The TOLI Trust Owned Life Insurance HANDBOOK

A Reference Guide For Trust Professionals, Fiduciaries and Regulators

Written And Edited By The Staff Of

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As you move through the Trust Owned Life Insurance (TOLI) Handbook, it will become clear that managing life insurance is complicated and takes a team effort. Long gone are the days when a life insurance trust could be managed with an Excel sheet and a Word document by those without specialized training. This is now a recipe for disaster, as we at ITM TwentyFirst have witnessed on more than one occasion. The management of this asset takes a joint effort by dedicated experts following a rigorous process.

- A trustee must understand all of his or her responsibilities as well as the regulations and case law that direct them (Chapter 2).
- The work of trust administration specialists must be grounded in the prudent processes of irrevocable life insurance trust (ILIT) administration (Chapter 3).
- All who help manage the asset must have a thorough understanding of the asset (Chapters 4 through 10).
- There must be an understanding of the effects of the economy and market on life insurance policies, such as the reasons for and results of the recent rash of cost of insurance (COI) increases (Chapter 11).
- While this is typically not discussed during the life insurance sales process, a trustee needs to understand the nuances of policy selection (Chapter 12).
- The sale of life insurance into the secondary market will become a bigger issue for trustees moving forward (Chapter 14).
- The weak link in ILIT management has always been policy remediation (Chapter 16). What will a trustee do when a grantor says he or she will no longer fund a policy or when policy performance falters? At any point in time, 20 percent of the policies in a trust may need remediation. A trustee still has a responsibility to the beneficiary to maximize the asset in the trust. Understanding policy taxation (Chapter 13) and using a life expectancy (LE) report (see the story at end of Chapter 15) will help a trustee prudently manage a policy.

In short, the management of life insurance is not easy, but with help, it can be done prudently. This handbook will help guide a trustee, fiduciary or regulator manage this asset more efficiently and prudently. It will also highlight an issue in the marketplace—management fees that do not take into consideration everything necessary to manage life insurance correctly. There is a cost to managing this asset prudently, though some TOLI trustees continue to undercharge for their services. For those who also skimp on the management of the asset, there can be a much greater cost—litigation.

If there is ever anything we can do to help, please reach out to us.

Michael Brohawn, CFP®, CLU®

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INTRODUCTION

The man and woman shaking hands in the conference room had met many times before, usually at a business function–a local Rotary event, a business-to-business mixer. Occasionally, they would bump into each other at a social event, and though they were not friends there was a feeling of mutual respect between them. He was a local attorney, well-thought-of in the legal community, and she was the head of personal trusts at the largest bank in town, and for many of the business leaders in the area, a trusted advisor. It was an email that brought them together formally–a request from the attorney to discuss a life insurance trust held at the bank, and created by his client, a local dentist.

When Anne received the email, she pulled the trust file and all seemed in good order. The policy, a 30-year level term policy taken out 15 years earlier, had premium due three months prior, but she saw that it was paid–in full and on time.

After settling in, Anne and the attorney got down to business.

Anne: "John, what can I do for you today?"

John: "Well, Anne, as you know, my client, Jeff, has held a life insurance trust with your bank for 15 years. I have always heard you were very thorough when dealing with all your clients, so it is somewhat awkward for me to be discussing this issue with you of all people. Anyway, a few months back, Jeff's health took a turn for the worse. While his condition is not life threatening, it may affect his practice and it has caused him to re-evaluate his estate plan. He came to me to start the re-evaluation process, and while reviewing all the options concerning his life insurance policy we reached out to a local life insurance advisor, as his original agent has been retired for a few years. The advisor said that although Jeff's intention when he created the trust was to eventually purchase a permanent policy to replace his term policy, due to the state of his health, the cost of purchasing that new policy would be very high. You see, when Jeff bought his term policy he was considered an excellent risk, but that is no longer the case. What was interesting is that the advisor also told us that his term policy had a clause that would have allowed Jeff to convert that policy to a permanent policy at the original preferred rating without any type of underwriting. Were you aware of that Anne?"

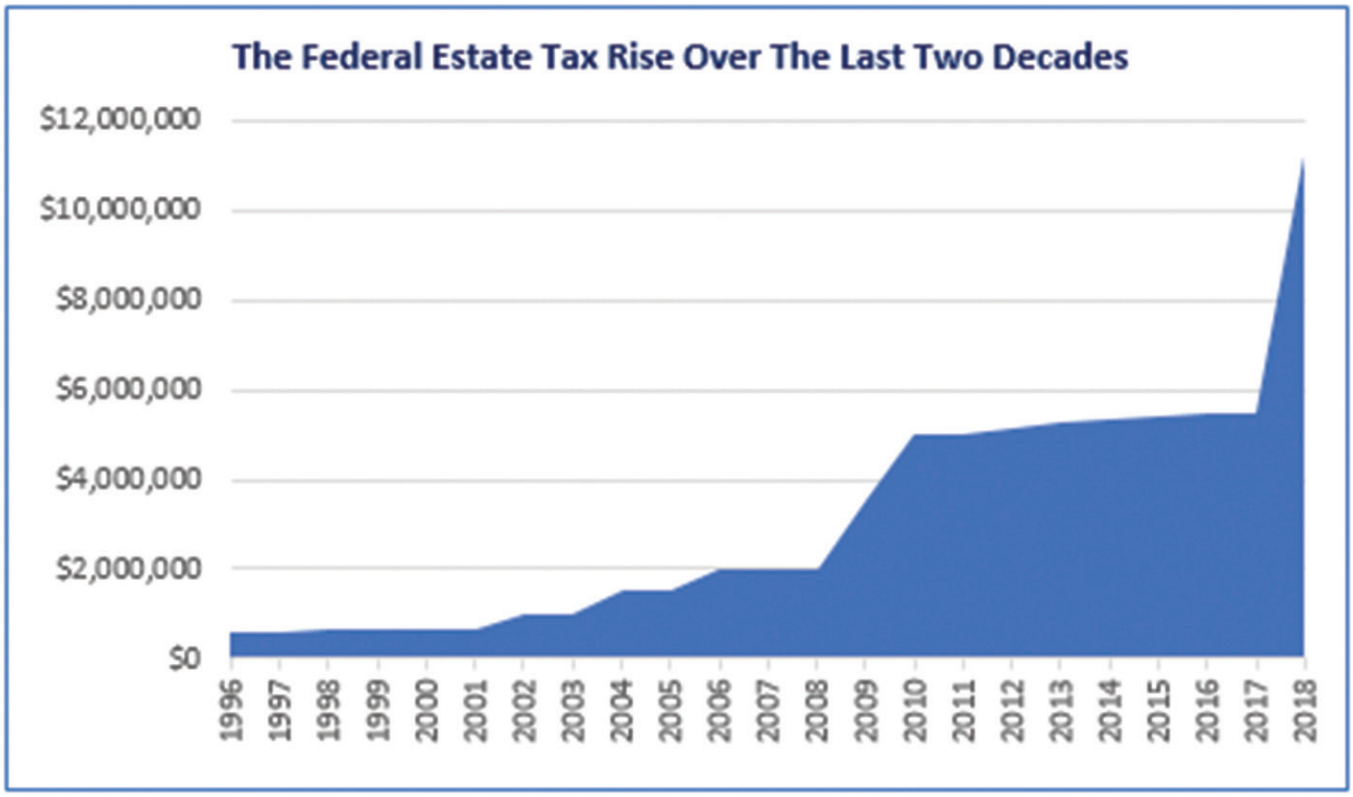
Anne: "Actually, John, I pulled Jeff's file, but I didn't see the policy contract in there, so I didn't get a chance to read it. This is surprising news to me."

John: "Well, Anne, Jeff was not aware of this either, and in fact, if he had been aware he would have taken advantage of the feature since his health began to fail last year, and according to the contract, he could have converted the policy at that time. Unfortunately, he no longer has that option as it expired just a few months ago."

Anne: "Oh, I see."

John: "So the problem, Anne, and the reason I am here, is that the only permanent policy Jeff can get is over $5,000 more per year than the policy he could have gotten had you made him aware of his options. Anne, we want the bank to pay the difference in premium."

Managing trust owned life insurance is not an easy undertaking. Scenes like these play out across the country, increasingly in the last few years. Policies have evolved with more moving parts and features to understand, and a greater opportunity for something to go wrong. During the last two decades, interest rates have steadily dropped, and because most permanent life insurance cash value is invested in fixed investments, performance in those policies has lagged. And in the last few years the cost of insurance inside some permanent life products has increased dramatically, an unprecedented event. Policy management has become more than just a simple annual review. Goals for the trust often change over time, necessitating adjustments in the trust asset. Personalities around the trust (grantors, beneficiaries, advisors) must be managed, and trust administration procedures must be followed or the trust tax advantages can be compromised. In addition, a TOLI trustee is not always compensated sufficiently for the work performed, often the trust is taken in as an accommodation. As can be seen in our vignette of a real-life scenario, even thorough professionals make mistakes with life insurance that can be potentially costly.



The need for a life insurance trust for estate planning has dropped over the years as the federal estate tax exemption, the portion of an estate exempted from estate taxes, has increased. The Tax Cuts and Jobs Act passed in December of 2017 raised the federal estate tax exemption from $5.49 million to $11.18 million per person. The estate tax now affects only 1 in 1,000 estates (1).

The level of federal estate taxation has been fluid and today's estate tax situation may not be the same tomorrow. In the last election, President Trump grabbed 290 electoral college votes, but 70 were in states where the margin of victory was less than 1.5%, in some states the margin was just .04%. If

she had won, Hillary Clinton was proposing to lower the federal estate tax exemption to $3.5 million with a 65% tax rate, much higher than today's 40% rate. According to the new law, after 2025, the exemption will revert to $5 million. So, though the need for life insurance trusts for federal estate tax payments may have lessened for now, the use of a life insurance trust still has a place in today's estate plans.

Moving forward, TOLI trustees will have to work harder for their fees. Clients will need to be reassured that the trust they have still makes sense. And if it doesn't, or the asset should be altered, it is the trustee's job to ensure that the asset in the trust is maximized for the beneficiaries. This means understanding how to analyze all options for a policy, which will be covered in greater depth in a later chapter.

This book was designed as a practical reference guide for those who work with life insurance in a fiduciary capacity. It will assume that you are aware of life insurance, but not an expert. It is not all inclusive, but will provide an overview of the responsibilities of a TOLI trustee and act as a guide on how best to live up to them.

Throughout the handbook we will refer to guidance from publications such as the OCC's *Unique and Hard-to-Value Assets Handbook*, and uniform acts like the Uniform Prudent Investor Act (UPIA). In addition, we will refer to legal cases that help outline and frame the responsibilities of a TOLI trustee. While reading the handbook, it is important to consider that we live in an evolving world and the fiduciary responsibilities of a TOLI trustee can and will change with time.

This handbook grew out of the practical application of publications, regulations, and case law. It also grew out of trial and error from real-life experiences, and will include many examples that are based on actual situations encountered by ITM TwentyFirst team members. At ITM TwentyFirst, we are proud to be the preeminent TOLI administration and policy review service provider to TOLI trustees in the United States. We are so committed to the TOLI market that in 2018 we opened an affiliated company, Life Insurance Trust Company, the only trust company in the US focused on life insurance trusts. In addition to the TOLI services we provide, we also provide life insurance policy management services to institutional investors nationwide, and we are one of largest providers of life expectancy (LE) reports, a life insurance policy management tool that every TOLI trustee should be aware of. The combination of services gives us a rare insight into life insurance policy management, which will become evident as you read this handbook.

We envision the TOLI Handbook as a live document and assume that some of it will change and adapt to the marketplace and the product. However, we believe that it represents the best single source of information available for managing TOLI trusts and life insurance.

If you should have any questions, please feel free to reach out to us.

CHAPTER 1

The Irrevocable Life Insurance Trust (ILIT)

Malcom Forbes was an eccentric businessman who helped build a well-respected magazine that still bears his family name. Though he is probably more celebrated for his ballooning exploits (he was the first person to fly coast to coast in the United States in a hot air balloon), love of Harley Davidson motorcycles (he was inducted into the Motorcycle Hall of Fame), and lavish parties (he spent $2.5 million on his 70th birthday party in Morocco, flying in nearly 1,000 of the world's rich and mighty on three chartered planes), Forbes was also wise, and before he died he amassed just under $70 million of life insurance in a life insurance trust. The entrepreneur, whose private Boeing 727 was nicknamed Capitalist Tool, used one of the most efficient financial tools to pass his business interests intact, and today, his son, Steve, still serves as editor-in-chief of Forbes magazine.

Warren Burger, the longest tenured Chief Justice of the 20th century, was central to important legal decisions like the Miranda decision and the 1973 Roe v. Wade ruling. Despite exhibiting a sharp legal mind, it was discovered after his passing that he left behind a one page personally typed Last Will and Testament, 176 words that subjected his less than $2 million estate to a $450,000 federal estate tax. Chief Justice Burger, who put himself through law school by selling life insurance, would have done his family a service by utilizing a basic Irrevocable Life Insurance Trust (ILIT) to pass on his wealth free of all taxes.

The Irrevocable Life Insurance Trust (ILIT)

The ILIT is one of the most common estate planning techniques in use today. When set up and administered correctly it removes the death benefit of a life insurance policy from the estate of the grantor. By removing the asset from the estate, the benefit passes to the beneficiaries of the trust free of federal estate taxes. Life insurance is generally void of income taxes, so by placing the policy in an ILIT, the full benefit is passed completely tax free.

To take advantage of the tax efficient nature of an ILIT, the grantor must completely relinquish control over the ILIT and all title to the trust property contributed to the trust, typically cash gifts to pay the premiums.

Once the ILIT is established, the grantor generally cannot:

- Receive any income from the trust
- Direct the investment of the trust
- Change the beneficiary designations or the interest of the individual beneficiaries
- Act as trustee of the trust
- Maintain a reversionary interest in the trust that exceeds 5 percent of the trust's value

While a grantor cannot change the beneficiaries, or alter the share of assets each beneficiary will receive, the trust can include special provisions that provide flexibility. An example of a special provision would be giving discretionary power to the trustee to distribute income from the trust to each beneficiary differently. Therefore, it is important that the trust document is well-thought-out before an irrevocable life insurance trust is created.

Setting up an ILIT is not an onerous process, however there are certain steps that must be followed. Typically, the first step is to reach out to a life insurance advisor to determine the availability of life insurance. The advisor should work with the grantor, along with any other financial advisors, to determine the amount of life insurance required and the type of coverage. Once it is determined that life insurance can be obtained, an attorney should be hired to draft the trust document to hold the policy being purchased. During the drafting process it is possible for the underwriting process to occur concurrently. However, the trust document should be in place before the life insurance purchase can be finalized. Although most insurance carriers will allow for a "dummy" application that can be signed later by the trustee to start the underwriting process if a trust is not yet established, it is best for the trustee to apply for the policy as the policy owner. The trust should be in place to officially apply for the policy as owner and to establish a checking account to pay the policy premiums. Some carriers will not accept a starter check, so it is important that the bank account in the name of the trust be established and checks obtained quickly.

Once the trust is established and a policy ready for purchase, the grantor can make a gift to the trust to cover the cost of the first premium. The trustee will accept delivery of the policy and pay the first premium with a check in the name of the trust. At delivery of the policy there will be additional paperwork (delivery requirements) that will require trustee signatures. If there are amendments to the policy, the carrier will supply them to the trustee for signature.

The Crummey Provision

Gifts made to the trust by the grantor to pay the premiums on a policy may be considered taxable as the beneficiary's ability to access and use the gift will be deferred for some time. To make the gift one of present interest, the trust document includes a Crummey power or provision which grants the beneficiary the right to current access of trust assets. The name of the provision comes from the grantor who first sought to qualify the gifts he was making to his ILIT for the annual gift exclusion.

Everyone has the right to make limited gifts to as many individuals as they wish annually if the gift is viewed as a present interest gift. This is called the annual gift exclusion. The annual exclusion amount today (2018) is $15,000, and rises with inflation.

If a married couple wishes to make annual exclusion gifts jointly, they can make an annual gift of up to two times the annual exclusion gift amount to each beneficiary without any tax consequences through a gifting method known as gift-splitting. In many situations, insurance trusts have two grantors, an individual and their spouse. In that case, if the trust has three beneficiaries, a premium of up to $90,000 can be paid by gift-splitting without paying any gift taxes, as shown in the diagram below.

Most trustees follow a specific process to ensure the annual exclusion amount is considered a present interest gift under the Crummey provision. The process is as follows:

- Once a gift is made to the trust, the trustee notifies all trust beneficiaries. If the beneficiary is a minor, then the guardian is notified. The beneficiaries are alerted that they have a right to withdraw their portion of the gift made to the trust. The right to access the gift is for a limited period—usually 30 days, though occasionally as many as 60 days or as few as 15 days.

- As soon as they are notified, the beneficiaries (or guardians) indicate if they wish to make a withdrawal from the trust. If they do not, they allow their right, or power, to make a withdrawal from the trust to lapse.

- After all the withdrawal powers have lapsed, the trustee can use the grantor's gift to pay premiums on the life insurance in the trust.

Note: What happens if the premium on the policy must be paid, but the trustee did not get the gift in time to satisfy the Crummey provision? This is a facts and circumstances situation for the trustee, who would have to weigh the effect of a late premium payment on a policy. If the policy were a flexible premium product the effect would be minimal and waiting to pay the premium would not be an issue. However, if the policy would be negatively affected by a late premium payment, the trustee, as steward of the policy, would have to decide whether to send the premium in before all notification letters are returned or wait and hope that the policy will not suffer from the late payment. We will discuss policy characteristics that will help with this decision in later chapters.

The process and procedures behind the compliant administration of an ILIT is reviewed in Chapter 3, Developing a TOLI Administration System.

CHAPTER 2

The Responsibilities of a TOLI Trustee and Some Guidance

The trustee of an ILIT must follow the directions outlined by the trust document and make trust decisions solely in the best interest of the trust beneficiaries. The trustee is a fiduciary with a duty to put the interests of the beneficiary above all other interests, as well as:

- Prudently invest trust assets
- Follow the specific terms laid out in the trust agreement
- Refrain from using the trust property for the benefit of the trustee
- Act impartially and administer assets in the best interests of the beneficiaries
- Avoid conflicts of interest

In this chapter we will cover the duties of a TOLI trustee by reviewing regulations, guides, and a handful of court cases.

The Uniform Prudent Investor Act (UPIA)

Endorsed by the American Bar Association, American Bankers Association, and approved in 44 states as well as the District of Columbia, the UPIA revamps and updates rules that govern the actions of trustees. The trust document can override the UPIA, but if not overridden, the UPIA must be followed. While every aspect of this Act may not be applicable to TOLI, there is enough guidance to make the document the framework for prudent TOLI trust management.

- In Section 1, called the Prudent Investor Rule, a trustee is reminded that they owe "a duty to the beneficiaries of the trust to comply with the prudent investor rule set forth" in the UPIA.

- In Section 2, Standard of Care; Portfolio Strategy; Risk and Return Objectives, the trustee is reminded to "invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution."

- In Section 4, Duties at Inception of Trusteeship, a trustee is required "within a reasonable time after accepting a trusteeship or receiving trust assets . . . [to] review the trust assets and make and implement decisions concerning the retention and disposition of assets, to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and with the requirements of this [Act]."

- Section 5 refers to loyalty to the real client of a TOLI trust, the beneficiary, and requires trustees to "invest and manage the trust assets solely in the interest of the beneficiaries."

- Section 7 focuses on Investment Costs and requires the trustee to "only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee."

- Section 8 of the UPIA is an important concept regarding prudent decision making as it deals with Compliance, which is "determined considering the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight."

- Section 9 of the Act refers to the Delegation of Investment and Management Function and allows trustees to "delegate investment and management functions" if they do not have the necessary skills to manage this asset.

The Unique and Hard-to-Value Assets Handbook

Published by the Office of the Comptroller of the Currency (OCC) in August of 2012, the OCC *Unique and Hard-to-Value Assets Handbook* provides direction for life insurance trustees. The document is designed to provide "bank examiners with expanded examination procedures," but is also a true guide for a TOLI trustee.

The handbook points out that while there are risks in managing any type of asset, "the inclusion of unique assets further increases a bank's risk . . . [since they] often require special expertise to manage, are sometimes subject to special ownership rules, and are frequently hard to value."

While some states passed legislation in the last few years to limit the liability of a life insurance trustee that perhaps rescinded "requirements under state law to perform due diligence on insurance companies as a directed bank fiduciary," the handbook points out that trustees must still "follow

12 CFR 9.6(c) and 12 CFR 150.220 and to conduct annual investment reviews of all assets of each fiduciary account for which the bank has investment discretion."

Those requirements, taken directly from the handbook, are:

- "Initial post-acceptance review–12 CFR 9.6(b) and 12 CFR 150.210: Upon acceptance of a fiduciary account for which a bank has investment discretion, the bank shall conduct a prompt review (approximately 60 days after substantial funding of the account) to evaluate all assets of the account to ensure they are appropriate."

- "Annual review–12 CFR 9.6(c) and 12 CFR 150.220: At least once during every calendar year, a bank shall conduct a review of all assets of each fiduciary account for which the bank has investment discretion to evaluate whether the assets are appropriate, individually and collectively, for the account."

Later, we will review prudent processes for reviewing new and replacement life insurance policies, as well as the characteristics of a good annual review. The *Unique and Hard-to-Value Assets Handbook* provides some guidance to both processes.

- For an initial review the trustee should evaluate "the needs of the grantor and beneficiaries and established investment objectives. This review is designed to ensure that all assets for which the bank has investment discretion meet the objectives of the account or that action plans have been established for disposition of the asset. It is also an opportunity to ensure that all assets have been properly received and titled by the bank."

- "On an annual basis, each unique asset for which the bank has investment discretion must be reviewed to determine whether the asset remains an appropriate holding for the account's portfolio . . . If bank staff does not have the expertise to provide this information, the bank must retain vendors with appropriate expertise to perform this analysis."

Section 9 of the UPIA points out the use of outside vendors can be a prudent alternative for the trustee that lacks the requisite in-house skills. The *Unique and Hard-to-Value Assets Handbook* explains that "a bank fiduciary must understand each life insurance policy that the trust accepts or purchases, if not, the bank fiduciary must employ an advisor who is qualified, independent, objective, and not affiliated with an insurance company to prudently manage these assets." To be qualified, the advisor should be seasoned, well-versed in life insurance products, and preferably have at least one designation such as Certified Life Underwriter (CLU), Certified Chartered Consultant (ChFC) or Certified Financial Planner (CFP). It is also important that the objectivity of the provider not be questioned. While a commissioned life insurance agent can provide great insight on the selection and purchase of life insurance and is a needed and vital component of that process, a truly objective fee-based viewpoint should be obtained for policy management and even policy selection decisions, if the expertise cannot be found internally.

Even if the asset management is outsourced, the fiduciary "should still have sufficient understanding of the underlying risks and characteristics presented by those assets to properly supervise outside managers of those assets," and when contracting with an outside vendor, "should only delegate duties pursuant to a written management agreement prepared by legal counsel . . . [that will] specify each party's responsibilities."

The risks around a policy can include the financial risk of the carrier itself. Per the *Unique and Hard-to-Value Assets Handbook*, a trustee should "periodically review the financial condition" of the carrier. Current ratings can be deceiving. As late as 2005 AIG held a high financial rating, but by September of 2008, the Federal Reserve had to take a majority position in the company to save it from bankruptcy. An understanding of the business model of the carrier is important. In the case of AIG, its life insurance business was sound, but it took part in risky bets on insuring credit default swaps thought to be essentially risk free, that turned out to be anything but. Some carriers purchase blocks of business from other carriers and operate a runoff model, turning a closed block of policies into an investment. They are not in the business of selling new policies, but simply attempt to maximize the profits on an existing block. While this does not necessarily mean that performance in the underlying policies will suffer, it stands to reason that the chances increase.

Besides evaluating carrier financial health, the trustee should "determine whether the policy is performing as illustrated or whether replacement should be considered." While this quote is taken directly from the *Unique and Hard-to-Value Assets Handbook*, just because a policy may not be performing up to expectations, a replacement should not always be the first inclination. We will discuss this in greater detail in a later section, but it is important to point out that as trustee you must understand policy performance. If the policy is not performing as expected, what is driving cash value growth? Depending on the type of policy, cash value growth is propelled by dividends (whole life), a credited interest rate (universal life), separate accounts (variable life) or an index account (equity indexed universal life.) If the cash value has lagged, why has it? Will those cash value drivers improve because of market changes? What about internal costs, another major factor in policy performance? Do you know the costs inside the policy? Have costs gone up or are they the same as shown in the original sales illustration? It is only after you have a thorough understanding of the existing policy that a replacement policy should be considered. Once it is determined that a replacement will be considered, you must understand and document all the factors that determine whether the replacement makes sense. You must also gauge the health of the insured. A replacement may not even be viable because of poor health; or the costs in a new policy might be dramatically higher if the health of the insured has diminished. You must develop and follow a consistent process for determining a suitable replacement.

Process is a big focus of the *Unique and Hard-to-Value Assets Handbook*. Trustees are told they must "have well-developed risk management practices to evaluate and administer accounts with insurance policy holdings." That risk management process should be written down, and all who manage the

asset should be aware of it and follow it. The process should be reviewed periodically and focus on maximizing beneficiary value and mitigating your liability, which often goes hand in hand.

Per the *Unique and Hard-to-Value Assets Handbook*, for life insurance, the risk management system should review and address:

- Sufficiency of Premiums: Is the current premium "sufficient to maintain the policy to maturity or to the insured's life expectancy?"
- Suitability: Replacement should be considered if there are "concerns with the condition of the insurance provider or if that provider does not meet the needs of the grantor or beneficiaries."
- Carrier Selection: The trustee must "evaluate the carrier's financial condition."
- Appropriateness of Investment Strategy: The trustee must "evaluate the appropriateness of investments of any segregated account to support the cash values."

Taking on the responsibility of a life insurance policy, per the handbook, "can increase the bank's risks," especially since these "assets often require special expertise to manage." The risk can be operational since "inadequate or failed internal processes or systems" can lead to lower "current or anticipated earnings or capital." A "violation of . . . laws, rules, and regulations" can lead to a compliance risk. This can be averted if the trustee adheres to "sound fiduciary principles." The trustee assumes "strategic risk" when taking on life insurance policies "without having the expertise and systems to properly manage" the asset. Since the management of life insurance falls outside more traditional investment strategies, "management must ensure that personnel are qualified to manage these assets." That lack of expertise can "subject the bank to significant losses, potential litigation, and reputation risk."

While case law dealing with TOLI is limited, there are some cases that provide guidance.

The Cochran Case–KeyBank

The most well-known case is Stuart Cochran Irrevocable Trust v. KeyBank, NA, a case decided in March of 2009. According to information gathered from the lawsuit, KeyBank was successor trustee to a trust that contained three life insurance policies and one annuity with a collective net death benefit of $4,753,539. KeyBank became successor trustee after the former trustee relinquished control over the trust at least partly because of the grantor's "insistence in having third parties," including himself and his insurance agent, "involved in the trustee's decision-making process." At about the time KeyBank took over, the agent for the grantor recommended that the trust exchange the existing policies for two variable life policies tied to the equity market, overall totaling $8 million in death benefit. That exchange was approved by KeyBank in the first quarter of 1999. Following the 9/11

attack in 2001, the equity market dropped, with an "adverse effect on the value of the mutual fund investments contained in the VUL policies." In both 2001 and 2002, the separate accounts in the policies had negative returns. In 2003, KeyBank retained an outside consultant to audit the VUL policies. At the time, the insured was 52. For both policies, assuming an 8% return, the outside firm said the policies would run until the insured was approximately 70. If the returns were 0%, they calculated the policies would run to approximately ages 58-60. It was noted that the grantor's "financial fortune had also taken a negative turn by this point in time," and he no longer had the ability to "supplement the trust with additional resources," so the policy reviews were run assuming no additional policy funding.

The agent for the grantor suggested the purchase of a John Hancock Guaranteed Universal Life policy, with a death benefit of $2,787,624. With the cash value in the existing policy and no other contributions, the policy would be contractually guaranteed to run to age 100. The new policy would dramatically reduce the market risk of the trust. The outside advisor listed the advantages and disadvantages of the transaction and recommended KeyBank "move forward with the proposed John Hancock coverage if the client is comfortable with the reduction in death benefit." KeyBank did move forward placing the policy in force in June of 2003, although a final underwriting downgrade on the insured lowered the death benefit to $2,536,000. In January 2004, the insured died unexpectedly, at the age of 53. The beneficiaries filed suit claiming, among other things, that "KeyBank had breached its fiduciary duties as [t]rustee."

The court found in favor of the bank noting that "the ultimate question" was whether the trustees actions were "consistent with the Settlor's intent as expressed in the Trust document," whether they met their "fiduciary duties to the [b]eneficiaries," and if "based on the circumstances facing the Trust in 2003," whether it was "prudent" for the exchange "from insurance policies with significant risk and likelihood of ultimate lapse into an insurance policy with a smaller but guaranteed death benefit." The court concluded that the trustee decisions were "consistent with the standard established by the prudent investor rule."

While the court agreed that "in hindsight" the decisions made by the trustee resulted in a "significant reduction in the death benefit paid to the beneficiaries," they felt that "at the time of its decision [it was] prudent [for the trustees to] protect the Trust from the vagaries of the stock market and from predicted lapse of the existing policies."

The court did state that "it would have been preferable for the [t]rustee to provide regular accountings to the [b]eneficiaries," but offered that the "receipt of timely financial reports by the [b]eneficiaries would not have changed the negative financial condition of the Trust."

The court answered important specific arguments:

- The beneficiaries claimed that that KeyBank "imprudently and improperly" delegated certain decision-making functions to the insurance agent and to the grantor by moving ahead with

the policy replacement that the agent initiated. The court disagreed. The fact that the agent provided a policy replacement option did not "constitute a delegation of KeyBank's decision-making duties," since KeyBank looked to an "outside, independent entity with no policy to sell or any other financial stake in the outcome" to review the policy replacement and provide recommendations. The court found that the bank did not delegate "any investment or other duties" to the writing agent.

- The beneficiaries argued that KeyBank disregarded the outside vendor's advice concerning the replacement of the variable policies, but the court found, after reviewing the reports from the vendor, that the advisor felt both options were "palatable." Each option had "their own sets of pros and cons. The existing VUL policies may have lapsed before Stuart Cochran reached the age of 60 and would likely have required additional premiums to finance—money that he no longer provides. The John Hancock policy, on the other hand, offered a significantly reduced death benefit, but was guaranteed to remain in force until he reached the age of 100 and would require no additional financing." The court stated that, "KeyBank merely chose between two relatively acceptable options—a decision it was entitled to make as trustee. We do not find that it acted imprudently on this basis."

- During the process of replacement, the trustee essentially reviewed only one policy type from one carrier and the beneficiaries faulted the bank for "failing to investigate alternatives aside from retaining the existing VUL policies or exchanging them for the John Hancock policy." While the court agreed that the trustee "could have done more," and the bank's process "was certainly less than perfect," they also believe it was "adequate."

- The beneficiaries argued that KeyBank breached its duties by "failing to provide sufficient information regarding its plan to carry out the 2003 Exchange." The court disagreed pointing out that the trust document "gave the trustee the power to surrender or convert the policies without the consent or approval of anyone." According to the court, the trustee had no "requirement [to] notify the [b]eneficiaries of the impending exchange . . . [since] neither their consent nor approval were required to carry out the transaction."

- The beneficiaries claimed that the bank "breached its duty of loyalty to them" through contact with the grantor concerning the policies and policy replacement, which they believed was evidence that the bank was "loyal" to the grantor, not the beneficiaries. The court did not agree, since a trustee would have to, "as a practical matter," have discussions with the grantor/insured if changes were to be made to the policy since the changes would require a physical exam. The underwriting process "cannot be effectuated without communication between a trustee and settler," the court said, noting that "nothing in the law prohibits contact between a trustee and settlor, nor should it."

Key Lessons from the KeyBank Case

Though the outcome of this case favored the bank, it was at some cost. The goal is not to win the case, but to avoid the need to defend the case. Here are some lessons a TOLI trustee can learn from this case:

- KeyBank was acting as successor trustee, with the former trustee noting it no longer wanted to act as trustee because of the grantor and others "insistence" on being "involved in the trustee's decision-making process." Though the court outlined those areas where involvement was warranted, grantor involvement and outside influence can and does create conflicts that should be avoided.

- While the court decided that the replacement of the variable policies with a guaranteed universal policy with a lower death benefit was "prudent," the rapid replacement of the policies–a replacement of the existing policies in 1999, followed by another replacement in 2003, two replacements within 4 years could suggest a "flavor of the month" selection process. The replacement of a policy comes with costs–commissions and expenses–and in this instance, the second replacement resulted in a loss of over $100,000 in surrender charges.

- In the process of replacement, the bank looked to an "independent outside insurance consultant" who had no "financial stake in the outcome." The court pointed out that the bank could "delegate" these "investment and management functions" and though the life insurance agent "proposed" the replacement, by relying on the non-biased outside vendor for advice, the bank circumvented the beneficiaries claim that they were "improperly delegating certain decision-making functions" to the grantor and life insurance agent.

- The court pointed out, rightly, that in the process of policy purchase, contact with the grantor, who is also typically the insured, will occur, but simply "rubber stamping" the grantor request or advisor recommendation is still not advocated. The addition of a non-biased outside specialist to review and provide trust documentation is advised if internal resources are unavailable.

- While the banks process of policy replacement was deemed "adequate," a more rigorous review of policy options based on trust circumstances is probably warranted in most situations. Most pundits believe that the court set a low bar and a more comprehensive written review process for replacements is preferable.

- While the courts stated that the bank had no "requirement" to "notify the [b]eneficiaries of the impending exchange," if everyone had been made completely aware of all options and outcomes, the probability of winding up in court would have been decreased.

The documentation by the bank showed a prudent process, and though you could differ with the rigorousness of the process, you could easily track it and see that the outcome was based on the best facts and circumstances available at the time, an important point to consider.

French, et al. v. Wachovia Bank N.A.

The French v. Wachovia case grew out of another replacement case, one which resulted in a large commission for the trustee's insurance affiliate. According to court documents, the primary claim against the bank was for "self-dealing," as the beneficiaries "were taken aback" by the more than $500,000 in commissions earned in the transaction. The revenue generated, though large, was considered industry-standard. The beneficiaries' claim the bank had breached its "duty of loyalty" was rejected with the court "relying on an express conflict-of-interest waiver in the trust document."

The grantor, a successful entrepreneur, approached Wachovia after he grew disillusioned with his former trustee. His trust held two whole life policies that were "underperforming assets." After meeting with insurance advisors at Wachovia on several occasions, a proposal was developed to exchange the two whole life policies for John Hancock Guaranteed Universal Life policies that would provide "the same death benefit but at a much lower premium." A memo was provided that outlined the pros and cons of the transaction. For example, the new policies "ensured that the contracts would pay the promised death benefit as long as the premiums were paid," but the trust would lose some premium flexibility, as well as the higher cash value of the whole life policies, since the new policies would not generate much cash value.

After signing the application for the new policies, the grantor was provided with a waiver that disclosed Wachovia would receive compensation for the transaction and included a broad release of claims arising out of Wachovia's purchase of the insurance on behalf of the trust. The grantor inquired about the possibility of rebating the commission, and after being informed that that was not allowed under law, refused to sign the conflicts waiver. After consultation with legal counsel, Wachovia withdrew its request for signature and proceeded with the policy replacement.

A few months later, the grantor and beneficiaries complained to Wachovia about the "process surrounding the insurance exchange" and retained a law firm, attempting to reverse the transaction, which could not be un-done. The children, as beneficiaries, moved ahead and sued Wachovia.

The beneficiaries claimed that the insurance replacement "violated the prudent-investor rule" and if not, the bank at least "made the insurance swap in bad faith." The court noted that the trustee "is under a duty of undivided loyalty to the beneficiaries of the trust," and that "one aspect of the duty of loyalty is the strict prohibition against self-dealing." However, the court pointed out that the "trust instrument may waive the general rule and authorize the trustee to engage in transactions that involve self-dealing," and pointed to an "express conflicts waiver" in the trust document that allows the trustee to operate "without regard to conflicts of interest."

The beneficiaries also argued that the replacement was "such a bad investment that it amounted to a violation of the bank's duty of prudence," but the court disagreed. The exchange of the whole life policies for the new policies "maintained the same death benefit and saved $620,000 in premium costs." Although the new policies lacked the cash values of the whole life policies, "the trust did not need life insurance cash value as a tool; the trust was well diversified in other assets." The courts found in favor of the bank and awarded the bank over $700,000 in attorney's fees.

Key Lessons from the Wachovia Case

This case is important as it provides needed guidance in those situations where a bank or trust company may have an affiliated entity that is receiving compensation from a transaction occurring within the trust.

- Understanding the trust document when bringing a trust in is key to successful TOLI management. In this case, the trust document language allowed self-dealing, and overrode the prudent investor rules because of its specific language.

- While the trust language benefited the trustee, the fiduciary must still show it acted in good faith. The bank could show a rigorous review that included numerous meetings with both the grantor/insured and the beneficiaries. That comprehensive review process was headed up by experienced life insurance professionals who provided all parties with documentation outlining the advantages and disadvantages of the existing and replacement policies. The policy replacement provided the trust with a "less expensive" policy, but also less cash value, which was pointed out.

