A Lapsing Life Insurance Policy Crisis? The Need for Dispute Defensible Advisor Practices[1]

How Could This Happen?

In recent years, much has been written concerning the lapsing life insurance policy crisis, continued illustration abuse and continued promotion of questionable policy administration and risk management schemes for flexible premium non-guaranteed death benefit policies. Moreover, cautionary warnings have been specific to senior insureds as well as to trustees of policies owned in Irrevocable Life Insurance Trusts to seek creditable, dispute defensible risk management consulting and policy management.

Every flexible premium policy type has been impacted. The degree of impact is directly related to the policy investments and, secondarily, the insurance costs (also described as COIs). After 40 years of cautionary warnings, the known questionable sales and inadequate risk management practices still persist; however, dispute defensible policy sales and management practices have been available for most of this time to safeguard the policy owner's best interests. Also, throughout this time period, many sales agents promoted policy replacement, yet creditable risk management and policy rehabilitation typically are more favorable for the policy owner, assuming the planning objectives have not change significantly.

Today's lapsing policy crisis brings into question Advisor due diligence, product disclosures and suitability determinations at the time of policy issue. For example, 'sales' agents typically overlooked the disclosure of annual policy administration and risk management evaluation services needed to maximize the probability of a favorable planning outcome[2]. The usual response to this question is that agents are paid to sell new policies, and carriers do not offer policy risk management services appropriate for flexible premium products. Further, carriers financially benefit when policies are surrendered or lapsed (a surrender charge is obtained and a death benefit is not paid.

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[1] E. Randolph Whitelaw is co-author of *The Life Insurance Policy Crisis - The Advisors' and Trustees' Guide To Managing Risks and Avoiding A Client Crisis* published by the American Bar Association. Many of the prudent practices discussed in this article are also discussed in more detail in this book.

George P. Whitelaw is Managing Director of The TOLI Center, LLC (TTC) that risk manages several thousand policies for skilled and unskilled trustees, attorneys and law firms, and family groups. TTC has 'white papers' or their equivalent on most of the prudent process issues discussed in this article, which are available upon request.

[2] 35% of UL and VUL policies are currently estimated to lapse prior to insured life expectancy or 5 years after. ILIT trustees, grantors and professional advisors are so uninformed about life insurance that they warrant a simple 1, 2, 3, 4, 5 product suitability check-list at the time of policy purchase and annually thereafter to maximize the probability of a favorable outcome.

The purpose of this article is to review both the 'illustration abuse' questionable practices creating the lapse problem as well as the 'dispute defensible' (litigation-tested[3]) advisor practices that maximize the probability of a favorable planning outcome. Informed and experienced advisors play a value-added role in the prudent practices process.

What is 'Illustration Abuse?

The term 'Illustration abuse' accompanied the introduction of universal life products approximately 40 years ago and the subsequent introduction of other flexible premium non-guaranteed products, specifically variable universal life and equity indexed universal life.

Much has been written and published by legal, tax, investment, and life insurance advisors as well as regulators to avoid lapse and, and in so doing, the threat of litigation. However, due to continued policy owner inattention, lapse persists as a threat to policy owners and especially senior insureds. Creditable policy risk management solutions have been known and available for over two decades but just not employed by the traditional retail distribution channel. Periodic policy replacement has been the customary recommendation rather than credible ongoing policy risk management.

Why is there a Lapsing Policy Crisis?[4]

Flexible premium non-guaranteed products are ideally suited for individual and family planning, corporate benefit programs, multi-generational wealth management and transfer planning programs; however, credible annual policy risk management has been typically overlooked. Carrier illustrations make full disclosure that illustrations for these products only show how the product works, and do **<u>not</u>** serve a predictive value purpose. Hence, annual policy risk management has always been necessary to maximize a favorable planning outcome.

