

# ABA Trust & Investments

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# The Prudent Investor and Trust Owned Life Insurance (TOLI)

## PART 1

**T**he adoption by most states of the Uniform Prudent Investor Act (UPIA) has far-reaching effects on trust drafting and administration.<sup>1</sup> One of the often overlooked consequences of the Prudent Investor Act is its effect on the administration of irrevocable life insurance trusts (ILITs). This article will address the unique (and often opaque) nature of life insurance as an investment and the effects the Prudent Investor Act can have on trustee ownership of life insurance. Part 1 reviews the theoretical underpinnings of the Prudent Investor Act and discusses the ways these theories can adversely affect how trustees invest for particular families. It then explores the Prudent Investor Act itself, and the types of drafting and administration issues it engenders.

Part 2 looks at the nature of life insurance as an investment, focusing on the factors that go into pricing insurance products and the effects of those factors on policy performance. Finally, Part 3 looks at trust administration of ILITs. What follows is the first part of a three-part series tackling the prudent investor and trust-owned life insurance. Look for parts 2 and 3 in future issues of ABA Trust & Investments.

**Christopher P. Cline and Barry D. Flagg**



## MODERN PORTFOLIO THEORY, THE RESTATEMENT (THIRD) OF TRUSTS AND THE PRUDENT INVESTOR ACT

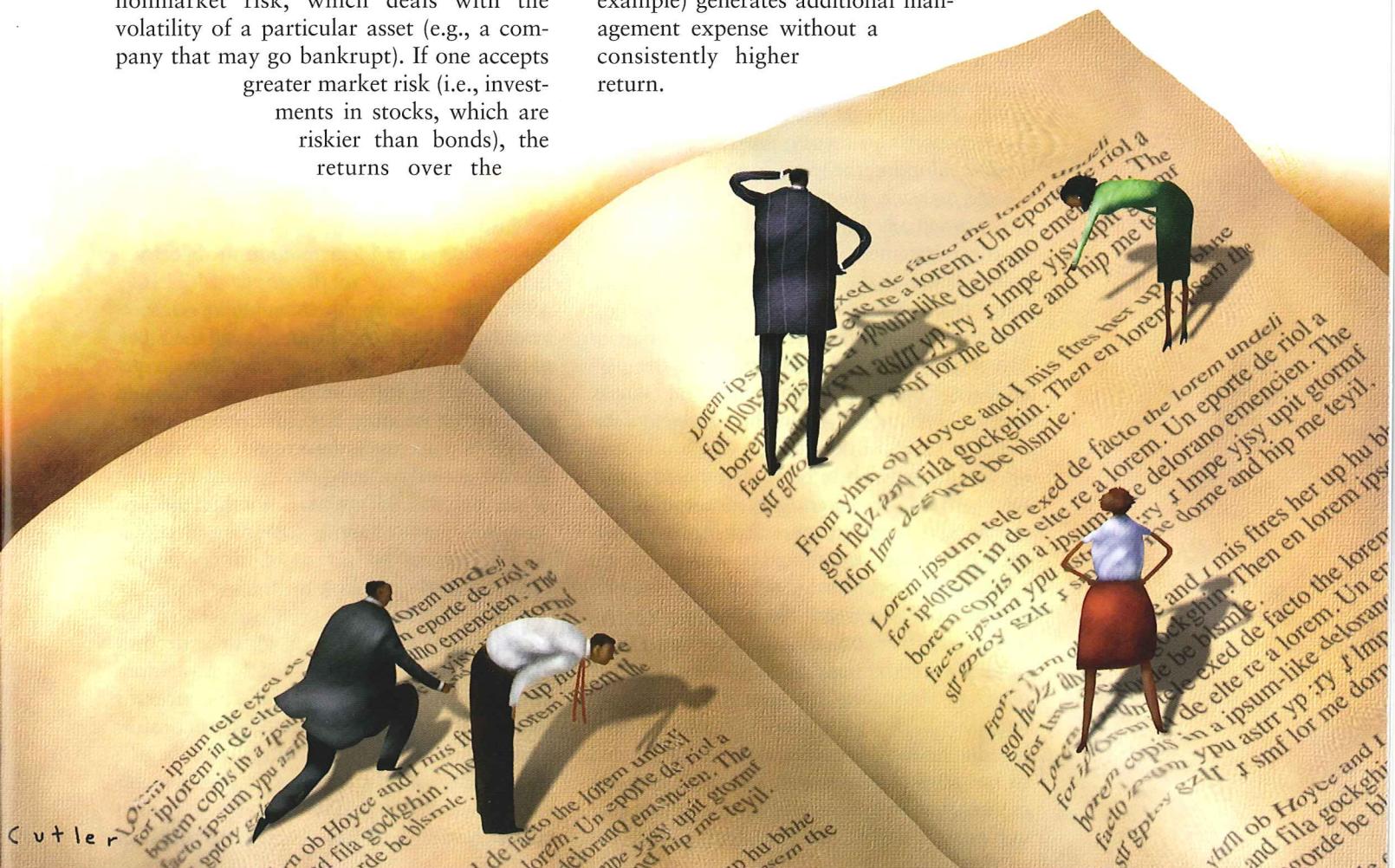
The Prudent Investor Act is rooted in modern portfolio theory and the *Restatement (Third) of Trusts*. The “prudent investing” concept was overhauled in 1992 with the publication of the restatement. Academics, trustees, and advisers sought to eliminate arcane trust investment rules in favor of “modern portfolio theory.”<sup>2</sup>

### *Modern Portfolio Theory and the Restatement*

Although this article is far too brief to cover the intricacies of modern portfolio theory, two crucial concepts must be recognized. First, the nature of risk must be considered. There is market risk, which deals with market volatility (e.g., the stock market) and nonmarket risk, which deals with the volatility of a particular asset (e.g., a company that may go bankrupt). If one accepts greater market risk (i.e., investments in stocks, which are riskier than bonds), the returns over the

long term should be greater. However, non-market risk generates no additional return because one can avoid it by diversifying investments. This concept of risk puts at least two burdens on an investor: (1) determining the acceptable level of volatility (the level of market risk) in exchange for the hoped-for return; and (2) diversifying the portfolio in accordance with the chosen level of market risk to avoid nonmarket risk.

The second important concept is that of market efficiency, which assumes that asset information is disseminated efficiently and therefore all assets are priced more or less correctly. An investor's best strategy, in that case, is to invest passively through index funds, which should perform as the market does as a whole, because no investor should be able to consistently outperform the market. If markets are efficient, most active management (picking particular stocks, for example) generates additional management expense without a consistently higher return.





The restatement, which applies investment principles to trustees of private trusts, incorporates modern portfolio theory. It adopts the concept of risk,<sup>3</sup> distinguishing between market and nonmarket risk, and at least implies that a trustee breaches its fiduciary duty to preserve capital if it selects a level of return that allows inflation to erode the trust property's value. In other words, a trustee can get in trouble by playing it too safe: It must accept a certain amount of market risk and avoid nonmarket risk by diversifying investments.<sup>4</sup>

The restatement also adopts, to some extent, the efficient market theory.<sup>5</sup> Further, the restatement specifically prohibits a trustee from incurring unreasonable costs in managing and investing trust assets.<sup>6</sup> In other words, the restatement can be read for the proposition that passive asset management (for example, through the use of index funds) is generally a more prudent investment choice than active management.<sup>7</sup> Because the Prudent Investor Act is based on the restatement and modern portfolio theory, the act also can be read as adopting the same concepts.

As an aside, the question of whether markets are actually efficient may not be as settled as the restatement implies. The equity value rollercoaster of the last five years has caused many to question the validity of the theory. An alternate view of market valuation is that of behavioral finance, which considers the psychology of investing. Under behavioral finance, investor behavior is often the product of biases,<sup>8</sup> or "rules of thumb," by which investors make decisions. These biases can include judgments based on stereotypes, overconfidence, the inability to properly account for new information, aversion to ambiguity, and emotional and cognitive problems.<sup>9</sup> Such bias can lead investors to be seriously influenced by such factors as loss aversion and regret over past decisions. Swayed by these factors, investors cause prices to stray from fundamental values, potentially for long periods of time, making markets inefficient.<sup>10</sup> Inexperienced investors tend to be more confident that they will beat the market than experienced investors (a fact that in hindsight should be self-evident, given all of

the day trading that went on five years ago). Wall Street strategists are more prone to gambler's fallacy, while individual investors are more prone to betting on trends.<sup>11</sup>

Finally, investor psychology (both individual and professional) is not given adequate consideration, even if market efficiency theory and not behavioral finance theory, can be proved correct. For example, John C. Bogle, founder and former chairman of the Vanguard Group, reviewed the history of the mutual fund over the past 50 years and noted some remarkable changes.<sup>12</sup> In his view, the mutual fund industry has changed from one that stressed stewardship to one stressing salesmanship, in which short-term gains were more important than long-term strategies. As a result, although "the stock market provided an annual return of 13 percent during the past 20 years, and the average equity fund earned an annual return of 10 percent, the average fund investor, according to recent estimates, earned just 2 percent per year." In other words, even if the markets are efficient, and passive investment in index funds is the best approach, the average investor simply isn't following those rules.

For instance, \$1 invested in the S&P 500 in 1926 would have grown to \$1,114 by 1996. However, if the same dollar was invested but the investor got out of the stock market during the 35 best months of the period (a total of 840 months), the dollar would have grown to only \$10. Expressed differently, 99 percent of the growth during that 70-year period occurred during only 4 percent of the months. Miss those months, and you miss your appreciation. Investors, in other words, have to hang around for 96 unproductive months, waiting for the big one.

The disparity between market return and investor return, taken with the need to stay in a market for the long term, demonstrates a need for continued guidance for many investors. If an investor takes comfort knowing the person or institution managing his or her money, that investor might maintain an investment strategy more consistently, resulting in less investment turnover



This concept of actively managing trust holdings is all the more important for trust-owned life insurance (TOLI) holdings where expenses are considerably greater than in the investment world when changing from a fixed interest oriented product like universal life and whole life to a product where asset allocations can be balanced.

and therefore higher returns. Such consistency can be far more important in achieving higher overall levels of return than whether a client chooses passively or actively managed funds. Indeed, it could be argued that if done consistently, following the advice even of a financial planner with a slightly second-rate actively managed portfolio will generate higher returns on trust investments than following a passive mutual fund approach if the investor gets skittish and pulls out of the market during one of those crucial months.

This concept of actively managing trust holdings is all the more important for trust-owned life insurance (TOLI) holdings where expenses are considerably greater than in the investment world when changing from a fixed interest oriented product like universal life and whole life to a product where asset allocations can be balanced. For instance, up until the late '70s and early '80s, TOLI holdings consisted predominantly of whole-life products. However, when prevailing interest rates soared, many whole-life TOLI holdings were exchanged for universal-life products offering the promise of higher policy interest crediting rates. Of course, the promise of then-high prevailing interest rates, that were typically guaranteed for only 30 days but used on premium computations for 30-plus years, did not hold up. As such, because of the considerable expense involved in making such a change in ILIT holdings, and because many universal-life products were based on an unreasonable expectation as to the expected policy earnings rate, many universal-life holdings purchased in the 1980s are in jeopardy of lapsing without value and without paying the expected death claim.