- When deciding on a policy replacement, the policy characteristics and performance must be considered, but so should other factors that could affect the decision-making process. Does the trust document call for any type of distributions that might make a cash-rich policy more attractive? Are there other assets in the trust to draw upon? Often there are no other assets, but in this case, there were significant assets, therefore the decision to purchase a more efficient death benefit at the expense of cash value was deemed prudent under the specific facts and circumstances.

- The documentation kept by the bank on its policy review procedure was instrumental in offsetting the possible negative effect of the large commissions paid in the case. The policy purchased was substantial and the commission paid was not out of line with industry standards, but to an outside observer such significant revenue may have been considered unwarranted had the bank been unable to outline the lengths to which it went to provide thoughtful analysis to the grantor and beneficiaries. The analysis and memos that outlined the pros and cons of the transaction, along with the numerous meetings with the grantor, beneficiaries, and advisors, showed that the bank had satisfied its duty to show good faith and make a prudent decision, as well as earn a large, but warranted, fee.

A few other cases warrant mention and can provide guidance for the TOLI trustee:

Hatleberg v. Norwest Bank, Wisconsin

Hatleberg v. Norwest Bank, Wisconsin was a case from 2004-05 centered on issues around a poorly written trust document and the trustee's responsibilities to alert the grantor, once they were made aware. The representative of the bank suggested to a client that an irrevocable life insurance trust be formed. The grantor utilized her neighbor, a local attorney, who, "by his own admission . . . was not an expert in estate planning," to draft the document. The trust document, which was essentially copied from a form book, "was defective because it did not contain Crummey provisions." This error was not initially noticed until the bank performed an annual review. While both the bank and the attorney who created the document evaluated the situation they did not alert the grantor. In fact, the issue was not mentioned until the grantor passed away, at which point a representative of the bank wrote to the probate attorney and expressed concern over the "lack of Crummey provisions" in the trust document.

The court found that the trustee "had no duty to review the trust to ensure its effectiveness as an instrument to avoid estate taxes," since "the trust instrument did not assign this responsibility to the trustee and the trustee did not draft the trust." However, the court agreed that the trustee "breached a duty" to the grantor by continuing to direct her to contribute to the "trust to save estate taxes after it realized the trust was defective." The court found that both the trustee and attorney were financially liable for the additional estate tax costs.

Key Lessons from the Hatleberg v. Norwest Bank, Wisconsin

While it is reassuring that a trustee may not be held liable for a poorly drafted document that hinders the goals of the trust, it is clear that once alerted to an issue regarding the document, a trustee bears a responsibility to alert the grantor and beneficiaries, and can be held liable for potential damage. The case also points out the need for the proper administration of the Crummey provision when present, since a challenge to the use of an annual exclusion could subject the ILIT to estate taxes, as in this case.

Paradee v. Paradee

Paradee v. Paradee was a 2010 case filed in Delaware, in which the trustee and a non-fiduciary family member were found liable to the beneficiary because of trust transactions. According to court documents, William Charles Paradee (Charles Sr.) set up a life insurance trust in 1989 for the benefit of his grandson (Trey), the son of his estranged son (Charles Jr.). The policy which was a single pay survivorship policy, that insured Charles Sr. and his second wife Eleanor. Charles Jr. worked in the family business, but due to familial disagreements, the business was divided, and a portion of it was

run by Charles Jr. as a separate entity. Charles Jr. believed his father's second wife "turned his father against him, and he felt slighted by the small portion of the company he received." His father believed that he was betrayed by his son, and that his son "received far more than he deserved."

The initial trustee of the ILIT was the agent who sold the policy, who over the years had "generated significant business" from the family firm.

Three years after creating the trust, the Paradees instructed the agent/trustee to revoke the trust. Trey, who sued in the case, believed that his step grandmother, Eleanor, was the "driving force" behind the request. His grandfather had suffered from heart issues, and began to slip mentally, at which point Eleanor had taken over their financial affairs. Eleanor said the family business needed the cash from the policy to pay unexpected back taxes, though there were other significant assets to draw upon.

After receiving the request to surrender the policy, the trustee/agent reached out to the family attorney that drafted the trust document, who consulted with Eleanor and told her the Paradee family could not access the policy's cash value by revoking the trust. Eleanor asked whether the trust could loan the money, and after the attorney discussed the idea with the trustee/agent, a loan was made, but only after an outside attorney cautioned the loan could be made only if terms were "comparable to those which a commercial bank would offer," with security "equal to 125% of the loan." A loan was obtained on the policy at an interest rate that was higher than the rate charged to the trust. Interest was paid on the loan, but Eleanor again asked for the policy to be surrendered. The request was denied and soon after, Charles Sr. passed away. Per the court documents, "the Trust had the right to recover the principal and interest due," but the trustee/agent "made no effort to collect."

Shortly after his grandfather died, Trey turned thirty which meant that he was "entitled to serve as trustee." Although this was specified in the trust document, no one informed Trey of his right.

In the ensuing years, Trey and Eleanor grew apart, the original trustee/agent passed away, and Eleanor appointed herself trustee of the trust. Interest was not paid on the policy loan and the policy lapsed. Shortly thereafter, Eleanor resigned and appointed a family handyman as trustee. Eventually, because of the new trustee's insistence, Trey was finally informed of his rights by the drafting attorney. After becoming trustee, he demanded the loan be repaid to the trust, and it was paid back.

The court declared that the original trustee who sold the policy breached his fiduciary duty and was "aided and abetted" by Eleanor. The trustee was "under a duty to [the] trust beneficiary to administer trust property solely in the interests of the beneficiary," but when deciding whether to allow a loan from the trust, he did not evaluate "what was in the best interests of the Trust, he evaluated whether he could please his long-time clients."

Eleanor was also found liable as the "conduct of one who knowingly joins with a fiduciary . . . in breaching a fiduciary obligation, is equally culpable." She was held liable for over $1 million, with additional awards shared by Eleanor and the trustee.

Key Lessons from Paradee v. Paradee:

While this case involved a non-corporate trustee, the findings of the court rings true for corporate trustees. Often the grantor of a life insurance trust has other, more profitable business dealings with the trustee, but the value of that business cannot sway the trustee from following required duties to "administer trust property solely in the interests of the beneficiary." The grantor requests must not damage the assets of the trust, or the trustee could be held liable. Family squabbles, second marriages, failing physical and/or mental health of the grantor are all red flags that signal a trust requires special diligence. The failure of a life insurance trust often comes, not because of the poor performance of a policy, but because of the poor performance of those surrounding the trust. Advisors and even family members can sometimes get caught up in litigation, but the trustee will always be the central figure in any lawsuit.

Rafert v. Meyer

Rafert v. Meyer was a breach of trust case that found its way to the Nebraska Supreme Court in 2015, in which the trustee's action, or lack thereof, was not held defensible because of exculpatory language in the trust document.

Jlee Rafert had her attorney draft an ILIT in 2009 that contained three policies totaling $8.5 million in death benefit. The attorney named himself trustee. According to court documents, Article II of the trust instrument provided "that the trustee had no duty to pay the insurance premiums, had no duty to notify the beneficiaries of nonpayment of such premiums, and had no liability for any nonpayment."

The drafting attorney, as trustee, signed applications for all policies in the trust. It is not known why, but on each application, he provided a false address in South Dakota as his address as trustee. Approximately $250 thousand in premiums were paid to start the policies, but subsequent premium and lapse notices were sent to the false address. Another $250 thousand in premiums was paid to the agent of record, but was not forwarded to the carrier. Per court documents, the beneficiaries "did not know what happened to the premiums." All three policies lapsed and a suit was filed by the beneficiaries alleging the trustee "breached his fiduciary duties as trustee" and as a direct result of the breach, "the policies lapsed, resulting in the loss of the initial premiums," as well as the monies paid directly to "a corporation owned by the agent."

The trustee cited the exculpatory language found in Article II as his defense, but the Nebraska Supreme Court disagreed. Citing "common law rules," the court stated, "as a general rule, the authority of a trustee is governed not only by the trust instrument but also by statutes and common-law rules pertaining to trusts and trustees." They found the trustee's defense "untenable," since it "challenges the most basic understanding of a trustee's duty to act for the benefit of the beneficiaries under the trust," the most fundamental duty being the protection of the trust property. The exculpatory

language could not be relied upon to "abrogate" the trustee's duty to "act in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries."

Key Lessons from Rafert v. Meyer:

While we have seen, in some cases, that trust language can alter or even waive some trustee responsibilities, the fundamental duties of a trustee must be followed and exculpatory trust language will not necessarily provide protection. This case also points out some basic administrative guidelines. Review every life insurance application to verify all information is correct, especially if you are signing an application you have not personally filled out. Never provide a check for premium payment that is not made out to the carrier, and send all checks directly to the carrier.

Nacchio v. David Weinstein and the AYCO Company

Nacchio v. David Weinstein and the AYCO Company is not a TOLI case, but one that every TOLI trustee should review as the defendants in the case were deemed to be fiduciaries and the settlement awarded to the plaintiffs was large.

Joseph Nacchio was CEO of Qwest Communications. Davis Weinstein was a longtime advisor who worked at AYCO, a subsidiary of Goldman Sachs. AYCO had developed an executive compensation plan that utilized life insurance as part of an "estate enhancement program (EEP)." According to the lawsuit, Weinstein encouraged Nacchio to take part in the program and he agreed and allowed Weinstein "to implement all aspects of the EEP program."

According to Mr. Nacchio, based on Mr. Weinstein's suggestion he purchased two survivorship variable life policies with approximately $95 million of death benefit with a single payment of $4.5 million in 2000. At the time of purchase, it was projected the policies would run until age 100 assuming investment returns of 10.68% and 10.8% on the policies, respectively. In 2010, the policies were evaluated and it was found that they were underperforming. Participation in the EEP program was discontinued at a cost of over $2 million in termination and legal fees and taxes. Mr. Nacchio and his wife moved ahead and purchased approximately $85 million in life insurance coverage for a total premium of just under $27 million. The coverage that they obtained was single life coverage on Mr. Nacchio's wife, Anne Esker, since Mr. Nacchio, by this time, was a convicted felon having been found guilty of insider trading of Qwest stock in 2007.

Mr. Nacchio and his wife filed suit in 2010 while Mr. Nacchio was still in prison. They alleged that their adviser, who testified at Mr. Nacchio's earlier trial, had breached his duty of care to Mr. Nacchio. They had a life insurance expert testify that Mr. Weinstein was a fiduciary under the Investment Advisers Act of 1940 and that based on his analysis, the policies had a less than 25% chance of persisting until the insured's age 93, assuming the policy funding. The lawsuit alleged that Mr. Weinstein was negligent and deviated from an expected level of care.

The defendants had their own expert who testified that the EEP program identified the risks of the plan and that additional premiums might be needed, a point that the attorneys amplified in the trial. They mentioned that not only were Mr. Nacchio and Ms. Esker informed of the issues, but their estate planning attorney was also made aware of them.

After a 75-minute deliberation, the jury awarded the plaintiff's $14.2 million, which was the amount that would have been needed to purchase the coverage they thought they were getting in 2000.

Key Lessons from Nacchio v. David Weinstein and the AYCO Company:

While this case does not deal directly with a TOLI trustee, even the defendants' expert witness agreed that Mr. Weinstein was a fiduciary. Mr. Weinstein designed a life insurance program with an expectation of a 10.6% plus return over the life of the policies. And even though court testimony showed that he and representatives of AYCO met with the defendants at least quarterly, the jury found that the defendants deserved compensation of over $14 million. This case should give a TOLI trustee pause as it highlights the need to disclose and document the expectations around the policy when bringing a policy into their trust. It also emphasizes the need to make sure the expectations are reasonable and that actual policy performance is monitored with documentation that all pertinent parties have been made aware of a policy's performance outcome annually.

While guidance available to TOLI trustees is minimal, the information provided in these cases helps to illuminate proper and prudent trust administration and policy management procedures. The lessons learned from these cases should be used in your everyday practices.

CHAPTER 3

Developing a TOLI Administration System

The voice on the other end seemed distressed. It was a client, a good client who typically did not call me directly unless there was an issue or she needed a favor.

"Michael, I have a problem. It seems that one of our trust administrators took in a policy about a month before she gave her notice, and we just found the paperwork along with the actual policy when we were getting her desk ready for a new employee. Obviously, it has not gone through our normal onboarding process and I wanted to alert you that it would be coming over today."

Sometimes problems occur–an employee makes a mistake, or one heading for the door is forgetful. But having a strong, prudent process in place can often overcome problems. In this case, the bank that we worked with had robust internal TOLI onboarding practices following an outline we provided. Though the policy sat in a desk for far too long, the paperwork was solid, with the signatures and authorizations that we needed to review the policy and begin administering the trust that very day.

The system is the backstop, and, in this case, the trustee escaped with their reputation intact. Irrevocable life insurance trusts are some of the most stressful accounts a trustee must administer. Their complexity, liability, and generally low fee amounts are three reasons many trust companies have decided to move away from them entirely. For those who want to create a successful business line around ILITs, a compliant and efficient process is a prerogative. To do so you need to have the right people, system, procedures and review process in place.

People

The successful administration process starts with the individuals that are charged with handling the ILIT accounts. Are they comfortable with this unique asset? Life insurance is a complicated asset with more liability than just missing a premium, which more than a few trustees have done. Does

your staff understand the nuanced issues that surround different policy types, each of which could lead to significant liability?

For example:

- Do they understand the conversion option in a term policy and the eligibility and limitations placed on them?
- Do they understand the premium timing issues that surround policies with no lapse guarantees?
- Do they understand the use of an Automatic Premium Loan (APL) in a whole life policy and the problem that could occur if a premium was missed without this feature in place?
- Do they understand the additional requirements of a variable life policy, the only policy type that requires the policy owner to make all investment decisions, and the only policy whose investments can lose money?

Ideally your trust administrators will have a thorough background in life insurance. However, if problem policies can be handled by other internal resources, you may get by with trust administrators that have rudimentary knowledge, though it will raise your risks. An in-house training program, if available, is in order. If not, connecting with educational resources outside your firm should be a requirement for all handling this asset. Your administration staff must, at a minimum, understand the basics of life insurance, and recognize the red flags that come with each unique type of policy before any issues arise.

The successful administration of a TOLI trust starts with an understanding of the trust document itself. A seasoned TOLI trust administrator can examine a trust document and pull out the required information needed to administer a trust in a compliant manner, but because there are often questions about the document, an in-house trust attorney should be available to also review the document. There are two focus points when reviewing a new trust agreement–the basic administrative provisions that need to be followed daily to keep the trust management compliant, and those unusual provisions that should be noted in the trust file. A trustee must be confident that the trust document review points out potential issues or points of liability and that the administrators are aware of them.

Most organizations rely on a single administrator to handle all aspects of the ILIT process (Document Review, Legal Document Prep, Administration, Policy Review, Account Review), which lends itself to errors. For example, what happens when that person is out for an extended period? Do you have someone else that can adequately cover for them? What if that person were to leave, especially abruptly? Cross-training should be encouraged and fostered in your organization to create an easy succession plan. And whenever possible, multiple sign offs should occur in critical areas, as we will discuss shortly. Just as banks utilize multiple sign offs for cataloguing end-of-day contents in the vault, you should have multiple people sign off on different administrative tasks, a check and balance system that allows for additional oversight.

The System

Even with the right people and correct training, a trustee must also have an efficient system to administer and review this asset. The *Unique and Hard-to-Value Assets Handbook* requires fiduciaries to have a system in place that controls and mitigates risk and is focused on monitoring adequate internal control processes.

The system can be homegrown or obtained from a third-party vendor, but it must contain certain features, starting with premium tracking. A missed premium will almost always create some sort of liability issue. Basing premium payments on antiquated methods or systems, or simply waiting for the carrier to send a premium due notice, is a mistake. These manual processes leave you open to human error. A good system will not only allow you to easily track premiums that are coming due, but also provide a snapshot of where each policy falls in the administration process. You should be able to easily determine what action is required for every policy you manage in real time. The system does not need to be intricate, but it should remove most of the human error from your premium tracking process.

The system should also help you accurately track your administrative fees collected, due and past due. There should be a set process in place for dealing with late fees, with someone responsible for each step (initial request, follow-up request, late contact and final payment) of the collection process. You need to make sure that you are getting paid what you are owed and tracking it properly. Too often, TOLI trusts are considered an accommodation because of the grantor's business relationship with the trustee. In these cases, adequate fees are not charged or collected. This is a mistake with a high liability asset.

One important feature of a TOLI trust administration system is the tracking ability that creates a historical log of the account, with documentation and notes. You may have an account file, but it is a cumbersome process to review the file to get an answer, or to retrieve a document. Your system should be able to do both quickly. If an administrator wants to find out when a gift notice was sent in 2010, or when the fee was paid in 2014, they should be able to retrieve that information with a few clicks. Administrative details needed for future work, such as who should be copied on gift requests, and whether there is a special advisor authorized to receive an annual policy review should be easily accessible as well.

Automating procedures and reducing human error is another benefit of an efficient system. Automated templates for letters that allow the administrator to pull in updated account information such as addresses, premium and fee amounts, etc., allow the administrator to create letters efficiently, without transcription errors. Using saved documents from past correspondence does not provide the confidence that year-to-year changes are recognized, and dramatically increases the time that is spent on correspondence.

Another component of a well thought out ILIT system is the ability to quickly prepare status reports on the portfolio. Management or trust committee reviews and reports should be able to be generated quickly.

Systematic centralization of all trust files, notes, and information is needed for exceptional TOLI administration. Centralization allows for better monitoring–lowering trustee liability–as all relevant materials can be stored electronically in a single, safe, and secure location.

Procedures

The first step in the TOLI administration process occurs when the policy and trust come in**.** Gathering all the needed information is crucial to successful onboarding, which is in turn crucial to successful management.

Creating checklists is the best way to ensure consistent onboarding and gathering of trust and policy information. For the trust, at a minimum, the following should be gathered:

- Copy of signed/dated trust agreement
- All contact information for:
  - Grantors
  - Beneficiaries
  - Advisers
    - Insurance agent
    - Attorney
    - Accountant
    - Other advisers
- Fee schedule agreement signed
- If a transferred trust:
  - Acceptance and appointment document signed
  - Resignation/removal agreement signed
  - Any other related documents
  - Copies of previous Crummey letters and gift notices
  - Copies of previous trust correspondence

When bringing in a policy, at a minimum, the following should be gathered:

- Copy of the policy contract, with application
- The "as sold" illustration based on the premium to be paid
- Any agreements or documentation around the policy (split dollar, etc.)
- If it is a transferred policy:
  - Past in force illustrations and quarterly and annual reports

- Last premium notice, as well as premium paid history
- Any other carrier correspondence

For ongoing administrative procedures, there should be three focus areas:

1. Timing
2. Preparation
3. Incoming Correspondence

For gifting and Crummey correspondence, timing is crucial. Waiting only leads to stress and potential liability. The goal is to allow more than enough time for the grantor to make a gift since they are not always timely with their payments. Standard procedure should be to send the first gift request 60 days before the premium due date, and if the premium is not received before 30 days before the due date, send a follow-up request. Ideally, the gift will be received within the first 30 days, allowing enough time between the full withdrawal period prior to the due date.

The 30 days prior to mailing the gift notice can be used as a review period to evaluate all aspects of the account, with a focus on verification and anticipation.

Sample information reviewed:

- Is the current information correct and up-to-date? This is simply a confirmation of existing information, but it is critical as things do change year to year.
  - Are the premiums being paid correct?
  - Are the fees correct? Are any fees past due?
  - Has any contact information changed?
  - Were there recent discussions with the client about the account?

Are there any changes or issues that should be noted?

- Are there premium changes, which could be due to an end of level premium period in a term policy, dividend changes in a whole life policy, or short pay funding strategies in a universal life policy?

- Are any policies facing a lapse, or shortened life span because of missed premiums, poor cash value performance, cost of insurance (COI) increase, or other reasons?

- Are there any term policies that are reaching the end of their conversion opportunity, or any rider in any of the policies that could be triggered?

This review period allows you to confirm all the relevant facts around the trust and policy, and gives you the ability to get ahead of any issues in the trust or policy.

Don't Forget the Mail While the gift request process is considered by many to be the most important step in your ILIT administration process, how you handle incoming mail may be just as critical. The items that you receive in your incoming mail will often drive your activity for the day and can provide a quick glance into the condition of your portfolio. Missing a critical piece of mail can lead to major liability.

In most situations, incoming mail is handled by the same person that manages or administers the account. This makes sense, especially for a low priority and low margin account like an ILIT. But this may not be the best process for mitigating liability. Everyone makes mistakes, and the chance of a mistake occurring increases when a process is accomplished by only one person. A separation of duties, including incoming documents automatically sent to multiple individuals for review, will mitigate liability most efficiently. For example, a specific document type (late premium notice, lapse notice) may go to the administrator, but should also be sent to a manager. Most of the mail you receive is expected, but the occasional critical mail is the type that should always be seen by more than one person. It is important to build an efficient system, and the more eyes that you can put on your critical mail, the less liability you will face.

Once mail is processed, it should be filed electronically in your centralized administration system. Original documents can be kept in a safe and secure location, but electronic documents relating to the trust file should be kept in a central location where all who are authorized have access. As we have mentioned, your files should be set up in a secure location with adequate firewalls.

Review

There are three components to administrative reviews:

1. Policy Review
2. Annual Account Reviews
3. Audits

We have already highlighted the *Unique and Hard-to-Value Assets Handbook*, which states, "at least once during every calendar year . . . a trustee must . . . review . . . all assets of each fiduciary account . . . to evaluate whether they are appropriate, individually and collectively, for the account."

Every trustee should have someone on staff who intimately understands the inner-workings of each type of life insurance policy in the portfolio and can comprehend the current economic environment and its effect on the policies. That person should complete a thorough review of each policy on an annual basis. They will also need to be able to determine which policies represent high liability cases. Through trial and error, we have found that approximately 20% of all TOLI policies have issues at any one point in time, and they typically fall into one of three issue categories:

1. Those with a high probability of policy lapse prior to maturity or life expectancy
2. Those with significant loans against the cash value, which can cause a policy lapse, triggering a possible taxable event
3. Those that require a premium increase to keep the full death benefit in force for the duration of the policy

This means that even if you only have 50 policies in your portfolio, you probably have 10 policies with issues that could cause significant liability for your company.

The last step in the policy review process is to deal with those 10 policies. That means going through the process of reviewing and offering options for problem policies, notifying the grantor (and possibly beneficiaries) of the situation, and documenting the file with their acknowledgements of the current situation or plans for remediation**.** A solid policy review process is needed and may cover OCC requirements, but the key to mitigating your risk is to make sure that your clients understand the condition of the policy and documenting that understanding. We will cover this in detail in a later chapter.

Besides the annual policy review, a standard annual account review needs to occur - the Reg 9 review. The Reg 9 review is a required procedure for OCC regulated firms. To keep this review as efficient as possible you should be able to use your administration system to automate as much of the process as possible, especially those parts that do not change, or rarely change over time. While each review should stand on its own, make sure that past reviews are available to the administrator completing the current review. Below is a listing of the information that would be included in an annual account review of both the trust itself and the asset in the trust.

Checklist

- ✓ Date completed
- ✓ Account title
- ✓ Account number
- ✓ Administrator
- ✓ Trust inception date
- ✓ Are the policies linked to the account correctly?
- ✓ What is the date of the governing document?
- ✓ What state is the governing law of the document?
- ✓ Is the account type coded correctly?

Have the policies been reviewed? List all

- ✓ Carrier
- ✓ Policy Type
- ✓ Last Review Date
- ✓ If Variable, has allocation been reviewed?
  - ✓ If so, when?
- ✓ Is the policy still appropriate?
  - ✓ If no, please note reasons why
- ✓ Have any loans or cash withdrawals been taken?
  - ✓ If yes, note reasons, repayment plan
- ✓ How long is policy projected to stay in force?
- ✓ What is the insured's life expectancy?
- ✓ Do you know what the chances are of the insured living beyond his/her life expectancy?

Have the premiums been paid? List all

- ✓ Carrier
- ✓ Policy number
- ✓ Premium due date
- ✓ Last premium paid date
- ✓ Last out of pocket premium paid amount
- ✓ Was premium paid in full? If not, list why not

Have Crummey Letters been sent

- ✓ Yes
- ✓ If no, why not?

For Term policies, are there still conversion privileges to a permanent product?

- ✓ If yes, has client been notified in writing?

List name, contact Info, DOB, for current grantors, beneficiaries, and remainder beneficiaries

- ✓ Address
- ✓ Address
- ✓ Home #
- ✓ Business #
- ✓ Cell Phone #
- ✓ Fax Number
- ✓ Email

What is date of the last tax return filed?

Is there a W-9 for all current beneficiaries?

Have there been any client complaints, written or verbal, since the last review?

- ✓ If yes, elaborate

Have annual reports been sent to Grantor?

- ✓ If no, why not?

Have annual reports been sent to Beneficiaries?

- ✓ If no, why not?

Are the fee invoices up to date?

- ✓ Last paid date
- ✓ Last paid amount
- ✓ Is account subject to a fee exception?
- ✓ Has fee exception been approved in last 12 months?

Are there investment restrictions?

- ✓ If so, list restrictions

Are there any other assets held in the account?

- ✓ If so, list assets

Who has investment authority?

- ✓ If outside authority, list

What is the tax status of the account?

- ✓ Grantor Trust?

Is a tax return necessary for this account?

Was a 1041 tax return filed for this account?

Administrator comments and recommendations

While the annual reviews of the trust and policy are important, periodic audits are necessary to make sure that the outcome of your ILIT administration process is correct. Audits should be handled by someone other than the administrator, and should focus mainly on two items:

- Critical Incoming Mail–This should be audited daily by a manager as these documents are most likely to offer liability issues and should be dealt with swiftly and accurately. These documents should also be kept for a periodic audit later in the year.

- Timing of gift requests, receipts and premium payments–Periodic audits should review these items for each account that is pulled. Separate periodic reviews of each administrator's workflow should be completed to ensure that each step in the administration process was completed in a timely fashion and all due dates are correct.

Remember–mistakes will happen. You need to be sure that you have multiple people reviewing your files and you need to continually review your actions and the actions of your team. ILIT administration is a complex process with a unique asset that requires a team to ensure it is handled properly.

This chapter provides you with the guidelines to develop an administrative process that fits your business model. While these guidelines provide direction, you can successfully adapt this process and reduce your liability if the right people, system, procedures, and review processes are in place. If you are lacking in any of these areas, your liability will increase dramatically.

CHAPTER 4

An Introduction to Life Insurance

Roger Earnhardt had humble beginnings, but even in youth he was an entrepreneur who turned a teenage grass cutting business into one of the largest landscaping companies in the Northeast-a 50-acre nursery that supplied his firm and other smaller firms in the area with quality locally grown plants. Early on, he joined forces with his younger brother, who, learning from Roger, quickly became adept at growing plants and installing award-winning landscapes.

It was a good life for Roger and his wife Kay, who could fulfill her dream of developing a horse farm and giving their children, two young girls, a life that revolved around the outdoors, a life she dreamed about as a child.

As his responsibilities grew, Roger's advisors at the local bank informed him of different life insurance options. Roger reluctantly purchased two policies, policies he thought were too large; one a personal policy, and one funding a buy-sell agreement with his brother. Both policies were held in a trust at the bank.

When Roger passed away tragically, just shy of his fifty-sixth birthday, much of the town's business community and just about all of his clients, were at the funeral. In the following weeks, though some called on Kay and the kids, they were now on their own–for the first time ever.

A week after the funeral, Kay and her brother-in-law met at the bank to go over the details of the buy-sell agreement. While Kay and her daughters were unfortunately forced to make a new life for themselves, the life insurance held at the bank proved valuable. The buy-sell agreement proceeds ensured Kay was compensated for Roger's portion of the company instead of becoming part owner of a business she had no interest in running. Roger's personal policy cemented the dream that Kay and Roger had - now their daughters could grow up in the home Roger and Kay built, keeping her longtime dream alive.

It is often said that life insurance is sold, not bought. That is probably true. But when a benefit is paid out, no one says the benefit is not needed or too large, in fact, often it is found that it is not large enough. As a life insurance trustee, you have a responsibility to maximize the value of a TOLI trust for the beneficiaries of the trust - for Kay and her children. And that is not always easy. Over time, life insurance products have evolved to meet changing market forces and needs. Unfortunately, at times the products were developed with overly optimistic expectations and projections, often designed to lower the premium, always designed to make the policy more attractive to the consumer.

A general outline of the evolution of life insurance follows. Though not in perfect chronological order of introduction, it does provide a marketing timeline. For example, term insurance was the first policy created. Since there was a need for lifelong coverage, whole life was created. When interest rates rose in the early 80s, current assumption universal life was created, etc.

In this chapter, we will outline the different types of life insurance to provide you with a background to help you understand the use of life insurance in a trust setting. We will focus on the advantages and disadvantages of policy types, provide insight to the concerns around a policy type, and outline steps to minimize your liability as trustee and to maximize the benefits to your ultimate clients–the beneficiaries.

Term Insurance

- Easiest life insurance to understand. You pay a premium for a death benefit only. There is no cash value in the policy; the policy's purpose is to provide protection only.
- It is the least expensive type of insurance to purchase, at least initially.
- While there are term policies with annual premium increases, most policies sold today have a level premium that is guaranteed for a specified period (up to 30 years), after which the premium to continue the policy increases, usually dramatically. However, those level term policies can often be continued for a more reasonable premium after a process called re-entry, where the insured must submit to another underwriting process. The cost of the continued coverage for the additional period will be based on the current age of the insured.

- Term insurance policies usually contain a Conversion Provision. This provision allows the insured to convert the term policy to a permanent policy at current age, at the underwriting class of the original policy, without providing evidence of insurability. This is a very important provision if the policyholder has suffered a change in health, as the cost to obtain permanent coverage, if underwriting is required, would typically be much higher. However, if the insured has retained his health when a conversion is being contemplated, a market review is in order, as often the open market can provide a better policy than the conversion policy being offered. The opportunity to convert a term policy is typically available for a limited time, for example 30 days before or after a policy anniversary date and can have term or age limitations, for example, for the first 10 policy years or until age 65, whichever comes first.

- Term insurance is typically used to provide a death benefit for a limited time. It is often used by those who have a large insurance need, but lack the cash flow currently and plan on converting the coverage to permanent coverage in the future. It is sometimes used to fill a short-term need such as additional protection when the children are young. Availability is limited by age, with policies typically unattainable after age 80. The length of the level premium period will shorten at higher ages.

ISSUE	WHAT TO DO
Missing the premium payment. **No Cash Value cushion** with Term insurance so **premium must be paid on time.**	Alert management any time premium will possibly be late.
Missing the Conversion Period is perhaps the biggest mistake that can be made other than allowing policy to lapse. **Missing the Conversion Period can cause substantial liability to Trustee.**	Provide documentation so Grantor is made aware of Conversion option. Follow up should occur as Conversion Period comes closer.

Whole Life Insurance

Provides a guaranteed death benefit if premiums are paid in full every policy year, as well as a guaranteed cash value. Participating whole life policies also provide additional cash value through dividends.

The investment portion of a whole life policy goes into the general account of the life insurance company, and is composed primarily of long term bonds and mortgages, as dictated by various state insurance laws.

From Vital Signs

Bonds	71.50%
Mortgages	11.90%
Policy Loans	4.00%
Cash & Short Term Investments	3.20%
Stocks	3.70%
Real Estate	0.70%
Other Invested Assets	5.00%

Average General Account Portfolio of the 25 Largest Insurance Carriers.

Whole life contracts pay dividends considered to be a return of premium paid when premiums received turn out to be more than the company needs. This could be due to fewer insureds dying, lower expenses, or portfolio returns being more than what was guaranteed. Dividends can fluctuate above and below the dividends shown in the current policy illustration.

The dividends that are earned on a policy can be used in several ways:

Reduce premium

- The dividend can be deducted from the stated premium to provide a lower out-of-pocket premium that must be paid.

Purchase paid-up additions

- Paid-up additions act as little policies within the policy and have their own death benefit and cash values. The death benefit of the policy will be increased over the stated death benefit by using this option.

Take in cash

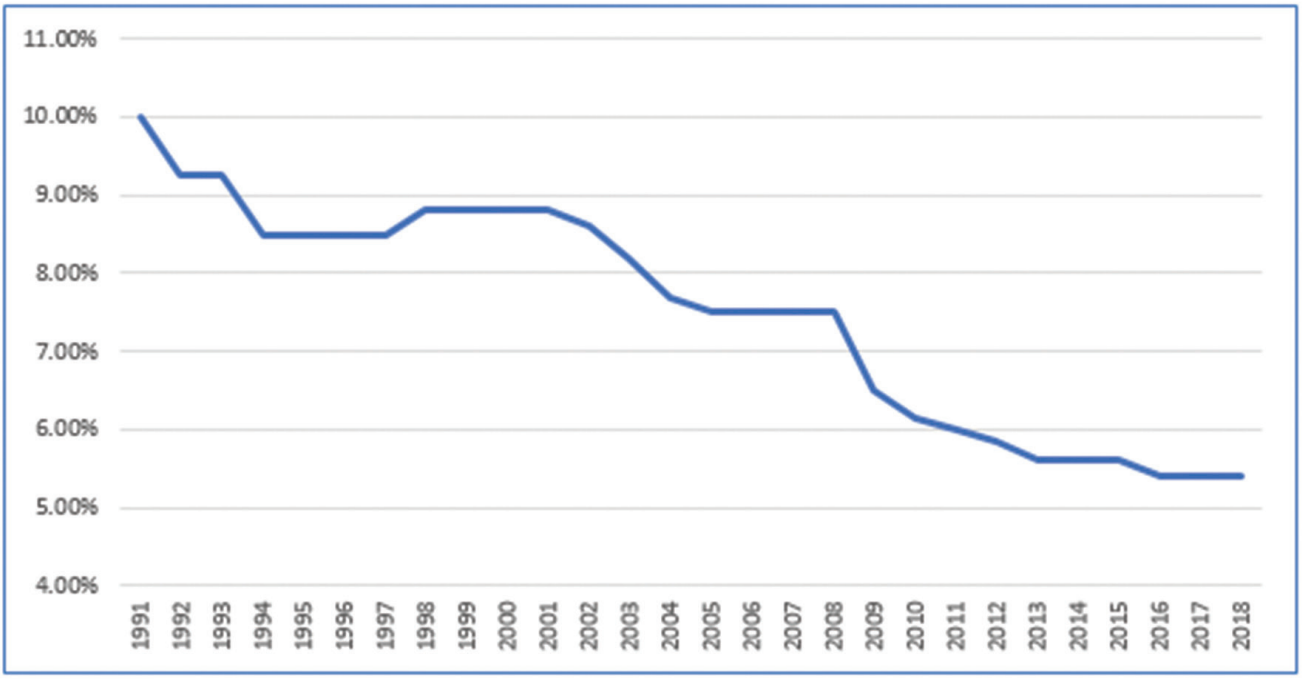
- The amount taken in cash will be considered tax free until an amount greater than cost basis is received, after which the amount would be taxable. This is rarely done.

Left with carrier at interest

- This is almost never done, as the policy owner would typically want to access the cash or maximize the value of the policy.

Repay loans on the policy

- If a policy loan has occurred, you can use the dividends to reduce the loan on the policy which will increase the net cash value of the policy.



Dividend Interest Rate (DIR) for a WL policy from carrier provided information

Over the years, the dividend scale on whole life policies has dropped, as shown in the chart above. Policy performance has suffered and many policies did not live up to expectations.

Whole life contracts can be blended with a term portion, typically using a term rider. This lowers the cost of the policy, but also lowers the guarantees in the policy as the cost of the term portion is not guaranteed. Typically, these plans are designed so that over time the term portion is replaced with base whole life coverage, until the entire contract has been converted to base coverage. The ability to convert the policy is driven by the premium paid and dividend performance. In some situations, where there is a high term component, it is often impossible to convert all the coverage, and the policy death benefit in the later years will drop, or the cost to maintain the full death benefit will increase as the cost of the term portion rises.

Although whole life policies have fixed premiums, the premium does not always have to be paid out of pocket. As mentioned, dividends can be used to pay the premium or a portion of the premium. The premium can also be paid from the cash value of paid-up additions, those little paid up policies within the contract that are purchased with dividends. If the dividend or other sources are not

enough to pay the policy premium, the premium can also be paid by a policy loan. Often, this occurs automatically–a feature known as automatic premium loan (APL).

- The APL feature in some policies must be selected at policy issue, and if not checked on the application, the policy may not include this feature. If a policy premium is missed without this feature, the policy death benefit can be reduced as the policy may revert to a paid up, but reduced death benefit policy, based on the nonforfeiture options of the policy.

