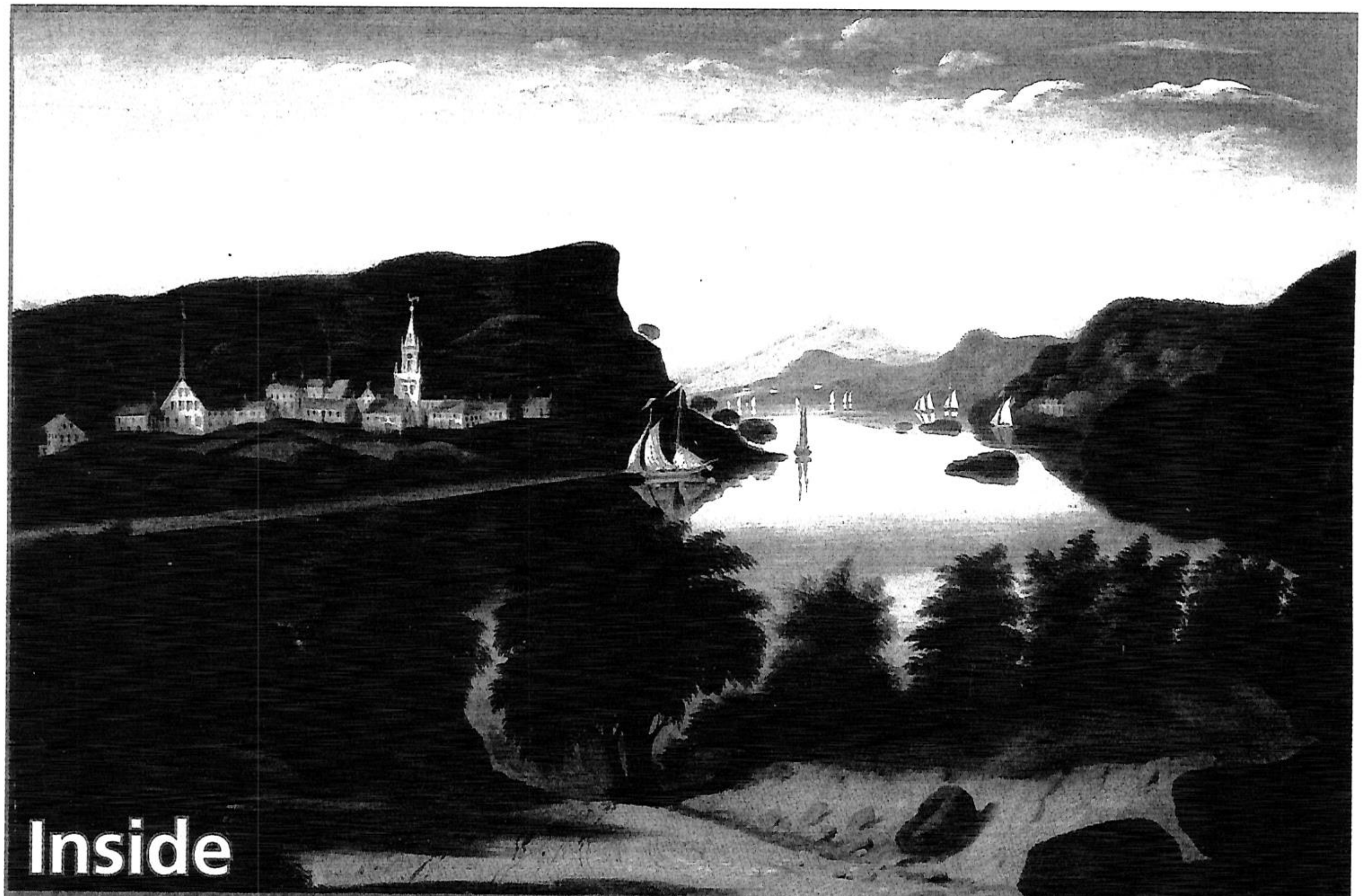
NYSBA

SPRING 2014 | VOL. 6 | NO. 1

The Senior Lawyer

A publication of the Senior Lawyers Section of the New York State Bar Association