To seemingly add insult to injury, on the heels of falling interest rates in the late '80s but rising stock market performance in the early-to-mid '90s, the response of the insurance industry in many cases was to promote an exchange from universal life to variable life. Once again, the exchange was reactionary to then-current but not sustainable market conditions, and premium computations were predicated on the expectation that

then-prevailing high market earnings rates, which were not guaranteed at all, would continue for 30 or more years. Of course, such then-current but historically high earnings expectations proved unreasonable, and because of the considerable expenses involved in again making such a change in ILIT holdings, many variable-life holdings purchased in the 1990s are in jeopardy of lapsing without value and without paying the expected death claim.

Both of the above situations are clear examples of where ILIT trustees would have been far better served by following the advice of a financial planner and setting reasonable expectations as to the appropriate return on trust cash value assets, even if with a slightly second-rate portfolio of actively managed product(s). Both situations also certainly contributed to the current state of TOLI holdings reported in the April 1999 issue of *Trusts & Estates* magazine, where a survey of TOLI holdings reported that TOLI death benefits can be increased by 40 percent or more, or TOLI premiums can be reduced by 40 percent or more, in 65 percent to 85 percent of single life and survivorship trust-owned policies, respectively.

Given this experience over the past 20-plus years, it is no wonder ILIT trustees may be hesitant to take further action to comply with requirements of the Prudent Investor Act. However, we will discuss "The Problem with Illustrations" in Part 2, that contributed to the above situation; then provide guidance for how ILIT trustees can go about setting reasonable expectations as to the appropriate rate of return on trust cash value assets in Part 3; and also better understand the expenses involved in proactively managing TOLI holdings in Part 2.



## *The Prudent Investor Act*

The prefatory note to the Prudent Investor Act states that, relying on the restatement, it makes five significant changes to the law of trustee investing. First, the prudence standard “is applied to any investment as part of the total portfolio, rather than to individual investments.” Second, a trustee’s primary consideration in investing is the tradeoff “between risk and return.” Third, categorical restrictions on types of investments are eliminated; a trustee may “invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing.” Fourth, investment diversification is incorporated as an integral part of prudent investing. Finally, trustees can delegate investment and management functions.

Under Section 1 of the Prudent Investor Act, the prudent investor rule is a “default rule” that may be expanded, restricted, or eliminated by the trust terms, but which must be followed if not overridden. Section 2 sets forth the trustee’s standard of care: A trustee “shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust.” In other words, a single investment approach for all trusts is inappropriate. Investments are judged under Section 2(b) in the context of the trust portfolio as a whole and as a part of an overall strategy, after evaluating risk and return objectives. So, as the comments to that section point out, a trust “whose main purpose is to support an elderly widow of modest means will have a lower risk tolerance than a trust to accumulate for a young scion of great wealth.” Section 2(c) lists some circumstances a trustee must take into account when developing an investment strategy: general economic conditions, inflation, expected tax consequences, the beneficiaries’ other resources, beneficiary needs for liquidity, and an asset’s special relationship or special value, if any, to the trust purposes. Finally, Section 2(f) states that a trustee with special skills or expertise has a duty to use them.

Section 3 requires a trustee to diversify trust investments unless, because of special circumstances, the purposes of the trust are better served without diversifying, such as holding an undiversified block of low-basis securities with built-in gain or retaining a family business. Under Section 4, a trustee must, within a reasonable time after accepting the trusteeship, review the trust assets and decide whether they are appropriate investments in light of the factors just discussed. In other words, a trustee cannot simply rely on the fact that a predecessor held these assets, even if the predecessor was the grantor.

Sections 5 and 6 set out the trustee’s duties of loyalty to and impartiality among the beneficiaries. Section 7 states that a trustee may only incur costs in investing and managing trust assets that are appropriate and reasonable. Section 8 provides that 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.” As the comments point out, “[t]rustees are not insurers ... . Not every investment or management decision will turn out in the light of hindsight to have been successful. Hindsight is not the relevant standard.”

Section 9 provides that a trustee who properly delegates investment and management functions is not liable for the decisions or actions of the agent to whom the function was delegated. This section reverses the former trust law that imposed a rule of nondelegation and “is designed to strike the appropriate balance between the advantages and the hazards of delegation.” Further, “the trustee must balance the projected benefits against the likely costs” of delegation, and “take costs into account.” So, for example, if a trustee’s regular compensation schedule assumes that the trustee will manage investments, “it should ordinarily follow that the trustee will lower its fee when delegating the investment function to an outside manager.” ti

*The second part of this three-part series, to appear in the March/April 2007 issue of ABA Trust & Investments, will address*



## *factors that determine life insurance pricing, performance, and suitability.*

<sup>1</sup>See, e.g., Hoisington, Modern Trust Design: New Paradigms for the 21st Century, 31st Annual Phillip E. Heckling Institute on Estate Planning, Ch. 6 (1997); Horn, Prudent Investor Rule, Modern Portfolio Theory and Private Trusts: Drafting and Administration Including the "Give-Me-Five" Unitrust, 33 Real Property, Probate & Trust Journal 1 (Spring 1998); Wolf, Total Return Trusts—Can Your Clients Afford Anything Less?, 33 Real Property, Probate & Trust Journal 131 (Spring 1998).

<sup>2</sup>See, e.g., Macey, An Introduction to Modern Financial Theory (2d ed. (1998); Malkiel, A Random Walk Down Wall Street (6th Ed. 1996).

<sup>3</sup>See, e.g., Restatement (Third) of Trusts, § 227, cmts (b)(h) (1992).

<sup>4</sup>Id. At § 227, cmt g.

<sup>5</sup>Restatement (Third) of Trusts, Ch. 7 (Introduction, pp. 6-7; Reporter's Notes, pp. 75-76) (1992).

<sup>6</sup>Id. At § 227(c)(3).

<sup>7</sup>See, e.g., Horn, supra at fn. 2, pg. 17.

<sup>8</sup>Shefrin, Beyond Greed and Fear, 13 (Harvard Business School Press, 2000). This book synthesizes the work of several academics in the area of behavioral finance.

<sup>9</sup>Id. at Ch. 2.

<sup>10</sup>Id. at 42.

<sup>11</sup>Id. at 52.

<sup>12</sup>All of Mr. Bogle's remarks are contained in "The Mutual Fund Industry in 2003: Back to the Future," delivered January 14, 2003, to the Harvard Business School Association of Boston. Transcript available at [www.vanguard.com](http://www.vanguard.com).

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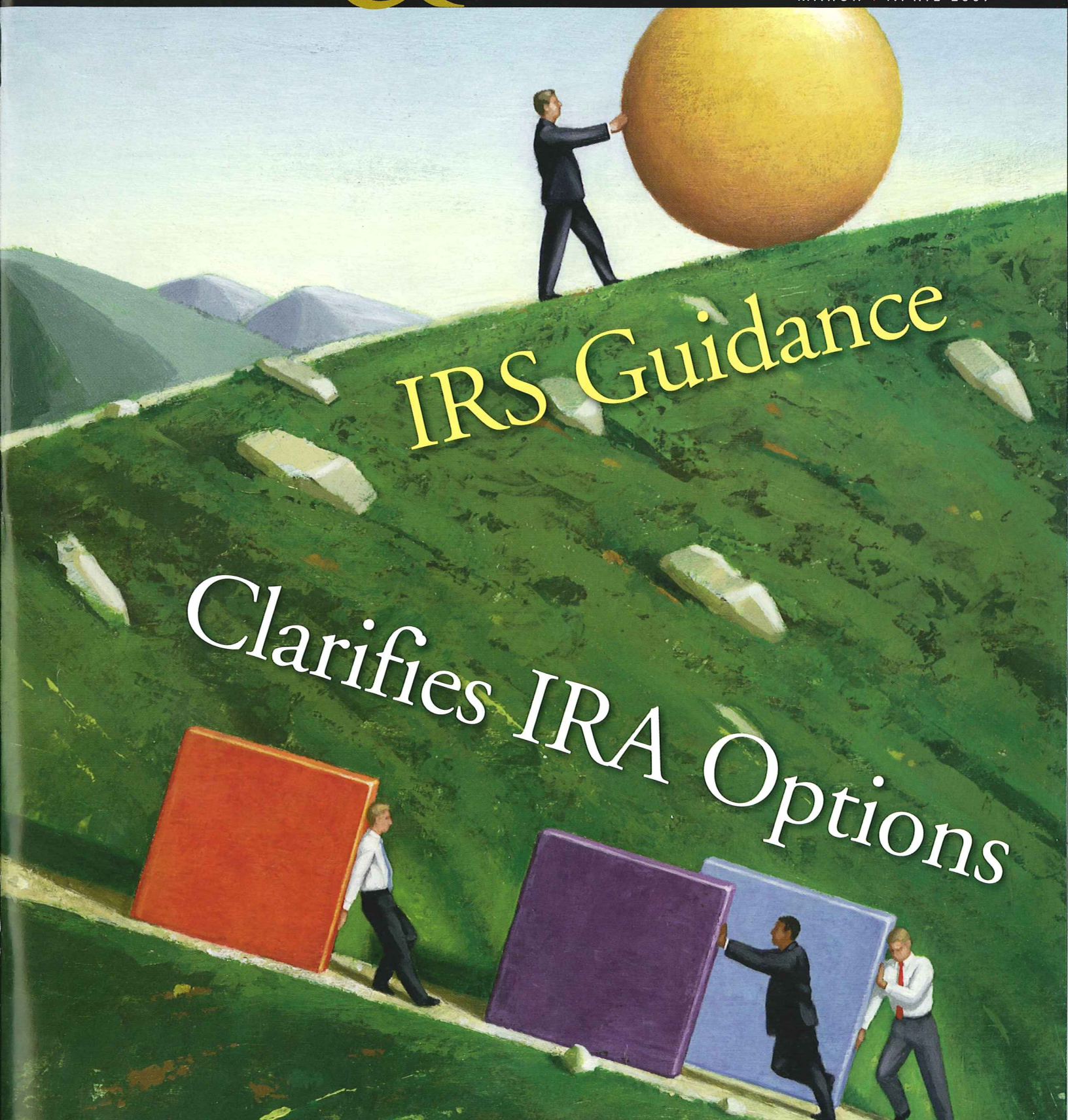
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# The Prudent Investor and Trust Owned Life Insurance (TOLI)

## PART 2

**T**he adoption by most states of the Uniform Prudent Investor Act (Prudent Investor Act), has far-reaching effects on trust drafting and administration.<sup>1</sup> One of the often overlooked consequences of the Prudent Investor Act is its effect on the administration of irrevocable life insurance trusts (ILITs). This article will address the unique (and often opaque) nature of life insurance as an investment and the effect of the Prudent Investor Act can have on the trustee ownership of life insurance.