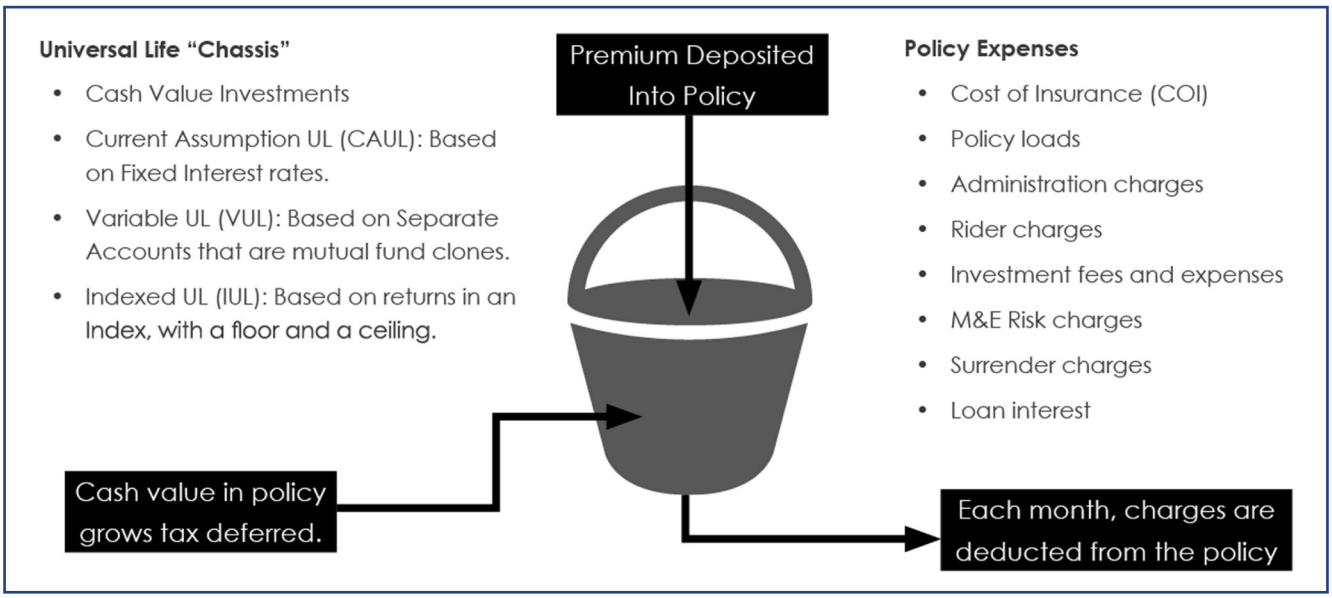
- While policy loans can be a welcome feature, the long-term use of loans to pay the policy should be discouraged and if done, monitored very closely. A heavily loaned whole life policy can be subject to a loan squeeze if the loan amount grows too large relative to the cash value. If left unattended, the policy can lapse creating a taxable event.

ISSUE	WHAT TO DO
Dividends have not held up, at historic lows now.	Track all policies and make sure signed documentation is in file that points out Dividends are not guaranteed.
"Blended" policies are especially stressed. Dividend drop affects conversion to Paid Up portion. Cost of Term portion is not guaranteed.	Review current illustrations and outcomes. Track actual outcome versus as sold illustration or expectation and review cost of Term component versus as sold illustration or expectations. Signed documentation in file points all out.
Automatic Premium Loan feature not set up can cause policy death benefit to be lost.	Confirm APL is part of contract on all Whole Life policies in portfolio.

Universal Life Insurance

While whole life insurance was considered a black box, with moving parts that were hard to see, universal life insurance was different. As transparent as whole life was opaque, for the first time the consumer could clearly see the inner workings of a life insurance policy. All the expenses, charges, and investment earnings were spelled out in computer generated illustrations and reports. The universal life policy was easy to understand. It operated much like a bucket with a spigot on the side. The premium was placed into the policy (bucket), expenses and charges were deducted (spigot), and the balance of the cash value grew at a rate determined by the investment vehicle of the chosen policy. Current assumption policies were invested primarily in fixed investments, variable policies in separate accounts that mirrored specific mutual funds, and equity indexed policies tracked a selected index, like the S&P 500®. If the cash value in the policy stayed positive, the policy death benefit would be

paid. Once the cash value was depleted, the policy would lapse, unless there was a secondary death benefit guarantee, a feature that has grown in popularity. Typically, a universal life policy allows adjustment of both the face amount of the policy and the premium level funding the policy - subject to minimum funding levels to start the policy. Underwriting approval is needed if the death benefit is later raised.



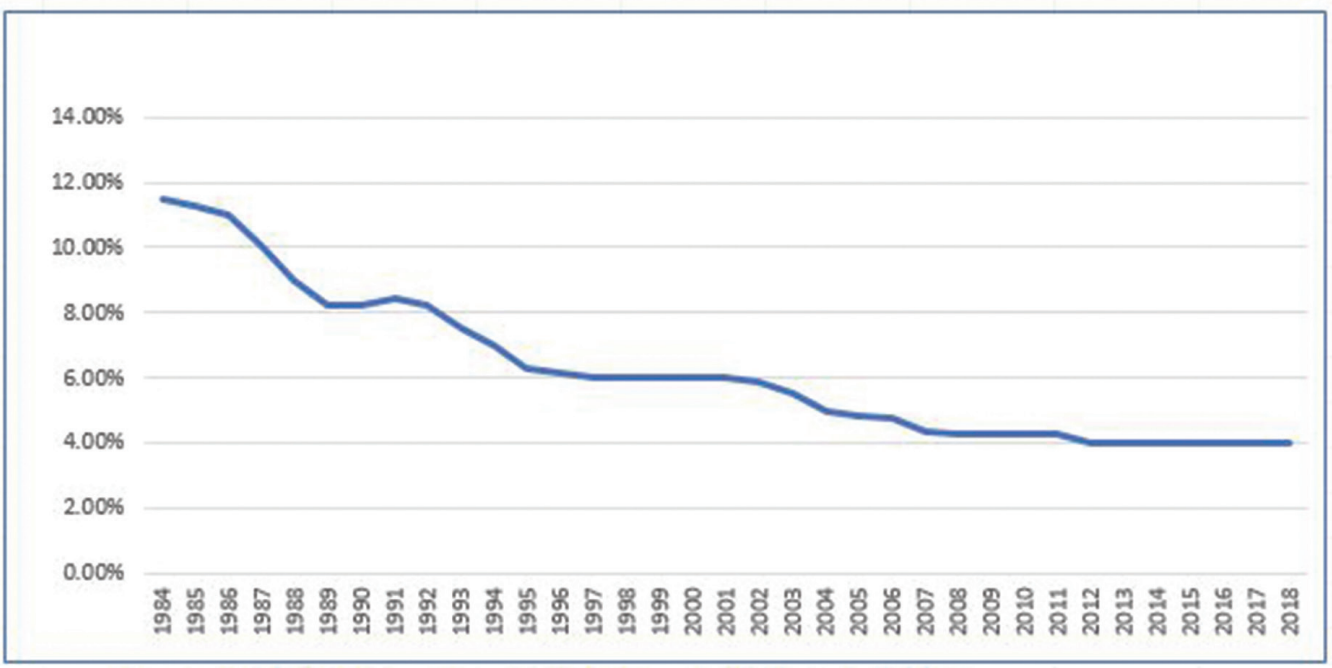
Current Assumption Universal Life Insurance (CAUL)

During the late 1970s and early 1980s, short term interest rates skyrocketed. The public clamored for an opportunity to participate in this high rate of return, and money market funds were born. Money flowed out of existing whole life policies into these newly formed money market accounts.

The insurance industry, being market driven, came up with a product that would combine the high fixed rates of return that existed at that time with the tax advantages of life insurance.

From 1981 to 1986, the percentage of whole life policies sold dropped from 78% of the marketplace to 30%, as the sale of universal life policies grew.

These policies were sold based on projected current assumptions–the interest rate being credited and the current costs being charged on the policy at the time of issue. The current crediting rate over the last 25 years for a top tier Universal Life carrier is shown in the next chart. Rates have fallen dramatically over the years. Since expected policy performance was initially based on the current crediting rate at the time of sale, most policies did not accrue the projected policy cash values. Many policies sold in the last twenty-five years, if sold with a premium expectation based on these current assumption projections, turned out to be underfunded and many lapsed or will lapse without additional funding.



Crediting rate for a CAUL policy from carrier provided information

Because these policies provided the consumer with complete flexibility of premium payment (after an initial minimum premium is paid) many were not funded as originally expected. This underfunding has exacerbated the issues around the declining crediting rates on the policies.

Insurance carriers have the right to increase the current costs in these policies (subject to maximum guaranteed rates), and in the last few years, some carriers have raised the cost of insurance inside these policies. In some instances, the increased COI has caused the premium requirements to carry the policies to more than double. Whether these increases will continue remains to be seen, but for some owners of these policies, the COI increases have made their policies economically inefficient and decisions about future funding and policy viability must be made.

ISSUE	WHAT TO DO
Crediting rates on CAUL policies at historic lows.	Track current rates against expectations and re-project costs to reach policy goals. Signed documentation obtained for file.
Historic low interest rates putting pressure on carrier causing **cost of insurance (COI) increase on many policies.**	Track COI increases as they occur and develop options. Documentation obtained for file if changes noted.
Mortality charges in later years can be much higher than policy premium if policy values run down.	Generate in-force ledgers at policy lapse and determine costs. Provide signed documentation for the file.

Because so many current assumption universal life policies were underfunded and many lapsed, the insurance industry came up with a new feature in universal life polices–the secondary death benefit guarantee policy.

Secondary Death Benefit Guarantee Universal Life Insurance (GUL)

- A new generation of universal life policies with death benefit guarantees that took the market risk out of universal life policies; however, it took the premium flexibility that was an advantage away.

- With a guaranteed death benefit policy, you have a stated premium that must be paid in full and on time or the policy death benefit guarantee will be compromised–typically lowering the age to which the policy is guaranteed. Each carrier has different policy designs, but in most situations if a premium is missed or late, a catch-up premium can be paid to put the policy guarantees back on track. However, these policies should not be thought of as flexible premium policies, and should be managed with the understanding that a fixed premium will be paid each year.

- One disadvantage of these new generation policies is that the cash value growth is typically much less than with a current assumption product. The product is designed to provide a guaranteed death benefit, not develop significant cash value. If you review a sales illustration of a GUL policy, you will see that the cash value will often go to zero at some point. At this point, the policy is running on the death benefit guarantees alone, as the cash value has been exhausted.

- These policies gained favor for use in TOLI trusts, as most trust goals are focused on the death benefit provided, not cash value growth.

ISSUE	WHAT TO DO
No premium flexibility. Policy premium must be paid in full and on time. Any variation to premium payment can hurt policy guarantees.	Use language like the following in documentation - *"Trust Company will not be responsible for policy death benefit guarantees lost or policy lapse because of inadequacy or lateness of gifting to the trust. Trust gifts must be made to the trust to allow for adequate administration and timely premium payment.*
Low or no Cash Value, especially in later years.	Make sure Grantor(s) understand this.

Variable Universal Life Insurance (VUL)

- Introduced in 1985 by Pruco Life, a subsidiary of Prudential Life.
- Like CAUL policies, VUL has a flexible premium.
- The most important difference is that the owner of the policy, not the carrier, invests the cash value.
- Cash value is invested in separate accounts that are mutual fund clones.
- Like all universal life policies without guarantees, the VUL policy will stay in force if the cash value in the separate accounts is sufficient to pay the monthly charges. Unlike other universal life policies, a VUL policy investment could lose money, making the product more unpredictable.
- When funded to reach a certain goal, the investment return will have a large impact on the premium needed. The chart below shows the annual premium needed to carry a VUL policy under current cost assumptions to age 110, assuming a 65-year-old male underwritten as a standard non-smoker.

	4% Net	6% Net	8% Net
Run to Age 110	$34,729	$30,811	$27,750

- All VUL policies have a fixed account option that allows for a guaranteed rate of return.

ISSUE	WHAT TO DO
Policy separate accounts **can have negative returns.**	Documents should include reference to the fact that policies can lose money, no rates of return are guaranteed, actual outcomes will differ than shown in illustration and additional premium may be needed.
Owner invests the Separate Accounts.	Develop internal allocation process. Any policy in Money Market or Fixed Account should be reviewed for reasoning.
Most policies issued in the last 10-15 years **have not hit their goals.**	Review all Variable policies and re-project premium needs. Document for the file.

Indexed Universal Life Insurance

- Designed to provide the upside of equities while limiting losses.
- The product ties investment returns to a specific index such as the S&P 500® Index without dividends. It eliminates down years with losses by providing a floor on the investment return. This floor might be as low as 0%, but will never be negative.
- In addition, there is a participation rate, a percentage factor that the actual index return is multiplied by to arrive at the adjusted return. The carrier invests the policy premium in fixed investments and uses a portion to purchase hedges or options on the Index chosen, which determine the credited return for the policy.

ISSUE	WHAT TO DO
Client **expectation may be too high.**	Include in all documentation reference to fact that no rates of return are guaranteed, actual outcomes will differ than shown in illustration and additional premium may be needed.
Policies **hard to understand.**	Make sure Grantor understands risks of the policy.

Life Insurance Cash Value Investments Recap

Each permanent life insurance policy type with cash value has a specific investment strategy with differing investment risk. In most policies, the carrier is investing the cash value. In a variable life policy, the owner directs the investment, choosing among separate accounts. In an indexed UL policy, an index is tracked.

Policy Type	Cash Value Type	Invested by
Whole Life	Fixed	Carrier
Universal Life	Fixed	Carrier
Variable Universal Life	Separate Accounts (mutual fund clones)	Policy owner, Separate accounts chosen by owner
Indexed Universal Life	Tied to an index with cap, floor and participation rate	Carrier, who purchases options, Possible that index can be chosen by owner

Additional Notes

- The descriptions provided in this chapter are not all inclusive and many policies marketed share some characteristics. For example, an equity index universal life policy may have a secondary death benefit guarantee for a specific period if a stated premium is paid in full and on time.

- Permanent life insurance policies can either pay at the death of one person (single life policies) or at the second death of two insureds (survivorship policies). Survivorship policies are often used in TOLI trusts as estate taxes are typically due after the second death in a marriage.

- For each policy brought into your trust, you should obtain a copy of the policy contract and understand all provisions or riders. A few common riders are:

    1. Waiver of Premium Rider: If the insured is disabled, the policy premium may not have to be paid. Make sure you understand the policy specifics. These riders often expire when the insured turns 65 years of age. Make sure you keep in touch with the insured(s) annually to track his/her health.

    2. Term Rider: Additional term insurance can be added to the base policy death benefit, often for a specified period.

    3. Accelerated Death Benefit Rider: A living or advanced benefit which pays part or all the policy face amount of coverage if an insured is diagnosed with certain health ailments, typically terminal.

    4. Long Term Care Rider (LTC): Like the advanced benefit rider, this pays a cash benefit that can also be used to pay for long-term care related expenses, should they be necessary. Policies paying LTC benefits are gaining in popularity.

    5. Accidental Death Benefit (ADB) rider: Also known as double indemnity rider, it is not often found in a TOLI policy and pays a higher (unusually double) benefit if the death was accidental.

    6. Change of Plan Provision: Known by different names, this rider allows the policy to be exchanged for another policy issued by the company. Often useful in divorce situations where a survivorship policy can be exchanged for two single life policies.

CHAPTER 5

Whole Life Insurance–A Closer Look

Walt Disney was a visionary whose dreams became concrete realities, realities that remain part of Americana more than 50 years after his passing. A filmmaker who won 22 Academy Awards, he created animated jewels like Snow White, Bambi, Pinocchio and Fantasia - each with a richness of color and attention to detail that even today's computer-generated pictures cannot match. His characters, Mickey and Minnie Mouse, Daisy and Daffy Duck, Pluto and Goofy, captivated generations of children, their charm never growing old. He pioneered the theme park concept, first with Disneyland in California and later with Disney World, which turned Orlando, Florida from a sleepy, citrus growing town, to a 2 million plus population metropolis with more entertainment attractions than anywhere else in the world.

Like all entrepreneurs, Walt had financial challenges along the way. Disneyland, which opened in 1955 with future president Ronald Reagan officiating, was a $17 million project that stretched his wallet to the limit. According to Walt, to open his park, he "had everything mortgaged, including my personal insurance."

Similar stories can be told of other iconic business names. It is said that when McDonald's was in its early years, Ray Kroc borrowed against his whole life policies to meet payroll. And James Cash Penney, otherwise known as J.C., used cash from his whole life policies to keep his company afloat after the Great Depression.

Cash-rich whole life policies were an investment mainstay for our parents' generation, providing financial stability and wealth accumulation. The tax favored slow but steady cash value growth provided a long-term investment option for Americans saving for their golden years and the tax-free death benefit provided security along the way.

We, at ITM TwentyFirst, often encounter whole life policies taken out many years ago with annual cash value growth that exceeds 4%. For example, the chart that follows is from a 66-year-old whole life policy we manage with the dividend paying the premium. In calendar year 67 the ending cash surrender value is $108,399. The next year, calendar year 68, the cash surrender value is $113,292.

The illustrated numbers assume non-guaranteed dividends are used to reduce premium, with excess to paid-up additions

End of Year	Insurance Death Benefit	Dividend	Annual Premium Outlay	Cash Surrender Value Increase	Cash Surrender Total
66	127,334	3,657	0	NA	103,680
67	131,499	3,833	0	4 719	108,399
68	135,829	4,010	0	4,893	113,292
69	140,318	4,183	0	5,061	118,353

CV Year 67	108,399
CV Year 68	113,292
Difference	4,893
CV Growth	4.51%

The 4.51% annual cash value increase is a very respectable return for a fixed investment, especially in a low interest rate environment. The increase illustrates why whole life insurance was (and still is to some) considered to be a secure and practical, though not very glamorous, financial product. But in the TOLI world, the rate of return on the death benefit provided is often more important than cash value growth in a policy, and we have seen the use of whole life insurance fall over the years in TOLI trusts. In our TOLI Survey we found that a decade ago whole life insurance made up about 40% of the life insurance we saw in the TOLI market. Today that figure has dropped to 30% (2).

Dividends

Guarantees are one attraction of a whole life policy. If the premium is paid each year, the death benefit is guaranteed, and the policy is guaranteed to endow (cash value equals the death benefit) at maturity. Besides the guaranteed cash value in a participating policy a dividend is also paid on the policy. Dividends are not guaranteed and are driven by the operating performance of the company. The guarantees in the policy are based on very conservative assumptions for investment returns, mortality, and expenses. However, it is assumed that the actual performance of the policy will surpass the guaranteed outcomes. When that occurs, a divisible surplus is created out of which a dividend is paid.

What is the difference between a participating and non-participating policy? A participating policy is one that pays a dividend, the policy participates in the "profits", technically the surplus earnings, of the company. Typically, participating (par) policies are offered by mutual companies and non-participating (non-par) policies are offered by stock companies, though they can offer par policies.

What is the difference between a mutual and a stock life insurance company? A mutual company is "owned" by its policyholders. A stock company is owned by its stockholders. In a mutual company a portion of the profits earned are returned to policyholders, in a stock company the profits are distributed to stockholders.

Each year, The Board of Directors approves the payment of dividends and declares the dividend interest rate (DIR), which is the investment component of the dividend. The dividend is based on the performance of three components.

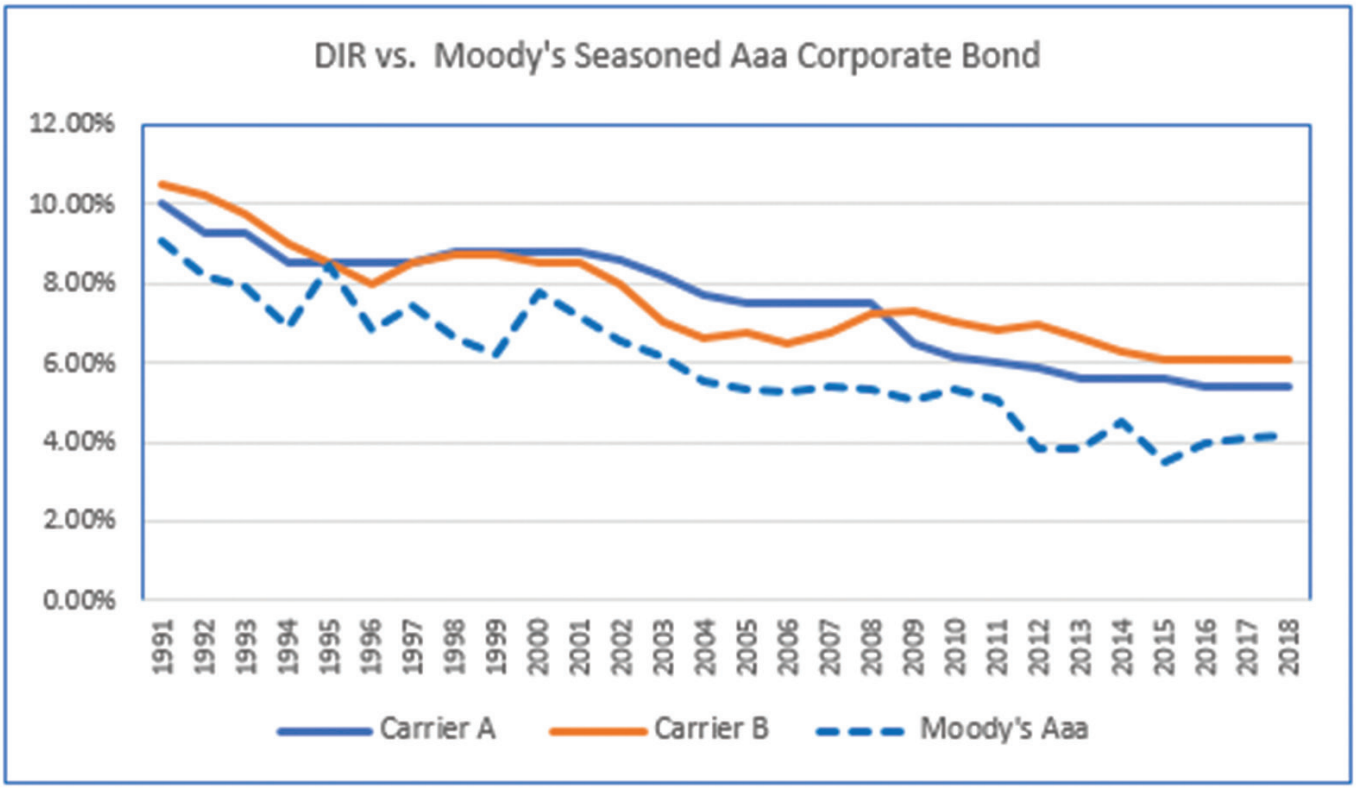
1. Investment Results: The interest rate portion of the dividend, the DIR, is declared by the carrier annually based on the actual rate of return generated from the investment portfolio versus the underlying guaranteed return on the policy. As we illustrated in the Average General Account Portfolio chart in Chapter 4, the cash value of a whole life policy is invested in fixed instruments, primarily high-grade bonds and mortgages. These fixed instruments tend to have little year to year volatility with interest rates rising and sliding slowly over time. However, over the last two decades, as can be seen in the Dividends for a Major Whole Life Carrier chart in Chapter 4, rates have dropped consistently and now stand at or near historic lows.

2. Mortality: When there are fewer death claims than projected, there is a savings in the mortality that will affect the dividend positively.

3. Operating Expenses: When the operating expenses of the company are less than anticipated, those savings will affect the dividend positively.

Carriers are very proficient in the art and science of underwriting an insured. Mortality tables provide a basic estimate of annual death claims, but each carrier also has internal data and guides that allow them to refine estimates. It is rare that a carrier will underestimate the mortality costs of a portfolio of policies, nor will the actual results deviate too far from expected. In many instances, larger policy death benefit liabilities are shared with re-insurers, thereby limiting the carrier's exposure. Most carriers tightly control operating expenses, and though costs can differ from carrier to carrier, most carriers' expenses are not far out of line with their expectations. In a whole life policy, both mortality and operating expenses are predicted very conservatively and generate savings greater than expected which are passed on to policyholders. The component that most affects the changes in the dividend paid is the investment return. Since a large portion of the investments in a whole life policy are in high quality bonds, the DIR will generally track the benchmark of a portfolio of long term bonds like Moody's Aaa Long-Term Corporate Bond Yield Average. As can be seen in the chart that follows, the historical whole life dividends for two top mutual carriers over the last 25 years generally follow the Moody's Aaa Bond Average (3), with the DIRs tracking slightly above.

Information from Moody's



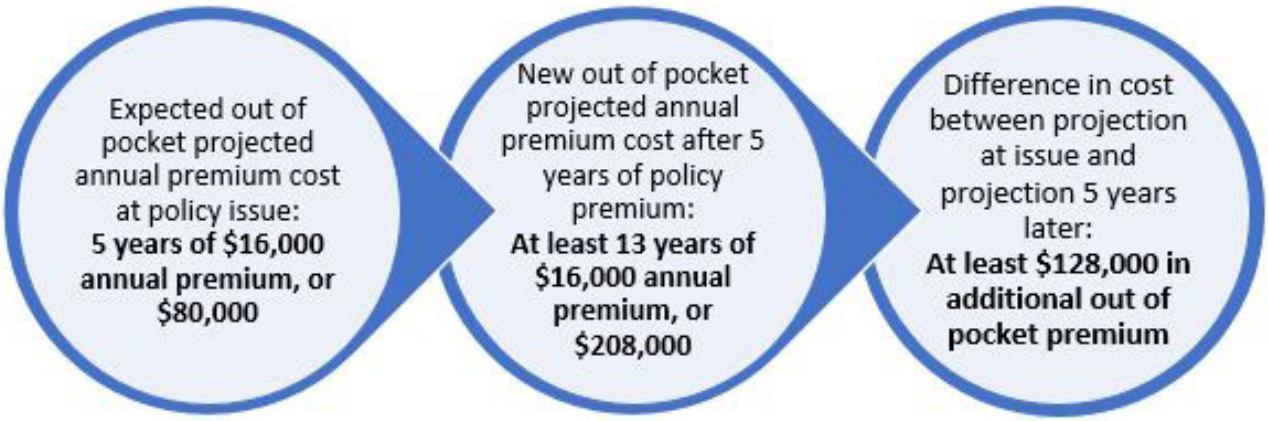
Both bond index and carrier DIR returns have sloped downward over the last 25 years. In most instances, the mortality and expenses for whole life policies have been favorable relative to expectations, but the low interest rate environment has negatively affected carrier investment returns causing policy performance to falter.

As with all permanent life insurance policies, an as sold illustration is provided at policy issue, which projects the current policy expectations over the lifetime of the insured. As we mentioned, if a whole life policy premium is paid in full each year, the policy provides guaranteed cash values that will allow the policy to endow at maturity. However, rarely is a TOLI policy fully funded. Typically, the dividends are used at some point to reduce the premium, and eventually eliminate out of pocket contributions.

Declining Dividends Lead to Disappointment

A sales technique, called "vanishing premium," was based on non-guaranteed sales illustrations showing that in a certain number of years the dividend would be sufficient to pay the entire premium on the policy, lowering the overall premium costs. The strategy was used to entice prospects to buy whole life policies, but because of the dividend drop, the strategy often failed, with additional premiums due.

The disappointment felt by whole life consumers who purchased vanishing premium policies led to numerous lawsuits against carriers, including New York Life, Prudential, Metropolitan, Transamerica, John Hancock, Great-West and Jackson National, with settlements of up to a billion dollars reached (4). The chart below shows the projected outcome that was assumed on a whole life policy at issue contrasted to the policy's actual performance. This example was part of a lawsuit against Merrill Lynch as trustee of an ILIT. A Merrill Lynch adviser had sold a $1 million Manulife whole life policy with the expectation that only 5 years of premium payments would have to be paid out of pocket. The balance of the premium costs was to be paid "by dividends generated by the Manulife policy or by surrender of PUA (paid-up additional insurance)." After paying premiums for 5 years, the grantor/insureds were told that "cash premium payments would be required for at least thirteen years before the premium payments would vanish." The difference in cost was substantial, and the grantors filed a complaint for "breach of fiduciary duty, negligent misrepresentation, fraudulent inducement, fraud and negligent supervision arising out of the sale" (5).



Vanishing Premium Scenario, Koehler v. Merrill Lynch, District Court of Florida, 1998

The vanishing premium problem was investigated by Congress in 1994, and listed as one of "the eight biggest rip-offs in America," in a cover story in a popular financial magazine (6). The lesson learned for a TOLI trustee? Since dividends are not guaranteed, any premium suspension funding strategy should be monitored and adjusted as needed, with written grantor acknowledgment of any changes.

Funding a Whole Life Policy

If the premium on a whole life policy is paid in full, the entire dividend can be used to purchase paid up additions, small policies within the whole life contract that add death benefit and cash value to the policy. A much higher cash value and death benefit will be generated in a fully funded policy with dividends purchasing paid up additions, rather than reducing the premium. The spreadsheet that follows shows the projected outcome of a 20-year-old whole life policy purchased on a 62-year-old.

The projected outcome assumes annual out of pocket outlay is suspended in the 20th year (Option 1) or is paid all years (Option 2). Column 5 shows zero out of pocket outlay assuming the premium suspension option, with Column 3 showing the death benefit of the policy, and Column 6 showing the total cash surrender value utilizing that option. Column 9 shows the payment of the full premium payment ($21,090), with Column 7 showing the death benefit, and Column 10 showing the total cash surrender value of the policy assuming the full premium payment option. The total cash surrender value shown includes the guarantee cash value plus the additional cash generated from the dividends paid.

		Option 1 - Assumes Premium Suspension				Option 2 - Assumes Full Premium Payment			
Column 1	Column 2	Column 3	Column 4	Column 5	Column 6	Column 7	Column 8	Column 9	Column 10
Policy Year	Insured Age	Death Benefit	Dividend	Annual Out of Pocket Outlay	Total CSV	Death Benefit	Dividend	Annual Out of Pocket Outlay	Total CSV
20	82	1,300,000	21,009	0	760,167	1,322,672	21,998	21,090	793,456
21	83	1,311,409	21,689	0	786,094	1,358,453	23,895	21,090	833,138
22	84	1,311,188	22,456	0	812,264	1,384,432	26,177	21,090	885,508
23	85	1,311,772	23,332	0	838,623	1,413,181	28,958	21,090	940,032
24	86	1,313,275	24,188	0	865,090	1,444,962	32,232	21,090	996,776
25	87	1,315,678	24,953	0	891,556	1,479,912	34,873	21,090	1,055,791
26	88	1,318,883	25,664	0	918,028	1,518,107	36,872	21,090	1,117,252
27	89	1,322,836	26,144	0	944,172	1,559,673	38,660	21,090	1,181,010
28	90	1,327,292	26,799	0	970,971	1,604,564	40,517	21,090	1,248,243
29	91	1,332,436	27,655	0	998,626	1,653,175	42,419	21,090	1,319,365
30	92	1,338,478	28,854	0	1,027,480	1,705,945	44,431	21,090	1,394,946
31	93	1,345,780	30,427	0	1,057,907	1,763,478	46,509	21,090	1,475,605
32	94	1,354,734	32,328	0	1,095,686	1,826,431	48,513	21,090	1,567,383
33	95	1,365,683	34,728	0	1,136,066	1,895,429	50,455	21,090	1,665,813
34	96	1,379,152	37,997	0	1,179,934	1,971,301	52,544	21,090	1,772,083
35	97	1,396,054	41,029	0	1,227,067	2,055,286	55,292	21,090	1,886,299
36	98	1,416,140	43,541	0	1,276,961	2,147,486	59,486	21,090	2,008,308
37	99	1,438,863	47,822	0	1,331,407	2,247,731	66,226	21,090	2,140,276
38	100	1,466,081	54,568	0	1,392,905	2,358,286	76,588	21,090	2,285,111

This policy was already well funded. The premium was paid in full for 19 years and the policy was started with a 1035 Exchange amount.

Some items to note:

1. The dividend paid dropped when the policy premium was suspended (Column 4 vs. Column 8). All else equal, the dividend for a whole life policy will decrease if the policy premium payment is stopped or a policy loan is taken. The divisible surplus is divided amongst all

policies based on their contribution to the surplus, and a fully funded policy is deemed to have contributed more.

2. Since the policy is well funded, the death benefit will still begin to increase when the insured reaches the age of 83 (Column 3) even though the dividend is paying the premium. This is because the dividend ($21,689) at that point is greater than the premium ($21,090), so the balance goes to purchased PUA. However, Column 7 shows the death benefit increasing by a greater amount as the full dividend is used to purchase paid up additions since the policy is fully funded by out of pocket contributions.

3. At age 100 - maturity, the fully funded policy (Option 2) has $892,206 in additional death benefit (Column 7 amount of $2,358,286 minus Column 3 amount of $1,466,081). However, the additional premium paid into the fully funded policy over the nineteen years equals $400,710 (19 years multiplied by Column 9 annual premium amount of $21,090). The increasing death benefit more than keeps pace with inflation and represents an approximate 7.5% return on the additional premium paid. Even without out-of-pocket premiums, the Option 1 policy would have run to maturity, and the death benefit would have grown (Column 3). As trustee, you must decide if the outcome would be more beneficial if out-of-pocket premiums were discontinued. Each case is driven by the specific facts and circumstances, but a decision should be made. A policy should not be funded blindly, there should be a plan and it should be noted in the trust file. Remember the goal is to maximize the benefit to the beneficiaries.

Considering the above example, one could argue that continuing to fund the policy at a 7.5% return is a reasonable return on a fixed product. However, there will be times when it does not make sense to continue funding a cash-rich whole life policy. If the policy cash value is not important then you need to review whether the death benefit can be sustained until maturity without additional out-of-pocket premium payments and whether the additional premium payments increase the death benefit in the policy. We have reviewed mature policies where additional funding did not generate a sufficient additional death benefit to warrant the expense. Each situation will be different and you must review your options, remembering that dividends can, and will, fluctuate.

APL Traps

An underfunded whole life policy must be handled with caution. As mentioned, one of the uses of a dividend is to reduce the out-of-pocket premium. However, if the dividend is insufficient to pay the premium and no other funds are available, the policy can be paid by an automatic premium loan (APL). The APL is a provision in a whole life policy that provides a loan from the policy's cash value to pay the scheduled premium automatically if the premium remains unpaid after the due date. The

loan carries an interest charge, but keeps the policy from lapsing or falling into one of the non-forfeiture options.

There are two traps a trustee can fall into when an APL is used to pay the premium. The first is assuming the policy has one when it does not. Most whole life contracts contain the APL feature, but it might have to be chosen at policy issue, a simple checking of a box in an application. Occasionally, that is not done, and a policy is issued without the APL feature. If a policy does not have the APL feature, it can lapse and go into one of the non-forfeiture options available (see box to the right). As the trustee on the policy, any of the options would more than likely reduce the specified death benefit to the trust, leaving the trustee potentially liable. On all whole life policies, you should confirm the existence of an APL provision as part of the onboarding process.

What are the Non-Forfeiture Options?

Designed to ensure that the policyholder receives some benefit when a policy lapses or is surrendered, the three options are:

1. Cash Surrender–The policy owner receives a check for the cash surrender value of the policy.
2. Reduced Paid-up–The policy cash value purchases a contractually guaranteed paid-up policy at a lesser death benefit than the existing policy, but needing no additional premium payments.
3. Extended Term–The policy cash value purchases a term insurance policy in an amount equal to the original policy's face value, however, for a specified period, typically less than the insured's life expectancy. When the term insurance expires, there is no more death benefit coverage.

While the APL/non-forfeiture trap is an issue that occurs quickly and often without notice, the loan squeeze trap only occurs over an extended period. A loan squeeze occurs when the loan on a policy grows so large it equals or exceeds the cash value of the policy. If this occurs, the policy will lapse, possibly creating a taxable event.

Example of a taxable event as the result of a loan squeeze lapse

Assume a grantor purchased a $1M whole life policy for his ILIT twenty years ago. The fixed annual premium is $25,000. The grantor pays the premium for 7 years, then allows the APL to pay the premium for the next 13 years, at which time the policy experiences a loan squeeze. The trustee, as the policy owner, receives a premium payment notice to avert a policy lapse. If the policy lapses, any gain in the policy is taxable at ordinary income tax rates. An outstanding loan is generally treated as an amount received if a policy is surrendered or lapsed. Gain is defined as amount received from the policy minus the net premium cost. Net premium cost is the total premiums minus any tax-free distributions received. In this case, there would be no surrender value received from the carrier as the loan is greater than the cash value of the policy. When the policy lapses there would be phantom income created because the loan on the policy is forgiven, creating a taxable amount due.

Total Premium Paid: $175,000

Minus Loan Received: $326,251

Taxable Amount: $151,251 (difference between Premium Paid and Loan Received)

Taxes Due (assuming 30% tax rate): $45,375

A policy lapse caused by a loan squeeze can create a taxable event, a real issue in an unfunded trust. Even if you continue to fund a policy with a large loan to avert the lapse, the outcome is not always economically attractive, as can be seen in the case study below.

Case Study: What Would You Do?

SCENARIO: A newly onboarded trust was being readied for a first-time premium payment. The sixty-five-year-old grantor contacted the trust administrator concerning the polices in the trust, four whole life policies with a total death benefit of almost $1.7 million that had been in force for almost 20 years. The grantor was informed by his agent that the policies did not need any additional premium payments. The grantor informed the administrator that no gifts would be made to the trust, stating that "the policies I have are self-sustaining," since his agent told him, "the premium and the interest due can both be paid by values in the contract."

