

Checking Under The Hood

Trust-owned life insurance needs to be monitored just like an investment portfolio. BY DAVID W. FREELEY AND MELVIN A. WARSHAW

SINCE THE COLLAPSE OF THE GLOBAL markets, wealthy families have been examining their investment portfolios and expecting due diligence and transparency from all of their advisors. But they should also expect no less from those managing their trust-owned life insurance.

Life insurance is no longer a sleepy, static, buy-and-hold asset. The trustee of life insurance held in trust—typically in an irrevocable life insurance trust (ILIT)—must regularly perform due diligence on the policies held in trust, and compare the past and projected performance of existing policies with that of newer products and strategies.

In fact, a trustee should expect to make changes in trust-owned life insurance just as he would expect to make changes when managing a traditional investment portfolio held in trust. A trustee will typically allocate assets and retest and rebalance the model as time goes on as part of the trust's ongoing management. The same should be true of a large trust-owned (TOLI) life insurance portfolio. Since life insurance often represents a concentrated asset held in trust, and is a complex asset for even professional trustees, the management of trust-owned life insurance presents some unique challenges for most trustees of ILITs.

A Dynamic Asset

There is now well in excess of \$1 trillion of life insurance held in trust, much of it in ILITs. Wealthy individuals



typically ask friends or relatives to serve as trustee of the ILIT. Sometimes a professional advisor or financial institution, such as a national bank or trust company, is asked to fill the role. The trustee should, but often does not, participate in the process of selecting the initial policies to be owned by the ILIT. But trustees still need to be familiar with the insurance product landscape.

One reason they need to be aware of the industry is because it is continually chang-

ing. Insurance products continue to evolve as do actuarial assumptions and pricing. While there have been very few truly new life insurance products developed over the last few decades, one product has been introduced that is truly unique: secondary guarantee universal life.

Secondary guarantee—also called “no lapse”—universal life (NLG UL) features low cash values and guaranteed death benefits, premium amounts and durations. The product has flourished. Even if the

life insurance carrier later drops its policy crediting rate or increases its “cost of insurance,” the secondary guarantee stays in effect. If premiums are paid in a timely fashion, the carrier will pay the death benefit. In an NLG UL policy, investment risk has been shifted to the carrier.

A confluence of events, however, has caused carriers to reconsider the product, with some suspending the issuance of new NLG UL policies and others repricing policies about to be issued. Bond portfolio losses, more stringent capital and reserving requirements and the cost and supply of credit to backstop NLG UL policies have forced most carriers to reassess the future of this product. Future changes in

products, are interest rate, dividend or market sensitive, and their performance must be monitored annually. Even NLG UL policies should be reviewed every year to ensure that premiums were paid on time and the carrier guarantees remain in effect. A policy review every three years or more may be inadequate to capture recent deterioration in policy performance.

Anyone who doubts the need for frequent reviews, and the transient nature of the insurance business, need only take a look back at how industry trends have evolved. In the 1980s, insurance agents often recommended replacing whole life policies with universal life policies. Using illustrations that typically projected a

cation and risk management are what investors expect today of their investment portfolio managers.

For wealthy families, the same need for diversification and risk management applies to their life insurance portfolio. Events of the past few years have clearly shown why diversification is so important. In 2007, for example, AIG had a 98 Comdex rating, among the highest in the industry. Today, the Comdex rating for AIG is 83, whereas the ratings of almost all its peers remain in the high 90s.

We recommend diversification not only among insurance companies but also among product types. Constructing a diversified portfolio of different TOLI products permits a blending of guarantees, interest rates and product return risks that produces a set of features not possible with only one product type.

Trustees should also be aware of the following variables when it comes to assessing insurance products held in trust:

The longer life expectancy in the U.S. should result in lower “costs of insurance” translating into reduced premiums, but only for policies issued after 2008.

