERPERFORMED ORIGINAL PROJECTIONS

Let's examine some reasons behind policy underperformance. There are some common themes and problems that are often encountered.

First, the dramatic decline in interest rates over the last 40 years has affected all carriers. Low interest rates put pressure on financial services companies and the interest sensitive products they issue, including life insurance. Falling interest rates have reduced the returns of all whole life and universal life policies to one degree or another. Insurance companies live off the spread they earn above the rate credited on policy cash values. When times are good, life insurers profit from long-term investments made over the past 20-30 years. In today's environment, it's challenging for insurance companies to generate necessary returns to meet rate guarantees built into existing policies. The result? Insurance policy crediting rates have trended down for many years. Whole life policy dividend rates have dropped from around 11% in 1988 to current rates closer to 5%.

Secondly, the historical use of overly optimistic sales projections (called "illustrations" or "ledgers") have caused problems. Rosy illustrations coupled with declining interest rates have negatively impacted many older policies. Simple adjustments to the premium or death benefit of an inforce policy may be all that's needed. Alternatively, it may make sense to replace (think "upgrade") the old policy with newer coverage that is more in line with current goals and objectives. A classic example of an overly optimistic illustration is the "vanishing premium" whole life design. This design calculated the point in time when policy dividends and values would be sufficient to pay the annual premium. A statement was made by the agent at the time of sale along the lines of "this premium will vanish 12 years from today." Unfortunately, the agent didn't finish the sentence. The remaining part is "assuming the policy dividend rate doesn't go down." And unfortunately, that's exactly what happened. The falling interest rate environment has caused almost all of these "vanish dates" to be extended into the future and the results are often dramatic. In keeping with the prior example, where the whole life premium was expected to "vanish" in year 12 – a reduced dividend rate will likely require the premium to be paid for an additional

5-7 years. Understandably, this news may be very upsetting to insureds and policyowners.

As if that wasn't enough, sometimes policies were designed with vanishing premiums AND a term life component to reduce premium costs. These "lowball" premium policies usually take the form of a whole life policy with a maximum term blend or a minimally funded universal life policy that relies on optimistic interest rate assumptions and/or shortened life expectancies. In either case, these policies start out underfunded and way behind the curve - they have little chance of ever catching up. Both types of policies (the whole life term blend and the minimally funded universal life policy) were doomed from the beginning. They required unrealistic high returns in the future to pay down the increasing internal costs inherent in their design. This was rarely understood by the client and as the years went by internal policy costs increased as predicted but future returns never materialized.

Why all the problems? In basic terms, competition drove the internal costs of insurance policies below where they should have been actuarially and many consumers (with help from their agents) fell into the trap of paying too little for their insurance in the short-term, unaware and unfocused on the long-term consequences. Without intervention, many of these thinly priced policies will lapse before the death of the insureds, leaving no residual value.[7]

HOW TO REVIEW AN INFORCE POLICY

Step one is to obtain an "inforce ledger" to show the policy's current status and project performance into the future based on certain assumptions. An "inforce ledger" is obtained from the issuing insurance company and is a tool that can stress test policy performance under various scenarios. I typically like to order three inforce ledgers showing three possible future scenarios:

1. An "as is" scenario showing no changes to the policy
2. A "pay no more" scenario showing no more premiums being paid
3. A "minimum premium" solve scenario which estimates the minimum annual premium needed to keep the policy inforce until the insured's age 100

Depending on the type of policy, I may also ask for each scenario to be run one percent below the current crediting rate and if I can get a copy of the original "sales illustration" that will establish a baseline. Keep in mind these are just tools to illustrate possible future policy performance - but they are helpful in analyzing the policy and any possible alternatives.

BE SKEPTICAL OF "LEDGERS" AND "ILLUSTRATIONS"

The standard tool used to show how a policy may perform in the future is a numerical table. When the table is used at the time of sale to show future performance, it's called a "sales illustration." When the table is used to show how an *inforce* policy may perform moving forward it's called an "inforce illustration" or "inforce ledger." Both are prepared by the issuing insurance company. Unfortunately, both are inherently unreliable and potentially misleading if you don't understand how to read them.

Illustrations and ledgers project a constant rate of return for the policy in the future. This is often called the "crediting rate." Projecting a constant crediting rate does not mimic reality and can be misleading. The crediting rate being used is likely just the rate being paid by the carrier when the illustration or ledger is run. The crediting rate is not a prediction of future rates. The rate has changed in the past and will continue to change in the future – *it is not constant*. Depending on a number of factors, it may or may not make sense to use the carrier's current rate to estimate future policy performance. Recent regulations have improved certain aspects of illustrations and ledgers to better clarify their potentially misleading format.

CONSIDERATIONS WHEN REPLACING ONE POLICY WITH ANOTHER

When a review seems to call for a new policy, there are several points to consider before making the final decision.

First, as stated earlier, the declining interest rate market has affected all carriers and products to one degree or another. That's why it's important to understand what the "minimum premium" inforce ledger scenario shows for the current policy. It may be more appropriate to keep the current policy and pay a higher premium than switch to a new policy at a new carrier.