Column 1	Column 2	Column 3	Column 4	Column 5
Year	Age	Annual Required Premium	Cumulative Required Premium	Net Death Benefit
1	65	0	0	1,697,987
2	66	0	0	1,635,750
3	67	0	0	1,584,096
4	68	2,135	2,135	1,535,824
5	69	2,354	4,489	1,489,269
6	70	3,195	7,684	1,442,493
7	71	4,387	12,071	1,395,790
8	72	5,096	17,167	1,349,613
9	73	5,673	22,840	1,302,678
10	74	6,387	29,227	1,253,792
11	75	7,194	36,421	1,222,598
12	76	7,903	44,324	1,194,054
13	77	8,344	52,668	1,163,840
14	78	9,650	62,318	1,132,549
15	79	11,345	73,663	1,099,103
16	80	13,245	86,908	1,063,306
17	81	14,352	101,260	948,873
18	82	16,134	117,394	908,721
19	83	18,745	136,139	866,071
20	84	21,943	158,082	823,289
21	85	23,415	181,497	780,071
22	86	26,340	207,837	734,921
23	87	45,673	253,510	709,430
24	88	49,043	302,553	687,145
25	89	51,285	353,838	663,394
26	90	54,734	408,572	638,607
27	91	58,342	466,914	612,963
28	92	62,135	529,049	584,319
29	93	65,790	594,839	552,938
30	94	67,394	662,233	517,541
31	95	68,930	731,163	475,838
32	96	71,293	802,456	430,912
33	97	73,654	876,110	380,659
34	98	78,403	954,513	329,600
35	99	65,392	1,019,905	274,418

Even as the Cumulative Required Premium increased (Col. 4), the Net Death Benefit (Col. 5) decreased.

REVIEW: The policy analysis above found that if no more out-of-pocket contributions were made to the policies over the next three years, the loans already on the policies would cause a loan squeeze. Contributions would have to be made to the portfolio to pay at least the interest on the loans or the policies would lapse one by one, with each lapse causing a taxable event.

In four more years, a minimal amount would have to be paid to support the policies, but within 10 years the cumulative premium paid would reach almost $30,000 (Column 4) and each year thereafter the amount would grow with a spike occurring at age 87, 23 years out. Since the required payments on the policies would be just enough to keep the policies from lapsing, the trust death benefit would drop as the loan grew. If the grantor lived to age 90, the total net death benefit in the trust was projected to drop to $638,607, even after paying the minimum required cumulative payments of $408,572.

Another alternative for the trust would have been to take paid-up policies in the first year which would not have triggered a taxable event but would have lowered the death benefit in the trust to approximately $600,000. However, the death benefit would have been guaranteed with no more premium payments.

OUTCOME: The future policy lapse and negative taxable event for the trust was discovered before it was too late. But a decision would have to be made. Take the $600,000 death benefit now or continue knowing additional premium would have to be paid?

Blending a Policy with Term Insurance

Whole life policies can be blended with a term insurance component, which lowers the premium cost. As you would expect, there is a trade-off. A blended policy is designed so that the term portion is converted to base insurance coverage over time. The cost of the term portion of the policy will increase as the insured ages. If the term component of the policy is not converted, the death benefit coverage may have to be reduced, or premium costs will increase substantially. If policies are funded poorly, or the term blend is very high, the likelihood of this occurring increases. When dealing with blended policies it is important to look ahead, as these issues tend to come in the later years and you must make grantors aware of any issues well before they arise. If the insured passes away before the problem emerges, there will not be any liability. However, there are times, especially in an underfunded policy on an older insured, where problems will occur. When managing life insurance, you must be able to spot developing issues like this well before they become a problem.

As mentioned, the use of whole life as a TOLI policy has dropped over the years while universal life, especially guaranteed universal life, has gained favor. However, there are still many whole life policies in TOLI portfolios.

For the whole life policies in your portfolio the following are some practices that should be employed:

- When taking in a policy, review the automatic loan (APL) provision to ensure that it is currently in force.
- In those situations, where an APL is used, make sure the policy will not become over-loaned, creating a loan squeeze. It is important to review a policy with a loan annually, keeping the later years in focus as that is when most issues tend to occur.
- For polices with a term component, make sure the policy is adequately funded. This will ensure that the term component is converted over to base whole life, which will alleviate any premium spikes and/or loss of the death benefit in the later years.
- Unless there are reasons (for example, income distributions) for developing significant cash values, it is key to review the policy funding, dividend election, and loan usage, to maximize the internal rate of return on the policy death benefit. While it is important to ensure that the policy will mature and pay the entire death benefit, the premium payment, especially in the later years, may not be necessary to reach policy goals.

CHAPTER 6

The Mechanics of the Universal Life Chassis

- "Probably the most versatile and attractive financial planning instrument ever introduced by a life insurance company" (7).
- "Gives you permanent lifetime protection and tax advantages. A sophisticated product specifically designed to give people with substantial resources the financial protection and flexibility their situation requires. That makes it an ideal financial and estate planning vehicle" (8).
- "If you tried to invent the ideal policy, it might resemble universal life" (8).

The quotes above came from advertisements and magazine articles that heralded the arrival of the universal life concept. While these quotes focused on current assumption universal life, the first universal product, all universal life products operate in essentially the same manner, whether current assumption (CAUL), variable (VUL) or equity indexed (EIUL). If the policy does not have a secondary death benefit guarantee, the policy will run until the cash value in the policy is insufficient to pay the monthly deduction, at which time the policyholder is alerted to make additional contributions. If no contribution is received within an allotted timeframe, usually 60 days, the policy lapses.

Unlike whole life policies, universal life policies are very flexible. The premium paid can fluctuate, and the death benefit provided can be adjusted (death benefit increases will be subject to underwriting approval).

The Transparency of the Universal Life Chassis

Universal life policies are transparent with all costs, as well as investment credits clearly shown. Annual statements for universal life policies break out the costs and investment credits.

The transparency of universal life is also evident in the sales and in force illustrations provided by the carriers projecting possible policy performance. As can be seen in the policy breakout page from an illustration below, the mathematics of a universal life policy is easy to follow. If you take the ending value in year 11, add the premium contributed and interest credited interest in year 12, then subtract out the deductions taken from that year, you will be left with the ending value in year 12.

Sample Current Assumption Universal Life Policy Illustration
Policy Break Out Page

Male - Preferred Nonsmoker Base Face Amount $1,000,000
Based on Current Charges and an Initial Current Rate of 4.55%

Policy Year	EOY Age	Planned Premium	Premium Charge	Issue/ Admin Charge	Insurance Charges	Interest Credited	Policy Value	Surrender Charge	Net Surrender Value	Death Benefit
1	46	10,234	614	2,299	1,653	341	6,008	20,440	0	1,000,000
2	47	10,234	614	2,059	1,643	620	12,547	18,169	0	1,000,000
3	48	10,234	614	2,059	1,632	918	19,394	15,898	3,496	1,000,000
4	49	10,234	614	2,059	1,876	1,224	26,303	13,627	12,676	1,000,000
5	50	10,234	614	2,059	2,127	1,532	33,268	11,356	21,913	1,000,000
6	51	10,234	614	2,059	2,120	1,849	40,558	9,085	31,473	1,000,000
7	52	10,234	614	2,059	2,112	2,181	48,188	6,813	41,374	1,000,000
8	53	10,234	614	2,059	2,103	2,528	56,174	4,542	51,632	1,000,000
9	54	10,234	614	2,059	2,093	2,892	64,534	2,271	62,263	1,000,000
10	55	10,234	614	2,059	2,082	3,273	73,285	0	73,285	1,000,000
11	56	10,234	614	120	3,497	3,927	83,215	0	83,215	1,000,000
12	57	10,234	614	120	3,478	4,409	93,646	0	93,646	1,000,000
13	58	10,234	614	120	3,494	4,914	104,566	0	104,566	1,000,000
14	59	10,234	614	120	3,757	5,437	115,746	0	115,746	1,000,000
15	60	10,234	614	120	4,035	5,972	127,183	0	127,183	1,000,000
16	61	10,234	614	120	4,337	6,519	138,864	0	138,864	1,000,000
17	62	10,234	614	120	4,708	7,076	150,732	0	150,732	1,000,000
18	63	10,234	614	120	5,077	7,641	162,796	0	162,796	1,000,000
19	64	10,234	614	120	5,476	8,216	175,036	0	175,036	1,000,000
20	65	10,234	614	120	5,839	8,800	187,497	0	187,497	1,000,000

The Math of Universal Life

The Net Surrender Value in Policy Year 11	$83,215
Plus the Planned Premium in Policy Year 12	$10,234
Minus the Premium Charge in Policy Year 12	$614
Minus the Issue/Admin Charge in Policy Year 12	$120
Minus the Insurance Charges in Policy Year 12	$3,478
Plus the Interest Credited in Policy Year 12	$4,409
Is equal to the Policy Value in Policy Year 12	$93,646
There are no Surrender Charges in Policy Year 12	$0
So Net Surrender Value in Policy Year 12 is Equal To	$93,646

All universal life policies, whether CAUL, VUL, or EIUL have this transparent operation. The major difference in the three types of policies is in the investment underlying the policy. Current assumption policies are invested in fixed interest rates, variable life policies in separate accounts that include equity investments, and equity index universal returns are driven by the returns of a specified equity index (without dividends).

Once you comprehend several concepts of the universal life chassis, the mechanics of the policies become more logical, and policy management less complicated. The prior cost breakout shows the actual insurance charges (Column 6) - the cost of insurance (COI) that is deducted from the policy each month which represents the pure mortality cost of the policy. In policy year 12, the total annual charges shown are $3,478 - approximately $290 per month is deducted from the policy. It is typical that the COI is the largest cost over the lifetime of the policy, but until policy year 11, the issue and administration charges (Column 5) are greater. This charge represents the "overhead" for the policy, the cost to issue the policy (including underwriting cost, commissions, etc.), as well as ongoing administration. The charges are highest in the early years while the cost to issue the policy is recouped. During these years, a surrender charge (Column 9) will be assessed against the policy value (Column 8.) A policy surrendered in the early years will not return all policy value to the policyholder since the carrier will deduct the surrender charges to recover the policy issue costs. After those costs are recovered, the surrender charges drop off and the full value of the policy will be received upon policy surrender.

The COI charge shown in Column 6 is computed by the carrier, based on the cost of pure death benefit coverage, called net amount at risk. The net amount at risk is the difference between the death benefit that will be paid and the cash value of the policy. Our policy example has a death benefit of $1 million, but when that death benefit is paid, the carrier keeps the cash value. The difference, the net amount at risk, represents the true risk to the carrier. In policy year 19 the death benefit is $1 million (Column 11), the policy value (Column 8) is $175,036, so the net amount at risk is $824,964.

$1 million minus $175,036 *equals* $824,964

The COI charges are deducted monthly, computed on a cost per thousand dollars of net amount at risk. The COI costs shown are based on current charges, but carriers can increase them (see Chapter 11–Why Did the Cost of Insurance Increase in My Policy?). The policy contract will include a table of guaranteed rates showing the maximum cost per thousand dollars of coverage that can be charged.

Net amount at risk is equal to the death benefit that will be paid minus the policy cash value.

The cost per thousand dollars of coverage in a universal life policy increases annually as the insured ages. This charge can be calculated by dividing the annual insurance charges by the net amount at risk and dividing that amount by 1,000 (see example below).

Sample Current Assumption Universal Life Policy Illustration Policy Break Out Page
Male - Preferred Nonsmoker Base Face Amount $1,000,000
Based on Current Charges and an Initial Current Rate of 4.55%

Col 1	Col 2	Col 3	Col 4	Col 5	Col 6	Col 7
Policy Year	Age	Annual Insurance Charges	Policy Value	Death Benefit	Net Amount at Risk	Annual Insurance Charge Per Thousand Dollars of Coverage
1	46	1,653	6,008	1,000,000	993,992	1.663
2	47	1,643	12,547	1,000,000	987,453	1.664
3	48	1,632	19,394	1,000,000	980,606	1.664
4	49	1,876	26,303	1,000,000	973,697	1.927
5	50	2,127	33,268	1,000,000	966,732	2.200
6	51	2,120	40,558	1,000,000	959,442	2.210
7	52	2,112	48,188	1,000,000	951,812	2.219
8	53	2,103	56,174	1,000,000	943,826	2.228
9	54	2,093	64,534	1,000,000	935,466	2.237
10	55	2,082	73,285	1,000,000	926,715	2.247
11	56	3,497	83,215	1,000,000	916,785	3.814
12	57	3,478	93,646	1,000,000	906,354	3.837
13	58	3,494	104,566	1,000,000	895,434	3.902
14	59	3,757	115,746	1,000,000	884,254	4.249
15	60	4,035	127,183	1,000,000	872,817	4.623
16	61	4,337	138,864	1,000,000	861,136	5.036
17	62	4,708	150,732	1,000,000	849,268	5.544
18	63	5,077	162,796	1,000,000	837,204	6.064
19	64	5,476	175,036	1,000,000	824,964	6.638
20	65	5,839	187,497	1,000,000	812,503	7.186

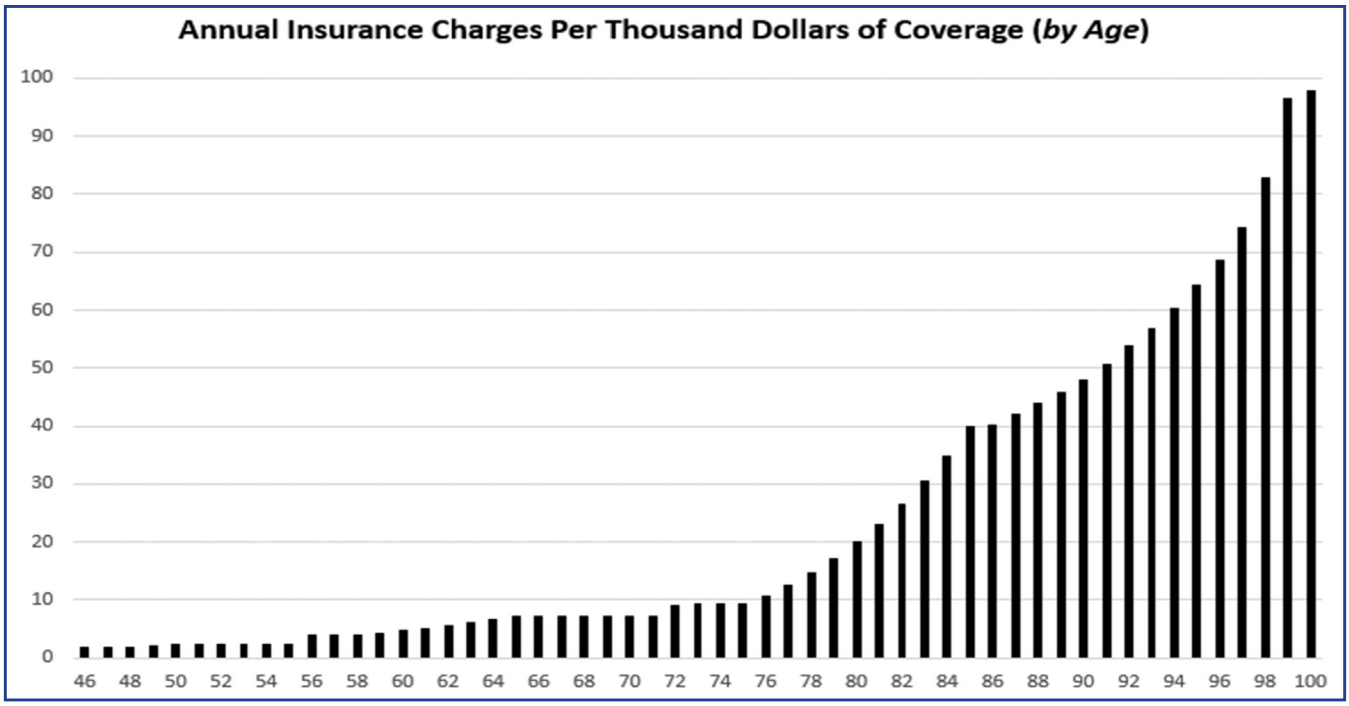
NOTES:

1.) The Net Amount at Risk (Column 6) is computed by subtracting the Policy Value (Column 4) from the Death Benefit (Column 7).

2.) The Annual Insurance Charge Per Thousand Dollars of Coverage represents the true mortality costs in the policy and is found by dividing the Annual Insurance Charge (Column 3) by the Net Amount at Risk (Col. 6) and then dividing that result by 1,000.

The cost per thousand dollars of coverage grows from $1.66 per thousand dollars to $7.18 per thousand dollars, an increase of 332% over 20 years, as the insured ages

As can be seen in the prior prior spreadsheet, the annual charges per thousand dollars of coverage increases by just over 330% over the first 20 years of the policy, from ages 45-65. The following chart shows the current annual COI charges for this policy through age 100.



The cost of insurance increase in the policy slopes slowly upward until about age 75, at which point the cost begins to increase significantly. While each universal life policy will differ in exact costs, the general slope will be consistent.

The TOLI trustee must be aware of the effect on the policy of the increased costs in the later years, especially in policies that are lightly funded with a cash value that drops as the insured ages. Remember that the net amount at risk increases as cash value drops. Too often, TOLI trustees allow the policy cash value to dissipate and are then faced with the proverbial double-edged sword of rising costs per thousand dollars of coverage and higher net amount at risk. In our sample policy, in policy year 40, when the insured is 85, the annual charge per thousand dollars of coverage is $34.90, but the actual cost of insurance charged in the policy will depend on the cash value in the policy.

Col 1	Col 2	Col 3	Col 4	Col 5
Assuming Death Benefit Paid Is:	And Cash Value Is:	The Net Amount at Risk Is:	Assuming the Annual Insurance Charges per Thousand Dollars of Coverage Are:	The Annual Insurance Charge In Policy Is:
1,000,000	750,000	250,000	$34.90	$8,725
	350,000	650,000		$22,685
	1,000	999,000		$34,865

Even though the charge per thousand dollars of coverage is the same in the three scenarios shown above, the actual cost will be significantly higher if the cash value in the policy is lower. This policy had an annual premium of $10,234, yet if policy cash value drops near zero, the annual cost required to keep the policy in force for another year approaches $35,000 and continues to grow each year. I

have spoken to grantors that simply cannot understand how the cost of the policy could be more than the premium they had paid in the past. This issue is important, because as a society we are aging, and your TOLI portfolios are too. Ten years ago, less than 15% of the insureds in our portfolio were above age 80, today that number is above 25% (2).

What Happens at Age 100?

There are 72,000 Americans over the age of 100, and that number is expected to grow eightfold in the next thirty-five years (9). While the chances of a grantor living to age 100 are slight (the 72,000 number represents only 2.2 persons per 10,000), it does occur. The insurance industry has acknowledged this, and policies today are issued with maturity ages of 120 and beyond. But what happens with an older policy that matures at age 100? Unfortunately, often not what you (and your clients) may expect.

Older universal life policies that mature at age 100 typically mature for the cash value only, which can create two major issues. First, if the policy contract matures for the cash value, not the death benefit, the proceeds could be subject to taxation, just as if the policy were surrendered for its cash value. The amount received over cost basis would be subject to income, not capital gains, tax rates.

The second, and more common occurrence, is that the policy matures with minimal cash value. There is an old adage with life insurance, "I want to die with a dollar of cash value in my policy." Unfortunately, for some who live to maturity, a dollar is about all they get.

Some older policies include a maturity extension rider that pushes the death benefit out past maturity should the insured still be alive. Some of these were put on after policy issue, when it was clear that insureds were outliving coverage, ultimately creating an issue. The maturity extension can be for the total death benefit, but is more often for the cash value amount only. This deals with any tax issues that may occur, but for those policies that do not endow (cash value equals death benefit at maturity), the trust can be left with a much lower value. It is a hard to explain to a beneficiary why they gave up taking hundreds of thousands of dollars by forgoing their Crummey rights and only received a fraction of the amount. It is important as your grantors reach age 85 and beyond that you alert them (and especially the beneficiaries) to that possibility. Below is a situation that we encountered which makes a great case study as it illustrates the importance of communication.

Case Study: Current assumption universal life (CAUL) policy with a death benefit of $2 million issued 16 years prior to our first review of the policy. The policy had an anniversary date in December. We placed the policy in our remediation triage because of the advanced age of the insured, who was 97 when we took over the policy.

August, Year 1: Our policy review showed that just over $1.5 million had been paid to date on the policy. The grantor was no longer funding the policy. We alerted the grantor that the policy would

lapse within two years without additional funding. The grantor was turning 98 in February of the second year.

March, Year 2: We alerted the beneficiary to the condition of the policy. A conversation over the phone took place, and a letter was sent to re-iterate the condition of the policy and the fact that should the policy reach maturity, cash value, not the death benefit, would be received by the trust. We provided the beneficiary with a short presentation explaining the mechanics of a CAUL policy. The health of the grantor was stable, even improving, per the beneficiary. She had had lingering ailments in the past, but had "come out of them." Without additional premium payments, the policy would last until February of the following year. We provided premium payment options to the beneficiary in case gifts were to be made to the trust to pay the premium, but gifts would not be made. We documented with all parties that we would be tracking the policy and would report back.

Throughout Year 2: There were documented email conversations with the beneficiary. We were updated on the health of the grantor and provided cash value updates on the policy. The grantor's health remained stable.

February, Year 3: The grantor turned 99. As expected the policy went into lapse mode with a negative cash value of just over $6,000 once the monthly charges were subtracted. After reviewing in force illustrations, we provided payment options and alerted the beneficiary and grantor to the fact that a major cost increase would occur at the next anniversary date. While we did not know the exact amount, we knew it would be substantial–approximately 6-7 times greater than current monthly costs. Enough funds were gifted to the trust to fund the policy through January of the following year. The current monthly charges on the policy were approximately $6,200, but would increase on the policy anniversary date.

December, Year 3: The policy anniversary date arrived, and the charges on the policy jumped dramatically as we had expected. The charges increased from the $6,200 amount to over $40,000 per month.

January, Year 4: The carrier provided us with a lump sum premium payment option to fund the policy to maturity - approximately $400,000. Maturity in this policy was the anniversary date following the insureds 100th birthday - December of that year. We computed and provided the beneficiary with the cost to carry the policy to maturity, if the policy was paid monthly, assuming minimal cash value at maturity.

February, Year 4: Insured turns 100. We knew the cash value would turn negative that month, so we contacted the carrier. We discovered a lapse notice would be generated, and that the policy would lapse in approximately two months if no funds were received. The grantor's health had deteriorated.

March, Year 4: Gifts were made to the trust to minimally fund the policy on a month to month basis, keeping the policy from going into lapse mode, but nothing more. Approximately $40,000 was sent monthly to the carrier with receipt confirmed.

July, Year 4: Insured passes away. Trust receives full $2 million death benefit.

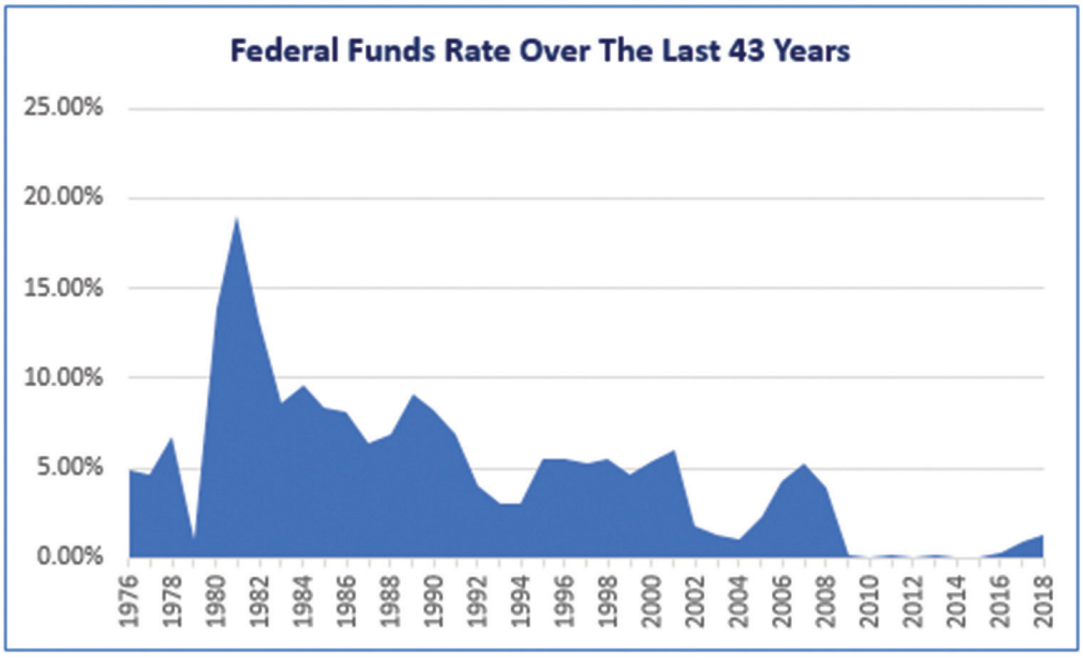
In the case study above the trust paid approximately $1.8M for $2 million of death benefit, not a significant return. But life insurance typically does not generate a high return if the insured lives to 100. It is important, as the population of your TOLI portfolio ages, that the beneficiaries receive the maximum value possible for the asset in the trust. In this case, if the insured had lived a few more months there would have been little returned to the trust since the cash value at maturity would have been negligible, but the decision was made to fund the policy, and it turned out to be a beneficial decision. While you, as trustee, cannot control the outcome, you must develop and document a prudent process to make the decisions around a policy, and you must communicate your decisions to all pertinent parties. In this case, we began reviewing the policy as soon as we received it, and immediately explained the policy and outcome at maturity. By then the grantor was 97. For policies that may pay less than full benefit at maturity, a notification should be sent as soon as possible, and at least by the time the insured turns 85.

Once understood, the mechanics of a universal life chassis are logical. That does not mean that these policies are easy to manage, since each policy type has its own special characteristics and challenges. The following chapters on specific universal life policy types will provide additional, helpful insight.

CHAPTER 7

Current Assumption Universal Life–A Closer Look

The early eighties were an unprecedented time in American economic history. Throughout the seventies, the economy was sour with soaring oil prices, gas lines and stagflation–a combination of inflation and stagnant economic growth. The misery index–a measure of economic health which added inflation and unemployment rates together–registered 21 in 1980. While unemployment was an issue, it was the sky-high inflation that took precedence. According to a recap of the Federal Reserve Board and Federal Open Market Committee of December 18-19, 1980, "the need to deal with the deep-seated problem of inflation was emphasized" (10). To squash it, the Federal Reserve substantially increased interest rates. The Federal Funds rate in January of 1981 when Ronald Reagan took office had soared to 19.08%, a rate never seen before, nor since. The high interest rates had a tremendous negative effect on the economy as auto and housing sales dropped and led to a recession shortly thereafter that lasted from July of 1981 until November of 1982.



The high interest rates that made home mortgages and car loans so expensive (see following Cost of a $250,000 30 Year Mortgage example) were a boon for savers as bank rates, even short term, skyrocketed. The financial industry took notice and created the money market account where even idle money could generate high returns. Stodgy whole life policies with their long-term bond investments that may have been tried and true in past years, looked less attractive as rates climbed and many people surrendered those policies to invest the cash in the expanding financial services industry. The life insurance industry responded and developed a new product to capture these dollars. The product, current assumption universal life (CAUL), was first introduced in 1979 by Life Insurance Company of California, which later became E.F. Hutton Life (11). A popular magazine of the day touted the value of the new policy type. "Life insurance . . . is regarded as a bad deal during inflationary times," but universal life is a "solution for inflation" (12). Described as "something between whole life and the other basic life policy form, term," universal life was so revolutionary that the IRS issued private letter rulings dealing with its taxation (11).

Cost of a $250,000 30 Year Mortgage		
Year	Interest Rate	Monthly Principal and Interest (P&I)
1981	18.00%	$3,768
2018	4.15%	$1,215

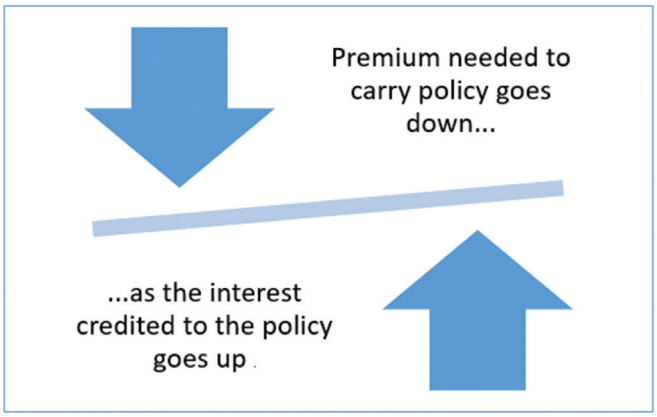
Policy Transparency and Flexibility

Besides capturing the high interest rates of the day, CAUL provided a transparency and flexibility in product design that was missing in whole life. The policy separated out the cash value from the pure mortality or death benefit, and for the first time the consumer could see where every dollar in the policy went per easy-to-read statements provided by the carrier.

The flexibility was a leading sales feature. You could pay as much or as little as you wanted, subject to certain initial minimum premium, and you could pay when you wanted. You could reduce or increase (with underwriting approval) the amount of the death benefit provided, so the need for additional policies was lessened, and rather than just taking a loan against policy values, as with whole life, you could withdrawal money directly from the contract. With your increasing needs, your life insurance policy could now adapt and grow. As your needs changed, the policy could change with you, because you could "determine the most advantageous way to fund protection and long-term savings needs," and "easily switch to an emphasis on the savings element," using your cash value build up to "cover the current costs of pure protection, meet planned or emergency financial needs," or "provide retirement income." The policy transparency was also a big selling point as this new policy could depict how "cash values are determined month by month," with an annual report "showing all transactions over the previous months" (8). However, the biggest selling advantage was the rate

currently being credited to the policy, and for a current assumption universal life policy advertised in November of 1981, that crediting rate was 12% (13).

The high credited interest rate projected in CAUL sales illustrations made the policies very attractive. The higher the investment return credited to a universal life policy, the lower the premium needed to carry the policy. There are two reasons for this. The more obvious reason is that a universal life policy (without a secondary death benefit guarantee) lapses when cash value is insufficient to pay the next month's deductions and a higher return will generate a higher cash value which will allow the policy to persist longer. The second reason, not so obvious, deals with the net amount at risk - the difference between the death benefit provided and the policy cash value. Since the carrier keeps the cash value when a death benefit is paid (assuming a level death benefit policy), the cost of insurance (COI) that is deducted from the policy each month is not based on the full death benefit, but the net amount at risk and that cost will be lower as the cash value increases. The high interest rates projected higher cash values, which lowered the COI cost charged. The projected sales illustrations shown in the early '80s were attractive. The premium needed to carry the policy was very low and the up to 12% crediting rate being shown generated substantial cash value, creating the illusion of an efficient savings vehicle. However, the rates being credited were an economic aberration, and sales illustrations showing that abnormality projected over the lifetime of the insured created expectations that could not be fulfilled.



Industry actuaries of that era were aware of the interest rate risks noting that "any actuary . . . must consider the risk of loss from changes in prevailing interest rates . . . immediately apparent in Universal Life contracts" (11).

Consumers were attracted to this new policy, and in the early '80s sales of the product jumped dramatically from 2% in 1981 to 25% just two years later. This was a result of buyers purchasing policies as much for their upside investment potential as the death benefit protection provided. A 1985 New York Times article pointed out how the wedding of the "traditional benefits" of "low interest loans and tax-deferred income" combined with the "possibility of a high return" created an "enticing package" for the public that was now choosing from a broader selection of financial opportunities in the market (14).

Credited Interest Rates For A CAUL Policy							
1984	11.50%	**1993**	7.50%	**2002**	5.85%	**2011**	4.25%
1985	11.25%	**1994**	7.00%	**2003**	5.50%	**2012**	4.00%
1986	11.00%	**1995**	6.26%	**2004**	5.00%	**2013**	4.00%
1987	10.00%	**1996**	6.15%	**2005**	4.85%	**2014**	4.00%
1988	9.00%	**1997**	6.00%	**2006**	4.76%	**2015**	4.00%
1989	8.25%	**1998**	6.00%	**2007**	4.35%	**2016**	4.00%
1990	8.25%	**1999**	6.00%	**2008**	4.25%	**2017**	4.00%
1991	8.45%	**2000**	6.00%	**2009**	4.25%	**2018**	4.00%
1992	8.25%	**2001**	6.00%	**2010**	4.25%		

The sales illustration for a CAUL policy shows the outcome based on the current costs and crediting rate at that time projected over the lifetime of the insured. The birth and rapid growth of CAUL coincided with the use of computers in the life insurance sales process. Often, rather than explaining the mechanics of a policy, the salesperson would simply wow the consumer with the numbers generated by high crediting rates. Life insurance sales illustrations also showed the outcome under the guaranteed assumptions (guaranteed crediting rate and costs), but eyes were too often drawn to the much more compelling, but unobtainable, high cash values and/or low premium based on the unrealistic current assumptions.

Premium needs drop as interest credited rises and the reverse is also true, and as the credited rates on these CAUL polices slowly dropped, the premiums needed to keep them in force until maturity rose. However, most policies were not monitored, the premium paid was not increased, and the cash value dissipated. In addition, unlike term or whole life policies with fixed premiums, these policies had flexible premiums and many were not funded as originally intended.

The credited rates shown above are for a policy that was issued in the mid-1980s. The current crediting rate on the policy is 4% which is also the guaranteed rate on the policy. Just as all universal life policies have a guaranteed cost of insurance specified in the contract, a CAUL policy will have a contractually guaranteed crediting rate–the lowest rate the carrier can credit to the policy. For older policies, this can be as high as 5.5-6% and as we will see, this "high" guaranteed rate is considered by some to be one of the reasons we have seen COI increase in these policies (for more information see Chapter 11–Why Did the Cost of Insurance Increase in My Policy?). Current CAUL policies have much lower guaranteed crediting rates, most in the order of 2-3% with current crediting rates in the 3-4% range.

Current assumption universal life policies were considered less costly than whole life policies when introduced, but they came with few guarantees. For example, some policies came with a limited death benefit guarantee for a specified period (if the required premium was paid), but the suggested or target premium, even if paid in all years, did not guarantee coverage to maturity.

The management of a CAUL policy will depend on the year of policy issue. Older policies that were issued with a current crediting rate substantially higher than those being paid today will be underfunded if the premium paid has not increased over the years. Some older policies have been hit with significant cost of insurance increases which make them economical inefficient, as we will see in a later chapter. Older policies were sold with unrealistic expectations and grantors need to be made aware of the true costs of holding the policy to maturity.

Newer policies–those issued in the last decade - were issued with more reasonable expectations and the funding of these policies, more than likely, will not have to be altered as much to reach original projected goals.

Just as with dividend rates in whole life policies, the crediting rates in CAUL policies will not rise as quickly as interest rates in general. This is a result of the carrier's legacy investments moderating interest rate gains.

For CAUL policies in your portfolio the following are some practices that should be employed:

- When accepting a policy, review the current funding and outcome and make sure that the grantor's funding commitment to carry the policy to maturity is documented.

- As we mentioned in our last chapter, the cost of insurance in universal life policies increases as the insured ages. It is important to monitor policy cash values, especially in the later years as the combination of low cash value (high net amount at risk) and increased COI can make a policy cost prohibitive if cash value can dissipate.

- Watch for unexpected COI increases. As soon as a COI increase is announced, review the affected policies and options. We will be reviewing the reasons for COI increases and the steps you should take should one occur in later chapters.

The flexibility and transparency of the CAUL policy allows TOLI trustees to manage the policy efficiently, even with changing trust goals, a true advantage since the primary responsibility of the trustee is maximizing the benefit of the policy even when trust goals change.

CHAPTER 8

Guaranteed Universal Life–A Closer Look

One of the weaknesses of the universal life chassis product (current assumption, variable, equity index) is their lack of guarantees. Whole life policies have guarantees and even though dividend rates may fall, a whole life policy is guaranteed to pay a death benefit if the (admittedly high) premium is paid each year.

The performance of universal life chassis policies is dependent on an investment return that may or not achieve the expected results. As we have mentioned, a high crediting rate on the policy cash value can lower the needed premium to carry a policy to maturity or to some point in the future. However, the opposite is also true, and a lower than expected return will mean additional premium payments will have to be contributed to the policy or the policy will lapse.

This often occurred for consumers who purchased universal life policies in the early 1980s when fixed investments backing the policies were at historic highs. The rates of return obtained in the investments backing the policies often did not live up to the assumptions used in the sales illustrations.

Guaranteed Universal Life (GUL) or Secondary Guarantee Universal Life was the answer carriers provided for consumers wanting to take market risk out of the purchase of life insurance. Developed in the 1990s, the policies provided a guaranteed death benefit for a premium cost that was known and definitive.

Cumulative Premium Model

The methodology for guaranteed universal life policies can be simple or complex. A simple policy structure is the cumulative premium model. In its basic design, a set annual premium is determined. If at any time, the cumulative premium is equal to or greater than the number of policy years multiplied by the annual premium, the death benefit is guaranteed. Many early policies were designed this way. It allowed the policyholder the opportunity to catch up a premium payment to restore a full death

benefit guarantee going forward. Many carriers assigned an interest rate to the catch-up premium, while some catch up provisions were interest free. A simple example is shown below.