Part 1, published in the January/February 2007 issue of ABA Trust & Investments, reviews the theoretical underpinnings of the Prudent Investor Act, and discusses the ways in which these theories can adversely affect the way trustees invest for particular families. It then explores the Prudent Investor Act itself, and the types of drafting and administration issues it engenders. Part 2 looks at the nature of life insurance as an investment, focusing on the factors that go into pricing insurance products and the effects that those factors have on policy performance. Finally, Part 3, to be published in the May/June 2007

issue of ABA Trust & Investments, looks at trust administration of ILITs.

This article is the second installment of a three-part series tackling the prudent investor and trust-owned life insurance (TOLI).

### **FACTORS DETERMINING LIFE INSURANCE PRICING, PERFORMANCE, AND SUITABILITY**

Now that the basics of the Uniform Prudent Investor Act have been laid out, its application to life insurance as a trust asset will be considered.

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**Christopher P. Cline and Barry D. Flagg**



## Some Crucial Facts about Insurance

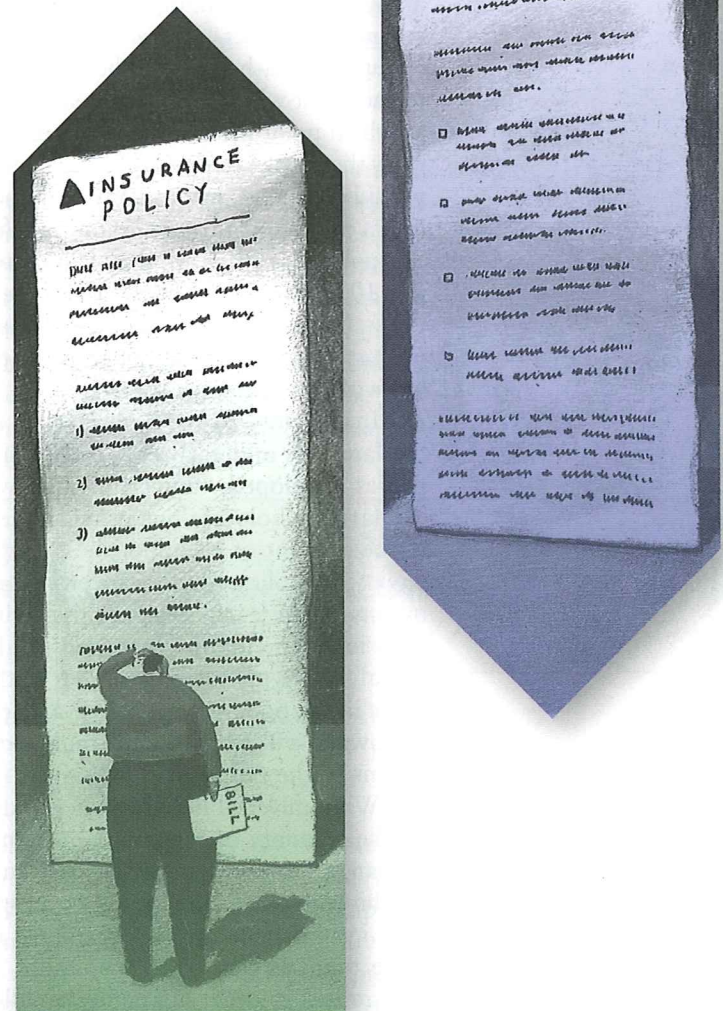
To begin any discussion of life insurance as an investment, it is important to understand how the various insurance products work. This, in turn, requires an understanding of the types of products available and the expense structure behind them.

### Insurance Product Types<sup>2</sup>

In its purest form, insurance is simply the insurance company pooling a sufficiently large number of risks (i.e., individual insured lives) that individually are unpredictable but which collectively become statistically very predictable under a principle known as the Law of Large Numbers. Under this principle, the company calculates each year how much it must be paid for it to assume the risk that the insured will die in that year and that the company will then have to pay the stated death benefit to the insured's beneficiaries. The amount it must be paid, in the form of an annual premium, is determined based upon actuarial assumptions about the insured, including the insured's sex, age, personal habits (e.g., smoking and skydiving), and medical condition and history. An insurance company will accept a small premium from a healthy 25-year-old nonsmoker with no family history of illness; the annual premium on such a person for \$1 million might be \$1,000. In other words, the insurance company is willing to accept a relatively small premium due to the statistical probability that it is very unlikely the insured will die that year in which case the insurance company keeps the premium. On the other hand, a 98-year-old smoker would have to pay an amount approaching \$1 million for the same policy; that is, the company knows there is an extremely high probability that the insured will die that year, so it must collect a correspondingly large premium to be able to pay that death claim. This kind of "pure" insurance is called "term insurance," and it is used primarily to provide security for younger insureds (or for group insurance,

with a large risk pool), because as the insured gets older, the premiums become prohibitively expensive. More on how insurance companies calculate this "pure risk" cost of insurance below is found in this Part 2.

As an alternative to term insurance, most insurers also offer various products that can provide permanent coverage. The earliest form of "permanent life insurance" is "whole life insurance," the premiums for which consist of a term insurance component and an investment component. In the case of our 25-year-old nonsmoker, the premium for a whole life policy with a \$1 million death benefit might be twice as much, with \$1,000 going to pay the





cost of the term insurance and the balance (after the commissions are paid to the agent) going into an investment account regulated by the state insurance commissioner. This investment account grows over time and can either become part of the death benefit that is paid or be used to reduce policy costs over time (see discussion of net amount at risk below). For instance, if the cash value in the policy grows to \$750,000 by the time the insured is age 50, the portion of the premium paid each year allocated to the term component of the policy gets smaller, because now the company is only insuring the insured's life for \$250,000. Because the value of the investment account increases over time, the premium never increases (as it does under term insurance) because the amount of the premium necessary for real insurance decreases. If the insured lives long enough, the cash value on the policy increases to the point where it equals the death benefit, at which point the insurance company simply gives the money to the insured or continues to provide coverage without any additional premium or cost. This point in time is referred to as "policy maturity" and usually happens at age 100. The owner of the policy can withdraw the cash value in the policy at any time or borrow against it, although if the policy is left with too little cash it can lapse.

In response to the high interest rates of the late '70s and early '80s, insurance companies developed "universal" life, which is similar to whole life but provides flexibility in the amount of premium the policy owner pays. The policy owner can pay larger premiums in the early years of the policy and then lower premiums (or none at all) later on, always with the caveat that if the cash value in the policy drops below a given level, the owner will have to contribute extra premiums to the policy or it will lapse.

With universal life, the policyholder gives up the certainty of a guaranteed premium in exchange for a lower current cost and more flexibility in paying premiums. In reality, however, insurance companies guarantee nothing more than they do with whole life. Rather, they repackage their guarantees to allow this

flexibility by applying the same interest and mortality assumptions used for reserves, but also transferring the premium sufficiency risk to the policyholder. If more money is needed because the interest crediting rate drops or mortality costs increase, then more premiums would be due and (if they are not paid) the policy eventually terminates without value when the policy assets were used up by those increased costs.<sup>3</sup> Because this new risk often is not explained by insurance agents and therefore not understood by policyholders, many policyholders pay less than is needed to keep their policies alive, thinking that the quoted premiums were a promise of no future increases. As a result of this confusion, some believe that universal life has created a "legacy of disappointment and broken promises" for policyholders and advisers alike.<sup>4</sup>

A decade later, after the significant rise in value of the stock market, policy owners grew tired of having the cash values of their insurance policies invested in "safe" regulated investments approved by the insurance commissioner (typically bonds and government-backed mortgages). The insurance industry responded with "variable life," which usually is a universal-life product, but the cash value of which can be invested in one of several investment packages. For example, the company may offer mutual fund packages allowing investments of 100 percent in stocks, or 50 percent in stocks and 50 percent in bonds. The policy owner is limited to the investment choices offered by the insurance company, which typically have higher-than-average costs associated with them. These higher costs may be offset, over time, by the fact that the growth of the assets inside the insurance policy occurs free of income tax liability. Note, however, that this investment flexibility can work both ways; if the policy owner decides to invest primarily in equities and the stock market is doing well, the cash value will build in the policy faster than expected, which means that the future premiums can be much smaller. On the other hand, if the stock market drops in value significantly, the policy



owner may be faced with much larger premiums than were originally quoted.

As with universal life, policyholders tend to view the optimistic illustrations provided by agents as a promise that the product will perform and that premiums will not increase. However, the significant fluctuation in stock market values over the last seven years has demonstrated that projections for premiums in variable-life products are not reliable at all. Therefore, as with universal life, variable-life products have proved to be a disappointment to many.

## The Problem with Illustrations

Another issue policy owners need to deal with, after the appropriate type of policy is chosen, is the illustration, or projection, of premium payments presented by the agent selling the policy. In the late '70s and early '80s, with the advent of universal life, insurance companies and agents were among the first to either own or have access to personal computers in order to run the illustrations for this more complex product.<sup>5</sup> Unfortunately, however, this technological advance became somewhat stratified, with the result that illustrations no longer adequately presented purchasers with an appropriate picture of the risks involved. This is so because policy illustrations, even so-called "in-force" illustrations, are constrained by both insurance regulation and industry tradition to projecting a constant return assumption.<sup>6</sup> So, for example, if illustrations are run showing an 8 percent return (the most that can ever be illustrated is 12 percent), the illustration will assume that each and every year the investments inside the policy generate an 8 percent return.

The problem, of course, is that no investment generates such a flat-line return. For example, suppose a 10 percent return is being illustrated. If \$1,000 is invested and it generates an even 10 percent each year for five years, the value of the investment will be \$1,611 at the end of the period. If on the other hand the investment earned in each suc-

cessive year 10 percent, 20 percent, 0 percent, 30 percent, and a loss of 10 percent, the average percentage return would still be 10 percent over the five years, but the investment would be worth only \$1,544.<sup>7</sup> This fluctuation in values based upon return can have great significance; in some cases, it can mean the difference between a policy being adequately funded by the premiums and requiring additional premiums in the future. A better way to illustrate, albeit one that is not commonly provided, is the "Monte Carlo" simulation, under which a computer enters a significant number of permutations, or "runs" of outcomes, all of which lead to the same average percentage return. This exercise will tell a potential buyer of insurance the percentage likelihood that the policy will remain in force and will not require additional premiums.<sup>8</sup>

## Pricing Issues

To manage any portfolio of life insurance products (even just a single policy), trustees must first measure the factors underlying the products' pricing and performance. Whether disclosed or not, these factors are the same for all policies: (a) cost of insurance charges, (b) policy expenses, and (c) policy earnings. Therefore, the pricing and performance of any policy can be measured using the following formula:

Pricing/ Performance	=	Cost of Insurance Charges	+	Policy Expenses	-	Policy Interest/ Earnings
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Each of these factors is discussed in turn.