Inside

- Rights of Passengers in Cruise Ship Accidents
- Defective Metal on Metal Hip Implant Claims
- Planning for Seniority
- Are You Ready for the Elder Years?
- The Law and Lifelong Learning
- Dangerous Myth of Reinvention
- New York Adopts Uniform Adult Guardianship Act
- AEP: A Significant Opportunity
- Senior Appellate Attorneys Drive Success of New York Pro Bono Program
- Importance of Life Insurance Performance Evaluation
- Action to Maintain Reduction in Real Estate Taxes
- Self-Insurance and the Affordable Care Act
- From Egg Creams to Politics

The Importance of a Life Insurance Performance Evaluation

By Henry Montag, CFP, CLTC

Have you ever discovered a bank entry error in your checking register, resulting in a balance $100 or $1,000 less than what it should be? Imagine how much worse you would feel if your, or a client's Life Insurance policy worth $1,000,000, or more, that you thought would be available to a spouse, child or others upon death, were rendered unavailable due to a technicality.

Flexible Premium Life: The Industry's "Ticking Time Bomb"

Among the important reasons why a Life Insurance contract should have its performance evaluated and monitored is to determine how much longer the contract is expected to remain in force. The reason you need to be proactive, whether your client privately owns or is an amateur trustee responsible for a trusts owned life Insurance contract (TOLI), is because a great majority (85%) of life Insurance contracts that were purchased over the last 25 years were known as Flexible Premium Life Insurance contracts that are now in danger of expiring years earlier than originally anticipated (33%). These flexible premium life Insurance contracts will not sustain death benefit coverage for a lifetime because their originally illustrated performance was geared to last for a finite number of years, usually to age 95, based on a projected annual interest rate that was not guaranteed nor has been achieved.

The problem today is that very few private owners, amateur trustees nor many professionals are aware that their Life Insurance contracts can expire years earlier than originally anticipated. The client and trustee often incorrectly assumed that either the agent or Insurance Company was monitoring the situation to make sure the Insurance contract would continuously remain in force, but that wasn't the case. As a matter of fact, it would be in the Insurance Company's best interest if after all those years of an owner/trustee paying the premium it became exorbitantly expensive to maintain the contract and the Death Benefit had to be reduced or the policy surrendered for its cash value.

Allow me to explain: back in the mid-1980s, when prevailing interest rates were as high as 17%-18%, there were only two types of Life Insurance contracts: Term Life Insurance, in which a specific dollar amount of life Insurance was guaranteed to remain in force for a specific period of time at a specific guaranteed premium; and Whole Life Insurance, which was guaranteed to remain in force for the entire life of the insured. These Whole Life contracts contained an accumulation account known as Cash Value, which was typically earning 3% annually. The Cash Value was available to be withdrawn and used for any purpose, so long as the owner paid a contractual 5% annual interest charge on the money that was withdrawn.

In a Whole Life contract, if a person had an accumulated Cash Value of, say, $100,000 earning 3% interest, the owner had the ability to borrow the money at 5% and then place those dollars in a money market or savings account, where they could have earned, say, 15%. Thus, without any additional risk, the owner would be able to earn an additional 10% on their $100,000 of Cash Value, a meaningful sum.

Due to the competition from banks' significantly higher interest rates of the mid-1980s, the insurance industry watched billions of dollars from their Cash Value coffers being withdrawn and transferred to the individual bank accounts of the people it insured. In order to stop these outflows, the life insurance industry created a new product called "Flexible Premium Life Insurance," which consisted of Universal, Variable, Indexed or Adjustable Life Insurance, all of which paid an interest rate or yield based on prevailing market conditions, rather than a guaranteed fixed rate, as had been the case in Whole Life contracts. If interest rates or yields rose, then one's insurance coverage would become less expensive or last for a longer period of time as a result of the larger amount of accumulated cash value.