The current lapsing policy crisis in part reflects the fact that non-guaranteed products have been serviced by Advisors and Agents with the same minimal attention to annual risk management as is customary for guaranteed products. It should be noted that the

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[3] E. Randolph Whitelaw has expert witness litigation support and FINRA Arbitration experience. He has authored and co-authored a number of articles on 'dispute defensible' practices and the form they should take. His book written for the American Bar Association includes a discussion of the key defining matters and the important role that has been played by litigation-tested guidance.

[4] **Trust Asset Consultants LLC (TAC)** is a fee-based consultant to ILIT grantors, trustees and beneficiaries, individual, business and charitable policy owners, life insurance and investment advisors, attorneys and law firms, and tax advisors. Since 2005, TAC has specialized in consulting to ILIT grantors on product suitability considerations, ILIT trustees on trust and TOLI policy administration duties as well as beneficiary communication. TAC also provides Continuing Education Programs and webinars on basic life insurance policy suitability and risk management practices as well as life expectancy/policy settlement in lieu of policy lapse or policy surrender.

Universal Life 'family' includes Guaranteed UL which warrants annual policy administration attention that is typically overlooked because the scope of the 'guarantee' is either not explained by the sales agent or not understood by the policy owner, especially if the policy is owned in an Irrevocable Life Insurance Trust having an unskilled trustee.

"Illustration Abuse" warnings and guidance have been provided not only by the issuing life insurance carriers, but also the Society of Actuaries, American College of Trust and Estate Counsel (ACTEC), Financial Industry Regulatory Authority (FINRA), State Insurance Licensing Departments, Life Insurance Associations such as the Society of Financial Service Professionals (FSP) and National Association of Insurance Commissioners (NAIC)

As noted, carrier illustrations make full disclosure that non-guaranteed policy illustrations only show how the product works and do **not** serve a predictive value purpose. In turn, an agent's misuse of nonguaranteed life insurance policy illustrations in suitability determinations and sales presentations can reflect "illustration abuse" and can be described as deceptive, misleading and, occasionally, predatory.

Why is there a lapsing policy crisis? The simple answer is questionable 'sales' agent practices[5] over the past 35 years combined with questionable policy owner 'due diligence' practices and advisor reliance. The creditable use of carrier illustrations combined with creditable analytics is needed to provide dispute defensible suitability and prudent risk management determinations.[6]

For example, flexible premium non-guaranteed death benefit products have been marketed from the outset as 'buy term and invest the difference' products. The purchase of Variable Universal Life and Equity Indexed Universal Life products is an investment decision[7] mindful that the policy owner should consider target return, asset allocation, policy premium protection and investment management. The same Monte Carlo investment analytics used for investment modeling is available for flexible premium products.

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[5] In general, life insurance advisors do not consider post-sales policy performance reviews to be their responsibility, unless such review can result in a commissionable policy replacement or additional policy sale. Post sale policy performance reviews were not a condition of agent appointment by the issuing carrier, although some carriers promoted such reviews as a replacement opportunity. It is important to note that agents who are not securities licensed are limited in what information they can communicate to their clients to avoid allegations of unlicensed investment advice.

[6] The Life Insurance Policy Crisis – The Advisors' and Trustees' Guide to Managing Risks and Avoiding a Client Crisis' includes an in-depth discussion of creditable practices, litigation-tested practices, and litigation warranting reader consideration.

[7] Mark Whitelaw is Head of Design at Winged Foot Partners. He has over 30 years' experience in the case design role with life insurance carriers, producer groups and specialty advisors consulting to corporations in the design and management of non-qualified benefit plans as well as to affluent individuals and family groups.

What is Actuarially Defensible Policy Evaluation?

A credible dispute defensible option has been available for over 15 years but not offered by life insurance carriers or the traditional sales agent, brokerage general agent, most producer groups, and third-party illustration-based administrators distribution channels. Actuarial Evaluation uses generally accepted actuarial methods, impartial analysis and objective data to assess the probability that an illustration's scheduled premiums will successfully sustain the policy to contract maturity or insured life expectancy, as a minimum.