## Cost of Insurance Charges (COIs)

Cost of insurance charges (COIs) are deductions from permanent life insurance policies to cover the insurer's anticipated payments for death claims. They are the largest single cost of any policy, typically accounting for about 75 percent of total



premiums. (Indeed, if claims are not the largest single cost factor, then the product probably isn't really insurance against the risk of death.) These deductions are much like term life insurance premiums in that they are predominantly for claims paid during a given period (typically one year). For this reason, COIs are frequently referred to as the pure "risk" portion of the premium, reimbursing the insurance company for the risk associated with paying the death benefit. Because the risk of death increases with age, so does the COI.

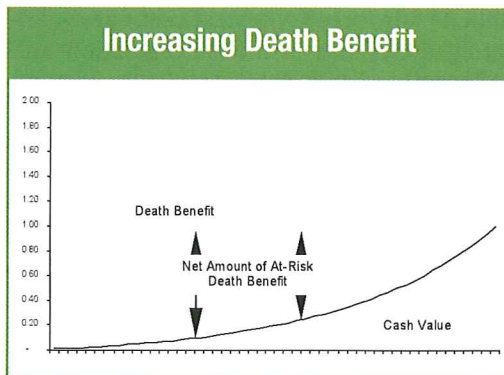
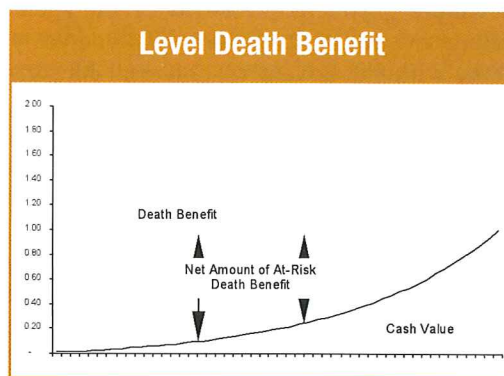
COI is calculated each year using two factors: the net "at-risk" amount of the policy death benefit and a COI rate provided by the insurance company for each age corresponding to each policy year for each product. The net at-risk amount is multiplied by the rate to determine the COI; the higher the death benefit or the rate, the greater the COI and therefore the higher the premium.

For example, assume an insurance company provides permanent life insurance for a group of 1,000 policyholders who all are insured for \$100,000, and three of those insureds die in a given year. The insurance company pays \$300,000 to the beneficiaries of those three insureds. The insurance company must therefore collect \$300 from each policy owner over the course of the period in order to pay this \$300,000. The COI rate would equal \$3 per \$1,000 of death benefit (i.e. each insured paid \$3 multiplied times 100 for each \$1,000 of death benefit). Of course, as the average age of the population increases, the risk of more deaths increases, and so does the COI and therefore the premium.

In the example above, the COI rate is assumed to be only the amount needed to pay claims; however, insurance companies add several other charges to COI. First, the company builds in a profit margin. Second, some insurers "load" the COI to cover other policy expenses that are not disclosed elsewhere. For instance, some policies are marketed as "no-load" or "low-load" policies and do not disclose certain policy ex-

penses or loads such as sales loads and other premium-based loads. However, because certain premium based loads must be paid (e.g., state premium taxes, federal deferred acquisition costs taxes, and the cost to distribute the policies), some insurers hide these costs inside "loaded" COIs.

The other factor, the "net at-risk" death benefit, is that portion of the total death benefit in excess of any policy cash value (e.g., the higher the policy cash value, the lower the net at-risk amount of death benefit to the insurer). If policy cash values increase over time, this net at risk death benefit will decline each year in a level-death-benefit policy design, or will remain level in an increasing death benefit policy design, as shown below:



While different policies calculate the net at-risk death benefit differently, this net amount at risk (NAR) in any given year can be generally calculated as follows:



## Net Amount at Risk = Policy Death Benefit - Policy Cash Value

Because COI is calculated on the NAR, and because COI increases geometrically with age, the NAR is a significant factor for the pricing and performance of any TOLI holding. COI is minimized when cash values are nearly equal to the policy death benefit. However, after the insured dies, the insurance company pays the death benefit in large measure by “giving back” the policy cash value. Because policy cash values are “confiscated” by the insurer upon death (in the sense that they offset the insurer’s obligation to pay the death benefit), any COI savings associated with high cash values and a corresponding low NAR must be measured against the “cost” of forfeiting policy cash values.

The reasonableness of COI for any given product can be measured against a generally accepted mortality table like the 1990 – 95 Gender Distinct Select and Ultimate Mortality Table published by the Society of Actuaries ([www.soa.org](http://www.soa.org)), COI benchmarking systems like the Policy Pricing Calculator (available without charge at [www.policypricingcalculator.com](http://www.policypricingcalculator.com)), or the Confidential Policy Evaluator (CPE) system from [www.theinsuranceadvisor.com](http://www.theinsuranceadvisor.com) (TIA).

## Policy Expenses

In addition to COI, most policy issues are priced for expected expenses related to actuarial design, sales and marketing, underwriting and new business processing, state and federal taxes, and service and administration. While different insurers use different names for these expenses, they all fall into one of three categories: fixed administration expenses, cash-wrap fees, and premium loads.

## Fixed Administration Expenses

Fixed administration expenses (FAEs) are charged as a fixed amount, either as a flat monthly charge (e.g., \$10 a month), or in relation to the originally issued policy face

amount (e.g. \$1 per \$1,000 of policy face amount). While this charge is fixed in amount at the time of policy issue, it can vary from year to year by a predetermined schedule. FAEs can include contingent or back-end policy surrender charges that are deducted from the policy cash account value upon surrender, cancellation or termination of the policy. These surrender charges are calculated in relation to the initially issued policy face amount and can be as much as 100 percent or more of the planned annual premium for policy issues available to the general public or can be reduced or waived for policies purchased in larger volumes. This surrender charge typically remains level for an initial period, then reduces to zero over an additional period.

## CashValueBased “Wrap Fees”

Cash-value-based “wrap fees” are charged as a percentage of policy account values in the same way that investment managers charge a management fee based on a percentage of assets under management. These fees can be divided into two categories: insurance fees, which are specific to the policy and collected at the policy level; and investment fees, which are also charged as a percentage of policy account values, but which are specific to the investment fund and collected at the fund level.

Fund-level or fund-specific charges relate specifically to the investment portfolio or separate account funds upon which the cash value is based and typically range from 0.25 percent to 2 percent, depending upon the type of investment funds used. Examples of fund-level or fund-specific charges include, but are not limited to, charges at the investment fund or portfolio level for investment management fees, investment advisory fees, and fund operating expenses. Whole-life and universal-life policies do not customarily disclose these charges, while variable products do. Because these charges are a function of the underlying investment portfolio, they should only be taken into ac-



count only when comparing investment or separate account fund selections, not when comparing policy level costs.

On the other hand, policy level or policy-specific charges relate to the policy itself, without regard to underlying investments, and typically range from zero to 1 percent, and can vary from year to year and based on the policy account value. The most common policy level or policy-specific cash-value-based charge is the M&E charge intended to cover the risks assumed by the insurance company that actual cost of insurance charges will be greater than expected (i.e., insureds live less time than anticipated resulting in increased claims) and that actual expense charges will be greater than expected. Some products also include policy level or policy-specific cash-value-based charges in addition to the M&E charge, both of which can vary depending on the year of the policy (e.g., 1 percent of cash values during the first 10 policy years, and 0.5 percent of cash values thereafter). These charges are true policy costs, to be considered when comparing one policy to another.

## Premium Loads

Premium loads are charged to policyholders as a percentage of premiums paid in a given year. They typically range between zero percent and 35 percent, and typically cover state premium taxes, DAC taxes, sales loads, and expenses. In addition, while insurance companies must pay state premium and DAC taxes, they are not required to assess these charges as a percentage of premium, so many pass these charges through as COI rather than premium charges. Premium-based charges can vary, depending on either the policy year in which a premium is paid or the level of the premium paid. For instance, a higher premium load may be assessed in the early policy years to recover up-front expenses related to underwriting, issue, and distribution of a given policy. After these up-front expenses have been amortized (frequently over a period of 10 policy years), premium loads are then

often reduced to cover the relatively lower policy owner service and policy administration expenses. In addition, a higher premium load may be charged on actual premiums paid up to a "base policy premium" or "target premium" level (generally the premium which, if paid every policy year, would endow or mature the policy for its originally issued face amount based on guaranteed policy pricing assumptions as to COIs, expenses, and earnings), while a lower premium load may be charged on actual premiums paid in excess of this amount.

## Application of Policy Expenses

The manner in which these fixed administration expenses, cash-value-based "wrap fees," and premium loads are constructed and calculated in a given policy determines the suitability of a given product to a given situation. For instance, products with low COI and FAEs perform best in defined death benefit, minimum premium situations, even if premium loads and cash-value-based fees are relatively high, because these expenses are calculated as a percentage of a minimum premium and minimum cash values and thus have less influence on performance. On the other hand, products with low premium loads and low cash-value-based fees perform best in defined contribution, maximum accumulation situations, even if COI and FAEs are relatively high, because maximizing premiums and cash values has the effect of reducing the net amount at risk, which in turn minimizes COI. Of course, the best of all worlds would be to hold a policy that has low COI, FAEs, cash-value-based fees, and premium loads. The reasonableness of such expenses for any given product can be again measured either against industry aggregate expense studies published by the Society of Actuaries ([www.soa.org](http://www.soa.org)), policy expense benchmarking systems like the Policy Pricing Calculator (available at [www.policypricing-calculator.com](http://www.policypricing-calculator.com)), or the Confidential Policy Evaluator (CPE) system from [www.theinsuranceadvisor.com](http://www.theinsuranceadvisor.com) (TIA).



## Policy Interest and Earnings

Premiums paid in excess of the premium expenses discussed above are credited with some form of policy interest or earnings based on product type and the allocation of invested assets underlying policy cash values. For instance, “fixed products” (i.e., universal life and whole life) are required by regulation to invest policy assets mainly in high-grade corporate bonds and government backed mortgages. As a result, the policy interest crediting rate for universal-life products and the dividend interest crediting rate for whole-life products is generally the same as the 6 percent historical rate of return on these investments. Similarly, “variable products” (i.e., variable universal life and variable whole life), which can invest policy cash values in a wide variety of mutual fund like “separate accounts,” have a policy earnings rate that is very similar to the rate of return for the assets classes into which cash values are allocated (domestic index funds, international funds, or balanced funds, for example).

Obviously, while life insurance policy pricing and performance projection systems allow for a wide range of interest and investment earnings assumptions in calculating hypothetical policy values, actual policy performance depends upon the actual performance of invested policy assets. In other words, while an illustration of hypothetical future policy values may reflect a current interest rate declared by the insurer, actual policy earnings will vary from those hypothetical values. Several factors can affect the actual performance of policy investments. For example, some insurers declare higher interest crediting rates for new policies than for renewing policies (e.g., 5.5 percent interest for new policies, 5 percent for renewals), while others declare a market interest rate at issue with a “bonus interest crediting rate” after some period of time (e.g., 0.5 percent bonus beginning in the 11th policy year). Either way, such declared rates are generally guaranteed for a year or less and are routinely changed. Variable

products allow for an even wider range of interest and investment earnings assumptions in calculating policy pricing and projected performance; earnings expectations are generally set by agent or broker rather than by the insurer and generally do not reflect actual rates of return for the actual policy investments. An agent or broker can project a policy earnings assumption between zero percent and 12 percent without regard to the actual type of investment accounts the policy will hold.

