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The Lapsing Policy Crisis: An Intervention Plan Is Needed

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For the past 35 years, flexible premium nonguaranteed death benefit policies—adjustable life, universal life, variable universal life, and equity indexed universal life—have been the life insurance products of choice; however, only a few of these policies will achieve their originally illustrated values. Furthermore, most policy owners are unaware that they retained performance risk and are unfamiliar with both the risks to be managed and the credible tools available to do so. Unsurprisingly, a high percentage of these in-force policies are now projected to lapse during the insured's lifetime, and this percentage can only increase unless corrective action is taken.

The First Steps

Very few lay people or professionals are aware that their life insurance contracts can expire during their lifetime. For example, approximately 40 percent of in-force nonguaranteed trust-owned life insurance (TOLI) contracts are carrier-illustrated to lapse during the insured's lifetime or within five years of life expectancy, posing a trust insolvency risk. Private policy owners and insurance trust trustees often incorrectly assume that either the agent or the insurance company is monitoring their contracts to make sure they will always remain in force; however, carriers and agents have no obligation to monitor policy performance relative to original performance expectations. Carriers are merely required to send a scheduled premium billing and an annual policy value statement. Agents are only required by the carrier to make delivery of the policy. It is solely the policy owner's responsibility to review the policy value statement and determine the needed premium adjustment in order to achieve originally illustrated policy values.

Intervention is needed, and the logical source is the policy owner's tax or legal advisor, working in combination with an experienced, fee-based life insurance advisor. To avoid fixing a problem by creating another problem, a request for proposal process should be used to ensure that an objective, unbiased consultant is engaged and credible policy evaluation will be provided. It is important to note that the lapsing policy crisis has triggered any number of aggressive policy replacement marketing programs that employ questionable—if not predatory—analytics to justify replacement (i.e., commissions).

Overview of the Lapsing Policy Crisis

In the early 1980s, interest rates reached the 20 percent level. Because life insurance companies were crediting guaranteed policies with much lower rates, thousands of astute policy holders switched the accumulated cash value in their whole life contracts into higher-yielding bank deposit instruments. In order to stop these outflows, the life insurance industry created new products called "adjustable life" and "universal life insurance" that credited the policy's cash accumulation account with an interest rate based on prevailing market interest rates instead of a fixed rate, as had been the case in traditional whole life contracts. If interest rates increased, the policy-crediting rate also increased, meaning the scheduled policy premium could be decreased or remain unchanged for policy coverage to remain in force. What was not clearly understood, however, was that if interest rates decreased, then the scheduled premium needed to be increased in order for the death benefit coverage to remain in force for the originally illustrated time period. But since the 1980s, interest rates have continually declined, resulting in policy-crediting rates at the 3 percent to 4.5 percent guaranteed minimum level depending upon issuing carrier.

Following the introduction of universal life and adjustable life, carriers introduced "variable universal life" (VUL), allowing policy owners to allocate the policy's cash-accumulation account. Agents initially illustrated VUL by assuming a constant 12 percent annual return that minimized the scheduled premium. Gradually, this practice

changed, but carrier illustrations using constant rate returns are “blind” to down-market periods and their implications for needed premium adjustments.

Taking Corrective Action

To avoid lapse risk, a policy performance evaluation of an adjustable life, universal life, VUL, or indexed universal life contract should be independently conducted in order to determine, at a minimum, 1) the probability that the current premium will sustain the policy to the insured’s life expectancy; 2) the insured’s age at projected policy lapse; 3) the competitiveness of policy charges; and 4) the needed correcting premium to sustain the policy to the insured’s life expectancy. Because in-force carrier illustrations disclaim predictive value, an actuarially certified evaluation should be obtained. In addition, for older insured individuals, a life expectancy report should be considered so that the premium payment period is based upon the insured’s medical history and current medical condition.

Whether there was transparency and full disclosure in the initial marketing and ongoing annual policy statements for these products can be debated; however, performance risk has always resided with the policy owner. The combination of low interest rates and the fact that the octogenarian demographic is the fastest growing segment of the population has created a ticking time bomb for lapse. Corrective action is needed, and it can only be taken by the policy owner. It typically takes the form of either 1) premium increase, 2) death benefit reduction, 3) exchange to a more suitable policy, 4) policy sale in the secondary market, or 5) a combination of these risk mitigation options.

If the policy is owned in an irrevocable life insurance trust (ILIT), the trustee has the sole duty and responsibility to manage the trust asset. Inattention poses reputation and litigation risk for corporate trustees, and reputation risk for legal and tax advisors to amateur trustees. This is especially true for family members serving as an accommodation and relying solely upon these advisors for all trust administration functions. It is estimated that 90 percent of TOLI policies are administered by unskilled amateur trustees, meaning that credible professional assistance is needed to create a prudent and reasoned process that maximizes the probability of a favorable outcome to the trust estate.

With regard to corporate trustee duties, the Office of the Comptroller of the Currency offers prudent process guidance. For example, policy performance evaluation should examine the financial health of the issuing insurance company and consider whether the policy is performing as illustrated. If the policy is underperforming or if it can be improved upon, the fiduciary should consider replacement or remediation. If a trustee lacks the expertise to evaluate the premium adequacy risk or the contract’s appropriateness to fulfill the beneficiary’s objectives, the trustee has a duty to delegate and engage the necessary experts to make these determinations and assist in the suggested remediation steps.

In addition to regularly evaluating and monitoring a life insurance contract, individual policyholders should also consider the availability of newer products that were not available when the contracts were initially purchased. For example, a chronic care rider that first became available at the end of 2011 allows an individual to withdraw up to $120,000 (annually adjusted for inflation) tax free in 2013 from the death benefit of a life insurance contract to pay for qualifying long-term care expenses. There is no reason not to have this benefit available in any life insurance contract.

Intervention Checklist

In their consulting practice, the authors specialize in TOLI policies administered by unskilled “accommodation” ILIT trustees who, along with their legal and tax advisors, usually lack life insurance product and policy performance evaluation expertise. The following is a checklist of the needed intervention steps that can also be applied to policies owned by individuals, businesses, and charities:

1. Formalize a TOLI investment policy statement (TIPS) that—

- updates the trust’s current death benefit requirement,
- summarizes the ILIT parties and their respective responsibilities,
- sets out trustee risk management criteria for carrier and product suitability determinations,
- identifies the life insurance product and policy evaluation duties and how they will be provided,

- establishes vendor due screening requirements for delegated life insurance functions, and
- affirms annual beneficiary communication requirements.

2. At the same time, obtain the underwriting carrier's current Comdex rating, along with an actuarially certified policy evaluation of the following data points:

- Percentage probability that the payment of currently scheduled premiums will sustain coverage to insured life expectancy and contract maturity.
- Earliest insured predicted lapse age and concentration of predicted lapse ages.
- Policy standards pricing deviation.
- Correcting modal premium to sustain the death benefit to the insured's life expectancy and contract maturity.

Based on this information, a risk mitigation plan can be implemented to safeguard the interests of all ILIT parties, as well as all parties to other forms of ownership. With the implementation of a reasoned risk management process that provides for delegation of the unavailable expertise functions, lapse can be avoided and informed suitability determinations can be made annually. The tools for prudent life insurance policy risk management are readily available; they just need to be used.

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