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Inside

- Estate Planning for Same-Sex Married Couples
- The Importance of a Life Insurance Audit
- "Spousal Impoverishment" Budgeting Rules for Long Term Care
- Article 81 Guardianship

The Paramount Importance of a Life Insurance Audit

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

Universal Life Insurance: The Industry's "Dirty Little Secret"

Among the important reasons that a life insurance contract should be reviewed is to determine how much longer the contract is expected to remain in force. The reason you need to be proactive, whether you are an individual who owns your own life insurance contract, or a Trustee protecting the best interest of your trusts beneficiaries, is because a great majority of life insurance contracts that were purchased over the last 25 years are in danger of expiring years earlier than originally anticipated. These universal life or variable life insurance contracts, unlike their more expensive whole life counterparts, which in certain situations have some lifetime guarantees, are not guaranteed to last for a lifetime because their performance was tied to an anticipated annual interest rate, or an anticipated stock index, neither of which are guaranteed.

The problem is very few lay people and professionals are aware that their life insurance contracts can expire years earlier than originally anticipated. The client and trustee often incorrectly assume that either the agent or insurance company is monitoring the situation to make sure the Insurance contract will always remain in force. As a matter of fact it would be in the insurance company's best interest if after all those years of your paying the yearly premiums it became exorbitantly expensive to maintain the contract and the death benefit had to be reduced or surrendered.

Allow me to explain: back in the mid-1980s, when prevailing interest rates were as high as 14%-15%, there were only two types of life insurance contracts: term life insurance, in which a specific dollar amount of life insurance was guaranteed to remain in force for a specific period of time at a specific guaranteed premium; and Whole life insurance, which was guaranteed to remain effective for the entire life of the insured. These whole life contracts contained an accumulation account known as cash value, which was typically earning 3% annually. The cash value was available to be withdrawn and used for any purpose, so long as the owner paid a contractual 5% interest charge on the money that was withdrawn.

In a whole life contract, if a person had an accumulated cash value of $50,000 earning 3% interest, the owner had the ability to borrow the money at 5% and then place those dollars in a money market or savings account, where they could have earned 14%. Thus, without any additional risk, the owner would be able to earn an additional 9% on his or her $50,000 of cash value.

Due to the competition from banks' significantly higher interest rates, the insurance industry watched billions of dollars in their cash value coffers being withdrawn and transferred to the individual bank accounts of the people it insured. In order to stop these outflows, the life insurance industry created a new product called "Universal life insurance," which paid an interest rate based on prevailing market interest rates instead of a fixed rate, as had been the case in whole life contracts. If interest rates rose, then one's insurance coverage would become less expensive or last for a longer period of time as a result of the larger amount of accumulated cash value. What was not as clearly understood, however, was that if interest rates decreased, then the length of time the coverage would remain in force would consequently be reduced, or a greater annual premium deposit would be required to prevent the earlier expiration of this coverage. In other words, the universal life contract provided no guarantee as to how long it would remain in force. If interest rates maintained their projected growth, everything was fine, but if interest rates fell below their projections there would be a problem.

The problem faced by many Insureds today materialized because of the steadily steeply declining interest rates following the higher interest rates of the mid-1980s. This resulted in 30-35% of today's universal life coverage on pace to expire years earlier than originally projected. When universal life was first offered, agents and brokers would ask their clients how long they wished the coverage to remain in force. Clients would typically respond that they wanted the coverage to last until age 92-95. Next an average interest rate was then assumed for the 20-30-year period it took to get to the specified age after the policy was issued and that interest rate was plugged into a computer. The resulting computer illustration would provide the anticipated premium needed to keep that particular amount of life insurance in force for the desired period, but that time period was not guaranteed, only assumed.

While this interest-sensitive product stopped the tremendous outflow of monies from the insurance industry's cash value coffers to the banks, the solution was not a long-term fix because it created other problems that have just began to surface over the last 5-6 years as a result of today's record-low interest rates. Let me explain. In the late 1980s, when interest rates were 14-15%, many assumptions were made that interest rates would remain in the 10-12% range for a long period of time. Even the more conservative agents and brokers were projecting 7-10% rates. Although those assumptions seemed perfectly reasonable at the time, our staggeringly low interest rate environment has decimated universal life contracts with even the most conservative projections. As a result, the original assumption that a life insurance contract would last until the person was age 92 has been shortened by as many as 8-9 years. While universal life has received most of the blame in the insurance industry, it needs to be pointed out that double and triple A rated Insurers are now beginning to also feel the effects of low interest rates as their whole life contract holders are being asked to either reduce their death benefits or increase their premiums as a result of poorly performing dividends which are not guaranteed.

An audit of a universal life contract examines the actual interest rate return earned each year since the policy was purchased and actuarially determines exactly how long the contract will last based on (1) the historic actual return, and (2) the current age of the insured, and (3) any outstanding loans. Many individuals and trustees neglect to request this historical projection, and are not even aware that as a result of a poorer than expected performance, their contracts are now in danger of expiring earlier than originally expected. The more advance notice an insured or trustee has about a potential shortfall, the less additional monies are needed to adjust the coverage back to its originally projected level. I have often referred to the hidden risk of premature expirations of coverage shortfalls in universal life contracts as the insurance industry's "dirty little secret" because there was not sufficient disclosure initially provided stating that this new product was not guaranteed to last for one's lifetime.