Declining Mortality Charges

The life expectancy of an insured at policy issuance is a major factor that determines premiums. Beginning in 2009, all U.S. carriers were required to use mortality tables based on the 2000 U.S. Census. The longer life expectancy in the U.S. should result in lower “costs of insurance” translating into reduced premiums, but only for policies issued after 2008. Carriers have also drastically reduced their profit margins, which has helped consumers reduce their insurance costs.

Underwriting Anomalies

Underwriting at the top carriers is situational. Both positive and negative underwriting anomalies occur daily. A favorable underwriting outcome may be offered to a life insurance applicant by a particular carrier simply because, for a limited period of time, it wishes to fill its mortality grid with people of the same age group. Check back a few months later when that carrier’s age bracket for that

its design can be expected. For example, it’s feasible carriers issuing new NLG UL policies will curtail lifetime guarantees in favor of less costly guarantees extending only through age 90.

As a result, those who have purchased a diversified portfolio of NLG UL policies in the past few years will likely determine that it is an extremely valuable asset whose benefits cannot be replicated in newer NLG UL products.

Advisors can expect continuing changes in product design and pricing availability, with new opportunities looming and then disappearing more quickly than in the past. It’s an environment that makes it incumbent on trustees to continually monitor trust-held life insurance.

“Non-guaranteed” policies, such as whole life, universal life and variable

fixed annual rate of return between 10% and 12% over 20 or more years, agents would often tell policyholders that universal life policy premiums would “vanish” at some point. But when carrier bond portfolios subsequently underperformed, the carriers had no choice but to decrease their interest crediting rates on these universal life policies and premiums were extended or reappeared.

The insurance industry then turned to the equity markets for double-digit annual returns, introducing variable universal life products in the 1990s and shifting all investment responsibility to the policyholder.

Diversification

Would a prudent investor construct an investment portfolio consisting of only Microsoft or Google? Asset allo-

product type is full and that offer may no longer be on the table.

Secondary Market Offers

Life insurance contracts on older, less healthy policyholders should have their secondary market value regularly checked. The secondary market has become increasingly transparent as states adopt regulatory oversight. Life settlement companies may be willing to pay as much as 30% or more of the death benefit amount to buy the policy, which is often well in excess of the cash surrender value of the issuing carrier.

Buy And Monitor

A "buy and hold" strategy is inappropriate for a life insurance portfolio. With medical advances and greater longevity, new policy pricing is improving rapidly. Carrier

profit margins, however, are being squeezed because of historically low bond portfolio yields, pressure on carriers by state regulators to strengthen balance sheets and the aftermath of previous aggressive pricing and reserving on NLG UL policies. For a wealthy insured who has not had a material health change, any policy over five years old could likely be made more efficient and any policy over ten years old almost certainly can be made more efficient.

What follows are the components of an ILIT checkup suitable for trustees responsible for managing TOLI:

Every year:

- Review in-force illustrations (re-projections) under various interest rate assumptions.
- Review all carrier ratings and financials.

Every three to five years:

- Conduct a full portfolio audit.
- Collect in-force illustrations and compare them to the products and pricing currently being offered.
- Compare new products to those held in trust, evaluating performance and guarantees.
- Scrutinize the design, including the tax and legal structure, and the premium payment method, of the TOLI portfolio.
- Estimate the value of contracts in the secondary market and factor those results into decisions.

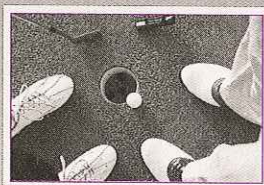
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David W. Freeley is president and Melvin A. Warshaw is general counsel of Financial Architects Partners, LLC, a Boston- and Palo Alto, Calif.-based life insurance boutique managing \$6 billion of TOLI assets for about 200 families. They can be reached at dwfreeley@fiarch.com and mwarshaw@fiarch.com.

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460 Park Avenue South, New York, NY 10016 | 212.754.6987 | info@lifestylistmarketing.com
www.lifestylistmarketing.com