As a result, trustees must look beneath the assumed policy earnings rate when setting expectations as to future policy performance (discussed in greater detail in Part 3) and instead consider the historical performance of the policy investments and the expected rate of return for the appropriate allocation of cash values among the separate accounts. The reasonableness of an illustrated policy earnings rate can be measured using LifeLink VitalSigns for performance of insurance company general accounts underlying whole- or universal-life policy cash values, while Morningstar PrincipiaPro can be used to measure the performance of variable life policy investments. Other services include policy performance benchmarking systems like the Policy Pricing Calculator (available at [www.policypricingcalculator.com](http://www.policypricingcalculator.com)) or the Confidential Policy Evaluator (CPE) system from [www.theinsuranceadvisor.com](http://www.theinsuranceadvisor.com) (TIA).

## Determining the Rate of Policy Earnings

Because the reporting of life insurance policy earnings is not yet standardized, measuring policy performance also requires an understanding of the three ways in which life insurance policy earnings can be expressed and reported: the gross rate, the net rate, and the net-net rate.

The gross rate is that rate of return credited to policy cash values reported before deduction of investment related fund management expenses (FMEs) and before deduction of cash-value-based insurance expenses. The gross rate is directly related



to the rate of return on invested policy assets and thus is more a measure of general "asset class rate of return" than of policy specific returns. Therefore, while the gross rate may be an interesting piece of information at it relates to benchmark performance of the respective asset classes underlying policy cash values, because it does not reflect the earnings actually credited to TOLI policy holdings, it is limited in its use by trustees in setting reasonable expectations as to the investment performance of TOLI holdings.

The net rate (or single-net rate) is that rate of return credited to policy cash values reported after deduction of investment related FMEs, but before deduction of cash-value-based insurance expenses. In other words, the net rate equals the gross rate minus FMEs and so is analogous to the "investment rate of return" on policy cash values. Because the net rate is derived directly from the gross rate for a given asset allocation, and because FMEs are a function of that asset allocation (i.e., they are lower for conservative fixed income cash value allocations than for aggressive equity allocations), the net rate is useful in setting reasonable return expectations for policy investments.

Finally, the net-net rate is that rate of return credited to policy cash values reported after deduction of both investment FMEs and cash value based insurance "wrap fees" (e.g., M&Es). In other words, this "net net rate" is equal to the net rate minus M&Es, and because this net net rate reflects the rate of return reported on policy cash values after deduction of all cash value based fees, it can also be referred to as the "policy rate of return" or the "double net rate" (i.e., the rate of return on

policy cash values after deduction of both investment and insurance "wrap fees," but not considering COIs, FAEs, or premium loads). Because this net net rate is a function of the individual TOLI holding, it is less useful in setting reasonable expectations as to the interest or earnings actually credited to trust assets and is instead most useful in measuring the appropriateness of policy expenses.

Because some TOLI policies may not disclose the gross rate, the net rate, or the net net rate or clearly distinguish which rate is which even if it is disclosed, ILIT trustees need to exercise considerable care both when setting reasonable expectations for return on investment from TOLI policies and when determining the suitability of one policy versus another. For instance, two TOLI policies may have the same underlying cash value asset allocation, the same 1 percent investment wrap fees, the same .75 percent insurance wrap fees and the same 8 percent rate of return. However, if the policies do not make clear that the Product A rate of return is net of only investment expenses (i.e., the single-net rate), while the Product B rate of return is net of all cash value based expenses (i.e., the double-net rate), the performance can vary significantly without the potential purchaser being aware of the difference:

	Product A	Product B
<b>Gross Rate</b>	9 %	9.75 %
Less Investment Wrap Fees	1 %	1 %
<b>Net Rate</b>	<b>8 %</b>	8.75 %
Less Insurance Wrap Fees	0.75 %	0.75 %
<b>Net Net Rate</b>	7.25 %	<b>8 %</b>

Comparing rates of return without determining which types of rate are being compared can lead to an improper choice of product (and ultimately a potential breach of fidu-



ciary duty claim if the purchaser is a trustee).

The same problem can occur when comparing two policies that report the same 9 percent gross rate of return, but where investment wrap fees are reported differently:

	Product A	Product B
<b>Gross Rate</b>	<b>9 %</b>	<b>9 %</b>
Less Investment Wrap Fees	1 %	0.25 %
<b>Net Rate</b>	<b>8 %</b>	<b>8.75 %</b>
Less Insurance Wrap Fees	0.75 %	0.75 %
<b>Net Net Rate</b>	<b>7.25 %</b>	<b>8 %</b>

Here the problem lies in comparing assumed rate of return, but not in determining which expenses are deducted from this return.

## Understanding Pricing and Performance Factors in Each Product Type

While all life insurance products are priced using COI, policy expenses, and policy earnings, different products use these pricing factors differently; some products disclose these factors while others do not, and some products guarantee certain factors while others do not. What follows is a discussion of the ways these pricing factors are constructed in each product, which products generally disclose these pricing factors, and which product types guarantee which pricing factors (by product type in alphabetical order).

### Fixed Duration Term Insurance

Term insurance products like annually renewable term (ART) and level premium term (e.g., LT10 for a 10-year term and LT20 for a 20-year term of fixed premiums) provide a specified death benefit for a fixed term of years and charge a premium corresponding to that duration of coverage, and

are thus often referred to as fixed duration term life. For instance, ART products charge a premium for one year of insurance coverage at a time and generally allow the policy to be renewed at an increasing premium for some number of years. As a result,

ART initially provides the greatest death benefit per initial premium dollar but becomes the most costly for extended durations of coverage due to the effects of actuarial

principles such as “select and ultimate rate scales” and “adverse selection.”<sup>10</sup> On the other hand, level premium term products charge a fixed, level premium for the specified duration of coverage (typically 10, 20, or 30 years). If coverage is renewable after the initial level-premium period, premiums generally increase substantially, cease to be guaranteed and continue to increase annually each year thereafter as with ART products. Further, because level premium term products rarely provide coverage under the initial level premium period that extends to life expectancy (in other words, no one older than 50 typically can obtain a LT30 product), level premium term products generally provide the greatest death benefit per premium dollar for the specified coverage period, because they are generally priced to pay claims on less than 50 percent of the insured population.

Pricing of term products is not disclosed but is generally guaranteed. Because ART product premiums by definition equal COI and expenses, policy earnings are not a factor. Further, because of the guarantee for term products, the reasonableness of pricing factors is the concern of the insurer, who bears the risk of unrealistic pricing assumptions, not the policyholder. Therefore, there are only three relevant considerations



in determining the suitability of a fixed duration term product as a TOLI policy: (a) the actual premium for the appropriate duration of coverage; (b) the terms of the premium guarantee (i.e., some insurers offer guarantees for the entire initial level-premium period, while others publish an initial level premium but only guarantee that premium for a portion of the specified coverage duration); and (c) the financial strength and claims paying ability of the insurer.

## **Flexible Duration Term Insurance (e.g., Universal Life Insurance with Secondary Death Benefit Guarantees)**

Flexible duration term life is a marketplace term for the genre of products that are filed with state departments of insurance on either a universal-life form or a whole-life form to include certain premium and death benefit guarantees known as either secondary death benefit guarantees or no lapse guarantees. However, because these universal-life and whole-life products offer a guaranteed death benefit in exchange for a guaranteed premium and include little or no cash value, they typically look, smell and taste more like term life insurance than permanent life insurance, hence the marketplace term flexible duration term. These products combine the flexible premium feature of universal-life and certain whole-life products (discussed in greater detail below) with the pricing features of fixed duration term products to provide level-premium term like coverage for a period of the policy owner's choosing ranging from an unusual term of years (e.g., the number of years to precisely coincide with a planning tool with a specific duration like a GRAT or a personal residence GRIT) or for the life of the insured (which has also given rise to the use of "permanent term" as another marketplace term for this genre of product). Coverage duration can vary from contract to contract and can generally be lengthened or shortened after policy issuance at any time during the initial coverage duration simply

by increasing or reducing planned annual premium payments. Because flexible duration term life products can be structured to provide coverage to and beyond the life expectancy of the insured, they are priced for the greater probability that the insured will pay a claim, and so are more expensive than fixed duration term products. On the other hand, flexible duration term life products can be most cost effective for either specific coverage durations not available with fixed duration term products, or coverage durations beyond life expectancy where fixed duration term products are not available and other forms of permanent life insurance are too expensive.

The underlying pricing of flexible duration term life products is generally not disclosed, at least not to the extent of guaranteed premiums and guaranteed death benefits. As with level-premium term products, flexible duration term life premiums in excess of underlying cost of insurance charges and policy expenses in the early years of the guaranteed period are credited with interest and earnings to create a surplus (commonly referred to as the "shadow account") to cover cost of insurance charges and policy expenses that exceed planned premiums in the later years of the guaranteed period. And like traditional universal-life products, flexible duration term death benefits are generally guaranteed only to the extent this shadow account is sufficient to cover the cost of insurance charges and policy expenses.

Because flexible duration term life offers guaranteed premiums and guaranteed death benefits, the reasonableness of underlying pricing factors is again less the concern of the policyholder and more the concern of the insurer. Therefore, as with fixed duration term products, the relevant considerations in determining suitability of a flexible duration term life product as a TOLI policy are (a) the actual premium for the appropriate duration of coverage, (b) the terms of the premium and death benefit guarantee, and (c) the financial strength



and claims paying ability of the insurer. However, unlike fixed duration term products, flexible duration term life products require greater scrutiny when determining the policy terms (i.e., some contracts include catch up provisions that allow for guarantees to be reinstated after a missed premium payment, while other contracts lapse without value and without paying a death claim in the event of a missed premium payment unless policy cash values are otherwise sufficient to cover cost of insurance charges and policy expenses).

## Universal Life

Universal-life (UL) products are distinguished by the fact that the owner's premium payments are flexible rather than fixed. Premiums paid in excess of COI and policy expenses create policy cash value, which is then credited with policy interest based on the insurer's general account portfolio of predominantly high grade corporate bonds and government backed mortgages. While death benefits under term and flexible duration term life products are typically based on the timely payment of premiums (i.e., death benefits lapse when a premium is not paid), death benefits under traditional UL policies generally remain in full effect without regard to the payment of a planned premium so long as planned premiums, accumulated cash values, and policy interest together are sufficient to cover COI charges and policy expenses.