As a practitioner, I can say that the combination of a low interest rate environment and the fact that the octogenarian demographic is the fastest growing segment of the population is a ticking time bomb for the life insurance industry. My greatest concern is that individual trustees, many of whom are the sons and daughters of the insured (or the grantor of a trust), are not even aware that they need to review their parents' existing life insurance contracts, nor is there a mechanism in place to conduct such a review. This inaction can be viewed as a failure of their fiduciary responsibility as a trustee leaving them vulnerable to litigation from other family members/beneficiaries that may lose trust assets in the process.

That being said, this article is primarily meant to draw attention to the professional or institutional trustees, who are now responsible for well over three trillion dollars of trust-owned life insurance (T.O.L.I) contracts. Many of these T.O.L.I contracts are ones in which the insured or grantor may have incorrectly assumed years ago about how interest rates would behave going forward. Historically 35% of those contracts contain death benefits that are no longer projected to remain in force due to continuously lowered interest rates. While some institutional trustees are aware of this problem and are employing third parties to conduct independent reviews, there remain problems with theses reviews, namely: 1) 83% of professional trustees surveyed admitted that they had no guidelines or procedures for handling these problems, 2) 96% had no policy statements on how to handle life insurance investments, and 3) too many are relying on policy reviews not consistent with the prudent investor principles which fiduciaries are required to follow and liable if they don't.

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

Harvey Pitt, the former SEC Chairman, cautioned banks that in today's heavily regulated post Sarbanes–Oxley environment, they should learn from their sector's past mistakes and replace inadequate and outdated processes with ones that are more efficient and up-to-date. Many of these flawed, outdated processes merely document and focus on the health of the insurance company instead of the shortcomings of the particular life insurance policy. Unfortunately, the mere analysis of the life insurance company fails to consider the appropriateness of policy expense as required under Section 7 of the Uniform Prudent Investor Act

(UPIA) and the reasonableness of performance expectations as required under UPIA Section 2, and thus will not provide a strong defense in the event of litigation. In accordance with O.C.C Reg. 9.6c.11, if a trustee determines that it lacks the expertise to evaluate the premium adequacy risk or the contract's appropriateness to fulfill the beneficiary's objectives, the trustee has an affirmative duty to bring in the necessary experts and inform the beneficiary of the suggested remediation steps.

Other Reasons to Review Your Life Insurance Contract

While the foregoing considerations are compelling enough by themselves to highlight the importance of regularly reviewing a life insurance contract, individual policyholders and trustees should also consider conducting such reviews for other reasons as well. One such reason is that the options and riders available in today life insurance contracts were simply not available when they first purchased their life insurance contracts.

One example of such an advantage is the chronic care rider. Notably, the chronic care rider first became available at the end of 2011, so any universal life contract purchased prior to 2012 does not have this rider available. The chronic care rider allows an individual to withdraw up to $116,000 tax free in 2013 annually adjusted for inflation from the death benefit of his or her life insurance contract to pay for qualifying long-term care expenses. The chronic care rider is a major new benefit that everyone should consider because of the added leverage and flexibility it provides, assuming they meet two criteria: (1) the individual is healthy enough to purchase a new contract from an insurance company that contains these provisions, and (2) the premium on the new contract would be similar to the premiums they are currently paying.

Another important consideration during an audit is ascertaining whether the life insurance contract you currently have is competitive in terms of net expenses and costs and whether it still fits your current objectives. That may involve measures as simple as evaluating whether the beneficiary and owner designations are still accurate and correct. If a life insurance contract is owned or controlled by the insured, he or she may have to unnecessarily pay a New York State estate tax, which can be as high as 16%. While the federal estate tax has been eliminated for estates under $5,250,000, the New York State estate tax is still required for estates valued over $1 million. This tax, however, can potentially be avoided by simply using an Irrevocable Life Insurance Trust (ILIT), as the owner of the life insurance contract rather than the individual insured. Trusts are wonderful tools as they provide management, distribution instructions, tax savings and flexibility for the trustee. However to be most efficient trusts must be updated and reviewed in terms of today's planning options, and trustees must be better educated in terms of what those obligations and options are and how they can best be executed for the benefit of the individuals they are protecting.

In conclusion, being aware of the potential problems and opportunities within the life insurance arena should be a major point of emphasis for individual trustees and professional or institutional trustees in order to protect the assets for the benefit of their beneficiaries. This is especially important for professional and institutional trustees due to the risk of litigation from a disgruntled beneficiary. A beneficiary can allege a cause of action in several situations. First, if the life insurance coverage prematurely expires, and the beneficiary is never made aware that a shortfall that could have been made up much easier years earlier existed. Secondly, if the proceeds of the life insurance contract are mistakenly included in the gross estate of the insured, resulting in their being unnecessarily subject to state or federal estate taxes. And lastly if the trustee does not examine policy expenses as required under UPIA Section 7, since beneficiaries can claim the trustee was overcharged and the beneficiaries could/should have had greater death benefits for the same premium paid.

An independently conducted, actuarial life insurance audit not only inoculates a trustee against litigation risk brought about by other family members, but equally important is that it is also highly likely to benefit the entire family if a better option costing less, with potentially higher death benefits, with a longer guarantee and new riders not previously available, were found to be available.

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