Example of a GUL Policy Catch Up Provision

Some years ago, we onboarded a two-year-old GUL policy that was purchased assuming a 1035 Exchange from another policy, plus a stated premium of $31,095 annually. When we ran an initial illustration assuming the stated premium going forward, the premium was insufficient to carry the policy to age 100 and beyond as had been shown in the as sold illustration. In fact, the policy was shown to lapse well before age 100. The 1035 Exchange amount had been paid into the policy, but the stated $31,095 annual premium was also assumed to be paid in the first year. It was not. While the death benefit guarantee period was dramatically reduced to below life expectancy, the remedy was quite simple (and inexpensive). Illustrations were received from the carrier to show the premium payments needed going forward to reinstate the guarantee to age 121. The options were:

- Pay an additional amount of $32,600 as soon as possible, then $31,095 starting in year 3 until age 121

  or

- Pay $32,460 starting in year 3 until age 121.

The original stated premium was simply increased by an interest rate factor. While the remedy was simple, it should be noted that missing the first years of the stated premium had a dramatic effect on the policy's guarantees.

The Shadow Account Model

A shadow account is a second calculation kept by the carrier separate from the cash value account. It is used only to determine if the policy death benefit guarantee is still intact. The values in the shadow account cannot be accessed by the policyholder, and in fact, the values are unknown to the policyholder.

When a premium is paid, the shadow account operates just like a traditional cash value account as expense loads and cost of insurance are deducted and interest is credited to determine the shadow account value. If the shadow account value remains positive, even if the cash value goes to zero, the policy guarantee is in effect.

Shadow account products can have catch-up premiums that are often much more onerous than the cumulative premium method. The design of these policies will vary from carrier to carrier, but if an underfunded policy can get off track the cost to get back on track can be considerable.

Carrier Advantages

With GUL policies, the policyholder will have a pre-determined premium that must be paid in full and on-time to keep the policy death benefit in force. The required premium is advantageous for the carrier as it creates a known and predictable cash flow not available on flexible premium products. The steady cash flow supports investment strategies that can potentially increase the underlying yields in the carriers general account.

Another advantage for the carrier is low cash values. GUL policies do not develop significant cash values, in fact, policy cash value often drops to zero, even when the policy retains its death benefit guarantees. The low cash value helps retain policies as there is limited cash value to jumpstart a new policy with a 1035 exchange. When a policy is surrendered there is little cash value going back to the policyholder, another plus for the carrier.

Policyholder Advantages

Relieving the policyholder of any market risk is the major advantage of GUL policies. In the past, policy performance has been outside the control of the policy owner. Even with VUL policies where the policy owner controls the investment choices, they do not control the outcome. With GUL they can, if they pay the premium in full and on time.

Policyholder Disadvantages

Premium inflexibility is a major policyholder disadvantage. When taking in a GUL policy you must be sure that the grantor will be able to fund the policy each year. Though there are short pay funding strategies that can limit the number of years of premium payments (with higher annual premiums), most policy funding strategies assume grantors will be funding their policy for the rest of their life. Will they have the cash flow? Even in their retirement years? While you can adjust the death benefit down to a lower premium, if the entire death benefit is needed, annual gifting will have to continue for the full required premium throughout the insured's lifetime.

The timing of premiums is important. A late premium–even an early premium in some cases–can compromise the death benefit. And apparently it has happened, as can be seen in the following example.

According to an industry expert (15) a major carrier that had been in the GUL business for less than 4 years performed an audit of all issued GUL policies. They found in the short time since policy issue, 31% of the policies were already off track and the primary culprits were early payment (53%), skipped premium (29%) and insufficient payment (8%). We have already spoken about the negative effect of partial or insufficient premium payment, but we have not touched on early premium payment, an issue that comes up because of the different load structures year to year in a policy. If you pay the policy premium early, the premium can be credited to the prior year when the loads on the policy (which tend to decline over the years) are higher. The fact that in less than 4 years almost a third of the policies issued no longer had the full death benefit guarantees should give pause to a trustee administering these policies.

GUL has been called term insurance for life, with good reason, as the policy is premium, not cash value driven and provides a guaranteed death benefit to the policyholder for a specific period, for a stated premium. The cash value in most GUL policies, even if funded fully, will eventually be minimal or even drop to zero, another characteristic of term insurance.

The minimal cash value makes these policies very inflexible, especially in the later years. Without an infusion of cash from the existing policy, the chances to upgrade a client's policy to a newer, more efficient policy is decreased. And the options for an unwanted policy are diminished when cash value is minimal, as a policy surrender will yield a meager amount–rarely enough to recover the premium paid. The only options for a policy that will not be funded going forward may be a reduction of the death benefit or sale in the life settlement market.

The use of GUL policies in a trust setting has grown over the last decade or so as clients, disappointed with the market returns in both fixed and variable policies, looked for a guaranteed death benefit free from market risk. While the low cash values of these polices may not be a concern in a TOLI policy focused on maximizing the rate of return on the death benefit, it should be mentioned in documentation in the file.

The use of a GUL policy should always be accompanied with documentation that alerts the grantor to required funding and limited policy options, especially in older policies.

The use of a GUL policy brings significant guarantees to a trust, but also limits any market upside that can occur because of rising interest rates or greater than expected equity returns.

For GUL policies in your portfolio the following are some practices that should be employed:

- When accepting a policy, review the required funding to the trust and ensure the grantor is committed to fund the trust accordingly. Review short pay options, if appropriate for the clients' situation.

- Track the policy on an annual basis for premium funding, obtaining in force ledgers to confirm policy death benefit is still on track.

- Remedy any shortfalls in funding that affect the policy death benefit guarantee as soon as possible.

While the use of a GUL policy in a TOLI trust eliminates market risk, it greatly increases administrative risk for the trustee. These policies should be handled with care.

CHAPTER 9

Variable Universal Life - A Closer Look

"Stocks have averaged a 10.2% return over the last 90 years" (16).

"Over the long term, the stock market news will be good. In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a fly epidemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497" (17).

The introduction of current assumption universal life insurance in 1979 was a revolution for the industry. The universal life chassis, with its flexibility and transparency, provided a potentially less expensive product for the masses, with upside cash value potential. In the early 1980s, the high fixed investment returns resulted in crediting rates of up to 12% in sales illustrations for current assumption universal life policies. However, these returns were an aberration as fixed returns are historically much lower. But equity investments have surpassed fixed vehicles. One hundred dollars invested in 10-year Treasury Bonds in 1928 would have grown to just over $7,000 in 2016, but that same amount invested in the S&P 500® would have grown to over $328,000 (18). This equity advantage was well known to investors in the market in the mid-1980s when variable universal life (VUL) was introduced.

Although VUL policies were not available until the 1980s, the concept of variable life had been introduced by Equitable Life Assurance Society in 1976 (19). However, this policy was strapped to a whole life chassis, and though it had the potential to outperform a traditional fixed whole life product, it was not until the equity investment concept was combined with the flexibility of a universal life chassis that the concept gained favor. The variable life chassis was a fixed premium product, and the universal chassis design allowed policyholders to minimally fund the policy for potentially low cost permanent insurance coverage, or overfund the policy to maximize the investment potential of the policy. Additionally, the policyholder could adjust the death benefit (an increase required underwriting approval) and take withdrawals from the policy, creating a tax efficient investment vehicle.

When Pruco, a subsidiary of the Prudential Life Insurance Company of America, introduced the first VUL policy in 1985, the equity market was booming with double digit S&P 500®returns in 3 out of the 4 prior years, strong returns the year of introduction and no losing year until 1990 when the S&P was down just over 3%, followed by a decade of positive returns. No wonder VUL was a marketing homerun.

S&P 500 Annual Returns							
1982	21.55%	**1987**	5.25%	**1992**	7.62%	**1997**	33.26%
1983	22.56%	**1988**	16.61%	**1993**	10.08%	**1998**	28.58%
1984	6.27%	**1989**	31.69%	**1994**	1.32%	**1999**	21.04%
1985	31.73%	**1990**	-3.11%	**1995**	37.58%		
1986	18.67%	**1991**	30.47%	**1996**	22.96%		

VULs greatest departure from prior policies was not just policy flexibility and the ability to invest in the equity markets, but the opportunity for the policyholder, rather than the carrier, to direct the cash value investments. Along with this opportunity came responsibility, and trustees that mismanage a VUL policy's asset allocation open themselves up to potential liability. For example, we have provided initial reviews for VUL policies with cash value allocated 100% in the Money Market account paying less than 1%. How does that happen? At policy issue the Money Market account is noted as the investment option with the understanding that the asset allocation will be reviewed in the future once the policy is issued–and it simply is not done. Luckily, this is rare, but it does happen.

The cash value in a VUL policy is invested in separate accounts, which are essentially mutual fund clones, often from well-known mutual fund families like American Funds, Fidelity or T. Rowe Price. The separate account selection often numbers 30 or more funds and typically includes a diversified group of asset classes. Fund selection from a well-known carrier, which is typical of the separate account variety available, is listed below. The generic fund names are provided to show the variety of fund types. No fund company names are provided, but all funds are linked to well-known fund families.

Large Cap

- Large Cap Value
- Domestic Equity
- Equity Income
- Large Cap Blend
- Index 500
- Large Cap Core Stock
- Socially Responsive

- Multi Style Equity
- Growth Stock
- Focused Appreciation

Mid Cap

- Mid Cap Value
- Index 400 Stock
- Mid Cap Growth

Small Cap

- Small Cap Value
- Index 600 Stock
- Aggressive Equity
- Small Cap Growth Stock

Asset Allocation Funds

- Fund allocations based on investment temperament

International

- International Equity
- Emerging Markets Equity
- Non-United State Equity
- International Growth

Fixed Income

- Money Market Account
- Short Term Bond
- Core Bond
- Inflation Protection Fund
- Lon-Term US Government Bond
- Multi-Sector Bond
- High Yield Bond

Fixed Account

- A fixed return account paying a current return, and providing a minimal guaranteed return.

Real Estate

- Global Real Estate Securities

Commodities

- Commodities Total Return

Like a current assumption universal life policy, the charges within a VUL policy are easily determined in the annual statement or the cost report page of a hypothetical illustration. These include a premium sales charge or loan deducted from the premium before it is applied to the policy, which compensates the carrier for sales expenses, including any taxes that might be applied to the policy. Also included is an administrative charge, which reimburses the carrier for maintaining the policy, including accounting and record keeping, along with the cost of insurance (COI), the actual mortality charges based on the insured's age, gender, and health, and death benefit amount. The COI charges will be the largest expense over the life of the policy. A VUL policy will also include a charge for mortality and expenses (M&E), which compensates the carrier should the insured not live to the assumed age at underwriting. There are also fees taken at the fund level - fund management fees for the investment expenses of the separate accounts themselves. Each fund will have its own management expense structure fee stated as a percentage of assets. The M&E and fund expense fees will reduce the gross returns in the separate account.

It is important to note that this is a general outline of fees. Each carrier may calculate fees differently. Variable life insurance policies are securities under federal law, subject to the regulation of the Securities and Exchange Commission (SEC). They are sold with a prospectus, a mind-numbing document that spells out all policy fees in detail. An agent or broker selling a VUL policy must be licensed both as securities broker and insurance agent. Since it is a security, the policy must be considered suitable for the situation, but suitability is typically a low bar. Nevertheless, when purchasing a VUL policy in a TOLI trust, the trustee should make sure that the grantor is aware of the risks that accompany a VUL policy.

The major risk in a VUL policy is that unlike a fixed life insurance policy, a VUL policy can lose money as the underlying cash value in the policy can experience a negative return. Each month separate account shares are sold to pay the underlying costs associated with the policy which creates a double-edged sword in a down market since a greater number of shares will have to be sold to pay expenses as the market drops.

The asset allocation on a VUL policy is a responsibility of the trustee. While this book is not an investment manual, and we are not giving investment advice, we would be remiss if we did not provide some tips for managing this asset.

First, view life insurance illustrations as little more than a guide. In general, illustrations can be very deceiving unless you truly understand the underlying assumptions and all available pages, including cost breakouts. The illustration is not the contract and illustration manipulation can make policy performance appear better than it will be. Also, the illustration assumes a straight-line return–an illustration showing an 8% return assumes a level 8% return each year, which simply does not occur.

Second, you should match your illustration return to your expected allocation return. If your separate account asset allocation is intended to provide an 8% return, then your illustration should reflect

that. It is also important to obtain an illustration for a lesser return. If you project an 8% return, get an illustration that shows both 8% and 6% so you become aware of the downside should your returns be less than expected.

Third, asset allocation is an important part of investing. A Charles Schwab White Paper pointed out that:

- $100 invested in US large-company stocks (as represented by the S&P 500® Index) at the beginning of 1971 would have grown to $8,642 by the end of 2015.

- $100 invested in gold (as measured by the London Gold PM Fixing) would have grown to $2,836 over the same period.

But if that $100 had been invested in a 50-50 split of both investments, the portfolio would have grown to $8,692 over the same span. This return is more than either the stock or gold portfolio alone, and demonstrates lower average risk (20). The paper points out that this will not occur in all time periods, but in most it "dramatically reduced risk in the combined portfolio relative to the two asset classes individually. While stocks and gold are both deemed relatively risky investments, combining them helps mitigate the risk of the portfolio. This is due to their relatively low correlation to one another." The report goes on to acknowledge that since the 2008 financial crisis, some have pointed out there are "higher correlations between asset classes during periods of market stress," negating the advantage of diversification when it is needed most, but even in times of market pressure, "diversification makes sense as long as assets don't move in perfect lockstep."

Fourth, temper the expectations of the grantor. There are many experts that feel that going forward, we will not achieve the 10% equity returns we have seen in the past, and a more realistic estimate for stock returns would be 7%. Warren Buffet believes that returns of 6% to 7% in the stock market should be expected going forward (21). As trustee, you (and your investment counsel) will have to determine the asset allocation and return expectations for the policy.

Fifth, keep a steady hand. According to a Dalbar Inc. study, for the twenty years ending December 31, 2015, the S&P 500® Index averaged 8.19% a year, but the average equity fund investor earned a market return of only 4.67% (22). Why is this? According to Dalbar, "investor behavior is the number one cause." Overreaction causes bad financial decisions, whether you are responding to good or bad news. When the market drops investors tend to take their money out of the market, when the news is good and the market goes up, money returns. One tip–see if the policy allows you to take the monthly fees from the Fixed Account and each year place into the Fixed Account an amount sufficient to cover those costs. That way, if the market drops you will not be selling separate account shares low to pay monthly expenses (by taking the money out of the market you will also miss any gains, but it is still a prudent step).

The number two cause according to Dalbar? Fees. VUL policies, though they can provide efficient life insurance coverage if managed well, have those annual M&E expenses in addition to fund charges, which push down the net returns on a policy.

As with any other investment approach, a VUL asset allocation may need to change over time. For example, though the Fixed Account may not be a prudent allocation for younger insureds, it can be a viable option for well-funded policies on older individuals. We have come across VUL policies paying a guaranteed 4% net return in the Fixed Account which allowed the policy to run to maturity at current costs. In that case, a prudent decision might be for the trustee to "take the money off the table" for a policy on an older insured, since the recovery time for a market correction is shortened.

Typically, once an allocation is decided upon, we do not see trustees changing the allocations often, though they may be reviewed and re-affirmed annually. More often, a VUL policy allocation is determined when the policy is accepted with an investment professional or trustee committee overseeing the allocation. Historic returns for the separate accounts are available so your investment team can monitor their performance. Carriers actively review fund managers, replacing poorly performing funds periodically. The asset allocation process should be an active part of your TOLI administration process overseen by staff well-versed in investment strategies. Like any other aspect of policy management, asset allocation is a trustee decision, and though grantors and beneficiaries can be made aware of investment decisions, they should not unduly influence them.

The management of a VUL policy is not much different than any other universal chassis policy, the key difference being the additional investment responsibilities. Like all universal life policies, the higher the investment return, the lower the premium. The VUL policy has the greatest upside investment potential of all universal chassis products.

For VUL policies in your portfolio, the following are some practices that should be employed:

- Review your fee structure for ILITs containing VUL policies. Some trustees add a surcharge for the additional work required for these policies.

- When accepting a policy, review the expected rate of return assumed in the sales illustration (illustrations can show gross returns as high as 12%) and determine whether the rate of return is reasonable considering the trust and grantor risk profile. In general, if the allocation needed to generate a 6% return is outside the risk parameter of the trust, a CAUL or other fixed policy should be considered. While a VUL policy is an appropriate vehicle for TOLI policies in the right situation, additional internal costs typically make them less efficient unless a 6% gross return is obtained.

- Utilize asset allocation software to create an asset allocation that matches the expected return with minimal risk.

- Once an allocation is determined, resist the urge to re-allocate frequently, but utilize periodic asset allocation re-balancing (available in most policies) to take advantage of natural market fluctuations.

- To minimize the negative effects of market volatility, utilize the Fixed Account to pay monthly fees (if available), reviewing the policy and adding monies to the account on an annual or semi-annual basis.

- While the use of an illustration with level annual returns does not provide much more than limited guidance for a policy, use the original and in force illustrations, along with policy annual statements, to track policy cash values. If policy performance falters over several years, consider lowering the rate of return expectation and increasing premium contributions.

- Review the guarantees in the policy. While VUL policies usually do not come with long death benefit guarantees, there are products that provide limited guarantees, and some can be extended if funded at a specified premium level.

- While the grantor does not have investment control over the policy, provide the grantor (and beneficiaries, if desired) with annual reports showing the policy performance, and note any policy issues. Document all remediation processes for the trust file.

Variable universal life provides a TOLI trust with the potential for an extremely efficient (high rate of return on death benefit) asset, but adds more difficulty to TOLI policy management. The additional responsibilities should be acknowledged and specific processes should be placed around these policies.

CHAPTER 10

Equity Index Universal Life–A Closer Look

"September and October of 2008 was the worst financial crisis in global history, including the Great Depression." Of the 13 "most important financial institutions in the United States, 12 were at risk of failure within a period of a week or two." (23)

In October of 2007 the Dow Jones Industrial (DJIA) exceeded 14,000. By March of 2009 the DJIA had dropped to 6,660. A decline of over 53% in 17 months.

The economic downturn that started in 2007 had a very detrimental effect on investors in the United States and not just on their pocketbooks. In an article in the Guardian, a chief executive of a major financial company said that the subprime housing crisis was "one of the greatest panics I have ever seen" and would "have a material effect . . . on the psyches of the American people" (24).

Many variable life policyholders who hoped to capture the policy's upside - high equity returns that could potentially lower premium costs - experienced its downside - it is the only policy whose cash value return can be negative.

The life insurance industry had an answer ready for those policyholders interested in capturing the upside of equities without the downside risk. It was called equity index universal life, a product popular now and touted by many as being more conservative than variable life.

The Policy Basics

It is considered more conservative because the interest credited to the policy can never drop below a floor–a set crediting rate (usually 2% or 0%) below which returns can never fall. So, unlike a variable life policy, the cash value cannot experience a negative return. Note that even though the credited interest rate may not be negative, policy charges including administrative fees, expense charges, cost of insurance charges and rider charges will still be deducted so the policy cash value can still go down.

The policy is credited with a return that is tied to an index, most commonly the S&P 500®. While the downside is limited by the floor, the upside is also limited–by the cap, which is set by the carrier.

The participation rate, set by the carrier, is the percentage of the actual index return that is used when crediting the policy. For example, if the participation rate is 100%, then 100% of the actual performance will be used, subject to the cap rates. If 200% is used, then an index return of 5% would create a crediting rate of 10%, again, subject to the cap rate.

The rate credited does not include dividends, it is strictly mathematical. Assuming a point-to-point computation, if the premium entered the policy on January 1 when the index stood at 1,000, and a year later the index stood at 1,100, the rate credited would be 10%, subject to the cap.

The example below assumes a participation rate of 100%, a cap of 10%, and a floor of 0%, and shows how a policy would be credited under different scenarios:

Actual Index Rate	Times the Participation Rate	Equals the Adjusted Growth Rate	Subject to Growth Cap of 10% and Floor of 0%	Equals Credited Rate
18%	100%	18%	Subject to Cap	10%
9.25%	100%	9.25%	No Cap/Floor	9.25%
-14.25%	100%	-14.25%	Subject to Floor	0%

Year 1: In the first year, the index increases 18%, and since the participation rate is 100%, the entire return would be credited, subject to the cap. Since the cap is 10% the maximum that can be credited to the policy is 10%.

Year 2: In the second year, the index increases 9.25% and with the 100% participation rate and a cap of 10%, the entire 9.25% is credited.

Year 3: In the third year, the index drops 4.25%, a loss. However, because there is a floor of 0%, the policy does not suffer a negative credit or return.

While the computation of the credited returns seems rather straightforward, the mechanics of the policy are a bit more complex. The policy is a general account product since the carrier invests the premium in its general account, as it would a current assumption universal life (CAUL) policy. In fact, the policyholder can often allocate their premium into a fixed account, as in a CAUL policy, where it earns only the returns generated by the general account. Typically, this is not done as the policy is purchased for the equity upside.

The policy cash value is not invested directly in the index tracked. There is a three-step process to create the floor, the potential upside, and to determine the actual amount credited to the policy.

The Policy Process

Step 1- Satisfy the Floor: The policy net premium is originally placed in the general account (after all loads and charges are deducted). Most of the premium stays in the general account and that amount, along with the interest credited from the general account provides the policy with its floor (in our example above - 0%). For example, assuming a net premium of $10,000 and a general account return of 4.5%, $9,569 is placed in the general account where, along with the credited return, it satisfies the floor return of 0%, since the account value would increase to the original $10,000.

Step 2 - Create the Upside: The portion of the premium that does not stay in the general account is used to purchase options that generate the credited returns on the policy (if the index has a positive return) based on the participation rate and cap published by the carrier.

Step #3 - Credit the Policy: The carrier credits a return to the policy based on returns generated in the index and the crediting parameters. If the index returns are negative, the policy cash value does not experience a loss because of the policy floor.

While it would seem the greatest driver of policy performance is the return of the index, market volatility and carrier general account returns may play a larger role. Participation rates and caps are typically not guaranteed and can be adjusted by the carrier based on the cost of the options. The more volatile the market, the costlier the options, and the higher chance the carrier will need to reduce the cap and/or participation rates. The lower the interest rate credited to the policy the more the carrier must set aside to satisfy the floor, leaving less to purchase options. It is easy to see how low interest rates and/or market volatility can negatively affect actual policy performance.

Dividends Are Not Included

While the impact of dividends on the S&P 500®, the most commonly used index, has decreased since the 1960s, a significant portion of S&P 500® total returns are still due to dividends.

The average S&P 500® returns with and without dividends reinvested for 60, 30 and 10-year periods ending December of 2017 are listed below (25).

Years	Total S&P Return	Total S&P Return Dividends Reinvested
Last 60 Years	7.23%	10.46%
Last 30 Years	8.33%	10.69%
Last 10 Years	6.04%	8.26%

The equity advantage over fixed investments is evident, even without dividends factored in. So, it is not unreasonable to assume that an EIUL policy can generate a higher crediting rate than a current assumption universal life policy.

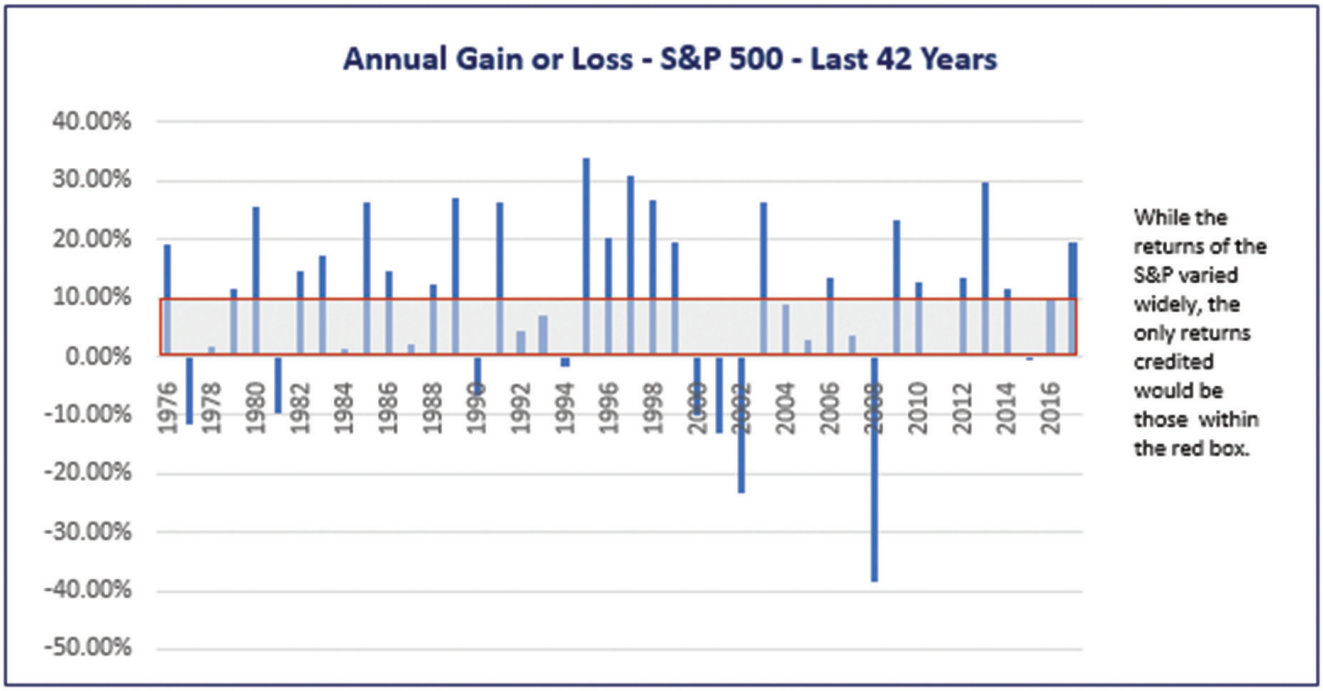
Client Expectations and Hypothetical Illustrated Returns

While the credited returns of an EIUL policy can outpace a fixed current assumption policy, the returns that are shown on hypothetical sales illustrations can lead to unmet client expectations.

The credited returns being shown in sales illustrations for many policies we reviewed in the past were typically above 7%. While it may be reasonable to expect returns of 7-8%, and even higher for the S&P 500®, the design of the EIUL product will limit the actual credited rate received. You cannot expect to generate the returns of the equity market while simultaneously removing the risk–there is a price to be paid.

The returns credited to an EIUL policy are subject to both a floor and a cap. In our prior policy example, we had a participation rate of 100%, a cap of 10% and a floor of 0% - which is a typical scenario.

In the chart below, we have plotted the annual returns and losses for the S&P 500®over the last 42 years. The box represents the minimum and maximum returns that would be credited to the policy–assuming a 100% participation rate, 0% floor and a 10% cap. Note that in 42 years you would have avoided 8 years of investment losses with the 0% floor. However, you would have lost the upside gain greater than 10% in over half of the years, creating a drag on actual returns credited.



A well-known carrier has an online tool that translates a hypothetical expected return in the S&P 500® to a corresponding hypothetical crediting rate in an EIUL policy assuming different crediting strategies (26). Assuming 100% participation rate, 0% floor, and 10% cap parameters, the tool would generate the following hypothetical credited returns assuming the hypothetical S&P 500® returns listed.

Hypothetical Long-Term S&P 500 Return	Translated Crediting Rate in an EIUL Policy
12%	6.46%
10%	6.03%
8%	5.60%
6%	5.17%

It becomes clear from the translated index return to crediting rate chart above that hypothetical illustrations showing EIUL credited returns above 6.4% are rather aggressive since they would necessitate a hypothetical 12% return in the S&P 500®, assuming the parameters spelled out. And yet, as we mentioned, hypothetical sales illustrations often showed credited returns well above 7%, meaning that the S&P 500® return would have to average 12% or more or the policy would "underperform" based on expectations. It has been estimated that before regulations limited the crediting rate that could be shown, the average rate shown in sales illustration was 7.46% (27).

AG 49

The high crediting rates shown in sales illustrations drew the attention of regulators. The New York State Department of Financial Services (NYDFS) began an investigation into industry sales practices in 2014, sending letters to 134 carriers who sold the product asking about their presentation of potential gains from it. Many in the insurance industry believed that more regulation was needed with the head of one trade group telling the Wall Street Journal that "tighter rules are needed" to clarify to consumers that projected returns are not guaranteed (28). The National Association of Insurance Commissioners (NAIC), an organization that sets the standards for state insurance laws and regulations, developed Actuarial Guideline (AG) 49. Implemented in two phases in 2015 and 2016, the guideline provided more consistency around the methods used to illustrate EIUL, and limited the crediting rate shown on all sales and in force illustrations to approximately 7%, with carrier and product variation based on specific methodology used.

While a hypothetical crediting rate as high as 7% is allowed, we have cautioned trustees to also have illustrations run at a lower crediting rate (5% for example) to show the outcome to the grantor if the 7% return is not obtained. That illustration should be part of the trust file, along with the grantors acknowledgement of the outcome. After accepting an EIUL policy, it should be monitored annually with revisions made to the funding to keep the policy on track.

Interest Bonuses and Multipliers

While AG 49 placed a lid on the crediting rate that could be shown in a hypothetical illustration, it did not stop the use of interest bonuses or multipliers, non-guaranteed enhancement to the cash value shown in a policy illustration. For example, while a sales illustration may show a credited return of 6%

at the top of the page, the fine print below may point out that the policy includes a 1.25% multiplier effectively increasing the crediting rate of the hypothetical illustration up to 7.5%. Understanding the policy illustration assumptions is important when reviewing these policies.

When AG 49 was introduced in 2015, the sales of the EIUL product cooled as agents "adjusted to the new regulatory regime" which lowered the hypothetical cash value growth that could be shown in prior sales illustrations. By 2017, new products introducing performance multipliers and bonuses that helped drive IUL sales. Insurers and agents could show "enhanced values on the non-guaranteed portion of the life insurance illustration, while avoiding the limitations imposed by AG 49," and equity indexed universal life became "the star of the life insurance show in 2017, thrust into the spotlight by a supporting cast of new products and features" (29).

Policy Costs

While the EIUL is most like a current assumption universal life (CAUL) product, the addition of the bells and whistles that provide the potential for higher crediting rates also increase policy costs. One industry source has estimated that "cumulative charges for every $1 of Net Amount at Risk (excluding premium loads)" in an EIUL policy are almost 50% higher than a CAUL policy. "Higher charges in EIUL products are highly correlated to higher caps. In other words, carriers provide more upside in exchange for higher policy charges." In addition, EIUL policies have a higher commission structure, with target commissions "50-75% higher than CAUL" policies and payouts that "also tend to be higher" (30). This is not to say that EIUL policies should not be considered but that, all factors, including costs, should be weighed.

Other Considerations

What is Guaranteed? With so many moving parts in an EIUL policy it is important to understand what, if anything, is guaranteed. Check to see whether the floor, participation rate, and cap is guaranteed. It is important to understand the changes that can occur since the participation rate and cap will affect the potential cash value growth of a policy. Caps typically change regularly as the option costs change based on market conditions. Remember that the sales illustration is not the product, the contract is. FINRA issued an alert (box to the right) for Equity Index Annuities (EIAs) that also applies to EIUL.

FINRA ALERT For index annuities that also applies to life insurance.

Caution! Some EIAs allow the insurance company to change participation rates, cap rates, or spread/asset/margin fees either annually or at the start of the next contract term. If an insurance company subsequently lowers the participation rate or cap rate or increases the spread/asset/margin fees, this could adversely affect your return. Read your contract carefully to see if it allows the insurance company to change these features.

What is the Crediting Method or Period? The index crediting method should be understood. Nearly every company offering EIUL policies uses the annual point-to-point method, as we used in our examples. With this method, the beginning index value is noted and compared with the end of period value. Any increase is divided by the beginning value to arrive at the percentage increase. Other methods may be used to credit the policy. Review the policy marketing information and contract to determine which method is used and how it works.

For EIUL policies in your portfolio, the following are some practices that should be employed:

- When accepting a policy, review the policy contract. These are complex policies and all moving parts need to be understood.
- Make sure that you and the grantor know what is and is not guaranteed in the policy.
- When reviewing an illustration and policy funding, make sure the grantor understands that the funding commitment to carry the policy to maturity may increase if the expected crediting rate is not obtained. Include a policy illustration at 4-5%, as well as the higher return that is typically shown, and document that the grantor is aware of the outcome at the lower crediting rate.
- Track the policy performance over time, and document that the grantor is made aware if policy performance is less than expected.

The EIUL product is a popular policy that is often misunderstood by the consumer. As trustee you must be sure that policy expectations are grounded and can be reasonably obtained.

CHAPTER 11

Why Did the Cost of Insurance Increase in My Policy?

"I had to cancel my policy because of the proposed premium increase and reduction of my cash value in the policy."

"Many of my clients are older with face amounts ranging from $1 million to $5 million and have been greatly affected by the COI increases [by] as much as a hundred and fifty to two hundred percent in some cases."

"(Carrier name deleted) have cheated me, I have paid on this policy since 1987, they are crooks. I want every cent I paid with interest."

"The COI increased by 100% on the (carrier name deleted) policy we own, insuring a 92-year-old male. Especially frustrating because the premium paid for this policy has already exceeded the death benefit."

"We have a client age 95 who is experiencing a 1,352% increase to continue policy to age 100. In my over 50 yrs. in this business I've never such behavior by [a] major carrier."

These quotes came to us from consumers and advisors, either via email or through comments posted on the ITM TwentyFirst blog after we provided updates on the cost of insurance increases we have seen over the last few years. People felt helpless after experiencing large cost increases on life insurance policies that had been in force for 20 or 30 years. The policyholders, mostly older in age, had dutifully paid premiums and were hit with cost increases of 20%, 50%, and in some cases, much more. The insurance advisors were disappointed that their clients were burdened. While it is easy to point fingers at the carriers, the reasons for the increases are varied. The final arbiter may be the court system, as many of the carriers that have raised their COI are tangled up in litigation, with the outcome unknown.

Most cost of insurance (COI) increases that occurred in the last few years were found in current assumption universal life (CAUL) policies. As discussed in past chapters, these policies are invested in fixed interest instruments. Interest rates have slowly slipped over the last few decades, but have taken a dramatic tumble since the downturn of 2008-09. In 2016, 35% of all government debt was issued at negative interest rates. Spain, Germany, Japan, Switzerland, Sweden, Italy and the Netherlands all issued debt with a negative yield (31). If there was a winner during the last decade it was government. European and US governments benefitted from 1.6 trillion dollars in lowered borrowing costs. In the United States, though government debt doubled from 2007 - 2017, net payments on debt dropped (32). While debtors benefitted, bond holders suffered. And life insurance carriers, dependent on high quality bonds to generate investment returns to pay claims, felt the pain.

CAUL carriers make money several ways, the first being interest rate spread - the difference between the interest rate return they receive and the interest rate they credit to the policy. For example, a carrier generates a 6% return in its investment account, credits the cash value in a CAUL policy with a 4% return and keeps the 2% return as profit. As we mentioned, a CAUL policy has a current crediting rate and a guaranteed rate - a minimum rate that must be credited to the policy. The Transamerica policies that were among the first hit with a COI increase had a guaranteed crediting rate of 5.5%, while the 5-year average total investment return for the carrier was only 4.38% (33).

Transamerica is not the only carrier that felt the pinch. Their investment returns were slightly above the industry average of 4.36% (33). In a review of our TOLI portfolio we found that 78% of the CAUL policies issued from 1980-1995 were currently crediting the guaranteed rate, and another 12% were within 1% of the guaranteed rate (34). Due to contract language developed in an era of higher interest rates, some carriers are forced to credit a policy with rates that are close to, or even above, their investment return. The historic low interest rate environment has taken the profit out of the interest rate spread for many carriers.

The investment issues have been industry-wide and documented in many financial publications. The Wall Street Journal has published numerous articles on the plight of consumers faced with escalating costs in their CAUL policies, calling the sting of the price hikes, “one of the most damaging but least-understood ramifications of years of low interest rates” (35). An article in the New York Times called the interest rate environment “unprecedented” and a “crisis moment for the life insurance industry.” The head of one of world’s largest life insurers called the move by a central bank to slash rates to zero “catastrophic” for the industry (36).

The rating agencies also took notice, with Moody’s observing in 2016, “[i]nsurers’ investment income remains under pressure from the continued low interest rate environment.” Even if interest rates rebound, Moody’s believes it “will boost insurers’ net income only marginally, because as their older, higher-yielding portfolio assets mature, investment portfolio rates will likely further compress” (37).

Carriers also make their money on the cost of insurance charged in the policy, a charge that includes overhead and other factors, but is essentially the true mortality cost of a policy. Since some carriers could not make their profits on the interest rate spread, there are some observers who believe that they simply made it by increasing COI charges.

In announcing their COI increases, Transamerica referenced neither interest rates nor mortality directly, simply stating that the increases were based "on our current expectations regarding our future costs of providing this coverage." Other carriers were similarly vague. Voya, when announcing increases to ReliaStar and Security Life of Denver policies in their portfolio, told their policyholders they "periodically evaluate . . . costs of providing insurance coverage. Because of the recent review of your policy, one of the charges assessed against the policy will be adjusted."