Traditional universal life premium pricing is generally not guaranteed (at least not as typically illustrated), but insurers generally do disclose current pricing assumptions (i.e., current COI charges, policy expenses, and declared interest crediting rate), and guaranteed pricing assumptions (i.e., guaranteed COI charges, policy expenses, and declared interest crediting rate). Because insurers can change current COI charges and policy expenses to some extent, and because insurers routinely change current policy interest crediting rates, ILIT trustees

bear the risk for unreasonable pricing assumptions and expectations regarding policy earnings. In addition, because guaranteed pricing factors are the basis for the insurer's reserve requirements (i.e., the higher the guaranteed charges the lower the reserve requirements, and therefore the greater the insurer's opportunity for profit), universal life guaranteed charges are typically set at the maximum allowable statutory amount. As a result, guaranteed prices are often similar from one universal life product to the next and are typically many times more expensive than nonguaranteed current pricing assumptions, and thus do not generally offer ILIT trustees much in the way of pricing protection. In fact, because guaranteed prices for traditional universal life products have more to do with insurer statutory reserve requirements and less with pricing protection, flexible duration term life guaranteed rates and terms are often far more attractive than seeking such guarantees though traditional universal life products.

However, ILIT trustees can mitigate this pricing risk by determining whether (a) current COI charges are consistent with historical mortality experience, (b) current policy expenses are consistent with historical operating experience, and (c) the current policy interest crediting rate is consistent with both the historical rates of return for the asset classes of investment holdings underlying policy cash values (i.e., predominantly high grade corporate bond and government backed mortgages), and the historical policy interest crediting rates for the current universal-life product series and for predecessor universal-life product series. In other words, in determining the suitability of a given universal-life policy as a TOLI holding, ILIT trustees should consider the competitiveness and stability of published pricing, the historical performance of assets underlying policy cash values, the liquidity and accessibility of policy cash values, and the financial strength and claims paying ability ratings of the insurer.



## Variable Life

Variable-life products (VL) allow the policy owner to invest policy cash values into a family of mutual funds like separate accounts (which can include domestic and foreign stock funds, domestic and foreign bond funds, a money market account, and usually a fixed account). Variable-life products tend to be universal, in that they can generally accept flexible premium payments. As with universal-life premiums, variable-life premiums, paid in excess of published COI charges and policy expenses create policy cash value, which then is credited with a return based on the performance of the separate accounts. Death benefits under variable-life policies also generally remain in force without regard to investment performance so long as planned premiums, accumulated cash values, and policy earnings are together sufficient to cover COI charges and policy expenses.

As with traditional universal life, variable-life premium pricing is generally not guaranteed (at least not as typically illustrated), but insurers generally do disclose current pricing assumptions (i.e., current COI charges, policy expenses, and declared interest crediting rate), and guaranteed pricing assumptions (i.e., guaranteed COI charges, policy expenses, and declared interest crediting rate). Because insurers can change current COI charges and policy expenses to some extent, and because policy earnings are based on the performance of the selected separate accounts, which can be positive or negative (variable-life policy cash values can actually experience a loss due to investment performance in addition to deductions for policy charges), ILIT trustees bear the risk for unreasonable pricing assumptions and unreasonable expectations regarding policy earnings. Indeed, this risk is even greater for variable-life products than it is for traditional universal-life products. In addition, because guaranteed pricing of variable-life products is essentially the same as that of universal-life products, flexible duration term life guaranteed rates and terms are

often far more attractive than guarantees through variable-life products.

Again, however, ILIT trustees can mitigate this pricing risk for variable life in the same manner as can be done for traditional universal life (in other words, an ILIT trustee should consider the competitiveness and stability of published pricing, the historical performance of funds similar to the separate accounts, the accessibility of policy cash values, and the financial strength and claims paying ability ratings of the insurer).

## Whole Life

Whole-life products (WL) are characterized by fixed, guaranteed, and typically level premiums set by actuaries. Whole-life premiums are based on undisclosed actuarial expectations as to mortality (i.e., COI charges), operating expenses and policy earnings (again based on the performance of the general account required by regulation to invest predominantly in high grade corporate bonds and government backed mortgages). As a result, level whole-life premiums are greater than expected COIs and expenses in the early policy years, and thus create cash value, eventually growing to an amount equal to the policy face amount by maturity. And as with term-life products, whole-life premiums must be paid each year, either in cash by the policy owner or from the cash value, or the policy can lapse. On the other hand, if the premium is paid (either in cash or from policy cash values), whole-life death benefits are generally guaranteed.

While actuaries set policy premiums, cash values, and death benefits based on their most conservative expectations as to COI, expense, and interest factors, whole-life policies generally pay a dividend if actual mortality experience is lower than the actuary's most conservative COI expectations, actual operations experience is lower than the actuary's most conservative expense expectations, or actual investment experience is higher than the actuary's most conservative interest expectations. In other words, whole-life policy pricing (as typically illustrated) effectively comprises (a)



guaranteed COI less a “refund” of “excess” COI charges to result in current COI, (b) guaranteed policy expenses less a “refund” of “excess” policy expenses to result in current policy expenses, and (c) the guaranteed interest crediting rate plus excess interest to result in the current declared dividend interest crediting rate. In addition, unlike universal-life products, whole-life product pricing may or may not require state departments of insurance approval of dividends.

Because WL policy pricing is generally neither guaranteed (at least not as generally illustrated) nor disclosed, ILIT trustees bear the risk for unreasonable pricing assumptions and unreasonable expectations as to the policy earnings rate. However, ILIT trustees can mitigate this pricing risk by determining whether or not (a) current cost of insurance charges are consistent with actual/historical mortality experience, (b) current policy expenses are consistent with actual/historical operating experience, and (c) the current policy interest crediting rate is consistent with both the historical rates of return for the asset classes of investment holdings underlying policy cash values (i.e., predominantly high grade corporate bonds and government backed mortgages), and the historical dividend interest crediting rates for either the current whole-life product series or for predecessor whole-life product series. In other words, in determining the suitability of a given WL policy as a TOLI holding, ILIT trustees should consider (1) the competitiveness of published pricing and (2) the stability of such published pricing, as well as (3) the historical performance of assets underlying policy cash values, (4) the liquidity and accessibility of policy cash values, and (5) the financial strength and claims paying ability ratings of the insurer.

## Private Placement

Private-placement products are not registered with the state departments of insurance and thus are available only to “accredited investors” through a private placement. While

private-placement products could conceivably take on the form of any of above policy types, they are typically constructed as variable universal life products (hereafter also referred to as PPVUL). These products can generally accept flexible premium payments, set by the agent or the trustee, which can vary between the contractual minimum premium set by each respective insurer and the TEFRA guideline maximum premium allowable under the definition of life insurance. Premiums paid in excess of published cost of insurance charges and policy expenses create policy cash value which can be directed to an even wider range of investments than in registered VUL products. Like registered VUL products, death benefits under these policies also generally remain in effect without regard to this investment performance, so long as planned premiums, accumulated cash values, and policy earnings are together sufficient to cover cost of insurance charges and policy expenses.

The pricing of private-placement products is not guaranteed but is generally disclosed both as to current pricing assumptions (i.e., current cost of insurance charges, current policy expenses, and current declared interest crediting rate), and guaranteed pricing assumptions (i.e., guaranteed cost of insurance charges, guaranteed policy expenses, and guaranteed declared interest crediting rate). This pricing can also be more flexible to accommodate specific client circumstances (e.g., more flexibility in structuring policy expenses to consider volume break points) or specific investment objectives (e.g., investing policy cash values in hedge funds otherwise unavailable in registered products). In addition, unlike with registered products, insurers can generally change current cost of insurance charges and policy expenses without approval of state departments of insurance, without having to justify the change, and without having to make uniform changes to all policies. As a result of the ability to make such changes, and of the increased volatility in these products, ILIT trustees bear the risk for unreasonable pricing assumptions and unreasonable expecta-



tions as to the policy earnings rate.

Once again, even though private-placement products generally include pricing guarantees, because guaranteed pricing factors are the basis for the insurer's reserve requirements, because higher guaranteed charges reduce reserve requirements, and because reduced reserve requirements increase the insurer's opportunity for profit, PPVUL guaranteed charges are typically set at the maximum allowable statutory amount. As such, guaranteed pricing factors are often similar to other VL products, are typically many times more expensive than nonguaranteed current PPVUL pricing assumptions, and thus do not generally offer ILIT trustees much in the way of pricing protection. In fact, because guaranteed pricing factors under PPVUL products have more to do with insurer statutory reserve requirements and less to do with policy owner pricing protection, guaranteed rates and terms under flexible duration term products are often far more attractive than seeking such guarantees through a PPVUL product.

However, ILIT trustees can mitigate this pricing risk by again determining whether or not (a) current cost of insurance charges is consistent with actual/historical mortality experience, (b) current policy expenses are consistent with actual/historical operating experience, and (c) the current policy earnings rate is consistent with the historical rates of return for the asset classes corresponding to invested assets underlying policy cash values. In other words, in determining the suitability of a given PPVUL policy as a TOLI holding, ILIT trustees should consider (1) the competitiveness of published pricing and (2) the stability of such published pricing, as well as (3) the historical performance of assets underlying policy cash values, (4) the liquidity/accessibility of policy cash values, and (5) the financial strength and claims paying ability ratings of the insurer.

## Summary

No product type is inherently more suitable than another for all situations. While term

products are most suitable for fixed coverage durations, universal-life products are most suitable where guarantees are less important and premium flexibility is needed, and variable-life products are most suitable where the asset allocation appropriate for trust assets includes some balance to assets underlying policy cash values beyond fixed income. Whole-life products can make sense where a fixed maximum annual premium is more important and pricing disclosure is less important, whereas private-placement products are most suitable in situations requiring maximum flexibility in the structuring of policy expenses and the investment of policy cash values. Ultimately, the suitability of any TOLI holding ultimately depends not only on product type, but also on

- the competitiveness of published pricing over the intended holding period
- the stability of such published pricing over the intended holding period
- the historical performance of assets underlying policy cash values (to the extent trust objectives are served by accumulating policy cash values)
- the liquidity/accessibility of policy cash values (if applicable)
- the financial strength and claims paying ability ratings of the insurer **ti**

*Part 3 of this three-part series, scheduled for the May/June 2007 issue of ABA Trust & Investments, will tackle the three duties and two objectives for proper ILIT administration.*

<sup>1</sup> See, e.g., Hoisington, Modern Trust Design: New Paradigms for the 21st Century, 31st Annual Phillip E. Heckling Institute on Estate Planning, Ch. 6 (1997); Horn, Prudent Investor Rule, Modern Portfolio Theory and Private Trusts: Drafting and Administration Including the "Give-Me-Five" Unitrust, 33 Real Property, Probate & Trust Journal 1 (Spring 1998); Wolf, Total Return Trusts—Can Your Clients Afford Anything Less?, 33 Real Property, Probate & Trust Journal 131 (Spring 1998).

<sup>2</sup> For a more complete discussion of the types of insurance products on the market, see Mezzullo, An Estate Planner's Guide to Life Insurance (ABA 2000).