What was not as clearly understood, however, was that if interest rates decreased, then the opposite would be true and the length of time their coverage would remain in force would consequently be reduced. And unless a greater annual premium was paid to the Insurance Company, the Insurance coverage would expire years earlier than had originally been anticipated. In other words, the flexible premium life contract provided no guarantee as to how long the coverage would remain in force. If interest rates maintained their projections, everything was fine, but if interest rates fell below their assumed projections, as they did over the last 20+ years, there would be a problem.

The problem being faced today by many private owners and amateur trustees, responsible for maintaining their trust owned life Insurance, is that their coverage is expiring years earlier than originally anticipated as a result of two factors:

1. Steadily, steeply declining interest rates 18% in the mid-1980s to 3% today

2. Failure to adequately adjust premiums upward to keep pace with lowered rates.

    This combination of interest rate risk and neglect on the part of those responsible for the contracts maintenance is resulting in, according to the Industry's own in force illustrations, an anticipated 30-35% of today's Universal Life coverage expiring years earlier than originally projected. To understand how so many individuals have been adversely impacted, let's look back to the mid-to-late 1980s. When flexible premium life Insurance was first offered, agents and brokers would determine the annual required premium in the following manner. First they established a particular dollar amount of life Insurance coverage required, then they would ask their clients how long they wanted the coverage to remain in force. Clients would typically respond that they wanted the coverage to last forever. But, once it was explained that the longer they wanted the coverage to last the more it would cost and conversely the shorter they wanted it to last the less it would cost, clients began looking at a reasonable age that they wished their coverage to remain in force for. A typical age was somewhere between age 90-95. Next an average interest rate was assumed for the 20-30 year period going forward. Once the amount of Insurance, the assumed interest rate, and the length of time the contract was supposed to have remained in force for was established that information would be input into a computer and a specific annual premium was determined. The resulting problems that have since occurred stem from this assumed interest rate that was neither achieved nor guaranteed, nor adjusted upwards to make up for the lost anticipated earnings of Interest rates in universal contracts, or stock or bond yields in the case of variable life contracts.

While this interest-sensitive product stopped the tremendous outflow of monies from the insurance industry's cash value coffers to the banks, the solution was not in the best interest of many of the individuals that purchased this product simply because these same individuals were not aware that going forward they assumed 100% of the performance risk of these non-guaranteed contracts. In the late 1980s, when interest rates were 16-18%, many assumptions were made that interest rates would remain in the 10-12% range for a long period of time. Even the more conservative agents and brokers were projecting 9-10% rates. Although those assumptions seemed perfectly reasonable at the time, our current low interest rate environment of 2-3% has decimated Universal Life contracts with even the most conservative projections.

As a result, the original assumption that a life Insurance contract would last until the person was age 95, has been shortened by as many as 7-9 years. While Universal Life has received the majority of the blame in the Insurance Industry it needs to be pointed out that double- and triple-A-rated Insurers are now beginning to also feel the effects of low interest rates as their Whole Life contract holders are being asked to either reduce their death benefits or increase their premiums as a result of poorly performing dividends, which are not guaranteed.

A performance evaluation of a Universal Life contract examines the actual interest rate return earned each year since the policy was purchased and actuarially determines how long the contract will last based on (1) the historic actual return, (2) the current age of the insured, (3) any outstanding loans, (4) current mortality costs and expenses. Many private owners and trustees responsible for their trust-owned life Insurance have neglected to request this historical projection, and to this day are not aware of the effect this shortfall will have on their life Insurance coverage. The more advance notice a trustee has to discover a potential shortfall, the less additional monies are needed to adjust the coverage simply because they'll have more time to spread out the additional monies needed to restore the coverage back to its originally projected level. I have often referred to the hidden risk of premature expirations of coverage in Flexible Premium Life Insurance contracts as the insurance industry's "Ticking Time Bomb" because sufficient disclosure was not made indicating this new product was Not Guaranteed to last for one's lifetime. The combination of a low interest rate environment and the fact that the octogenarian demographic is the fastest growing segment of the population is causing Life Insurance to expire while a great many grantors are only in their mid-80s at a time when people are living longer. More effort needs to be made to educate grantors as well as amateur trustees of this problem.

