The Hows & Whys of Reviewing Trust-Owned Life Insurance

BY MARK TEITELBAUM

Clients rely on many individuals and organizations to help execute long-term plans for themselves and their heirs. Nowhere is this reliance as critical as the relationship between a client and a trustee.

Because a client's trust may extend for decades beyond his or her life and is frequently used to provide for heirs and descendants, a trustee bears what is commonly referred to as a fiduciary liability. The trustee is required to act, at all times, as the client's (the trust grantor's) alter ego and the protector of the beneficiary's interests. Every state has laws intended to assure that trustees live up to this fiduciary liability.

Where life insurance is owned by a trust, special skills are required. This article will discuss many of the complexities and areas of exposure that trustees must consider when reviewing trust-owned life insurance. It will also explore how building expertise in this area can enhance trustees' relations with clients.

Trustees need to be able to navigate the many complexities and areas of exposure engendered by trust-owned policies. They also require a certain expertise when reviewing policies.

LIFE INSURANCE COMPLEXITIES FACED BY TRUSTEES

Although life insurance is sold on the basis of an illustration, few trustees understand that the visual is little more than a "snapshot" in time. Despite the fact that life illustrations display a range of alternative scenarios, including current and guaranteed assumptions, few trustees appreciate all the factors operating behind a life policy. As these factors shift, they affect the underlying policy such that the original illustration on which the policy was sold may become obsolete.

In particular, many policies sold in the 1990s and earlier were sold based on high crediting rates. It was not unusual to see variable life policies (sold to fund estate planning objectives) that assumed gross returns of 10% or 12%. Few policies have seen these levels of return sustained over time. Fixed and whole life policies were based on crediting rates and dividends that, as interest rates dropped in recent years, could not be sustained.

A trust-owned policy may also be at risk if it is inadequately funded. This is often done to keep the costs of gifts to a trust within a client's annual gifting capacity. It is also done to keep the policy's purchase price palatable to the client. Regardless, the thin funding may put a policy at risk relative to lower than illustrated rates.

Another concern is the step-type of policy design common in the 1990s. These policies allowed for the purchase of a life insurance policy at a lower than normal rate, with the understanding that at some point, often the 10th or 20th anniversary, the premium cost would jump to a higher than normal level. Often, these policies were sold with high illustrated rates and bought in the belief, based on those rates, that the policy would cover the higher costs internally. Many of these policies are now approaching critical anniversaries and, because of underperformance, owners will see higher than expected costs. This frequently occurs when a client's gifting capacity is halved due to a spouse's death.

Other factors may come into play, such as a change in an insurer's ratings or the client's situation. Clients may also need a greater or lower death benefit than was originally illustrated. For all these reasons, trustees need to closely track a policy's performance.

RISKS TRUSTEES FACE

Failure to review a policy will put a trustee at risk. Virtually every state has adopted the Uniform Prudent Investors Act (UPIA). Many states have adopted the act verbatim, while others have folded the act into their unique probate code. Included in all of these state versions is the requirement that a trustee review and monitor trust assets for the benefit of all beneficiaries. The UPIA was written broadly, but the law affects all asset classes, including life insurance. Of the 50 states, only Pennsylvania has carved out an exception for life insurance.

Result: A trustee can no longer simply buy and hold a life insurance policy as a long-term asset. Failure to monitor trust assets, including life insurance, can put a trustee at risk of a lawsuit by the beneficiaries. While trustees have not been sued for failing to monitor a policy, they have been sued for failing to monitor other assets. Additionally, trustees have been sued, with varying degrees of success, for failing to properly care for a trust-owned policy, such as failing to pay premiums.

STEPS A TRUSTEE CAN TAKE

The first approach should be for a trustee to order periodic in-force ledgers from the insurance carrier. These ledgers allow a policy owner to see how the policy might perform on a going forward basis. The in-force illustration begins in the policy's current year and is based on the policy's current values, rather than on the originally illustrated values. An owner can then see how a policy might perform under various assumptions.

Depending on the results, a trustee may need to weigh some options. In some cases, the policy may not deliver the originally illustrated death benefit without additional costs. Where additional funds are required, a grantor may be unwilling or unable to make increased gifts to a trust. If so, a trustee may need to weigh changes to the policy.

Trustees may find that the evolving nature of the life insurance marketplace affords them opportunities that did not exist even a

few years ago. Improved life expectancy is now reflected in the pricing of many policies. Insurers are offering guarantees and riders that did not previously exist. Some policies may be cash-rich but still at risk for underperforming on a long term basis, and a trustee may need to weigh the use of the cash.

In these cases, it may be less expensive for a trustee to purchase a new policy, even though the insured is older, through the use of an older policy's values. This action should only be taken after weighing such considerations as changes in an insured's health, new surrender charges, the loss of benefits from the older policy and the beginning of a new contestability period.

ONE BANK'S EXPERIENCE

One regional bank that I'll leave unnamed has actively pursued a review of its trust-owned policies. The bank realized that managing life insurance was different than managing other assets such as equities and bonds. By aligning itself with a dedicated life insurance specialist, the bank pursued a review of all of the policies it held as a trustee. The results were renewed and increased ties to clients who may have previously had limited ties to the bank.

The results also were interesting. The bank held 300 irrevocable life insurance trusts that owned more than 525 policies. The bank held just over $38 million in cash surrender value, but the policies they were shepherding totaled just over $425 million in death benefits. After undertaking a survey of their portfolio, the specialist concluded that 17% (94 policies) were in imminent danger of lapsing; and that 10% (54 policies) had a significant chance of lapsing before a client reached life expectancy.

As a result, the bank scheduled approximately 75 meetings that encompassed these and other policies. Of 36 trusts, the bank concluded that either no change was necessary, no change was possible due to the insured's health, or that the client wished to drop or decrease coverage. For the balance of the clients, the bank either changed the coverage or reduced paid up coverage to salvage some level of death benefits.

How often is a policy review needed? There is no definitive answer, but every few years might be about right. Such reviews can help protect a trustee from liability, assure that a trust's intent is carried and, not least, solidify the advisor-client relationship.

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