Second, if the insured's health has worsened since the policy was issued there may be difficulty in getting better coverage with a new policy. But don't jump to conclusions too quickly. In my career I have had clients who I never thought would get approved actually qualify for coverage. I have also seen the opposite – clients who appear to be in good health get declined for coverage. You just never know until you go through the process. An insurance advisor who has a broad understanding of the industry and multiple sources for offers can be a big help. Make sure not to cancel or surrender the old policy until new options are explored and any new coverage is inforce.

Third, any new policy will have a two-year contestable period – often called the "suicide clause." This two-year period allows for the payment of the death benefit to be denied in the event of suicide or commission of fraud during underwriting. Both of these events are very unlikely but do need to be considered.

Finally, a new policy will likely have a new surrender charge period. Surrender charges typically last for 10 years or longer in most life insurance policies. This should be discussed and weighed against the current policy's surrender charge schedule.

TAX-FREE EXCHANGES UNDER IRC SECTION 1035

With a policy replacement, the cash value from an old policy is often used as the initial premium for the new policy. If the cash value in the old policy exceeds the tax basis, taxes on the gain can be avoided with this tax-free exchange under IRC Section 1035. When the cash value of the old policy is less than its tax basis (a very common situation in my experience), there will be no tax due if the policy is surrendered. At first glance, surrendering the policy may seem like an easier path but an exchange may still be preferable to retain the higher tax basis. Because the new policy inherits the tax basis of the old policy, this "carryover basis" means less exposure to taxation if and when a much higher cash value is withdrawn from the new policy. Sometimes competing estate tax planning goals may eliminate any carry over basis benefits so all options should be considered.

To qualify for this special treatment under Section 1035 the exchanges must be "like for like." The insured must be the same on the old and new policies. You can exchange multiple policies on the same insured into a single policy. You can also exchange one annuity for another, or a life policy can be exchanged for an annuity. However, you can't exchange a tax-deferred annuity into a tax-free life policy – that would be too good to be true. The only exception to this "like for like" rule is that a surviving insured on a second-to-die policy qualifies for a tax-free exchange into a new single life policy.

Keep in mind the 1035 exchange rules for life insurance do not function like the IRA rollover rules. The carriers deal directly with each other in assigning ownership of the old policy to the new company. The new company then surrenders the old policy after the new policy is issued. Money is never sent to the insured to forward to the new carrier.

LIFE SETTLEMENTS

A "life settlement" is defined as the legal sale of a life insurance policy for a lump sum price higher than the surrender value but less than the death benefit. For a policy that is no longer needed, a life settlement can be an exit strategy to consider. A life settlement also presents a practical alternative for policies that have been ignored for many years and are in danger of lapsing due to underfunding.

Though the life settlement market has encountered challenges and missteps in the past, the proper advisor can be a valuable resource in a life settlement negotiation. An experienced TOLI advisor can help navigate the markets, provide transparency, and protect the trustee's best interests.

REVIEWING INFORCE TERM LIFE INSURANCE

It is often difficult, but not impossible, to get complete inforce information on term life insurance. Carriers don't create inforce ledgers for term policies, but they will provide you with information to do a complete analysis. Simply obtain the policy issue date, the current death benefit, the duration of the level term period and a premium projection as provided in the original policy specifications page. Though term insurance offers a low-cost solution, it may not always be the right choice. Focus should be choosing a coverage period that matches the duration of the risk. For example, it may be a mistake for a sixty-year-old to purchase a 10-year term policy for estate tax liquidity purposes since their life expectancy is greater than ten years. A policy that is guaranteed for life may be a more appropriate solution.[8]

CONCLUSION

For many high-net worth clients, trust-owned life insurance ("TOLI") is the cornerstone of their estate plan so advisors should take the time to understand the basic factors involved in analyzing and monitoring life insurance policy performance. Just like any other financial asset, life insurance should be reviewed regularly. Many clients have purchased policies for the proper reasons; however, they have not reviewed these policies in years. Their policies may be costly, out of date, or simply not appropriate for their current needs. Being proactive is the name of the game - seek out a professional who utilizes a prudent process for your TOLI policy review.

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[1] Whitelaw and Reis, "Managing Trust Owned Life Insurance Revisited," Trusts & Estates (April 1999).
[2] Teitelbaum, "Trust-Owned Life Insurance: Issues Trustees Face; Decisions Trustees Need to Make," Journal of Financial Services Professionals 38 (July 2005). See generally Leimberg, "TOLI Risk Management at Litigation Crossroads," Estate Planning Email Newsletter 110 (April 2007),
[3] Whitelaw and Colosimo, "Best Practices for Trust-Owned Life Insurance ("TOLI") Trustees, TOLI Fiduciary (3rd Quarter 2004).
[4] Harris and Prince, "The Problem with Trusts Owning Life Insurance," Trusts & Estates (May 2003).
[5] Teitelbaum. (The life insurance industry refers to this as an "orphan" policy or describes the policy owner as being "orphaned")
[6] McKinsey & Company, "Rethinking U.S. Life Insurance Distribution," Financial Services Practice (May 2016).
[7] Whitelaw and Reis.
[8] Whitelaw and Colosimo, "TOLI Risk Management - Guilty Without Proof of Innocence," Fiduciary & Investment Risk Management Association Newsletter (Spring 2004).