My greatest concern is that individual trustees, many of whom are the sons and daughters of the insured (or the grantor of a trust), are to this day not even aware that they have a problem as a result of their "Buy and Hold" rather than what should have been their "Buy and Manage" philosophy. This inaction can be viewed as a failure of their fiduciary responsibility as a trustee, leaving them vulnerable to litigation from other family members/beneficiaries that may lose trust assets in the process. Even if an amateur trustee is not personally sued, the negative family dynamic is certainly one to be avoided. According to Donald Walters, General Counsel for the Insurance Marketplace Standards Association, IMSA, "While Insurers have not publicized the issue there is a growing concern in the Industry about lapsing universal life policies." I'm not surprised as there is currently absolutely no incentive nor obligation on the part of the Insurance Industry, the agents, nor brokers to do anything to correct the situation.

While some institutional trustees are aware of this problem and are employing third parties to conduct independent performance evaluations, there remain problems with many of the smaller bank and regional trust departments who do not follow any such guidelines. According to a 2003 survey in Trusts and Estates, (1) 83% of professional trustees surveyed admitted that they had no guidelines or procedures for handling these problems, (2) 96% had no policy statements on how to handle Life Insurance investments and (3) over 70% of non-professional trustees had not reviewed their trust-owned life Insurance within the last 5 years. However the largest problem lies with the fact that over 90% of TOLI are managed by private or amateur trustees that are not knowledgeable about their duties and are relying on their adviser's for advice. Unfortunately neither the Attorney nor the CPA seem to feel that the area of policy evaluation is within the realm of their area of responsibility so in many cases no one is currently advocating for the Family. This process is not consistent with the prudent Investor principals UPIA, in which trust fiduciaries are required to follow and liable if they don't, French vs. Wachovia July 2011. According to Jan 2007 Fiduciary Advisor Services "Damage to the beneficial interest in these cases is both measurable and significant. Litigation, therefore, may be anticipated."

The disturbing aspect of this situation is that according to recent Office of the Comptroller of the Currency (OCC) guidelines, these Institutional trustees may be negligent in fulfilling their fiduciary obligation to protect trust assets for their beneficiaries. The OCC continues to require bank fiduciaries to follow 12 CFR 9.6(c) and 12 CFR 150.220, which direct them to conduct annual investment reviews of all assets within each fiduciary account for which the bank or trust company has investment discretion. This review should of course also include life Insurance, and should evaluate the financial health of the issuing insurance company, as well as examine whether the underlying policy is performing as illustrated. If the policy is underperforming, or if the policy can be improved upon, the fiduciary should consider replacement or remediation. If the trustee does not have the necessary skills to make this determination, it is the trustee's fiduciary obligation to obtain this expert service from an outside source.

Harvey Pitt, the former SEC Chairman, cautioned banks that in today's heavily regulated post Sarbanes – Oxley environment, they should learn from their sector's past mistakes and replace inadequate and outdated processes with ones that are more efficient and up-to-date. Many of these flawed, outdated processes merely document and focus on the health of the insurance company instead of the shortcomings of the particular Life Insurance policy. Unfortunately, the mere analysis of the life insurance company fails to consider the appropriateness of policy expense as required under Section 7 of the Uniform Prudent Investor Act (UPIA) and the reasonableness of performance expectations as required under UPIA Section 2 and thus will not provide a strong defense in the event of litigation. In accordance with O.C.C. Reg. 9.6c.11, if a trustee determines that it lacks the expertise to evaluate the premium adequacy risk or the contract's appropriateness to fulfill the beneficiary's objectives, the trustee now has an affirmative duty to bring in the necessary experts and inform the beneficiary of the suggested remediation steps.

Reasons to Monitor the Performance Evaluation of Your Life Insurance Contract

While the foregoing considerations are compelling enough by themselves to highlight the importance of regularly evaluating the performance of a Life Insurance contract, private owners and amateur trustees should also consider conducting such evaluations for reasons other than just monetary reasons. One such reason is that the options and riders available in today's Life Insurance contracts were simply not available when they first purchased their Life Insurance contracts.