<sup>3</sup> Rybka & Jones, J. of Financial Service Professionals, 50, 51-42 (July 2005).

<sup>4</sup> Id. at 52.

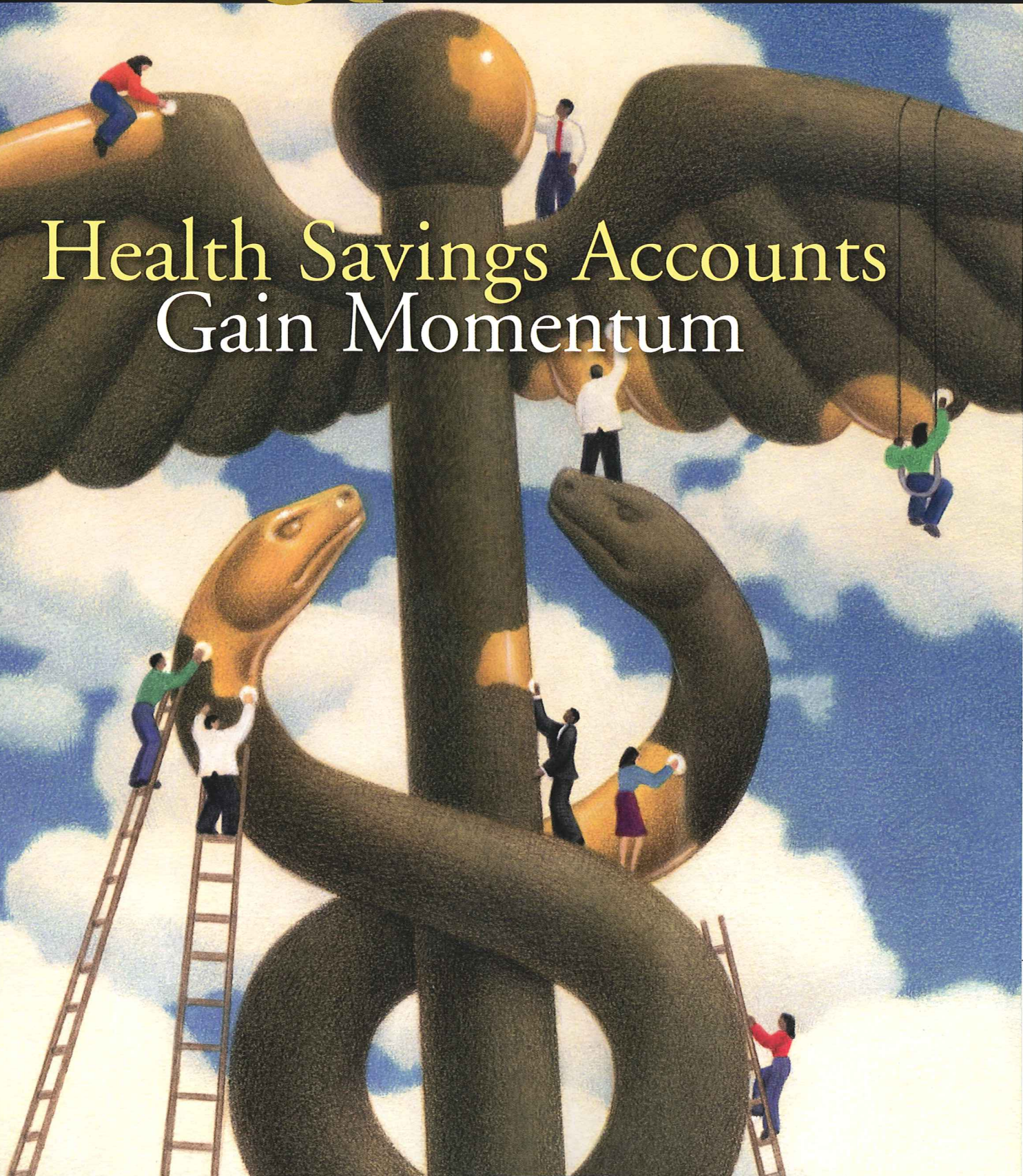


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## Health Savings Accounts Gain Momentum



Social Security

Indenture Trustees Fees

Marital Deductions



# The Prudent Investor and Trust Owned Life Insurance (TOLI)

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## PART 3

**T**his article is the third and final installment of a three-part series that tackles the prudent investor rule and trust owned life insurance (TOLI). Parts 1 and 2 appeared in the January/February 2007 issue and March/April 2007 issue, respectively, of ABA Trust & Investments.

### THREE DUTIES AND TWO OBJECTIVES FOR PROPER ILIT ADMINISTRATION

Under the Prudent Investor Act, irrevocable life insurance trust (ILIT) trustees must establish and follow a prudent process for determining the suitability of TOLI policy holdings and managing such TOLI holdings in response to changing market conditions.

Compliance hinges on process, not performance.<sup>1</sup> Suitability of TOLI holdings is largely determined by two criteria: investment performance and policy expenses.

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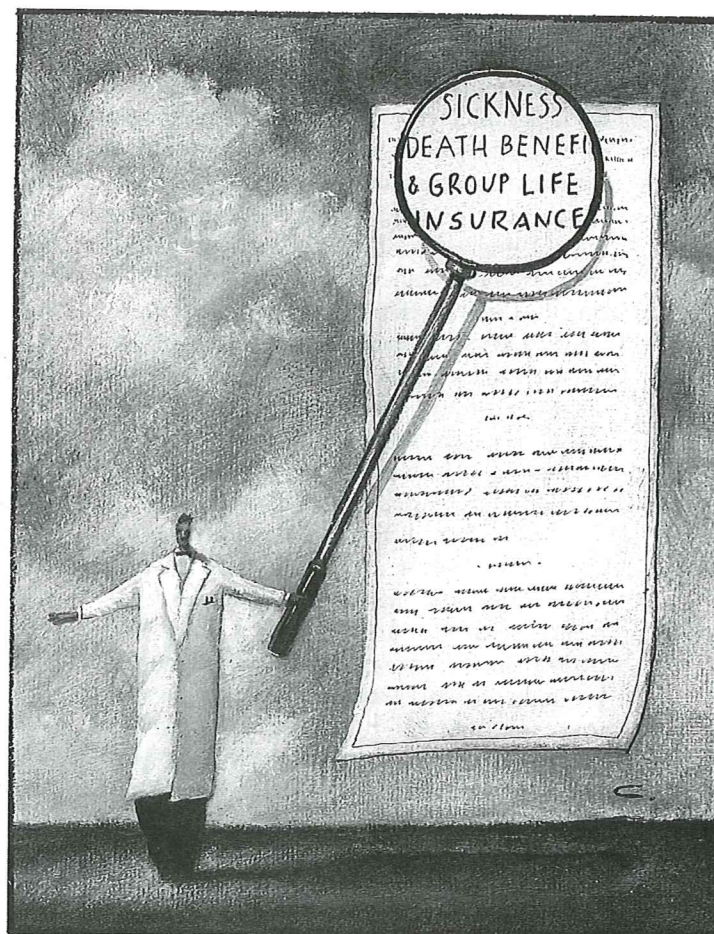
## INVESTMENT PERFORMANCE

Investment performance for TOLI holdings is ultimately determined by the rate of return calculated on the life insurance proceeds received by the ILIT trustee upon death of the insured less the premium investment in the policy contract as measured over the holding period. For instance, the rate of return for a TOLI contract with a \$1 million face amount and a \$100,000 lump sum premium investment would be 23.25 percent if held for 10 years (i.e., the insured dies in the 10th policy year), 11.57 percent if held for 20 years (i.e., the insured dies in the 20th policy year), or 7.70 percent if held for 30 years (i.e., the insured dies in the 30th policy year).

Of course, these differences are due solely to the timing of the death of the insured, not the investment performance of the policy itself, and thus do not lend themselves to "a prudent process for investing" as required under the act. A better measure of investment performance for purposes required under the act is the investment performance of invested assets underlying policy cash values.

Measuring performance of invested assets underlying TOLI cash values is important for both compliance and practical reasons. From a compliance perspective, the act requires trustees to form realistic judgments about expected returns, and measuring investment performance is essential in determining whether such judgments are in fact realistic. In addition, because trust owned policies typically use investment performance to pay future and increasing cost of insurance charges in

universal life and variable life policies, or to pay future premiums in whole life policies, as a practical matter the greater the expected rate of return on cash value investments, the greater the death benefit and the lower the risk of policy lapse.



Setting reasonable return expectations is even more important for TOLI holdings in ILITs than for other trusts holding other investments for a number of reasons. First, the magnitude of trustee liability related to the failure to set reasonable expectations as



to the performance of trust assets is considerable greater in ILITs than in other trusts. While trustee liability for other trusts is measured by the difference between actual performance and reasonably expected performance, liability for ILIT trustees can equal the entire TOLI death benefit.

Second, failure to set reasonable expectations as to the policy earnings rate can increase policy costs. Because COIs are calculated on the net amount at risk (NAR), and because the NAR increases when cash values fall short of original policy targets, failure to set reasonable expectations as to the policy earnings rate results in premiums that are insufficient to maintain target cash values, which in turn increases the NAR and therefore COI charges. In other words, failure to set reasonable expectations as to the TOLI earnings rate gives rise to trustee liability related to both deficient investment performance and excessive expenses.

Fortunately, there are a variety of investment research services available to ILIT trustees to help measure performance of invested assets underlying TOLI cash values, like Morningstar PrincipiaPro for the performance of separate accounts within variable life policies, and LifeLink VitalSigns for performance of insurance company general accounts underlying universal life and whole life policy cash values. Using such research to "paper the file" of an ILIT demonstrates the trustee is forming realistic judgments about expected returns as required by the act, mitigating lapse risk and the corresponding liability.

## POLICY EXPENSES

Section 7 of the act states that "a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee." In other words, trustees must avoid incurring costs that are not (a) justifiable and appropriate to the trust investment program or (b) reasonable in amount. Of

course, the investment program for ILITs is generally comprised of TOLI policies that have both an investment element (i.e., invested assets underlying policy cash values) and an insurance element.

This means the ILIT trustee must justify both investment related expenses just like all other trustees as discussed above, and insurance related expenses specific to TOLI. For instance, while it is taken for granted that trustees measure fund management fees (FMEs) and other investment related expenses to justify as appropriate and reasonable in amount, ILIT trustees must also measure TOLI expenses as to cost of insurance charges (COIs), fixed administration expenses (FAEs), cash-value-based wrap fees (e.g., M&Es), and premium loads so as to also justify as appropriate and reasonable in amount.

For many years, the premium for TOLI policies was seen by the ILIT trustee as the "cost" due largely to underlying policy expenses not being disclosed and, in the absence of more complete information, the premium was seen as the "cost" of the policy by default. However, for most TOLI policies, the premium does not represent the cost of the policy, any more than a \$2,000 contribution to an individual retirement account represents the cost of the IRA. The costs in either case are the expenses deducted from the premium paid or the contribution made.