AXA, when raising rates on approximately 1,700 Athena II policies, spoke directly about both investment returns and mortality, "[w]e reviewed our mortality and investment expectations . . . determined they are less favorable than was anticipated when the current schedule of COI rates was established." Legal & General was also specific by stating that, "investment returns have been at all-time lows . . . making it impossible to earn the investment income assumed in pricing," and "average mortality on these blocks has been unfavorable."

For some carriers, it may be that the squeeze on the interest rate spread caused their COI increases, but there are other factors that may have played a part. While mortality in the United States has improved in the last few decades (39), there are several reasons carriers may have experienced less favorable mortality on specific blocks of life insurance.

- Poor underwriting decisions: While most carriers are very adept at underwriting, mistakes are made. The underwriting practices at the carrier level may have created mispriced policies that did not show up until later.

- Table shaving programs: Life insurance underwriting places a prospective insured in a specific class according to health and personal habits–preferred non-smoker, standard smoker, etc. Those with health issues get additional table ratings that increase the cost of insurance in the policy. For business reasons, some carriers created marketing programs that "shaved" their underwriting, providing prospective insureds with a more favorable underwriting class. For example, a standard non-smoker might receive a preferred non-smoker rating, lowering the costs for the policy and making the policy more marketable. These table shave programs were designed to boost sales, for example, at year end. Some of the carriers who have exhibited COI increases were proponents of this marketing strategy in years past.

- Acquired blocks of business: Carriers who purchased a portfolio of policies may not have realized expected revenue based on the price paid, leading them to reevaluate policy economics. In some instances, healthier insureds flee simply because of the sale, leaving the purchasing carrier with a less healthy group–adverse selection. Lincoln National raised COI on a block

of policies in 2016 citing "persistently low interest rates, including recent historic lows, volatile markets, and an evolving regulatory landscape." Those policies were made up of current assumption universal life policies originally underwritten by Jefferson Pilot, which Lincoln Financial purchased in 2006. While it is not clear if the fact they were purchased was a prevailing factor, it could have played a part.

- Conversion policies: Adverse selection can have a negative effect on mortality if the portfolio contains a high percentage of converted term policies. As we mentioned, term policies contain the right to convert the policy to a permanent product without undergoing additional medical underwriting. If the term carrier does not have a competitive permanent product, those healthy enough to secure more economical permanent coverage will do so elsewhere, leaving the issuing carrier with the less healthy insureds. Legal & General's Banner is a case in point. A competitive term carrier that did not have market leading universal products, they cited "unfavorable" mortality, "almost always attributable to the conversion segments," when announcing their COI increase.

Re-insurance rate increases have been mentioned as a reason for cost increases. Life carriers often enter an agreement which obligates the reinsurer to pay a percentage of any claims that might arise on a policy. Carriers cede a portion of the mortality risk to the second company. A reinsurance cost increase may occur because of an increase in death claims in the portfolio ceded.

Increased regulatory costs is another factor in COI increases. It may be no coincidence that Transamerica, Voya, Legal & General, and AXA, with parent companies in Europe, have raised rates. Solvency II, a European Union law that took effect on January 1, 2016, directs all insurance companies to hold a financial buffer above their best estimate of future liabilities. The increased reserve requirements lower carrier profitability, possibly necessitating a price increase.

Carrier persistency, or lapse rate, may have also played a role in the increases, and was mentioned in one of the lawsuits filed against Transamerica. Persistency is one of the factors in policy pricing. Carriers expect as many as half of CAUL policies to lapse or be surrendered in the first 10 years. Due to surrender charges, the consumer will receive much less than they paid in, and even though the carrier has high acquisition costs, they are still well ahead because of those surrender charges. According to one white paper on the subject, while a block of policies with typical lapse rates would show a 13.6% projected profit margin, the profits would drop as the lapse rate dropped, and at a zero-lapse rate (nobody drops their policy) the margin drops to a negative 12.8% (39). In a class action lawsuit against Transamerica, the plaintiff's alleged that the carrier raised the COI in their policies to make the policies "more profitable by inducing more of them to lapse" (40).

The rise of the secondary market has affected the lapse rate, especially on specific policies. Investors purchase policies backed by life expectancy reports on the insured and sophisticated policy monitoring services that minimize premium payments. This combination of economic efficiencies maximizes the

return for the investors while lowering profitability to the carriers, and though they may not admit it, may have played a part in certain COI increases.

The COI increase effect on policy carrying costs has been dramatic. We have seen COI increases of up to 600% in polices we have reviewed, though many increases have been much less. Even a COI increase of 40% can increase policy costs to more than double, as seen below (41).

Case Study: We reviewed a $4 million Transamerica level death benefit current assumption UL policy on a male standard non-smoker, age 52 at policy issue that was subject to a COI increase. The policy was in policy year 28 and the trustee had paid $1,342,887 into the policy. Like many older CAUL policies, the policy pays only cash value if the insured is still alive at policy maturity.

The policy contract states that the full death benefit will be paid "if the insured dies before the policy anniversary date nearest the insured's age 100." However, if the insured is still alive on that date, the policy will pay only the "net cash value to the owner."

Policy Year	Old Monthly Deduction Charges	New Monthly Deduction Charges	% Change
28	3.29	4.61	40.23%
29	3.69	5.18	40.32%
30	4.09	5.75	40.44%
31	4.52	6.35	40.57%
32	4.94	6.96	40.70%
33	5.38	7.58	40.85%
34	5.85	8.25	41.01%
35	6.33	8.93	41.18%
36	6.84	9.67	41.35%
37	7.39	10.46	41.51%
38	7.97	11.29	41.68%
39	8.58	12.17	41.82%
40	9.24	13.12	41.91%
41	9.95	14.12	41.93%
42	10.78	15.28	41.83%
43	11.59	16.41	41.58%
44	12.41	17.52	41.15%
45	13.31	18.71	40.50%
46	14.74	20.56	39.49%
47	16.81	23.21	38.09%
48	19.50	26.59	36.38%
Monthly deduction charges per thousand dollars of death benefit coverage provided.			
Because of the cost increase, the premium to carry the policy to age 100 jumped from $36,400 to $81,595, a jump of over 200%.			

As we mentioned, the COI in a CAUL policy is drawn monthly based on the net amount at risk, the actual pure death benefit at risk to the carrier. As can be seen in the chart to the right, the COI increase per thousand dollars of net amount at risk is approximately 40%. For example, in policy year 28, the cost went from $3.29 per thousand dollars of coverage to $4.61 per thousand dollars of coverage, an increase of 40.23%.

The grantor was gifting $36,400 to the trust annually to pay the premium required for the policy to run to age 100 with minimal cash value at maturity. Because of the COI increase the carrying costs on the policy jumped to $81,595.

When alerting policyholders about a COI increase, the carriers typically provide three options:

1. Surrendering the policy for cash value.
2. Reducing the face amount to lower premium costs.
3. Retaining the existing death benefit with the acknowledgment that the premium will more than likely increase.

See Case Study #2 on page 133 for an analysis of this case.

Most policyholders do not have the requisite life insurance expertise to review their options and make an enlightened decision when faced with a COI increase. As trustee, you must. We will review a case study based on the policy referenced above in a later chapter that will provide guidance on the process you should follow.

The COI increases we have seen in the last few years have negatively affected the estate plans of many grantors. However, several class action lawsuits have been filed against carriers who have raised rates and these cases are working their way through the courts. It is important to note that in two previous cases–against Conseco (settled in 2013) and Phoenix (settled in 2015)–relief was provided to policyholders affected. In another case, DCD Partners v Transamerica Life Insurance Company in September of 2017, the jury found for the plaintiffs, awarding $5.7 million in damages.

CHAPTER 12

Selecting the Best Policy

Best: Superlative form of good

a: better than all others in quality or value "That is the *best* life insurance policy anyone can buy."

b: most appropriate, useful, or helpful "That is the *best* life insurance policy for your particular situation."

Meriam dictionary definition of "best"

What is the best life insurance policy? You cannot answer that without knowing the client and their situation and needs. As you have been reading in this book, different life insurance policy types have completely different characteristics. The right policy for one client may not be the right policy for another.

The statement, "that is the *best* life insurance policy anyone can buy" is not factual. There is no one best policy. But the second statement, "that is the *best* life insurance policy for your particular situation" rings true because a life insurance policy can be tailored to the personal needs of the client.

You can determine whether a policy type makes sense for your clients for their particular situation by understanding their financial profile and personal situation and applying the insight gained from this book. This is not to say that you are an expert, we will assume a life insurance advisor will be a rightful part of this equation, but as trustee of the policy you will need to understand the advantages and disadvantages of the policy and whether it fits your clients', as well as their trusts', goals. The following information outlining policy characteristics, though not all inclusive, will provide helpful guidance.

Premium Flexibility: One of the most important policy traits to review with the client deals with premium payment. Do your clients need flexibility in premium payment? Are you comfortable, based on your knowledge of the grantor's financial situation, that they will be able to gift the premium to

the trust in full and on time each year? And if they can do it now, do you foresee financial changes down the road that might preclude them from making timely gifts? Premium flexibility should be a starting point for the policy purchase conversation.

Premium Flexibility By Policy Type

Term	Whole Life	Current Assumption UL	Guaranteed UL	Variable UL	Equity index UL
No	Some - dividends or loans can be used to pay premium	Yes, assuming no death benefit guarantees	No	Yes, assuming no death benefit guarantees	Yes, assuming no death benefit guarantees

Cash Value Growth: We have mentioned that in the TOLI world cash value growth is generally not as important as the rate of return on the death benefit. In other words, the goal is often to pay the least premium for a policy no matter what the cash value accumulation is–the death benefit is the real asset. But a discussion should occur about the need for cash value. Is there some reason for the asset in the trust to have significant cash values? Perhaps there is some sort of income to be paid from the trust. Do you want to have the ability to "trade up" in the future if a more appropriate policy comes along? Often the ability to trade up is dependent on a tax free 1035 Exchange of cash value from the existing policy to jump start the new policy. Perhaps there is a chance the policy will be surrendered in the future. A GUL policy surrendered in the 20th policy year will more than likely have little to no cash value and bring minimal cash to the trust, usually not enough to even cover the past premium costs. Potential policy cash value and trust liquidity needs should be part of every policy acquisition discussion.

Cash Value By Policy Type

Term	Whole Life	Current Assumption UL	Guaranteed UL	Variable UL	Equity index UL
No Cash Value	Yes, potential for significant cash value growth	Yes, potential for significant cash value growth	Minimal cash value growth	Yes, potential for significant cash value growth	Yes, potential for significant cash value growth

Investment Risk: Another discussion point that goes hand-in-hand with cash value growth is investment risk. What is the investment risk of the trust? What is the risk tolerance of the grantor? Do you as trustee want to lower the premium costs of the policy by attempting to generate a higher return in the policy? If so, a variable universal life policy would be appropriate. And with the higher investment risk of equity investments in a VUL policy comes the responsibility that you, the trustee, will be accountable for making the investment choices among an array of separate accounts. Are you comfortable with that? If your client wants no investment risk, a GUL policy would be a logical policy choice (if a thorough discussion on premium flexibility occurs). Often decisions about policy type are made without a discussion of the long-term investment risk profile and market changes, especially negative ones, and result in policy replacements that are potentially costly and maybe even ill advised. Permanent life insurance is a lifetime decision and should be treated as such.

Investment Risk By Policy Type

Term	Whole Life	Current Assumption UL	Guaranteed UL	Variable UL	Equity index UL
None	Yes, dividend drops	Yes, crediting rate drops	None	Yes, high - potential for investment losses	Yes, but mitigated by floor in policy crediting rate

Death Benefit Guarantee: Since its introduction, guaranteed universal life (GUL) has been one of the most popular products for use in a TOLI trust. By providing a guaranteed death benefit for a set price, the cost to fund the policy to maturity is known. A whole life policy also provides death benefit guarantees if fully funded, but at a higher carrying cost. Some other universal life policies come with limited guarantees. The policy purchase decision should include a discussion of policy guarantees and the grantor and trustee should be aware of what is guaranteed in a policy and what is not. Changes in non-guaranteed costs down the road can dramatically affect the viability of a policy as seen by the cost of insurance increases that have plagued the industry in recent years and raised the carrying costs of CAUL policies by 200% or more. While policy guarantees may increase the cost of the policy they can mitigate future policy performance issues.

Is Policy Death Benefit Guaranteed?

Term	Whole Life	Current Assumption UL	Guaranteed UL	Variable UL	Equity index UL
Yes, in level premium policy - for a period of time	Yes, if premium paid each year	No, unless policy has a limited death benefit guarantee period	Yes, if premium paid each year	No, unless policy has a limited death benefit guarantee period	No, unless policy has a limited death benefit guarantee period

Other factors to consider:

- **Number of Years to Pay Premium:** While most policies are designed for a premium payment period that continues until maturity or the death of the insured, there are opportunities to shorten the premium payment period, known as a short pay option. These can be useful if

the grantor wishes to pay all the needed premium prior to retirement, for example. We have seen situations where grantors who have a liquidity event (the sale of a business, for example) allocate a portion of the funds to an ILIT holding a "short pay" GUL policy, allowing the grantors to use the balance of the funds for lifestyle needs while providing a known contractually guaranteed and tax-free death benefit to the next generation.

- **Level or Increasing Death Benefit:** Most policies are issued with a level death benefit, but there are policies that provide the trust with a death benefit that increases, typically by including the cash value or the premium paid in the death benefit proceeds. This policy design is especially useful for those trusts that have an increasing death benefit need. Often, they are used when the premium payment involves a loan with the increasing death benefit (base death benefit plus premium paid), providing the trust with the funds to pay the loan back at the death of the insured. An increasing death benefit will be costlier than a level death benefit, but based on the trust's need, can still provide an economically efficient way to reach the trust's goals.

- **Policy Riders**: While typically not a focal point when purchasing a policy, riders can be a worthwhile addition to a TOLI policy. One example is a policy split rider that allows a survivorship policy to be exchanged for two individual policies within one year of an event, such as divorce or a change to the federal estate tax law.

Underwriting

To obtain a life insurance policy your client must go through an underwriting process which includes both health and financial reviews. For large policies a financial supplement that includes a breakdown of the client's assets and liabilities will likely be requested. With a trust owned policy, the carrier will typically require a copy of the trust documents as well as specific carrier forms relating to TOLI policies. The prospective insured must list all current in force policies including any policies that have been sold. The carrier will want to make sure that the prospect can pay the ongoing premiums, and if the premium is coming from somewhere other than a verifiable income stream, additional explanation may be required.

In an estate planning scenario, the carrier will base the maximum coverage available on the current financial situation and liquidity needs and can include an annual growth rate factor if applicable. A 5-7% annual estate growth rate is often used, but higher or lower rates are considered subject to individual situations.

The underwriting offer obtained on your client will dramatically affect the carrying costs of the policy. Underwriting classifications are based on the sex, health, and lifestyle of the prospective insured and can range from Super Preferred or Preferred through Standard to Rated (individuals with some sort of health issue or undesirable height to weight ratio that leads the carrier to believe

that that they have a life expectancy that is below average). A rated policy carries a higher cost of insurance. All else equal, policies for cigarette smokers will also be costlier. Cigar smoking may or may not affect pricing.

To start the underwriting process, the applicant will sign a HIPAA (The Health Insurance Portability and Accountability Act of 1996) form that allows the underwriter to gather health information on the applicant. Once the health records are gathered, the applicant can receive an informal offer that provides guidance to the underwriting offer that may be available. To complete the process and obtain coverage, a formal application must be filed with the carrier, and the applicant must submit to a paramed exam, including a blood profile and a urine sample. A resting EKG may be part of the paramed exam, and for those 50 or older, and for coverage above $10 million, a stress test may also be required.

The paramed exam typically takes place at the prospective insured's house, though it can take place at an office, either a paramed firm or a doctor's office. It is important that the client is relaxed and ready for the exam, with a good night's rest. Fasting may be required and it is a good idea to schedule the exam during the morning. The client should bring a list of all doctors, as well as a list of all prescribed medications to speed up the process. It is best to avoid caffeine and alcohol before the exam and minimize salt intake. Exercise should be limited for 48 hours prior to examination. Workouts, jogging, or weightlifting can adversely affect both blood and urine results.

It is important that the applicant obtains good results from the paramed exam as it, along with the health records, will determine the pricing of the policy. On the right below is an example of the difference good underwriting can make. The example shows the pricing at one carrier for a $5 million GUL policy guaranteed to maturity for a male age 55, assuming different underwriting classes.

- Super Preferred: $52,555
- Preferred: $58,011
- Standard Plus: $67,146
- Standard: $71,742

As mentioned, the purchase of a life insurance policy will include the use of a life insurance advisor or agent who will facilitate the transaction. In general, there are two types of life insurance advisers:

- Captive Agents: These are agents that place most of their business with one company. Typically, the agent will be affiliated with one of the large mutual companies like MassMutual, New York Life or Northwestern Mutual. These companies are highly rated with competitive products. Mutual companies are owned by the policyholders, not stockholders. While most business may be placed with their main company, most of these agents can also place business with other carriers.

- Independent Agents or Brokers: These individuals place their business through brokerage firms that have relationships with many life insurance carriers. They may have companies

that they favor, but are not employees of a specific life insurance company, they are independent contractors.

Working with a trusted insurance adviser who understands the underwriting process and can shop for the best offer can save your client money. In the example to the right, an actual case from a few years ago, an applicant working with a knowledgeable broker solicited offers for a ten-year level term policy, a policy that lends itself to an apple to apples comparison. Though all carriers received the same information, the underwriting offers and pricing received were very different. Working with an advisor with access to several highly-rated carriers and the ability to position your client well with the carriers will get them the best policy pricing.

Same Insured/Different Carrier Offers: Actual Case: Male, Non-Smoker, Age 50, 6'5", 265 pounds, no medical issues noted on application, seeking $5M of 10 Year Term, Annual Premium

- Carrier #1: Rated, $18,586
- Carrier #2: Standard, $13,535
- Carrier #3: Standard Plus: $9,500

The information outlined in this chapter will help you guide your client to a policy that is best for them. But what happens if you are not part of the sales process? Maybe you are being asked to accept a policy with no real knowledge of the purchase process. This occurs frequently, and in that case, you can use the information provided here to review the policy with the client and create a document for the trust file that outlines the expectations and responsibilities around the policy. Doing so will ensure that all pertinent parties agree on the policy, and it creates a blueprint for policy management.

CHAPTER 13

Taxation of Life Insurance

The US Tax code affords life insurance tax benefits that few financial assets can match. First and foremost, the death benefit is income tax-free (IRC Section 101(a)). While it is subject to estate taxes, the proper drafting and administration of an ILIT will place that benefit outside of the grantor's estate, if the insured had no incident of ownership in the policy at any time within three years of death (IRC Sections 2042 and 2035). Thus, life insurance can pass free of any taxes.

The cash value in a life insurance policy grows tax-deferred, and the policy owner can access the cash value tax-free via withdrawals up to the policy's cost basis (IRC Section 72). If the policy stays in force, cash values exceeding cost basis may be borrowed from the policy income tax-free via loans (IRC Sections 72 and 7702). The amount loaned will reduce the death benefit of the policy, and if loans and interest on the policy increase substantially, a loan squeeze could occur. If a loan squeeze occurs, the policy could lapse without additional funding, creating a potential tax liability.

The owner of a life insurance policy can exchange the policy for another policy free of any income tax obligation, a transaction called a 1035 Exchange, named for the code section that allows it. A life insurance policy can also be exchanged for an annuity free of income taxes under the same code section.

A general knowledge of life insurance taxation is an important part of TOLI policy management. This chapter will highlight some of the important tax guidelines for trustees.

Regulations Affecting Taxation of Life Insurance

The tax advantages of life insurance were even more generous before Congress acted in the 1980s by enacting new regulations that capped contribution limits on a policy.

The first of these regulations came from the Tax Equity and Fiscal Responsibility Acts of 1982 (TEFRA), intended to generate revenue by closing tax loopholes. The government became concerned

that by contributing a large sum of cash, policyholders of flexible premium products were minimizing the pure mortality, or net amount at risk, making the policies more like tax-free investments than risk management products. TEFRA created guidelines limiting the amount that could be contributed to flexible premium products and still qualify for beneficial tax treatment.

The second regulation, the Deficit Reduction Act of 1984, or DEFRA, covered all cash value life insurance policies and created a statutory definition for life insurance. All policies issued after the act had to pass one of two tests to qualify as life insurance.

1. The Cash Value Accumulation Test - Limits the cash surrender value at any time to the single premium needed to purchase the future benefits of the policy.

2. The Guideline Premium Test - Limits the total premium paid at any point in time to the amount necessary to fund future benefits, along with a Cash Value Corridor Test which requires a minimum death benefit to be provided based on the cash value of the policy.

The insurer must indicate which test is going to be used when the policy is issued, and once issued, the insurer cannot change to the other option. The test choice will affect policy premiums, cash value, and the death benefit.

TAMRA and MEC Limits

Even with these limitations, the use of over-funded life insurance policies flourished. In March of 1988, the Senate held hearings to "explore the problems created by the recent explosion of single premium life insurance," which accounted for half of all life insurance premiums in 1988, growing in volume since 1984 an "astounding 850 percent." The hearing included industry executives and lobbyists, and featured agent advertisements for single premium whole life insurance - the "best financial vehicle ever created," with "guaranteed tax-free income based on current law" (42).

In 1988, the Technical and Miscellaneous Revenue Act (TAMRA), defining a Modified Endowment Contract, or MEC, was passed. If a policy is funded with an amount higher than allowed, the contract becomes a MEC, affecting the taxation of cash value withdrawals, with the IRS treating them as they would a nonqualifying annuity. The MEC status does not affect the tax-free nature of the death benefit.

Policies issued after June 20, 1988 were subject to a 7-pay test. Premiums paid during the policy's first seven years could not exceed the sum of the net level premiums necessary to fund a fully paid-up policy at the end of seven years, or the policy became a MEC. For example, if the policy allowed for $49,000 in total premium over 7 years, and by the 7th year $41,500 had already been contributed, the maximum premium that could be paid in the 7th year would be $7,500.

Year	1	2	3	4	5	6	7
Annual Premium	$5,000	$8,000	$7,000	$6,000	$7,500	$8,000	?

A few notes on Modified Endowment Contracts:

- Carriers will notify you if your policy will become a MEC.
- A policy can become a MEC at any time, but the tax code allows up to one year after a policy becomes a MEC to withdraw the excess premium paid so that MEC status can be avoided.
- Policies purchased before June 1, 1988 are grandfathered, and therefore, not subject to the MEC rules–unless they undergo a material change.
- Any distribution from a policy considered to be a MEC is treated on a last-in/first-out (LIFO) basis - the interest earnings on the policy are deemed first to be withdrawn and fully taxable to the owner until the policy's interest earnings are distributed. Once earnings have been distributed, the balance is considered a return of the owner's basis and are not taxable.
- In addition to income tax, MEC withdrawals, loans, and surrenders are subject to a 10% early distribution penalty on the taxable portion of the distribution if the owner is under the age of 59½. The penalty will not apply if the owner of the policy becomes disabled or if the distribution is annuitized over the policy owner's lifetime.
- Once a policy becomes a MEC, it will remain a MEC for the lifetime of the policy, and if the policy is exchanged for another policy, that new policy will also be a MEC.
- Any time a policy undergoes a material change, such as a reduction in the death benefit, the 7-pay test is applied again. If, at that point, the policy fails the test, it becomes a MEC.

Taxation of Policy Withdrawals and Loans

Policies that are not considered a MEC have very favorable first-in, first-out (FIFO) cash distribution tax treatments. Owners of universal chassis policies can take withdrawals (or partial surrenders), with monies taken out first deemed to be a return of basis and received free of income tax until the cost basis is recovered. Once the cost basis is recovered, future withdrawals would be taxed at ordinary income, not capital gains, rates. For example, assume a policy has a $100,000 cost basis and $150,000 of cash value ($50,000 gain). A FIFO withdrawal starts with cost basis taken tax-free until all is removed, with the balance (gain) taken taxable. Last-in, first- out (LIFO) accounting is much less desirable as the first dollars taken are assumed to be policy gain and are taxable until fully withdrawn.

Policyholders also have the right to borrow against the cash value in a policy. Whole life policy owners can use this feature to pay the premium on the policy (via automatic premium loan or APL), a feature we discussed in Chapters 4 and 5. All policy loans accrue interest, but if the policy is not a MEC, the policy loan will be received income tax-free, even on amounts above the policy's cost basis.

Policy loans and withdrawals will affect the policy death benefit, reducing the death benefit ultimately paid out by the amount of the withdrawal, and/or loan plus interest. As we have mentioned, if the sum of the loan plus accumulated interest ever exceeds the policy's cash surrender value, a loan squeeze occurs, and without additional funding, the policy will terminate, possibly creating a taxable event.

As we mentioned in Chapters 4 and 5, participating whole life policies receive dividends. Dividends are a function of a company's investment and operating experience, and are provided from the divisible surplus from operations.

There are several dividend options:

- Purchase paid-up additions
- Reduce the premium payment
- Take in cash
- Accumulate at interest with the carrier
- Repay policy loans
- Purchase one-year term insurance amounts

Dividends used to purchase paid-up additions or reduce the premium payment are not taxable. Dividends paid in cash to owners of participating life insurance policies are considered a return of premium for tax purposes, and are generally not subject to income tax. When dividends are left to accumulate at interest with the carrier, or when they exceed the amount of premium paid for the policy, some taxes may be due.

For example:

- When a policy owner chooses to let dividends accumulate at interest with the carrier, the *interest earnings* on those dividends *are* considered taxable income to the owner. That interest will be taxable in the year it is credited, whether it is withdrawn or not. The carrier will report the accumulated interest earnings to the IRS every year.

- When dividends exceed the amount of premium paid for the policy, they are considered a gain in the policy, and are taxable if withdrawn or paid to the policy owner. This gain is taxable at ordinary income tax rates, not capital gains rates.

Taxation of Policy Surrenders

All policies surrendered for their cash value are subject to taxation at ordinary tax rates. If the policy owner's costs basis or investment in the contract is less than the amount received, tax will be due on the difference. For purposes of a surrender, the basis is the cumulative premium paid plus other consideration paid for a policy, minus the untaxable amount received under the policy. The total premium paid does not include premiums attributed to additional benefits such as disability income or waiver of premium. Premiums paid through a waiver of premium rider are not counted toward total premiums paid for tax purposes. Once the total premium paid is determined, nontaxable distributions are factored to arrive at investment in the contract.

For example, in whole life policies:

- Dividends used to purchase paid-up additions or reduce premiums do not reduce investment in the contract.

- Dividends received in cash reduce the investment in the contract.

- Dividends used to pay off a policy loan generally reduce the investment in the contract.

- Dividends left to accumulate at interest reduce the investment in the contract, but any interest earnings on the accumulating dividends do not reduce the investment in the contract since they were already taxed.

In universal chassis policies:

- Withdrawals, if nontaxable, reduce the investment in the contract. If taxable, the taxable amount increases the investment in the contract.

For all policies, non-taxable loans do not reduce the investment in the contract, but taxable loans increase the owner's investment in the contract. No tax deduction is available for any policy surrendered at a loss.

Below is a policy surrender example.

> Anna was trustee of a $200,000 current assumption universal life insurance policy. As trustee, she paid a total of $25,000 in premium payments over 10 years. The premium breakdown was $2,425 annually for the death benefit coverage, along with a disability waiver premium that cost $75 annually. The trust received $28,000 when the policy was surrendered. *The taxable amount was $3,750, the $24,250 premium for the death benefit (the disability waiver premium is not part of the cost basis) subtracted from the $28,000 surrender amount.*

Taxation of Policy Sales to the Secondary Market

Selling a policy in the secondary market can result in taxes being due at the trust level, and any analysis of a policy sale for a TOLI policy should keep that in mind. Please refer to Chapter 14, Understanding Life Settlements, for a detailed review of the taxation of a life settlement transaction.

1035 Exchanges

Occasionally, because of changes in trust goals or investment temperament, or advancements in life insurance policy design, it is appropriate for a trustee to exchange one policy held in a trust for a replacement policy. Typically, the cash value of the existing policy is used to jump start the new policy. The tax laws allow for a 1035 Exchange of one policy directly into a new policy without incurring any taxes on the policy gain.

Some important notes on 1035 Exchanges:

- A life insurance policy can also be exchanged tax-free for an annuity–an endowment contract or a qualified long-term care contract.
- An annuity cannot be exchanged for a life insurance contract, but can be exchanged for another annuity.
- To qualify for a 1035 exchange, the exchanged policies must have the same owner and relate to the same insured.
- You can consolidate two policies, with the same owner and insured, into one new policy with the same owner and insured.
- A single life policy cannot be exchanged for a survivorship policy (insures two people and pays at the second death).

- The IRS in a private letter ruling (PLR-120-953-12) ruled that a survivorship policy could be exchanged for a single life policy if one of the insureds in the survivorship policy had passed away.

- A 1035 Exchange does not eliminate the MEC status of a policy. A MEC policy exchanged for a new policy will retain the MEC status.

- The cost basis of the new policy retains the cost basis of the old policy.

The Value of a 1035 Exchange in a Policy That Has No Gain

Utilizing a 1035 Exchange on a policy that has no investment gain can be very advantageous for your client because the cost basis of the old policy transfers over to the new policy (or annuity), which can create a higher cost basis in the new product.

For example, let's assume a policy in your trust has $125,000 in cash value and a cost basis of $300,000. If, as trustee, you surrendered the policy and put the cash into a new product, the cost basis in the new product would be the $125,000 put in. If a 1035 Exchange was completed instead, the cost basis in the new product would be the $300,000 cost basis that transferred over. This is especially useful if the new life insurance product may be surrendered in the future or the exchange was made into an annuity.

- 1035 Exchanges should be direct–from the existing carrier to the new carrier.

1035 Exchange with a Loan–*Boot*

Occasionally, you may complete a 1035 exchange on a policy with a loan, which can affect the tax treatment of the transaction. If the loan is repaid before the transaction, there are no tax consequences. If the policy loan is reduced or eliminated from the new contract during exchange, then the loan amount that was discharged, called boot, is reported to the IRS by the original carrier, and is taxable to the extent of gain in the contract.

An Example of a 1035 Exchange on a Policy with a Loan–*Boot*

John is trustee of a $1 million TOLI policy with a cash value of $350,000, a cost basis of $225,000, subject to a $25,000 loan. The policy has a $125,000 gain. John has decided to replace the policy with another policy via a 1035 Exchange. At the time of the exchange, the loan is discharged by reducing the cash value of the policy by the amount of the loan, and the reduced cash value is transferred to the new contract. The new policy starts with a cash value of $325,000, which is less than the cash

value when the 1035 Exchange began. The $25,000 *boot* will be reported to the IRS by the original carrier on IRS Form 1099-R.

	Old Policy	Old Policy After Loan Is Repaid	New Policy After Exchange
Basis	$225,000	$225,000	$225,000
Cash Value	$350,000	$325,000	$325,000
Policy Loan	$25,000	$0	$0
Gain	$125,000	$100,000	$100,000
Taxable Boot	$0	-$25,000	$0

In some situations, the new carrier may issue a new policy and carry over the same loan amount. There are a few carriers that will allow this, and in that instance, there will be no taxable event, since the policy owner has not recognized a gain. In most instances, however, it is desirable to pay off the loan from outside funds. A careful analysis around the best options for a policy with a loan should be reviewed by the trust committee and made part of the trust file before any actions are taken.

Taxation of Benefits Paid on a Matured Contract

Most life insurance policies pay a benefit well before the policy matures. However, in an era of increased longevity, some insureds will live until their policies' maturity date, at which time the benefit will be paid. In that case, the benefit, whether the full death benefit or the cash value of the policy, will be taxed as a living benefit–the cost basis is received income tax-free, and the balance is taxable as ordinary income.

This is an issue in older policies that mature at age 95 or 100. Most newer policies are written with a maturity age of 121. In some policies that do not extend to age 121, there is a maturity extension that pushes the policy benefit payout to an advanced age, usually 121. Typically, during the extension period, charges within the policy, including the cost of insurance, cease, and premiums are no longer due. If there is a loan on the policy it continues while accruing interest. Any death benefit provided by a term rider drops off, lowering the total death benefit by that amount.

The tax benefits of life insurance are one reason that it is such a versatile and flexible estate planning tool. Trustees must be aware of the benefits and pitfalls of life insurance taxation to maximize the value of the trust for the beneficiaries.

CHAPTER 14

Understanding Life Settlements

$112 billion in death benefits are lost each year by Americans aged 65 and up by lapsing or surrendering their life insurance policies. - *Life Insurance Settlement Association (LISA), February 2015 press release.*

"The Beneficiary, who has a vested benefit in maintaining the life insurance contract, can help preserve a high-yielding, tax-free asset by securing funds to satisfy the liquidity needs of the policyholder or by assuming the premium payments on the life insurance policy. The return on the Beneficiary's investments to preserve the life insurance contract is likely to exceed any other investment option." - *2005 Deloite study on life settlements*

Changes in the federal estate tax in the last decade have some grantors re-thinking their estate plans and their need for a large tax-free life insurance benefit to pay estate taxes. Some grantors have grown frustrated by policy performance issues caused by low investment returns and/or cost of insurance increases, and some have decided to stop funding their ILIT. TOLI trustees must now decide what to do with unwanted life insurance policies, and the easy answer is to surrender the policy or allow it to lapse. But is that the prudent answer? Today's trustee must consider the viability of a policy sale–a life settlement–or risk future litigation from a beneficiary alleging the trustee did not uphold the fiduciary duty to maximize the value of the asset in the trust.

It is estimated that every year, seniors in the US surrender or lapse well over $100 billion in life insurance death benefits. Most have no idea of their options, grow tired of the premium payments, and walk away without maximizing the value of an asset they may have paid for over a lifetime. It is the responsibility of a trustee to understand all options. A life settlement may or may not be the best option for a policy. After all, if someone is willing to buy a policy and pay the remaining premiums, they must think that maintaining the death benefit makes sense. This chapter will provide the TOLI trustee with a background in the life settlement market and explain the sales process and tax ramifications to ensure that an informed decision is made regarding this area of policy management.

A New Benefit for Life Insurance

For many years, life insurance policies only provided two benefits to a policyholder–a death benefit paid at the passing of the insured, and cash value, which could only be accessed through a loan, a withdrawal, or a policy surrender.

The ability to sell a policy is a recent occurrence, and provides the policy owner with the potential to obtain greater value from a policy. By selling a policy in the secondary market, a policy owner can receive more than its cash value, but less than its death benefit. The purchaser of the policy will maintain the policy by paying the premium until the death of the insured.

A life settlement is the sale of a life insurance policy to a third party for more than its cash surrender value, but less than its net death benefit.

The Legal Precedence for Life Settlements

A 1911 U.S. Supreme Court decision handed down by the famed jurist, Oliver Wendell Holmes, set the legal precedent for life settlements. A surgeon, Dr. A.H. Grigsby, operated on a patient who offered to sell the doctor his policy, presumably to lower the bill. The transaction occurred, the doctor paid the remaining premium due on the policy, but when the patient passed away about a year later, and the doctor attempted to collect the death benefits, the patient's estate challenged him in court and won. The appeal found its way to the highest court where Justice Holmes opined, "it is desirable to give to life policies the ordinary characteristics of property . . . to deny the right to sell . . . is to diminish appreciably the value of the contract in the owner's hands."

The Viatical Market

The life settlement industry grew out of the viatical movement of the 1980s, driven by the AIDS epidemic. In the early 1980s, the Center for Disease Control counted less than 500 AIDS cases in the US, but by 1989 that number grew to over 70 thousand, with 1.5 million Americans HIV positive. AIDS victims were given the opportunity to sell their life insurance policies to third parties to provide cash for the medical treatment and care needed to live out their shortened lives with dignity. These policy sales were called viatical settlements**,** a term that specifically refers to the sale of a life insurance policy on a terminally ill insured.

Accelerated Death Benefits

A life insurance policy feature that evolved out of the viatical sales movement is the accelerated death benefit, which allows a portion of the death benefit to be paid prior to death if the insured is diagnosed with a terminal illness, has contracted a disease that would shorten their life expectancy

without extensive medical treatment, is receiving long term care due to an inability to perform two or more activities of daily living, or will be permanently confined to a nursing home.

Not all policies have the accelerated death benefit option and there are carrier guidelines that vary from insurer to insurer, to receive the benefit. Some insurers require that an insured's life expectancy be no longer than 6 or 12 months, while other insurers accelerate death benefits if the life expectancy is 24 or fewer months. The carrier may also limit the death benefit that may be accelerated, and some consider the accelerated benefit a loan with interest applied. In all instances, the death benefit is reduced by the amount accelerated, but even so, this accelerated benefit is often more valuable to the policyholder than selling the policy.

Accelerated death benefits and viatical settlements can be received free of income taxes. To receive the death benefit free of income taxes, the insured must be certified by a physician to have a terminal condition - defined as having a condition or illness that is reasonably expected to result in death within 24 months.

The Life Settlement Industry

While the number of confirmed AIDS cases continued to climb through the 1980s, the percentage of those who died from AIDS declined because of new drugs and treatments that were effective in keeping those afflicted alive for a longer period of time. Consequently, the investors in those earlier viatical policies who hoped for quick returns, held on to policies longer than expected, with returns that did not match expectations. However, the idea of investing in life insurance took hold, and the industry simply shifted its focus from terminally ill insureds to non-terminally ill insureds age 65 years or older.