One example of such an advantage is the Chronic Care Rider. Notably, the Chronic Care Rider first became available at the end of 2011, so any Universal Life contract purchased prior to 2012 does not have this rider available. The Chronic Care Rider allows an individual to withdraw up to $116,000 tax free in 2014 annually adjusted for inflation from the death benefit of his or her Life Insurance contract to pay for qualifying long-term care expenses. This is only the case if the Insured/Grantor meets two criteria: (1) the individual is healthy enough to purchase a new contract from an Insurance Company that contains these provisions, and (2) that the premium on the new contract would be closely similar to the premiums they are currently paying.

Trusts are wonderful tools as they provide management, distribution instructions, tax savings and flexibility for the trustee. However, to be most efficient, Trusts must be updated and reviewed in terms of today's planning options, and Trustees must be better educated in terms of what those obligations and options are and how they can best be executed for the benefit of the individuals they are protecting. A grantor guidance letter is an excellent tool to insure the client's current beneficiary desires and percentages are still accurate as well as a way to informally communicate the information between the trustee and the grantor.

A private owner or an amateur trustee of trust-owned life Insurance has four avenues of remediation should they find themselves in a position in which their life Insurance may expire prior to life expectancy. They can choose to increase the premium in their existing contract. They can reduce the death benefit of their existing contract both remedies with the intent of lengthening the duration of time that their coverage would remain in force on a guaranteed basis. If their health is good, they can shop the marketplace and perhaps purchase a more competitive contract. Should none of the above-mentioned remedies be an option, they may consider a Life Settlement solution, which is an opportunity to sell their life Insurance contract to an Investment group who may be interested in purchasing your contract for a reduced face amount but at a value higher than the contracts cash value and certainly more than they would have received had they surrendered or lapsed the contract.

In conclusion, being aware of the potential problems and opportunities within the life Insurance arena should be a major point of emphasis for private owners, for the unskilled amateur trustees and the advisers that guide them, as well as for the Institutional trustees in order to protect the assets for the benefit of their beneficiaries and to avoid any intra-family disputes that can and should be avoided. A beneficiary can allege a cause of action in several situations. If the Life Insurance coverage prematurely expires and the beneficiary is never made aware that a shortfall could have been corrected. Or if the Trustee does not examine policy expenses as required under UPIA Section 7, since beneficiaries can claim the Trustee was overcharged and the beneficiaries could/should have had greater death benefits for the same premium.

An independently conducted, fee-based actuarially defensible life Insurance performance evaluation not only safeguards a trustee against litigation risk brought about by other family members, but it also is highly likely to benefit the entire family if a lower cost option with a higher death benefit, longer guarantee periods and new riders not previously available were found to be available.

Henry Montag is an Independent Certified Financial Planner who has been in practice since 1976 with offices in Long Island and New York. He is a principal of The TOLI Center East, which provides independent fee-based performance evaluation and monitoring services to private trustees, Institutional trustees and their advisers regarding trust-owned life Insurance.

He has lectured extensively on the subject of the proper utilization of financial products used to protect and preserve assets to organizations such as the New York State Bar Association and the New York State Society of CPA's New York City, Nassau and Suffolk chapters as well as the National Conference of CPA Practitioners. He has developed an understanding of and an appreciation for the overall coordination of various concepts, products and strategies related to Trust-Owned Life Insurance for business owners, private, professional and institutional trustees.

As a source for the media, he has been quoted in *The Wall Street Journal*, *Investor's Business Daily*, *Newsday*, *Long Island Business News*, and has appeared as a guest on Fox News & News 12, FIOS TV, The Main Street Money show and numerous radio programs. He has had articles published in various publications including *Financial Planning Magazine*, National Conference of CPA Practitioners and the Suffolk County Women's Bar Association.

This article originally appeared in the Winter 2014 issue of the Elder and Special Needs Law Journal*, published by the Elder Law and Special Needs Section of the New York State Bar Association.*