As mentioned throughout, compliance with the Prudent Investor Act is determined by the trustee's conduct in establishing and following a prudent process, not by the trust portfolio's performance. The act also prescribes the ingredients for such a prudent process: (1) a duty to monitor performance of trust assets,<sup>2</sup> (2) a duty to investigate the appropriateness of trust holdings relative to peer group alternatives,<sup>3</sup> and (3) a duty to manage trust assets in a manner that demonstrably minimizes costs and maximizes benefits.<sup>4</sup> While this standard of care has governed investment and retirement trusts for decades, the application of this



standard of care to ILITs has given rise to a variety of new service providers to support ILIT trustees in the monitoring, investigation, and management of ILIT assets in the following three essential areas.

## *Step 1: Monitoring/Administration*

Just as ERISA defines the standard of care for retirement trusts and creates the need for third-party administrators for administration and recordkeeping services, UPIA imposes administration and recordkeeping responsibilities on ILIT trustees, whose trust accounting systems often don't account for and administer premiums, cash values, and death benefits. As a result, several third-party administrators (such as Advicon, ILIT Analyzer, Resource Insurance Consultants, and TrustBuilder) have begun to provide such services.

## *Step 2: Investigation/Compliance*

Investigating the suitability of a given ILIT policy requires obtaining the needed information about the particular policy and identifying its strengths and weaknesses. Therefore, in addition to seeking third-party assistance with TOLI administration, ILIT trustees are also seeking such advice with respect to a given policy's financial strength and claims-paying ability (i.e., default risk), cost competitiveness, pricing stability, cash value liquidity, and historical performance of invested assets. This assistance is being provided by individual agents, consultants, and independent life insurance product research providers like LifeLink Corp., Morningstar, and TheInsuranceAdvisor.com.

Regardless of how the investigation is conducted, however, ILIT trustees must dig deeper than reviewing illustrations when determining the reasonableness of investment performance and the appropriateness of policy expenses. For instance, because illustrations show projected results based on combined investment and expense assump-

tions, they fail to provide trustees with the specific information about expected returns, COIs, FAEs, cash value-based wrap fees, and premium loads necessary to justify policy expenses. In addition, because illustrations are generally provided only to agents licensed with a limited number of insurers, comparing illustrations provides the ILIT trustee with only a fraction of the comparative data for the 100 insurers who underwrite 90 percent of policies each year, not to mention the thousands of products sold by the more than 500 insurers doing business in most states.

## *Step 3: Management*

When the trustee has obtained the needed data and knows the strengths and weaknesses of a given policy, the trustee is able to manage trust assets in a manner that maximizes benefits and minimizes costs. Such management occurs when the ILIT trustee defines portfolio objectives, continually measures the policy's pricing and performance, identifies the policy's strengths and weaknesses, investigates available alternative products, and makes necessary changes to the portfolio stemming from this information.

Further, if the objective of the ILIT is to provide a defined death benefit (for instance, to finance an obligation like buy-sell agreement funding or estate tax liabilities), the trustee must also ensure that planned premiums and corresponding cash values are adequate to pay future and generally increasing policy expenses until the policy matures at the insured's death. The trustee can do so by periodically measuring actual policy cash values against cash value targets from the original illustration of hypothetical policy values. What follows are five activities for ILIT trustees faced with a policy that is overfunded (i.e., the cash values in the policy are more than the amount needed to properly fund the policy) or underfunded (i.e., the cash values in the policy are less than the amount needed to properly fund the policy):



- **Increase or decrease premiums.** When a TOLI policy is overfunded, trustees should consider reducing or refunding premiums to the extent projected cash values remain sufficient to cover existing future policy expenses (to the extent such expenses are justified). Conversely, when a policy is underfunded, the trustee should consider increasing planned premiums to increase cash values to cover future policy expenses (which may require the grantor to make additional gifts to the trust).
- **Increase or decrease expected death benefits.** Because benefits from overfunded policies can often be increased without additional gifts from the grantor, trustees should consider increasing overfunded policy death benefits (which may require grantor cooperation to do so). On the other hand, trustees should also consider reducing policy benefits in underfunded policies in order to reduce policy expenses to amounts supportable by existing cash values (to the extent such costs are justified).
- **Change cash value investment allocations.** If the ILIT holds a policy that allows investment allocations to be changed, the trustee should, at least annually, re-evaluate the asset allocation appropriate to the trust objective and change TOLI cash value allocations accordingly.<sup>5</sup> For instance, in underfunded policies, trustees should consider a more aggressive asset allocation among asset classes with greater historical rates of return albeit with greater statistical volatility to the extent those more aggressive allocations are consistent with the stated trust objective. On the other hand, trustees with overfunded policies should consider more conservative asset allocations to reduce portfolio risk albeit also with lower historical rates of return, again to the extent those more conservative allocations are consistent with trust objectives.
- **Sell, buy, or exchange policies.** In the same way portfolio managers sell invest-

ments that are no longer suitable, ILIT trustees should consider either (a) exchanging less-suitable TOLI policies in favor of more-suitable products that offer rates and terms more consistent with trust objectives, (b) borrowing from policy cash values and reinvesting proceeds in a manner that maximizes benefits to trust beneficiaries, or (c) selling existing holdings on the secondary market for a profit that is greater than the cost and repurchasing a policy with the same benefits on the open market.<sup>6</sup>

- **Wait and see.** If policy cash values are slightly above or below targets but investment performance is within expected ranges policy expenses are justified, and cash values and planned premiums are sufficient to support projected expenses for the foreseeable future, then ILIT trustees can consider a “wait and see” approach to changes in investment returns.

Remember that Section 9 of the act allows for a “prudent delegation” of these investment and management functions to an investment or insurance advisor who is qualified to perform these functions. Whether performed by an ILIT trustee or delegated to a qualified advisor, these management activities clearly involve new roles, responsibilities, and services for the ILIT.

## SUMMARY

The good news is that the management process discussed above can produce a substantial increase in trust death benefits or reduced premium requirements for the same trust death benefit.<sup>7</sup> Either way, this represents a substantial cost savings (perhaps \$4,000 for each \$10,000 in premium) that the ILIT trustee can bring to his or her beneficiary.<sup>8</sup> Perhaps more importantly, following the process described in this article can keep an ILIT trustee out of trouble with his or her clients and beneficiaries. **ti**



## Exhibit A: Pricing Factors for Various Insurance Products

Product Type	Premiums	=	COI Charges	+	Policy Expenses	-	Policy Interest/Earnings
<b>Fixed-Duration Term</b>							
Annually Renewable Term	Set by actuaries and guaranteed for a 1 year term that is generally renewable.	=	Not Disclosed	+	Not Disclosed	-	0 percent or Not Applicable
Level Premium Term (LT## where ## is the term of years)	Set by actuaries and guaranteed for a fixed term of years (e.g., LT10 = 10 yrs).	=	Not Disclosed	+	Not Disclosed	-	Not Disclosed
<b>Flexible-Duration Term (Universal Life with Secondary Death Benefit Guarantees)</b>							
Guaranteed Pricing* Set by actuaries and guaranteed for a fixed term of	years set by agent/broker or policy owner.	=	Not Disclosed	+	Not Disclosed	-	Not Disclosed
Nonguaranteed Pricing	Set by agent/broker or policy owner.	=	Usually disclosed, but generally greater than COIs for guaranteed pricing	+	Usually disclosed, but generally greater than expenses for guaranteed pricing	-	Usually disclosed, but generally less than interest for guaranteed pricing
<b>Universal Life (Current Assumption Universal Life)</b>							
Nonguaranteed Pricing*	Set by agent/broker or policy owner to cover COIs and Exps for a specified duration	=	Usually disclosed and generally based on historical mortality experience	+	Usually disclosed and generally based on historical operating experience	-	Usually disclosed and based on performance of General Account of bonds and mortgages
Guaranteed Pricing	Calculated by agent/broker or policy owner from guaranteed COIs, Exps and i percent	=	Usually disclosed and generally set at maximum statutory limits	+	Usually disclosed and generally set at maximum statutory limits	-	Usually disclosed and generally between 3 percent to 6 percent
<b>Variable Life</b>							
Nonguaranteed Pricing*	Set by agent/broker or policy owner to cover COIs and Exps for a specified duration	=	Required to be disclosed and generally based on historical mortality experience	+	Required to be disclosed and generally based on historical operating experience	-	Required to be disclosed and based on performance of mutual fund like separate accounts
Guaranteed Pricing	Calculated by agent/broker or policy owner from guaranteed COIs, Exps and i percent	=	Usually disclosed and generally set at maximum statutory limits.	+	Usually disclosed and generally set at maximum statutory limits.	-	Usually disclosed and generally between 3 percent to 6 percent only for cash values allocated to general account.
<b>Whole Life</b>							
Nonguaranteed Pricing*	Min prem/yr set by actuaries, but payment duration set by agent/broker or policy owner	=	Generally not disclosed and instead included in proprietary dividend formulas.	+	Generally not disclosed and instead included in proprietary dividend formulas	-	Sometimes disclosed upon request and included in proprietary dividend formulas
Guaranteed Pricing	Set by actuaries at amount required to fully guarantee death benefits	=	Generally not disclosed and instead included in "tabular cash value" calcs	+	Generally not disclosed and instead included in "tabular cash value" calcs	-	Sometimes disclosed and generally around 4 percent

\*Indicates the most common/prevalent form of policy pricing.



<sup>1</sup> See Section 277 of the *Restatement*, Comment e, page 23 and Comment b, page 11.

<sup>2</sup> See Section 2, Subsections (a) through (d) of the act.

<sup>3</sup> See Section 2, Subsection (d) of the act.

<sup>4</sup> *Restatement of Trusts* 2d Section 174 (1959) provides as follows: "The trustee is under a duty to the beneficiary in administering the trust to exercise such care and skill as a man of ordinary prudence would exercise in dealing with his own property."

<sup>5</sup> See "Insurance Policy Selection for Irrevocable Life Insurance Trusts: New Challenges for Trustee and Advisors" in the February 2002 issue of *Trusts & Estates* magazine, as well as *Baker Boyer Nat. Baond v. Garver* (Ash. App. 1986) 719 P. 2d 583, 591, *Noggel v. Bank of America* (Cal. App. 1999) 70 CA 4th 853,

*Matter of Estate of Janes* (1977) 90 N.Y. 41 659 N.Y. S. 2nd 165.

<sup>6</sup> See page 2 of "The Two Headed Beast" in the April 2003 issue of *Financial Advisor* magazine.

<sup>7</sup> According to a CASCO survey reported in the April 1999 issue of *Trusts & Estates* magazine, TOLI death benefits can be increased by 40 percent or more, or TOLI premiums can be reduced by 40 percent or more in 65 percent to 85 percent of single life and survivorship trust owned policies respectively.

<sup>8</sup> Trustees can and should consider charging a fee for such services. For instance, if a trustee's regular compensation schedule for TOLI assumes that the trustee will serve only as custodian of TOLI policies, it should ordinarily follow that the trustee would be able to increase its fee when adding TOLI management services.

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