Annual or periodic performance monitoring and risk management should address the following questions:

Premium Adequacy: What is the probability that the current scheduled premium will sustain the policy to insured life expectancy and contract maturity? If the probability is less than 100%, what is the risk-appropriate correcting premium adjustment?

Lapse: Assuming timely payment of the scheduled premium, what is the age of the insured person when the policy is projected to lapse? Actuarial evaluation combines with Monte Carlo simulation using 1,000 randomized trial to calculate earliest lapse age and age range for the concentration of projected lapses.

Policy Expenses: How do the inforce policy's costs compare to the product standards benchmark for that product type? Are they higher or lower, and if so, by what percentage?

Policy Comparison: If a policy warrants restructure, actuarial evaluation facilitates a creditable analysis of carrier-illustrated restructure options, specifically the premium appropriate for the selected duration period, typically the insured's life expectancy. That said, it is important to remember that the annual life insurance mortality costs increase with age, and the increase is significant over age 70. A life expectancy report should be obtained to help determine the duration period.

The History of Flexible Premium Non-Guaranteed Policies (aka The Buy Term and Invest the Difference Transition)

In the late 1970s and early 1980s, fixed income interest rates were in the 16 to 17 percent range. The S&P 500 annual return for 1980 was 31.74%. Because of the portfolio crediting and blending approach applied by carriers to whole life products, the value proposition provided by traditional whole life products was questionable at best. For example, the owner of a whole life contract, with an accumulated cash value of $100,000, earning 3 to 5 percent interest, had the ability to borrow cash value at 6 to 8 percent and invest in a money market or savings account earning 15%. Thus, without assuming more risk, the owner could earn an additional 7 to 9 percent.

The life insurance industry watched the withdrawal and transfer of billions of dollars in their cash value coffers. In response to this outflow, life insurance carriers introduced Universal Life with illustrations showing an annual crediting rate of 15% or higher. "The economic conditions of the early 1980s were a perfect incubator for the universal life variation of whole life".[8] With the introduction of this new product, life insurance transitioned from a Buy-and Hold financial asset to Buy-Fund-Manage financial asset…but the requisite manage services were not provided then and still are not provided by the issuing carrier.

As investment returns and fixed income rates subsequently declined, most UL owners had no idea the 'as sold' policy values would never be realized unless corrective action was taken. This disclosure was rarely communicated by the sales agents prior to or at the time of policy delivery. Moreover, it is questionable what post-sales policy performance monitoring services were provided by the sales agent or what guidance the agent may have provided the buyer concerning how to obtain these needed services.

Several years ago, the policy 'crediting rate' of Universal Life policies was reduced by issuing carriers to the contractual minimum rate. Additionally, issuing carriers have increased the 'cost of insurance' charge. As a result, the probability of policy lapse has increased, especially for seniors, meaning a credible (dispute defensible) performance review should be a priority for flexible premium products insuring seniors.

Life Insurance Distribution Channels

There are three basic channels. Two are ideally suited for the prospective policy owner, and one is not. The third channel should be avoided unless the sales agent has clarified or will clarify how creditable (dispute defensible) annual or periodic policy risk management can be obtained that avoids illustration abuse and maximizes the probability of a favorable planning outcome.

1. **<u>The Traditional Retail Channel</u>** that markets Fixed Premium Guaranteed Death Benefit policies. Most of these sales agents have long-standing contracts with carriers such as Northwest Mutual, The Equitable, Prudential, etc. and are frequently described as 'captive' agents per their carrier contract.

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[8] Edward E. Graves, Editor, McGill's Life Insurance, 9th Edition, The American College, Byrn Mawr, Pennsylvania, 2013, pages 5.17-5.19.

2. **<u>The Institutional Channel</u>** comprised primarily of 'specialty producer groups[9]' having relationships with several larger carriers who offer specialty products and support services based upon the specific needs of each producer group. This channel also negotiated relationships with policy administration companies so that customers (such as Fortune 500 companies) have access to high-performing products as well as the supporting policy management requirements. This channel marketed the introduction of COLI (Corporate-Owned Life Insurance) and BOLI (Bank-Owned Life Insurance) programs.