The life settlement industry, also known as senior settlements, is generally focused on individuals age 65 and up who have had a decline in health. The decline in health increases the salability of the policy. Someone who was issued a policy as a preferred risk, but is now less healthy, would still have a policy priced as a preferred risk, making the policy a better investment. Typically, the maximum life expectancy for those selling their policies is less than 15 years, but can be longer for those 65 or younger. Today, life settlement sales greatly outpace viatical sales.

Why Sell a Policy?

As we mentioned, the secondary market frees up value in life insurance policies that otherwise would not be there. There are several reasons a policyholder might sell their policy.

- Needs Change: In the family market, policies purchased to ensure the income of a primary contributor, or provide education funding, may no longer be needed. Selling a policy can free

up additional monies, for example as the insured enters retirement when additional cash from a policy sale might be needed. In the business market, policies used to insure key employees, or to fund a buy-sell agreement may no longer be required, causing the policyholder to look for a way to monetize a business asset. In the TOLI market, changes in estate tax laws or family or financial circumstances may have lowered the need for life insurance in some instances, however maximizing the asset in the trust is still a trustee responsibility.

- Cost Increases: Because of the low interest rate environment, premiums on some permanent policies have risen as cash values have not grown as projected at policy issue. In some cases, the low interest rates have caused carriers to raise cost of insurance rates. Some grantors simply do not want to pay the increased costs and are looking for alternatives.

- Potential Policy Lapse: Because of cost of insurance increases, low returns, or inadequate gifting to the trust, many TOLI policies have cash values that are dissipating. To obtain some value for the policy, the trustee looks to sell the policy before it lapses.

The Life Insurance Settlement Association (LISA), in a February 2015 press release, unveiled research that found that $112 billion in death benefits were lost each year by Americans 65 and up by lapsing or surrendering their life insurance policies. Many TOLI trustees do not review the opportunity of a life settlement. The industry, and organizations like LISA, have been educating insureds, including grantors, on their right to sell a policy to the highest bidder. These enlightened grantors are expecting their trustees to investigate all options.

Why Buy a Policy?

Life settlements are considered an alternative investment to traditional investments like stocks and bonds and provide attractive yields. They are referred to as a non-correlated asset because the ultimate returns are driven primarily by mortality experience. This provides diversification to an investment portfolio; a reason large investment firms or pension funds allocate a small percentage of their investment to life settlements. While the returns can be less than expected, they exhibit lower volatility - another plus.

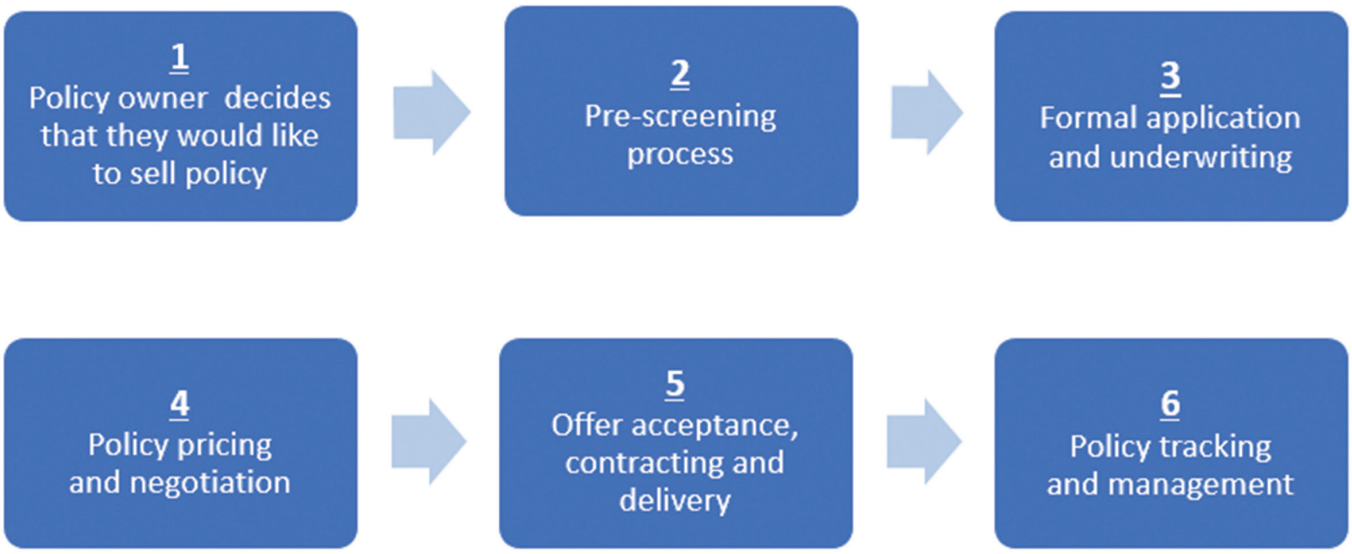
Most of the policies purchased in the life settlement marketplace are current assumption universal life (CAUL) policies. These policies are transparent - it is easy to see the costs in the policies and relatively easy to compute the minimum amount needed to keep the policy in force–important for cost conscious investors. Guaranteed universal life policies (GUL) are also purchased. These policies provide the investor with a maximum guaranteed premium. Term policies are also sold, but generally only if the term policy can be converted to a permanent policy like a CAUL policy. Other policy types are occasionally sold, driven by favorable (short) life expectancies of the insured.

Year	Annual Face Amount Setttled In Billions
2004	3.3
2005	5.5
2006	6.1
2007	12
2008	12
2009	8
2010	3.8
2011	1.2
2012	2
2013	2.6
2014	1.7
2015	1.7
2016	2.2

Over the years, life settlement volume has risen and fallen. The market reached its peak in 2007-08, but then dipped during the stock market correction and economic slowdown. The chart above shows the approximate annual face amount sold each year since 2004, as reported by the Life Insurance Settlement Association (LISA), which gathered the information from industry sources. A research paper published in 2005 predicted the market would "grow more than ten-fold to $160 billion over the next several years," but that never occurred (43). However, the market is now stable, even on a slight upswing. There is also a trend for smaller face policy sales. With an aging population, and the need for retirement income, the market will continue to grow.

The Life Settlement Process

The life settlement process begins when a policy owner decides to sell their policy. To gauge the viability of a sale, a policyholder submits information about the policy, as well health information about the insured to determine if a life settlement is a viable option. If so, formal underwriting and application can occur. This is where a life expectancy (LE) report comes in as part of the process. Typically, LE reports are obtained from two different vendors (for more information on LEs, see Chapter 15–Understanding Life Expectancy Reports).



The LE reports, along with information about policy premium funding, are used to generate a sale price. There is typically a negotiation process that occurs before a price for the policy is agreed upon. Once an offer is accepted, an extensive contracting process ends with delivery of the policy to the new owner. Once the new policy owner takes control of the policy, it is tracked and managed, either in house or through outside vendors. The investors typically manage the policies by paying the absolute minimum to keep the policy in force each month.

Regulations

In the early days of life settlements, there were few regulations, and consumers were often taken advantage of. Transactions occurred with most of the purchase price consumed by commissions and expenses. There were several lawsuits that exposed the issues, and as the industry grew, regulators, politicians, and industry leaders got involved to create best practices around the process, which ultimately proved to be beneficial for the industry.

Industry regulations have created transaction transparency. As of 2017, 42 states and the territory of Puerto Rico regulate life settlements, with approximately 90% of the US population affected by these regulations. Some of the state regulations follow model acts that were adopted by national organizations.

The Life Settlements Model Act was adopted on November 16, 2007 by the National Conference of Insurance Legislators (NCOIL), representing legislators from many states. The regulation was re-adopted seven years later in 2014. The 28-page act dealt with licensing and contracting and reporting requirements, as well as advertising and disclosure rules to insureds and insurance companies alike. The act outlined prohibited practices, specifically regarding fraud in the life settlement market.

The National Association of Insurance Commissioners (NAIC) passed a Viatical Settlements Model Act Revision in June of 2007 which enhanced and strengthened consumer protection. Like the Life Settlements Model Act, it dealt with the life settlement transaction, including licensing, prohibited practices, and reporting requirements.

Taxation of a Life Settlement

A TOLI trustee must make sure the beneficiary is receiving maximum benefit from the asset–the life insurance policy. A life settlement is an option that must be reviewed in its entirety. One aspect is taxation, which is laid out in general guidelines provided by the IRS. Although a policy in a TOLI trust is free from both income and estate taxes, a policy that is sold loses some of its tax advantages.

Determining the taxation of a life settlement sale is a 3-step process. Let's assume a policy was sold for $375,000 and the trustee had paid $100,000 in premium payments. Let's further assume that there was $125,000 cash value in the policy when it was sold.

Assumptions:

- Policyholder Received: $375,000
- Cost Basis (Premium Paid): $100,000
- Cash Value: $125,000

Step 1: Calculate Total Gain

The first step is to determine the total taxable gain on the policy. This is calculated by subtracting the cost basis of the policy from the amount received from the sale. The cost basis is typically the cumulative premium paid.

- Amount received minus Cost Basis (Premium Paid): $375,000 - $100,000 = $275,000

Step 2: Calculate Ordinary Income

The characteristic of the taxes due is dependent on the cash value in the policy at time of sale. If the cash value is greater than the cost basis, then ordinary income tax is paid on the difference between the cash surrender value and the cost basis. For example, in this case, the cash surrender value of the policy was $125,000 and the premium paid was $100,000, so $25,000 of the gain would be taxed as ordinary income tax.

- Cash Value minus Cost Basis (Premium Paid): $125,000 - $100,000 = $25,000

Step 3: Calculate Capital Gains Income

The ordinary income is subtracted from the total gain to arrive at the capital gains amount.

- Total Gain (Step #1) minus Ordinary Income (Step #2): $275,000 - $25,000 = $250,000

Note that if there is no cash value (a term policy, for example) or the cash value is lower than the cost basis in the policy, the entire amount is taxed at capital gains rates.

The tax calculation around a life settlement is somewhat complex so it is easy to see how this type of transaction can be very confusing if a TOLI trustee is not well versed in the taxation of life insurance.

The Life Settlement Participants

Who are the participants in the life settlement process? The first person is the policy owner, which if you are a TOLI trustee, is you. You may be working with someone, an advisor or a life insurance agent, that will guide you through the process, and for their efforts, they may receive a commission from the broker of the policy. The broker gathers the information on the policy and the insured (including life expectancy reports), and creates a package that is sent to life settlement providers who will review the information and present offers. The broker's job is to work for the benefit of the seller, and help the seller get the highest price for the policy. The provider is the person who enters a sales contract with the policy owner. Brokers and providers are highly regulated and licensed on a state-by-state basis. Ultimately, after the purchase, the policy may find its way to an end investor or buyer - an investment firm, pension fund, life settlement fund, etc. - who will own the policy until the insured passes away, or in some cases, until they sell the policy. Sales that occur after the policy has been sold into the settlement market are called tertiary sales.

Life Expectancy Reports

Life expectancy reports are an important part of the life settlement process. The life expectancy of the insured is one of the biggest factors when pricing a policy. The annual carrying costs can be predicted by reviewing in force life insurance illustrations. Once computed, the total costs will be approximated by estimating the number of years (or months) those premiums would have to be paid. The life expectancy reports provide that estimate, but if the estimate is off, the actual carrying costs for the policy may be more than expected.

There are ancillary costs, such as policy management and tracking fees, in addition to premium costs for each year a policy is held. If a policy was projected to be held for approximately 8 years until a benefit is paid, but is held an additional number of years, the cost to carry the policy rises and the profit on purchasing the policy drops.

After a policy is purchased, the investor who acquired the policy has the right to reach out to the insured to track their well-being and update their health information. This physical tracking is an important part of the ongoing management of the policy.

When a policy is sold into the life settlement market, the new policy owner usually strips the cash value out of the policy. Insureds typically have life expectancies that are relatively short. The investors pay the absolute minimum contribution needed to keep a policy in force for a short period, a practice called premium or policy optimization. The rate of return of this investment is driven by how little or how much is put into the policy to sustain it over its life, so funding a policy at its absolute minimum is important.

Life Settlement Case Study

The life insurance policy in a TOLI trust is an asset that must be maximized for the beneficiary, a requirement of a TOLI trustee. The following case study is an example of a life settlement policy sale. It will provide an understanding of the process and emphasize what you should be aware of during the transaction.

- Policy Insured: Female, age 73 at policy issue, rated non-smoker
- Policy: $1 million, Current Assumption Universal Life policy, policy currently in policy year 18.
- Current Cash Value: $225,500

When the policy was purchased, it was projected that an annual premium of $68,000 would carry the policy to maturity when it would over endow with a cash value and death benefit of just over $1.1 million. At policy issue, the crediting rate on the policy was 6.25%. Over the years, the interest rate credited to the policy dropped to 4%, the contractually guaranteed rate. The grantor notified the trustee that no more gifts would be made to the trust. Even though the premium was paid each year, the policy performance lagged and without additional premium payments, the policy would lapse in approximately 2 years. Even if the $68,000 premium was paid, the policy would lapse in about 3 ½ years. The insured was currently 92, but was, according to the trustee, in reasonably good health. Per in force ledgers obtained from the carrier, just over $90,000 in level premium payments would have to be paid each year for the policy to persist to maturity.

Since the grantor was not going to fund the policy, the trustee reached out to the beneficiaries to see if they would be interested in funding the policy. The beneficiaries were more interested in exploring the value of the policy in the secondary market. The trustee reached out to a licensed life settlement broker who pre-screened the life settlement viability based on premium need, and a general description of the insured's health. Once it was determined that a policy sale was feasible, the trustee moved ahead with the formal application. After receiving a HIPAA form signed by the insured, the

broker gathered health information and obtained two life expectancy reports. The information was shared with 9 providers, not all providing offers.

Bid History Report

Bidder	Bid Status	Initial	Round 1	Round 2	Round 3	Round 4
1	Declined					
2	Not Licensed					
3	Offer Surpassed	$325,000	$340,000	$340,000	$340,000	
4	Declined					
5	Offer Surpassed	$330,000	$350,000	$380,000	$390,000	
6	High Offer	$335,000	$350,000	$370,000	$385,000	$410,000
7	Declined					
8	Declined					
9	Offer Surpassed	$310,000	$340,000	$340,000	$340,000	
10	Declined					

After several rounds of offers, the trustee decided to accept the $410,000 offer. The net to the trust, after all commissions were paid, was $350,000. See the note on commissions below.

Notes about this case (and life settlements in general):

- The seller of the policy (trustee) should insist on a bid history sheet, and before settling on a broker, should ask the broker how many providers will be bidding on a policy. The prices that can be obtained may be affected greatly by the number of bidders competing for the policy.

- Both brokers and providers need to be licensed to take part in the sale of a life insurance policy.

- While the total paid for the policy was $410,000, there is a commission paid to the broker. The commission should be spelled out in detail beforehand. In this case, the commission was $60,000, the *lesser* of:
  - 6% of the death benefit of the policy, in this case $60,000 (6% of $1 million)
  - 30% of the gross offer, in this case $123,000 (30% of $410,000)
  - One third of the value created, defined as the difference between policy gross offer and cash surrender value, in this case $61,050 (1/3 of $410,000 minus $225,500 or $185,000).

- As we mentioned, there could be taxes due on a policy sale, but in this case, none were as the adjusted cost basis was greater than the net sale price.

- While the policy lapse was foreseen, it was not going to occur for approximately two more years. An alternative would have been to keep the policy for two years and monitor the health of the insured before selling the policy prior to lapse. There would be the risk a better offer could not be obtained at that time, but if the insured had passed away in the interim, the full death benefit could have been received.

- While it was not a viable choice in this situation, the death benefit could have been reduced to an amount that would carry to maturity with no more premium payments due. This is often a viable option; however, the trust would have to wait until the insured passes to receive the benefit.

- While not an issue in this case, as this insured could no longer obtain new life insurance (over age 90), a life settlement may affect the ability of the insured to purchase life insurance in the future, and should be a factor in the sale decision.

- During the sales process, the insured must allow access to their complete health history. After the sale, the insured will more than likely be contacted by the end buyer or a vendor on a quarterly basis to update information, including secondary contacts. This ongoing contact will be a requirement of the sale.

- The sale of a life insurance policy is not always the best option. If a policy is going to lapse, receiving something of value will almost always be the prudent move. However, if an investor sees value in a policy, funding that policy until death may bring a greater benefit to the trust than selling it. As pointed out in the Deloite quote at the beginning of this chapter, "the return on the . . . investments to preserve the life insurance contract is likely to exceed any other investment option."

Life settlements are an option that the prudent trustee needs to explore and understand. While the opportunity to sell a policy for more than its cash value is not always available, and some insureds will chafe at the thought of being contacted for the rest of their life by the eventual buyer, the viability of a sale should be reviewed and documented before a policy is surrendered or allowed to lapse, if no potential liability occurs.

CHAPTER 15

Understanding Life Expectancy Reports

Life expectancy reports provide a TOLI trustee with an important data point - a systematic estimation of an insured's remaining life. When making policy decisions, the addition of an LE report to a TOLI file helps to ensure that the decision being made is a prudent one, since it is based on all the relevant information available for review.

Life expectancy (LE) reports are an integral part of the life settlement process. They are used when a policy is being priced for sale. By determining an expected lifespan and premium costs until a benefit will be paid, the investor can calculate a fair purchase price for a policy that will enable the investor to make a profit on the investment. After a policy is sold, LE reports are periodically run on the insureds to value a life insurance portfolio.

The use of LE reports in the TOLI community is not as prevalent as it should be. This chapter will outline the methodology behind an LE report and clearly show the value of their use.

How an LE Report is Created

1. A HIPAA (Health Insurance Portability and Accountability Act of 1996) form is filled out and signed by the person who is the subject of the report. The form authorizes the firm providing the LE report to receive protected health information. Health records are gathered and reviewed by underwriters.

2. The underwriters determine the conditions that should be included in the life expectancy calculation based on age, gender, lifestyle, smoking status, family history and medical condition (underwriting factors) to create the LE report.

3. The life expectancy report typically includes the life expectancy estimate and can include the probability of mortality each year based on the insured's specific underwriting factors.

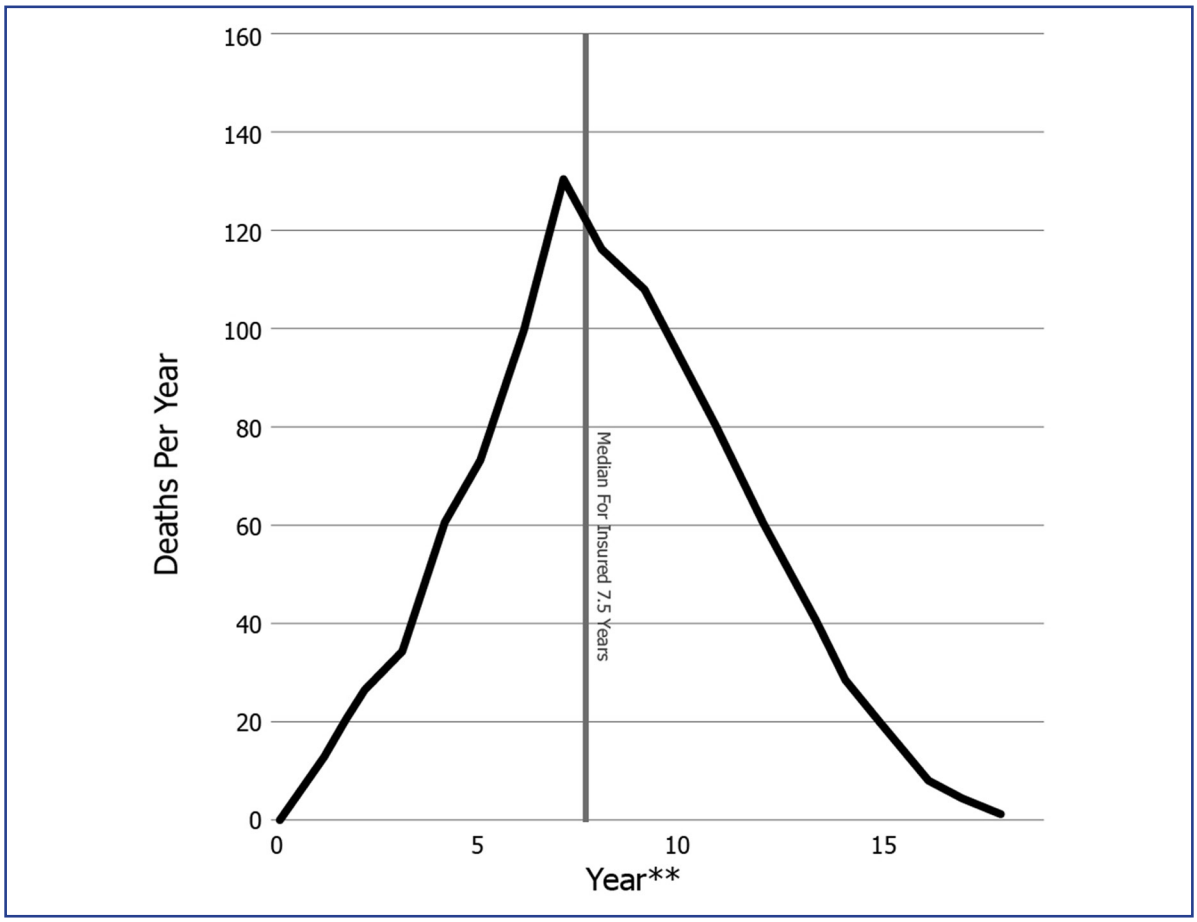
4. Unlike life insurance underwriting, where a client's poor health will stop the process, the underwriting for an LE report is often accomplished on individuals with moderate to severe health issues.

5. A base mortality table is developed. Debits and credits are applied to the table based on the health of the subject.

6. A mortality multiplier, which is the degree of adjustment made to the base mortality table, will be generated. The higher the multiplier, the shorter the life expectancy and the more time subtracted from the base table.

7. The report always lists the date range for the health records reviewed and the current age of the subject, as well as the family history, social habits (tobacco, drug/alcohol use, and fitness levels). A listing of the specific diseases or disorders found will be provided, that were included when calculating the life expectancy.

8. The life expectancy of the insured is reported in years and months and is based on the successive deaths of a population of individuals with the same underwriting factors as the focus individual. The prediction of those deaths creates a mortality curve that can be applied to the individual.



The reports produced by ITM TwentyFirst create a mortality curve that tracks the expected deaths of 1,000 individuals with the same profile as the subject individual. The curve provides a visual representation of the life expectancy of the subject.

The median, or point at which 500 of the 1,000 individuals has passed, is noted on the curve.

In addition to the mortality curve, a spreadsheet chart is provided that numerically tracks the expected deaths that would occur in the population of 1,000 individuals. While some consider the life expectancy to be the median, or 50% mark, others take a more conservative approach and consider the life expectancy of the subject to be at the 75% or 85% mark.

Year	Lives	Deaths	Accumulated Deaths
0	1000	0	0
1	988	12	12
2	961	27	39
3	926	35	74
4	866	60	134
5	**792**	**74**	**208**
6	693	99	307
7	562	131	438
8	445	117	555
9	336	109	664
10	**243**	**93**	**757**
11	166	77	834
12	106	60	894
13	61	45	939
14	32	29	968
15	14	18	986
16	5	9	995
17	1	4	999
18	**0**	**1**	**1000**

In the TOLI world, we can use the spreadsheet or chart to approximate the chances of death of the subject. This is not an exact science, it is just a data point that can be added to a policy analysis when decisions are made about a policy.

For example, in the chart above, we could convert the fact that 208 of the 1,000 individuals would have been expected to pass away by the 5th year to a 20.8% percentage chance. By year ten, there would be a 75.7% chance, and by the end of year 18, we can assume that the insured would have passed away.

A case study below illustrates how an LE report can be used in the TOLI world.

Grantor informs trustee that no additional gifting will occur for the trust.

Background: A trustee of a portfolio of three current assumption universal life policies totaling $10 million in death benefit has been informed by the grantor, a male, age 85, that no more gifting would occur to the trust. The trustee reached out to the beneficiaries who informed the trustee that they too were not interested in providing additional funding at the time. The trustee was concerned about the possibility of policy lapses, but wished to uphold his responsibility to maximize the benefit of the trust to the beneficiaries.

Review: In force illustrations were obtained on all three policies assuming no further premium was going to be paid into the policies. In addition, a life expectancy report was obtained on the insured/grantor. The information was summarized in the spreadsheet below.

	Year		Age	Projected Out of Pocket Contributions - Pay $0 Until Point of Lapse							Life Expectancy Report % Total Deaths	
				Policy #1 $5,000,000 policy		Policy #2 $2,000,000 policy		Policy #3 $3,000,000 policy		Total Cumulative Premium		
				Annual Premium	Cumulative Premium	Annual Premium	Cumulative Premium	Annual Premium	Cumulative Premium			
8 Years before any premium is needed	2016	1	86	$0	$0	$0	$0	$0	$0	$0	12%	At 8 years little chance the Insured is still alive
	2017	2	87	$0	$0	$0	$0	$0	$0	$0	29%	
	2018	3	88	$0	$0	$0	$0	$0	$0	$0	46%	
	2019	4	89	$0	$0	$0	$0	$0	$0	$0	64%	
	2020	5	90	$0	$0	$0	$0	$0	$0	$0	76%	
	2021	6	91	$0	$0	$0	$0	$0	$0	$0	85%	
	2022	7	92	$0	$0	$0	$0	$0	$0	$0	91%	
	2023	8	93	$0	$0	$17,650	$17,650	$0	$0	$17,650	97%	
	2024	9	94	$35,000	$35,000	$17,650	$35,300	$0	$0	$70,300	100%	
	2025	10	95	$70,000	$105,000	$17,650	$52,950	$18,000	$18,000	$175,950	NA	
	2026	11	96	$70,000	$175,000	$17,650	$70,600	$35,675	$53,675	$299,275	NA	
	2027	12	97	$70,000	$245,000	$17,650	$88,250	$35,675	$89,350	$422,600	NA	
	2028	13	98	$70,000	$315,000	$17,650	$105,900	$35,675	$125,025	$545,925	NA	
	2029	14	99	$70,000	$385,000	$17,650	$123,550	$35,675	$160,700	$669,250	NA	

As can be seen in the spreadsheet, it was projected no premium would have to be paid on any of the policies until the 8th year when Policy #2, the $2 million policy would have to be funded. All the policies would be nominally funded, allowing policy cash value to run to near zero before funding the policies with a minimal amount to keep the policies in force.

The last column shows the percentage of deaths that would be expected to occur each year, which can be translated to a percentage chance the insured would still be alive. The LE report obtained showed that the insured was expected to have passed away by the end of the 9th year.

While the LE report is not precise, it can provide guidance, and in this situation, it gave the trustee comfort that, at least for now, nothing should be done to any of the policies in the trust. The policies would run at the current death benefit without a premium payment for the foreseeable future,

considering the reoccurrence of annual reviews of the policies and the insured's health. This would keep the full trust death benefit in force and still allow for thoughtful change in the future, if needed.

Outcome**:** The policy could continue without additional funding and any changes. A document was created for the file and signed by all pertinent parties that:

- Reiterated that no more funding was forthcoming from the grantor or beneficiaries.
- Outlined the policy review that was undertaken.
- Noted that a life expectancy report was completed on the insured.
- Noted that based on the best information available to the trustee, there would be no changes to the policies in the trust presently, but that future annual reviews of both the policy and the insured's health would occur.

Notes About Case:

This is an example of a "wait and see" situation. Though made easier with the use of a life expectancy report, the decisions about this policy are far from over. In this case, the trustee has made a prudent decision based on the best information at this time, but the future tracking of the policy and health of the insured will determine the long-term outcome of the policy.

Life insurance policy management is not an easy task, and utilizing tools like a life expectancy report provide additional insight and help mitigate liability. When you gather all the pertinent information in the trust file and correctly interpret it, you lower your potential for litigation even if things do not go as well as hoped, as seen in the following case study.

How an LE Report Helped Mitigate Trustee Liability

A few years ago, an elderly grantor informed our TOLI trustee client that she was no longer going to fund her trust - which held 4 heavily loaned whole life contracts. When we reviewed the policies, we found that without any additional funding, the policies would lapse one by one in approximately 5 years, causing taxable events. The insured/grantor, though hard of hearing, was a very healthy 91-year-old, and a life expectancy report revealed a life expectancy of approximately 7 years. We reached out to the beneficiaries who informed us they had no desire to fund the trust. After a thorough review of all policy options, the decision was made by the trustee to surrender one of the policies and use the cash to fund the other policies, keeping most of the death benefit in force past the expected lifespan of the grantor. Phone calls were scheduled with both beneficiaries who, after reviewing the materials, agreed that this was the prudent decision.

The decision to move ahead was made, and all documentation became part of the trust file. Unfortunately, the grantor did not live 7 years, but passed away less than a year later after suffering from acute appendicitis.

After the death benefit was paid to the beneficiaries, our trustee client received a call from an attorney for the beneficiaries. Even though they had signed off on the trustee decision, they now wanted to sue our client.

The attorney asked our client how he could have possibly surrendered a policy on a 91-year-old?

Our client asked the attorney if his clients told him they had signed off on the decision? No, he answered. Had they told him we did a thorough review of the policies that showed they would begin to lapse in 5 years–with each lapse causing a taxable event? Again, he answered no. Was he aware that we had a life expectancy report on the insured that said she was expected to live 7 years? After our trustee explained exactly what an LE report was, the attorney answered no again. The attorney was never heard from again.

The decision to surrender one policy to keep all the other policies in the trust from lapsing, causing a taxable event and leaving the trust with a negative balance, was a prudent one, but without the life expectancy report to back up the decision, the attorney's question of how could we surrender a policy on a 91-year-old seemed very reasonable. Without the LE report, I am not sure we would have had a good answer.

Even though the insured passed away before her life expectancy, the LE report was the central piece of information that staved off possible litigation.

The cost of a life expectancy report is under $500, and with older aged and/or health impaired insureds, is a vital life insurance policy management tool that could turn out to be priceless, as seen in the example above. All TOLI trustees should become aware of these reports.

CHAPTER 16

Policy Remediation

Remediation

The act or process of remedying–to correct or counteract

From the Meriam-Webster Dictionary

To most, the act of remediating a life insurance policy means to fix a problem policy. But life insurance remediation also includes dealing with any changes or alterations to the policy necessitated not only by negative policy or market performance, but also by changes in trust or client goals.

While remediation certainly includes developing the best options for an underperforming policy suffering from lower than expected returns in the cash value investments or one subject to a cost of insurance (COI) increase, it also includes maximizing the value of a policy that a grantor believes is no longer needed, or one whose expected funding has stopped. These decisions must be well-thought-out. There must be a prudent process in place that steers the choices made. Often the decisions made are not black and white, they are grey. The management of life insurance is unlike any other financial instrument since the timing of the benefit paid is unknown, though assumptions on life expectancy can be made.

Remediation is often the weak link of TOLI trustee services as many trust companies and banks do not have the requisite skills to analyze life insurance policy options. This can lead to potential liability with an asset that could be worth millions of dollars.

In this chapter, we will review several case studies and examples focused on common situations and illustrate the prudent processes that should be followed. In addition, we will outline a system intended to prioritize and track policies as they wind through the process.

It is important as a TOLI trustee to have a complete file for every decision made on a policy with an analysis that shows all options, as well as the reasoning behind the decisions made. According to the UPIA, decisions made by a trustee should be based on the best facts and circumstance available at the time, but if a well-judged decision is made, the trustee who follows a prudent process will not be held responsible for an undesirable outcome. One should demonstrate that you gathered and reviewed all the facts and explored all the choices to document a prudent process.

Uniform Prudent Investor Act (UPIA), Section 8—Reviewing Compliance

Compliance with the prudent investor rule is determined considering the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight.

Reasons for Policy Remediation

There are many reasons policies land in remediation:

- Misunderstood Policy: Policies taken in without a clear understanding of policy funding needs or other policy details.
- Over-Loaned Policy: Policies with significant debt that can be subject to taxable policy lapse.
- Policy Performance: Many policies have not lived up to initial expectations because of less than expected cash value returns.
- Cost of Insurance (COI) Increases: A rather recent issue, COI increases can double or triple the carrying costs on a policy overnight.
- Premature Lapse: Because of policy performance and/or inadequate funding, policies may be projected to lapse prior to maturity or life expectancy.
- Changing Trust Goals: Modifications in tax laws or changes in the personal or financial situation of the grantor can alter the death benefit need.
- Changing Trust Contributions: Contributions to the trust available to pay policy premium may be reduced or stopped all together.
- New Policy Coming into Trust: A new or replacement policy entering the trust.

In each of these situations a trustee must maximize the value of the policy for the trust and the beneficiaries. To provide guidance, we will outline a series of cases for different remediation situations.

Case Study #1: Trustee is unaware of the actual condition of a portfolio of policies based on incorrect information provided by the grantor and his life insurance agent.

Background: A successor trust with a portfolio of three whole life policies on a 75-year-old insured was taken over by a TOLI trustee. The grantor informed the trustee that his agent told him the policies in his trust were adequately funded. An email from the grantor stated, "the insurance company will be making the payment" and "the policies I have are self-sustaining." The email from the grantor included an attached email from his agent that stated, "the premium due and the interest due can both be paid by values in the contract." While the policies could be paid by policy loan during the coming year, it was not clear what the long-term implications would be.

Review: While it was discovered no out-of-pocket contributions would be needed for 4 more years, the loans already on the policies would cause a loan squeeze and contributions would have to be made to the policies to pay at least the interest on the loans or the policies would begin to lapse. Because the loan exceeded the cost basis in each policy, each lapse would cause a taxable event. According to information gathered (see chart below), a minimal amount would be required in the fifth year. In the sixth year, the out-of-pocket contributions would grow to over $25,000, and each year thereafter the amount would increase. In the 10th year, the annual payment would be just over $37,000, and the cumulative payment would be just under $200,000. If the grantor were to live to age 90, the required cumulative payments would be approximately $425,000. In addition, because the required payments to the policies would be just enough to keep the policies from lapsing, the trust death benefit would drop. In fact, if the grantor lived to age 90, the total death benefit in all the policies would have dropped to approximately $754,000, even after paying the minimum required cumulative payments of $424,873. The net amount to the trust–the amount of death benefit after the future out-of-pocket contributions made would be $329,764, much less than the almost $1 million benefit that was originally in the trust. While the net benefit will be reduced by the premiums paid (unless the policy has a return of premium design), for all TOLI trusts in this case the grantor assumed no more contributions would be required.

		1	2	3	4	5	6	7
Year	Age	Projected Out of Pocket Contributions					Projected Portfolio Death Benefit	"Net" Death Benefit To The Trust
		Policy #1	Policy #2	Policy #3	Annual Total	Cumulative Total		
2017	75	$0	$0	$0	$0	0	$999,344	$999,344
2018	76	$0	$0	$0	$0	0	$970,341	$970,341
2019	77	$0	$0	$0	$0	0	$939,220	$939,220
2020	78	$0	$0	$0	$0	0	$905,412	$905,412
2021	79	$0	$0	$719	$719	$719	$869,985	$869,266
2022	80	$17,044	$0	$7,719	$24,763	$25,482	$855,629	$830,147
2023	81	$22,990	$0	$8,441	$31,431	$56,913	$846,550	$789,637
2024	82	$23,740	$0	$9,307	$33,047	$89,960	$837,244	$747,284
2025	83	$24,441	$0	$10,059	$34,500	$124,460	$827,805	$703,345
2026	84	$25,078	$0	$10,987	$36,065	$160,525	$817,436	$656,911
2027	85	$25,674	$0	$11,837	$37,511	$198,036	$806,125	$608,089
2028	86	$26,198	$0	$12,239	$38,437	$236,473	$794,712	$558,239
2029	87	$26,671	$0	$12,440	$39,111	$275,584	$783,407	$507,823
2030	88	$27,073	$0	$13,488	$40,561	$316,145	$769,539	$453,394
2031	89	$27,422	$0	$14,744	$42,166	$358,311	$752,211	$393,900
2032	90	$27,716	$23,083	$15,763	$66,562	$424,873	$754,637	$329,764
2033	91	$27,953	$24,919	$16,905	$69,777	$494,650	$756,188	$261,538
2034	92	$28,127	$25,904	$17,524	$71,555	$566,205	$756,911	$190,706
2035	93	$28,182	$26,837	$18,135	$73,154	$639,359	$756,145	$116,786
2036	94	$28,007	$26,968	$18,119	$73,094	$712,453	$753,141	$40,688
					Columns 1, 2 and 3 added together	Total out of pocket paid to date	Total death benefit in all polices in portfolio	Column 6 minus Column 5

NOTE: The information for Projected Death Benefit for Portfolio assumes Projected Out of Pocket Premium is paid and is based on carrier provided illustrations that assumes current dividends and charges. These numbers may or may not occur but provide a basis for discussion. Policy performance and dividends should be tracked annually.

Outcome: Surrendering the policies now would have netted little cash for the trust because of the heavy loans on the policies. There was no opportunity to buy a new, more efficient policy due to the health of the insured, and the grantor and beneficiaries were uncomfortable with selling the policies (they may not have been saleable anyway). Because of the life expectancy of the insured, the decision was made to continue the minimal funding as outlined. As part of the decision-making process a document was created and signed by all pertinent parties to the trust, that:

1. Included the policy review and emphasized that additional out-of-pocket premiums would be needed in the future.

2. Reviewed the general health of the grantor to determine expected funding needed (a life expectancy report could have been used, but was not in this case).

3. Reviewed all policy alternatives.

Included the trustee's decision on policy and funding as well as a note that the policy would be monitored and options would be reviewed again in the future.

Notes About Case #1: Often the grantor of a TOLI trust has a stronger relationship with the writing agent than the trustee. However, it is the trustee's responsibility to investigate and understand the policy and its funding. This is not always easy as the trustee is typically not privy to discussions that occurred between the grantor and agent during the sale of the policy, and even after. A TOLI trustee must have the expertise to review a policy independently to ensure the policy will meet trust goals.

Case Study #2: Cost of insurance (COI) increase in a current assumption universal life (CAUL) policy more than doubles the carrying costs of the policy.

Background: A TOLI trustee held a $4 million CAUL policy issued in April of 1990 to a male, standard, non-smoker, age 52. The policy was now in policy year 27. The insured was age 79, and in good health. At the time of the COI increase, over $1.3 million had been funded into the policy, and based on in force ledgers, an annual premium of $36,400 would be needed to carry the policy to maturity with minimal cash value. The policy COI increase was approximately 40% (see spreadsheet to the right that shows the monthly COI rates before and after the COI increase). The carrier provided the trustee with a letter that outlined options as: 1). "surrender policy for cash value", 2). "reduce the face amount" to a level supported by your premium payment, or 3). "take no action," though, "at some point, you may need to pay additional premiums to keep the policy in force."

Policy Year	Old Monthly Deduction Charges	New Monthly Deduction Charges	% Change
28	3.29	4.61	40.23%
29	3.69	5.18	40.32%
30	4.09	5.75	40.44%
31	4.52	6.35	40.57%
32	4.94	6.96	40.70%
33	5.38	7.58	40.85%
34	5.85	8.25	41.01%
35	6.33	8.93	41.18%
36	6.84	9.67	41.35%
37	7.39	10.46	41.51%
38	7.97	11.29	41.68%
39	8.58	12.17	41.82%
40	9.24	13.12	41.91%
41	9.95	14.12	41.93%
42	10.78	15.28	41.83%
43	11.59	16.41	41.58%
44	12.41	17.52	41.15%
45	13.31	18.71	40.50%
46	14.74	20.56	39.49%
47	16.81	23.21	38.09%
48	19.50	26.59	36.38%
Monthly deduction charges per thousand dollars of death benefit coverage provided.			
Because of the cost increase, the premium to carry the policy to age 100 jumped from $36,400 to $81,595, a jump of over 200%.			

The grantor informed the trustee funding of the trust would stop because of the cost increase. There were two beneficiaries to the trust that had no desire to fund the policy, nor did they have a present need for any proceeds from the trust.

Review: Potential options were outlined for the policy.

1. To maintain the $4 million death benefit under current, non-guaranteed assumptions (which assumed the average 40% increase to the monthly deduction rate), to the grantor's age 100, annual premiums of $81,595 would be required. The policy had no maturity extension, and at maturity (age 100) would pay only the net cash value to the trust.

2. If no premium was paid on the $4 million death benefit under current, non-guaranteed assumptions (which assumes the average 40% increase to the monthly deduction rate), the policy was projected to continue through policy year 37 and then lapse with no value in year 38–insured's age 89. To extend the existing policy beyond the projected lapse in policy year 38 without additional premium, the death benefit would need to be reduced now to $3,111,675, based on the same assumptions.

3. An option found in the contract (but not offered by the carrier in their letter) was to exchange the policy for a contractually paid up whole life policy with the carrier, which was calculated by using the net cash value divided by the net single premium for the insured's attained age. The paid-up death benefit would be $2,811,173.

The options to keep a policy in force to maturity are outlined below:

Options	#1	#2	#3
	Keep Policy As Is	Reduce Existing Policy Death Benefit	Get a Reduced Paid Up Policy
Death Benefit	$4,000,000	$3,111,675	$2,811,172
Contributions Going Forward	$81,595 annually, potential of $1,713,495 in additional cumulative premium	$0.00	$0.00
Value at Maturity	Net Cash Value	Net Cash Value	Full Death Benefit
Notes	Premium subject to future COI increases	Premium subject to future COI increases	Contractually guaranteed

Outcome: The decision was made to internally exchange the policy for a contractually guaranteed whole life policy with the carrier for $2.81 million. No underwriting was required for the exchange. The grantor was a healthy 79-year-old, and though no life expectancy report was done, there was a reasonable chance that the insured could live to age 89, when the existing policy was projected to lapse with no value. Since the grantor and the beneficiaries agreed that no more funding would be available for the trust, the trustee had to pick between options that required no additional funding, which ruled out Option #1. Though Option #2 had a higher death benefit than Option #3, if the existing policy death benefit was reduced, it could still be subject to future cost increases, while Option #3 provided a contractually guaranteed death benefit. In addition, the cash value in the whole life policy was projected to be larger than the existing policy, and though it was not anticipated that the cash value would be accessed in the future, the higher cash value was considered a plus.

The policy was exchanged for a contractually guaranteed whole life policy, but not before a document was created and signed by the grantor and beneficiaries that acknowledged the policy exchange and:

- Outlined the COI increase and the effect on the policy.
- Outlined all the options above in detail.
- Contained language that addressed the fact that, "based on currently available information and in light of the totality of the circumstances, it appears appropriate now to change the Policy to a Reduced Paid-Up (RPU) contract with no further premiums required."
- Reiterated that the death benefit drop would be permanent and that additional coverage on the insured may or may not be available in the future.

Though this was a "prudent" decision based on facts and circumstance, if the insured were in ill health, another option would be to hold off on any policy changes for a year or two and monitor the insured's health. Often, this can be done without impairing the policy. A "wait and see" cost analysis could be performed to review the effect on the policy.

Notes About Case #2: When determining the best course of action for a policy, all options, not just those easily identified, must be reviewed. In this case, a detailed examination of the policy contract yielded another option which was deemed to be the best choice under the facts and circumstances. Without an understanding of this contract option, an alternative option could have been chosen that would not have guaranteed death benefit coverage and subjected the trust to possible future COI increases.

Because of changes in the federal estate tax laws, some grantors are requesting TOLI trustees to surrender or lapse the policies in their trust. Here are two examples.

Case Study #3: Grantor asks trustee to allow policy with no cash value to lapse, leaving the TOLI trust with little value.

Background: A TOLI trustee is informed that a grantor of a TOLI trust housing a survivorship guaranteed universal life policy issued 5 years prior with a current death benefit of $5.5 million and no net cash value, wished to stop funding the trust. The scheduled annual premium was $240,000 and has been paid all years for a total premium outlay of $1.2 million. The policy was guaranteed to the insured's age 110, provided the $240,000 is paid on or before the scheduled due date every year to age 100. The policy is relying on its no lapse guarantee to sustain the coverage to maturity since there is little cash value. Both insureds were rated preferred non-smokers when the policy was issued, and both were still in excellent health at current age 80.

Review: Potential options were outlined for the policy:

Option #1 - Pay the scheduled annual premium of $240,000–*Reviewed*

- Policy is guaranteed to maturity, with premiums payable to age 100

Option #2 - No further premium

- Policy will lapse

Option #3 - Invest future premiums vs. paying premiums–*Reviewed*

- Assumes 4, 5 and 6% after-tax returns.

Option #4 - Sell the policy in the Secondary Market

- No offers were forthcoming because of policy type/client health

Option #5 - Policy replacement

- After obtaining informal application, no more efficient policy options could be found

Option #1 (from above): If the premium is paid in full until age 100, the total premium paid from this point forward would never exceed or even equal the death benefit provided by the policy. At the average life expectancy, approximately $2.4 million less would be paid into the policy (from this point forward) than would be paid out if the insured passes away. This does not factor the time value of money.

Continue Policy Scheduled Premium of $240,000					
Year	Policy Year	Age	Premium	DB	Total Premium Paid
2017	6	80	$240,000	$5,500,000	$240,000
2018	7	81	$240,000	$5,500,000	$480,000
2019	8	82	$240,000	$5,500,000	$720,000
2020	9	83	$240,000	$5,500,000	$960,000
2021	10	84	$240,000	$5,500,000	$1,200,000
2022	11	85	$240,000	$5,500,000	$1,440,000
2023	12	86	$240,000	$5,500,000	$1,680,000
2024	13	87	$240,000	$5,500,000	$1,920,000
2025	14	88	$240,000	$5,500,000	$2,160,000
2026	15	89	$240,000	$5,500,000	$2,400,000
2027	16	90	$240,000	$5,500,000	$2,640,000
2028	17	91	$240,000	$5,500,000	$2,880,000
2029	18	92	$240,000	$5,500,000	$3,120,000
2030	19	93	$240,000	$5,500,000	$3,360,000
2031	20	94	$240,000	$5,500,000	$3,600,000
2032	21	95	$240,000	$5,500,000	$3,840,000
2033	22	96	$240,000	$5,500,000	$4,080,000
2034	23	97	$240,000	$5,500,000	$4,320,000
2035	24	98	$240,000	$5,500,000	$4,560,000
2036	25	99	$240,000	$5,500,000	$4,800,000
2037	26	100	$240,000	$5,500,000	$5,040,000

Avg. "Generic" Life Expectancy

Note: Total Premium Paid is Never Equal to Death Benefit

Option #3 (from above): If we include the time value of money–annual premium invested at certain interest rate assumptions–we can better analyze a real-world alternative for investing the premium versus paying the policy premium. As can be seen in the analysis below, if we invested the premium dollars going forward, at the after-tax interest rates assumed, the investment account would not exceed the policy death benefit until the insureds were in their mid-90s, which was past the generic life expectancy for two current 80-year old people (if both would have passed away). However, both insureds had above average health, so the assumption could be made that one of them would live longer.

Invest Funds Assume Hypothetical Rate of Return						
Year	Policy Year	Age	Contribution	at 4%	at 5%	at 6%
2017	6	80	$240,000	$249,600	$252,000	$254,400
2018	7	81	$240,000	$509,184	$516,600	$524,064
2019	8	82	$240,000	$779,151	$794,430	$809,908
2020	9	83	$240,000	$1,059,917	$1,086,152	$1,112,902
2021	10	84	$240,000	$1,351,914	$1,392,459	$1,434,076
2022	11	85	$240,000	$1,655,591	$1,714,082	$1,774,521
2023	12	86	$240,000	$1,971,414	$2,051,786	$2,135,392
2024	13	87	$240,000	$2,299,871	$2,406,375	$2,517,916
2025	14	88	$240,000	$2,641,466	$2,778,694	$2,923,391
2026	15	89	$240,000	$2,996,724	$3,169,629	$3,353,194
2027	16	90	$240,000	$3,366,193	$3,580,110	$3,808,786
2028	17	91	$240,000	$3,750,441	$4,011,116	$4,291,713
2029	18	92	$240,000	$4,150,059	$4,463,672	$4,803,616
2030	19	93	$240,000	$4,565,661	$4,938,855	$5,346,233
2031	20	94	$240,000	$4,997,887	$5,437,798	$5,921,407
2032	21	95	$240,000	$5,447,403	$5,961,688	$6,531,091
2033	22	96	$240,000	$5,914,899	$6,511,772	$7,177,357
2034	23	97	$240,000	$6,401,095	$7,089,361	$7,862,398
2035	24	98	$240,000	$6,906,739	$7,695,829	$8,588,542
2036	25	99	$240,000	$7,432,608	$8,332,620	$9,358,254
2037	26	100	$240,000	$7,979,513	$9,001,251	$10,174,150

Avg. "Generic" Life Expectancy

Note: 4%, 5% and 6% net returns were used since this was a fixed investment product and those returns are representative of historic fixed returns. Other returns could be used, if appropriate.

Outcome: The policy would be allowed to lapse driven by the fact:

1. The grantor would be allowed not be funding the policy.
2. None of the beneficiaries were interested in funding the policy, even if the death benefit (and the needed premium) were reduced to a lower, more affordable amount.
3. Both insureds were still in excellent health.
4. The policy analysis yielded no compelling reason to continue funding the policy.
5. Because of the insureds' excellent health and the cost of the policy, no life settlement offers were forthcoming.

Before surrendering or allowing a policy to lapse, make sure you review possible 1035 Exchange options. The IRS allows a tax-free exchange for policies that have a tax gain (when the cash value is greater than cost basis) through a 1035 Exchange–a carrier-to-carrier transaction that transfers the cash value from the existing policy to a new policy. This method can also be used to move the cash value of a life policy tax-free into an annuity. The transaction also carriers over the cost basis of the life insurance policy. For example, in this case, though there is little cash value in the policy, there is a $1.2 million cost basis that would carry over, creating a very tax efficient investment vehicle in the new product.

Before the policy could lapse, a document was created and signed by the grantor and beneficiaries that acknowledged the impending policy lapse and:

- Reiterated that no more funding was forthcoming from the grantor or beneficiaries.
- Outlined the policy reviews that were undertaken.
- Noted the health of the insureds.
- Noted no other options, like a policy sale in the secondary market, were available.
- Noted that the trust would no longer hold any death benefit, and additional coverage on the insured may or may not be available in the future.

Notes About Case #3: This is a great example of a situation where the decision is made for the trustee, but an analysis and a review of options should still should be part of the trust file. There were no real options for the trustee as the funding for the policy was going to stop. But showing the outcome of funding the policy vs. investing the premium dollars was important as it may have made a clear case for keeping the policy (it did not). Reviewing policy alternatives, in this case a sale in the secondary market, should always be part of the trust file. The review did not reveal any other alternative strategies for the policy, but reinforced the trustee's decision

Case Study #4: Grantor informs trustee that he will no longer be funding the policy.

Background: A TOLI trust was holding a current assumption universal life policy issued 13 years prior with a level death benefit of $3 million and net cash value of $818,500. The grantor/insured, now 83 years old, has decided to not fund the policy and none of the beneficiaries are interested in funding the policy. The trustee must decide what to do with this $3 million asset.

Review: Potential options were outlined for the policy, and if relevant, were reviewed.

Option #1 - Pay the scheduled annual premium

- No money is forthcoming to fund the policy.

Option #2 - Surrender the policy for the cash value and invest it. R*eviewed (Columns 5 and 6 of chart that follows)*

- Surrender is not a taxable event as cash value was less than cost basis.

Option #3 - Allow the policy to run at the current death benefit with no premium payments. *Reviewed (Column 7 in chart that follows)*

- Policy to lapse in approximately 10 years.

Option #4 - Reduce the death benefit to an amount that will carry the policy to maturity with no premium. *Reviewed (Column 8 in chart that follows))*

- Death benefit of $2,150,000

Option #5 - Sell policy in the secondary market

- No offers forthcoming.

Option #6 - Policy replacement to maximize the death benefit

- After obtaining informal application, no more efficient options could be obtained.

Note: A life expectancy (LE) report was obtained and the results were added to the analysis (Column 9). While an LE report cannot tell the exact date, or even year, of death, it can provide another fact to consider in the decision-making process. As outlined in Chapter 15, an LE report shows when a group of 1,000 individuals with the same age, health, and lifestyle would be expected to pass away over a period. For example, in year 5 below, 250 or 25% would have passed away by year 5. By year 16, age 98, all would be expected to have passed away (Column 9).

In the analysis that follows, if the cash value were invested at a 4% net return the investment account would never reach $2 million in value (Column 5). At 6%, the investment account would reach the $2 million mark in approximately 15 years (Column 6). If the policy were left at current death benefit and not funded it would persist for 10 more years and then lapse. If the policy were lowered to a $2.15 million death benefit (Column 8), coverage would be guaranteed to run to maturity with no additional premium payments.

1	2	3	4	5	6	7	8	9
Year		Policy Year	Ages	Surrender Value Invested at 4%	Surrender Value Invested at 6%	Policy Outcome at Current Death Benefit of $3,000,000 and No More Premium	Policy Outcome at Reduced Death Benefit of $2,150,000 and No More Premium	LE Report % of Insureds Who Would Have Passed Away
1	2017	13	83	$903,240	$920,610	$3,000,000	$2,150,000	3.40%
2	2018	14	84	$939,370	$975,847	$3,000,000	$2,150,000	7.80%
3	2019	15	85	$976,944	$1,034,397	$3,000,000	$2,150,000	11.00%
4	2020	16	86	$1,016,022	$1,096,461	$3,000,000	$2,150,000	19.00%
5	2021	17	87	$1,056,663	$1,162,249	$3,000,000	$2,150,000	25.00%
6	2022	18	88	$1,098,930	$1,231,984	$3,000,000	$2,150,000	35.00%
7	2023	19	89	$1,142,887	$1,305,903	$3,000,000	$2,150,000	41.10%
8	2024	20	90	$1,188,602	$1,384,257	$3,000,000	$2,150,000	56.00%
9	2025	21	91	$1,236,146	$1,467,312	$3,000,000	$2,150,000	65.00%
10	2026	22	92	$1,285,592	$1,555,351	*Policy Lapse*	$2,150,000	71.50%
11	2027	23	93	$1,337,016	$1,648,672		$2,150,000	78.50%
12	2028	24	94	$1,390,496	$1,747,593		$2,150,000	83.00%
13	2029	25	95	$1,446,116	$1,852,448		$2,150,000	87.00%
14	2030	26	96	$1,503,961	$1,963,595		$2,150,000	92.00%
15	2031	27	97	$1,564,119	**$2,081,411**		$2,150,000	96.00%
16	2032	28	98	$1,626,684	**$2,206,295**		$2,150,000	100%
17	2033	29	99	$1,691,752	$2,338,673		$2,150,000	
18	2034	30	100	$1,759,422	$2,478,994		$2,150,000	
				Option #2		Option #3	Option #4	From ITM TwentyFirst LE Report

Based on the analysis above, surrendering the policy and investing the cash value at the returns indicated would likely not produce an amount equal to the death benefit that could be provided, even if the death benefit were reduced to $2.15 million. If there were a compelling reason, enabled by the trust document and justified by particular facts and circumstances, to surrender the policy and distribute the surrender value to the beneficiaries, that might be a consideration. But to maximize the value of the trust, it appears that keeping the policy in force is the prudent decision. Based on the LE report, if the policy is kept in force at the current death benefit, there is a chance that it would lapse without paying a death benefit. Lowering the death benefit to $2.15 million would guarantee that that amount would eventually be paid to the trust.

A case could be made to keep the policy in force for a few more years while tracking the health of the insured, but it was decided that since it would lower the eventual reduced death benefit too much, it was more prudent to move ahead now and reduce the benefit.

Outcome: The policy death benefit was reduced to $2.15 million driven by the fact:

1. The grantor would not be funding the policy.

2. None of the beneficiaries were interested in funding the policy.

3. The LE report showed a real possibility the insured could outlive coverage if the death benefit were kept at $3 million.

4. Waiting to reduce the death benefit would lower the eventual reduced amount.

5. No other options were available for the policy.

Before the policy death benefit was reduced, a document was created and signed by the grantor and beneficiaries that acknowledged the death benefit reduction and:

- Reiterated that no more funding was forthcoming from the grantor or beneficiaries.
- Outlined the policy reviews that were undertaken.
- Noted the LE report on the insured.
- Noted no other options, like a policy sale in secondary market, were available.
- Noted that the trust would hold a lower death benefit and additional coverage on the insured may or may not be available in the future.

Notes About Case #4: This case shows the extent to which you must review all options in a case to arrive at a prudent decision. And though the decision made could be proven prudent, the decision was not crystal clear. Sometimes these decisions are not black and white, they are grey. Which is why it is important to include all facts–in this instance, surrender value investment analysis, policy death benefit reduction outcome and life expectancy report–in your trust file.

New Policy Reviews

In Chapter 3 we outlined the minimum information that should be gathered when a newly purchased policy comes into your trust. Your remediation team should be part of any policy review for a new policy.

The team should review:

- A cover letter or email summary from the agent/advisor outlining the reasons for the policy purchased.
- Illustrations for the policy:
  - The actual sales illustration for policy assuming the funding that was agreed upon.

  - If the sales illustration does not show the policy running to maturity, another illustration showing what is needed at the time of lapse to continue policy to maturity is needed.

- Any additional information about the policy being taken in. For example, planning techniques that may occur in conjunction with the policy purchase, any split ownership or outside funding, etc.

Once all information is gathered, a review focused on the funding that has been established and reasonable expectation for the rate of return in the underlying cash value of the policy should take place.

After a thorough review, a document should be created for the file and signed by all pertinent parties that:

- Outlines the expected funding for the policy.
- Includes all advantages and disadvantages of the policy as well as any caveats.
- Reviews the outcome of the policy at expected, as a well as a lower, return assumptions.
- Outlines any specific grantor requirements, i.e. for a guaranteed universal life policy. All gifts to the trust must be made in full and on time or trustee cannot be responsible for any policy guarantees that may be compromised."
- Designates outside advisors for the policy, if any.
- Designates all individuals who will receive annual report and information on the policy.

In past chapters we outlined specific policy characteristics, advantages, and disadvantages. Review those chapters when developing your trust file documents.

Note: If the policy is one that relies on cash value return for its performance, make sure that you understand the outcome at various interest rates. For example, we reviewed a new $7.5 million equity index UL policy on a male preferred plus non-smoker, age 45 that assumed an $80,000 premium for 10 years only. The outcomes at two different interest rate assumptions are shown below:

Assuming a Net Crediting Rate of 4.8% and Current Assumptions	Assuming a Net Crediting Rate of 6.8% and Current Assumptions
Policy lapses at age 84, before life expectancy	Policy runs to maturity with a death benefit at maturity of $12.5M

The cash value return assumed has a dramatic effect on the outcome of a hypothetical illustration.

Policy Replacements

There are several good reasons to consider replacing an existing policy:

- Change in trust investment temperament
- Policy improvements
- Client health change
- Change in trust death benefit need

When reviewing a policy replacement, follow the same process as above, but make sure there is a valid reason for replacement and that the new policy provides a more efficient asset for the trust. Sometimes this is hard to decipher unless you can "look under the hood" of a policy, as in the case design below.

Case Study #5: Grantor informs trustee his agent is suggesting a policy replacement because of a change in investment temperament.

Background: A grantor with an $8 million survivorship variable universal life policy in his TOLI trust informed the trustee that his agent suggested he replace the variable policy with an equity index product because the grantor's "tolerance for risk was diminished" and there was a desire for a trust asset that was "more conservative." The agent submitted a sales illustration showing the outcome of the equity index policy assuming an 8.49% credited return, but lowered the death benefit in the new policy to $5 million since the grantor also believed that the death benefit he needed in the trust could be lowered. The agent provided no review of the existing policy outcome with a lower death benefit.

When reviewing a replacement policy, you must understand:

- The characteristics, expectations and costs of the new policy.
- The best options available for the old policy.

Review: The review focused on three components:

1. Underwriting
2. Policy Charges
3. Underlying Cash Value Investments/Policy Outcome

Underwriting: With the existing policy, the male was health rated, but in the new policy was considered a standard non-smoker–a plus. The health on the female had deteriorated dramatically to an uninsurable rating, meaning on her own she would not have been able to obtain coverage, but in a survivorship policy she could–at greatly inflated costs. This had the effect of increasing policy costs.

	Current Underwriting	New Underwiring	Upgrade?
Male	Non Smoker, Rated Class E	Standard Non-Tobacco	YES
Female	Preferred Plus	Uninsurable	NO

Policy Charges: The policy charges include mortality charges, as well as taxes, sales charges, asset based charges, processing and per unit charges, and other fees and expenses. The chart below totals all fees and charges based on carrier provided information and/or illustrations. All charges are based on current charges in the policy. Actual charges could go higher. Policy charges greatly affect the performance of a policy over time. We found the total deductions in the new policy to be significantly higher than the existing policy. In fact, in 30+ years, the new policy would be over 4 times costlier.

Years		Ages		***NEW POLICY*** TOTAL DEDUCTIONS		***EXISTING POLICY*** TOTAL DEDUCTIONS	
				Annual	Cumulative	Annual	Cumulative
1	2016	56	51	$8,001	$8,001	$2,756	$2,756
10	2025	66	61	$24,856	$155,619	$13,744	$89,159
15	2030	71	66	$43,069	$330,062	$12,760	$148,805
20	2035	76	71	$83,190	$657,445	$18,197	$221,551
25	2040	81	76	$163,294	$1,290,721	$34,111	$356,644
30	2045	86	81	$343,971	$2,584,419	$66,228	$611,355

Charges in the new policy were 4 times the charges in existing policy

Underlying Cash Value Investments/Policy Outcome: In the sales illustration the trustee received from the agent, the assumed crediting rate for the survivorship equity index universal life policy was 8.49%. As we mentioned in Chapter 10, regulations now limit the crediting rate shown on illustrations on EIUL policies to approximately 7% (this case was prior to AG 49) and with good reason. An 8.49% return will more than likely not be achieved in the policy, though showing a high return made the sales illustration attractive to the grantor. When we compared the two policies it was easy to see the new policy was not a good substitute for the existing policy. The existing variable policy had a Fixed Account that paid a guaranteed 4% return. As can be seen in the chart that follows, the new policy, even at the 8.49% assumed return, could not outperform the existing policy based on current costs assuming the 4% guaranteed rate. If we assumed the same $40,000 premium that was to be paid in the new policy was contributed to the existing policy at the guaranteed rate of return in the Fixed Account, the policy would run until the male was 95, the female 91.

Remember, all else, equal the higher the return shown in a universal life chassis policy sales illustration, the lower the premium need will be.

Policy	Assumption *$40,000 Annual Premium*	Outcome
Existing VUL Policy	4% guaranteed rate of return and current charges.	Policy runs for ***39 years*** and lapses.
	2% (2% less than guaranteed rate of return) and current charges.	Policy runs for ***34 years*** and lapses.
New EIUL Policy	Assumed Index rate of 8.49% and current charges.	Policy runs for ***32 years*** and lapses.
	Assumed Index rate of 3% and current charges.	Policy runs for ***22 years*** and lapses.

Outcome: Based on the information we provided the trustee refused the replacement.

Notes About Case #5: One of the prime responsibilities of a TOLI trustee is spelled out in Section 7 of the Uniform Prudent Investment Act ("a trustee may only incur costs that are appropriate and reasonable in relation to the asset." Accepting this replacement would have run afoul of that regulation. Sometimes it is hard to decipher the actual costs in a policy. The costs are not the premium, they are the underlying expenses. The premium costs can be hidden (lowered) by manipulating the illustration, but the actual costs cannot.

Case Study #6: Grantor informs trustee his agent is suggesting the three policies in the trust be replaced with one, more efficient policy.

Background: A trustee is approached by the grantor of a trust with a portfolio of whole life policies. The grantor is no longer going to fund the trust and the agent is suggesting that the three policies be replaced with one policy with a reduced death benefit. The existing portfolio totaled $5.7 million of coverage and had approximately $2.1 million of cash value. The agent is proposing to 1035 Exchange the cash from the existing policies into an equity index universal life policy that, based on a reasonable rate assumption and current charges, would carry the policy until age 92, which was past the life expectancy of the grantor/insured. The new policy would need no additional funding until age 92.

Review: While it is true that the new policy would need no additional funding, and assuming conservative crediting assumptions would carry the policy past the expected lifespan of the insured, no review was done on the existing policy options. After contacting the carrier, it was found that the existing policy death benefit could be reduced to $3.9 million by requesting a paid-up policy which would contractually guarantee $3.9 million in death benefit until maturity, when the policy would endow (cash value equals death benefit). The two best options, should the grantor wish to stop funding the trust, are listed below.

	Option #1 Exchange for New EIUL Policy	*Option #2* Request a Reduced Paid Up Policy
Death Benefit Provided	$3,000,000	$3,900,000
Assumed Outcome	Lapses before maturity	Runs to maturity and endows for full $3,900,000

Outcome**:** The requested transaction was refused by the trustee. The request was made to the carrier for a reduced paid-up policy, but not until a document was created for the file and signed by all pertinent parties that:

- Reiterated that no more funding was forthcoming from the grantor or beneficiaries.
- Outlined the policy review that was undertaken.
- Noted no other options, like a policy sale in the secondary market, were available.
- Noted that once the death benefit was reduced it could not be increased back to the original amount.
- Noted that the trust would now hold a lower death benefit, and additional coverage on the insured may or may not be available in the future.

Notes About Case #6: This case shows the extent to which you must review the options on the existing policy in a replacement scenario. Had the trustee accepted the transaction request, they would have been liable for a death benefit loss of $900,000, in addition to increased policy risk, as the new policy's death benefit was not contractually guaranteed. If the agent suggesting the replacement does not fully review the best options for the existing policy, you, as a TOLI trustee, need to. It is your responsibility.

Developing a Remediation Process

TOLI trustees should develop a rigorous process for policy remediation. While each firm can develop their own processes, here are a few guidelines to consider.

Remediation cases should be placed in categories indicating the reason or issue the policy is in remediation. These may include:

1. New Policy or Policy Replacement

2. Policy Lapse Imminent - Policy is projected to lapse within a very short period of time

3. Policy Lapse Projected:
   a. From 1 to 5 years
   b. From 5 years plus to maturity

4. Death Benefit Decrease in Policy - A decrease in the death benefit of the policy has been requested

5. Term Conversion/Premium Increase - The conversion deadline and/or level premium period will expire within 2 years on a term policy

6. Policy Loan Issue - Policy loan causing the death benefit to decrease, while increasing the lapse risk/taxable event

7. Whole Life/Term Blend Issue - Issues with this type of policy can include death benefit decrease, large premium increase.

8. Policy Surrender Request - Request to surrender the policy has been submitted

9. Other - Dividend change, maturity options, rider questions, etc.

> **Note:** Policies that are in imminent danger of lapse should be placed in triage and dealt with aggressively.

Remediation policies should be tracked based on their status, for example:

1. Active - indicates that actively working on the policy to identify a solution and/or obtain appropriate trust documentation. The following is a general outline of the Policy Remediation process steps when the status is Active.

   a. Issue Diagnosis/Options: A policy review is completed and a report is generated that outlines the issues or condition of the policy and provides options. In the case of a new policy or replacement, the report will review the policies and provide commentary as to appropriateness of the new policy.

   b. Contact: After a review is completed, the appropriate internal individuals (management, legal, trust committee, etc.) are contacted and findings are reviewed. During this period, others (grantors, beneficiaries, outside advisor(s)) may also be contacted.

c. Document preparation: Appropriate documentation is prepared, which outlines the policy situation and will typically include the trust file policy review/options, and any documentation required of the grantor(s) and/or beneficiary(ies). This may be prepared by the legal department depending on company policies and the scope of the issue.

d. Review/Signatures: Once any decisions are made, the documentation and decisions are reviewed with the pertinent parties, and any required signatures are obtained for the trust file.

2. Suspended: There are occasions when issues cannot be resolved within a desirable time frame. In those instances, if you have taken all appropriate steps to assist in resolving an issue you may suspend the case as long as there is no imminent liability. If there are any new issues or any policy changes, the case should be re-opened

3. Escalated: In those instances when you have taken the appropriate steps to resolve an issue but resolution is stalled due to issues beyond your control, or there are issues that need immediate attention, the case should be escalated to management or the trust committee.

4. Closed: Cases are moved to a closed status once all issues have been resolved and/or all required documentation has been received. If any new issues arise after the case has been closed, you can re-open it.

One reason for tracking all the operations of your remediation team is to document the time and effort spent dealing with policy issues. We have estimated that each year, 20% or more of your policies will be in remediation at some point–if you are doing your required job. This is a labor intensive and expensive part of your services.

Policy remediation is one of the most important tasks of a TOLI trustee. Making a prudent decision and documenting the reasons for, and the processes around, that decision will help to mitigate TOLI liability. Remember, the policy outcome cannot be completely controlled but the process can. By building on the steps laid out in this chapter you will be able to develop a more prudent process around policy remediation.

CHAPTER 17

Closing Thoughts

The outcome cannot be (completely) controlled, but the process can.

The management of life insurance, especially for those in the role of fiduciary, is an arduous task. As you have read in this book, market conditions have taken their toll on this asset class in the last two decades and the negative effects have accelerated in the last decade. Most permanent life insurance is backed by fixed investments, and we have lived through a decade of historic low, even negative, interest rates. The interest rate drag on product performance has been pronounced and cost of insurance (COI) increases, a new phenomenon, have raised carrying costs on some policies by 200% and more. Today's life insurance fiduciary must be well-versed in the management of this asset class, with a diversified team of experts on hand or they could face increased liability going forward.

The estate tax law changes that occurred with the passage of the Tax Cuts and Jobs Act reduced your federal estate tax ILIT prospect pool to 1 in 1,000 estates (1). Yes, trusts and life insurance will have a role going forward, but you, as advisor or trustee, will have to explain why they make sense to most of your clients with less than $11 million (single) or $22 million (married) in assets.

Many of your present clients will be asking you what they should do with their existing ILIT, which will considerably raise the level of service you will be providing going forward. Our chapter on remediation included some examples of the analysis that is required of you as a fiduciary. The work is time consuming and specialized, demanding expertise you may or may not have.

Litigation and settlements will increase in the TOLI world as we move forward. The application of the Uniform Prudent Investor Act (UPIA) to life insurance will evolve just as the application of the Employment Retirement Income Act of 1974 (ERISA) has entangled many companies sponsoring 401(k) plans in costly litigation. Are you compliant with the UPIA? Are you comfortable with the risk/reward component of policies in your portfolio? Are you secure that you have done all you can to investigate and manage the asset in your care? Are you sure that all decisions made about the policy or trust are solely in the interest of the beneficiaries without any undue influence of the grantor? Is there

any concern that the assets in the trust–the policies themselves, may have costs that are out of line? Would you even know if they were? Over the years, as this information becomes more transparent and TOLI fiduciary responsibilities expand, it could lay bare the inadequacies of TOLI trustees that were not so apparent in the past.

Most of the checks written to settle TOLI disputes do not come after a court room battle, they are written to avoid a courtroom battle. We have seen 5 and 6 figure checks written simply because a trustee made an administrative error or did not sufficiently investigate a policy replacement that turned out to be a mistake. These checks go unnoticed to all except the people who wrote them.

Throughout the book we have provided you with the tools and information you need to manage life insurance and life insurance trusts. To succeed, you need a robust centralized system, a team of trust and life insurance experts that work together well, open communication with all parties to the trust, especially the beneficiaries, a prudent process that is followed by all, a well-documented trust file that includes all the pertinent information you used to make decisions about the trust and policy and a pricing policy that will adequately support your services–and hopefully make a profit.

The decision making that occurs around a life insurance trust is typically not black and white, it is gray. You, as a fiduciary, cannot be assured that the outcome you choose will be "right", but you can be confident that it will be deemed prudent if you make a practical decision based on the best facts and circumstance available to you, and document the file on your reasoning for the choices made. According to the UPIA, "compliance with the prudent investor rule is determined in light of the facts and circumstances existing at the time of a trustee's decision or action and not by hindsight." Your role as trustee will be judged by your process, not the outcome. Make sure the process is prudent, includes all relevant information, and is well- documented.

In 2013, ITM TwentyFirst took part in the Leadership Workshop for Life Insurance Stewards at The Hotel Thayer at West Point, NY where leaders from the legal, financial planning, and insurance world got together to review and edit a draft of the Best Practices Standards for Life Insurance Stewards. Attendees at the session who dealt with TOLI and fiduciary litigation pointed out that there are many things outside of your control as a trustee, but if you are being accused of not living up to your duty as a trustee you had better be prepared to show the prudent practices you employed. As a trustee, the outcome cannot be (completely) controlled, but the process can.

Good luck to you as you move forward in managing life insurance and TOLI trusts. Do reach out to us if we can ever be of service.

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ITM TwentyFirst

ITM TwentyFirst is the largest provider of life insurance policy management services in the country. With 200 institutional clients, the organization administers over 25,000 life insurance policies with over $150 billion in death benefits. The firm provides complete outsourced services for trust-owned life insurance (TOLI) trustees as well as institutional investors in the life settlement market. In addition to its total outsourcing option, the firm offers a cloud-based secure system for those who wish to manage their policies in-house.

ITM TwentyFirst is also one of the largest providers of life expectancy (LE) reports, designed to estimate the lifespan of an insured person based on his or her age, gender, lifestyle, smoking status, family history and medical conditions. These reports are used by institutional investors to value policy portfolios, and they are a vital tool for TOLI trustees attempting to make prudent decisions in managing life insurance policies.

ITM TwentyFirst was formed in June of 2015 with the merger of three leading companies, TwentyFirst Services of Minneapolis, MN, and Insurance IQ and Insurance Trust Monitor (ITM) of Cedar Falls, IA. In June of 2017, ITM TwentyFirst merged with Pension Benefit Information (PBI), a California-based firm that is the leader in death audit and location services. The 30-year-old firm uses a proprietary system to deliver accurate actionable data to government agencies, third-party administrators, pension plans, insurance companies and other financial organizations.

In November of 2017, Life Insurance Trust Company received a charter in the state of South Dakota under the ITM TwentyFirst umbrella and operates as the only trust company in the United Stated focused specifically on life insurance trusts.

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