3. **<u>The 'Fire and Forget' Channel</u>** (also described as the 'Churn and Burn' Channel) marketed flexible premium products to individuals and family groups to generate a commission and move on. Suitability is questionable and policy management assistance unavailable unless an agent believes the analysis will justify purchase of another policy and payment of another commission.

   Post sales policy risk management services were minimal. Policy owners, in general, were not notified that the scheduled policy premium needed to be reset at a higher amount and future resets considered as the crediting rate declined and/or the Cost of Insurance charges increased. Today, the crediting rate is the contractual 4% to 5% guaranteed minimum before consideration of increased Cost of Insurance (COI) charges.

Policy Performance Review and Risk Management Process[10]

In talking with legal and tax advisors, skilled and unskilled ILIT trustees, businesses and family groups concerning credible inforce policy evaluation, we[11] recognize that most know very little or nothing about life insurance; hence, we discuss the following steps to be pursued:

- Establish simple defensible policy performance criteria, starting with policy sustainability (typically insured life expectancy).

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[9] While the producer group concept enhanced the perceived professionalism of life insurance and investment advisors, it also opened the door for 'churn and burn' advisors to take advantage of the producer group's reputation, marketing materials, and attractive commission comp arrangements. However, the expected post-sales scope of services was often <u>not</u> provided unless the sales agent expected policy replacement and availability of a new commission.

[10] Flexible premium life insurance products can be described as sophisticated 'buy and manage' products, assuming the 'manage' function is both creditable and dispute defensible. Mindful of the lapsing policy crisis, flexible premium policy owners and their 'trusted' advisors should request a copy of the sales agent's suitability determination and assure the 'manage' function is dispute defensible.

[11] The TOLI Center (TTC) administers and risk manages thousands of policies for skilled and unskilled trustees of Irrevocable Life Insurance Trusts, attorneys and law firms, individuals and family groups, and businesses.

- Understand that carrier illustrations show how the product works and provide the 'source' data for actuarial evaluation.

- Evaluate every flexible premium policy using Monte Carlo Simulation[12] and Actuarial Evaluation to calculate the needed premium to sustain the policy to the sustainability objective.

- Set the policy administration and performance review frequency (typically every year).

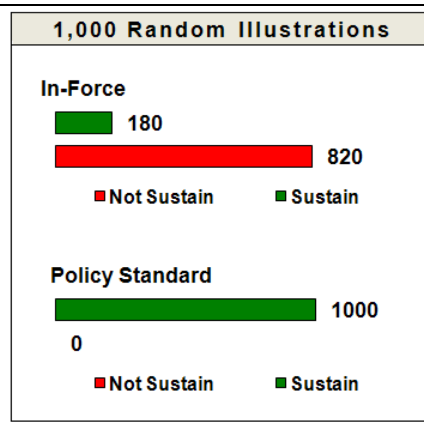
- Communicate with trust parties, typically trust beneficiaries.

- Document corrective action taken for underperforming policy decisions. For example, premium increases or death benefit reductions should be expected as well as life settlements for policies likely to lapse because increased premiums are needed but not affordable.

Sample Actuarial Evaluation Reports

An inforce $1,200,000 universal life policy current illustration for a male attained age 61 shows that the scheduled $18,368 annual premium will only sustain the policy to insured age 79, 8 years prior to the insured's estimated age 87 life expectancy. Actuarially-certified evaluation calculates policy lapse between insured ages 77-81, and calculates a $24,854 correcting premium is needed to sustain coverage to insured life expectancy. Also, the evaluation calculates the In-Force policy COI (Cost of Insurance) is less favorable (more expensive) than the Policy Standards average.

	In-Force	Policy Std
Asset Allocation Criteria (equity/bond):	N/A	N/A
Average Return / Projected Crediting Rate:	5.69%	5.62%
Actuarial Premium Adequacy Percent:	18%	100%
Current Funding Assumption Earliest Predicted Lapse Age:	77	88
Current Modal Premium Concentration of Predicted Lapse Age(s):	77 – 81	88 – 92
Policy Standards Pricing Deviation (+/-):	-.73	.00
Correcting Modal Premium to sustain Death Benefit at Premium Adequacy Risk Tolerance:	$24,854	$10,655



[12] Flexible Premium Non-Guaranteed Death Benefit life insurance products have been described from their introduction as 'buy term and invest the difference' products. They are described as investment products with the policy cash accumulation account allocated to fixed income, equity, and index accounts. Hence, Monte Carlo Simulation combines with actuarial evaluation to provide for the creditable and dispute defensible risk management of these 'buy term and invest the difference' products.

Trust-Owned Life Insurance (TOLI) policies often warrant more expanded evaluation especially if the trustee is unskilled, the sales agent does not provide any post-sales service, the ILIT grantor (insured) wants to assure trust gifting is adequate to pay annual premiums and the family attorney is expected to 'quarterback' timely premium payment and communication with all parties. The sample report for the Robert Johnson ILIT shows how an AE Report can provide information to differing life expectancy ages. The sample report pertains to a Variable Universal Life policy and assumes an 80%/20% asset allocation. It should be noted that differing asset allocations can be evaluated no different from differing life expectancies.

The inforce $4,000,000 death benefit policy issued in 2011 was reviewed as of its 2018 policy anniversary date. The insured is currently age 74 with a life expectancy of age 84. The carrier-provided inforce illustration showed the current $92,596 annual premium would only sustain the policy to insured age 80. In turn, we evaluated the premium amount needed to sustain the policy to age 84 as well as various other life expectancy dates for informational reasons. Additionally, the trustee requested that we expand the scope of evaluation to include other asset allocations.

	Age 80	Age 84	Age 90	Age 100
Asset Allocation Criteria (equity/bond):	80%/20%	80%/20%	80%/20%	80%/20%
Average Return / Projected Crediting Rate:	9.37%	9.41%	9.46%	9.39%
Actuarial Premium Adequacy Percent:	73%	1%	0%	0%
Current Funding Assumption Earliest Predicted Lapse Age:	78	78	78	78
Current Modal Premium Concentration of Predicted Lapse Age(s):	78-82	78-82	78-82	78-82
Policy Standards Pricing Deviation (+/-):	+0.59	+0.59	+0.59	+0.59
Correcting Modal Premium to sustain current Death Benefit to Evaluation Criteria	$96,978	$122,233	$155,384	$193,245

New Department of Labor Guidelines

Finally, as set out in the new DOL guidelines, the advisor must comply with the Impartial Conduct Standards that[13]:

- Provide advice that is prudent, meeting a professional standard of care;
- Operate in the best interest of the client rather than any competing interest of the advisor or financial institution;
- Charge no more than reasonable compensation, and
- Make no misleading statements about the investment transaction, compensation and conflicts of interest.

[13] Society of Financial Service Professionals "On the Call" program June 2, 2017

Conclusion[14]

Flexible premium non-guaranteed life insurance products remain ideally suited for personal and business planning purposes. However, traditionally-thinking life insurance and investment advisors seem frozen in the illustration abuse era. Legal and tax advisors typically defer life insurance suitability and risk management determinations to a life insurance sales agent without obtaining a second opinion specific to suitability and ongoing risk identification and management.

The tools are readily available to avoid questionable life insurance marketing practices and illustration abuse and to safeguard the interests of policy owners, beneficiaries and advisors – they just need to be used[15].

[14] A discussion of litigation related to COI increases and seniors is available upon request.

[15] The TOLI Resource Center (TRC) offers a wide range of counseling services including carrier selection, product suitability review, impaired risk underwriting, and life settlement options for ILIT trustees, affluent individuals and family groups, ILIT skilled and unskilled trustees, legal, tax, life insurance and investment advisors.