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THE IMPORTANCE OF MONITORING AND EVALUATING LIFE INSURANCE POLICY PERFORMANCE

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As a result of sustained low interest rates over the last twenty years as well as policy owner and trustee inattention to performance monitoring, approximately 35% of existing Flexible Premium non-guaranteed life insurance contracts are expected to expire prior to an insured's normal life expectancy.

Very few lay people nor professionals are aware that their life insurance contracts can expire prior to their lifetime. Clients and trustees often incorrectly assume that either the agent or the insurance company is monitoring their contracts to make sure they will always remain in force, but that's not true. As a matter of fact, it would be in the insurance company's best financial interest if, after all those years of paying the premium, it became exorbitantly expensive to maintain the contract and the death benefit had to be reduced or the policy surrendered. According to Donald Walters, General Counsel for the Insurance Marketplace Standards Association, (IMSA), "While insurers have not publicized the issue, there is a growing concern in the industry about lapsing universal life policies." Carriers and agents have no obligation to monitor policy performance relative to original performance expectations. Carriers are merely required to send a scheduled premium billing and an annual policy value statement. It is solely the responsibility of the policy owner to review the policy value statement and determine the needed premium adjustment to achieve originally illustrated policy values.

In August, 2012 the Office of the Comptroller of the Currency (OCC) issued revised guidelines which directs financial institutions serving as trustee of an insurance trust to treat life insurance as they would any other asset. This means life insurance, just like stocks, bonds and real estate, needs to be actively managed. Providing a policy performance evaluation and then monitoring it every 1-3 years, depending upon product type, is the only way to determine whether a life insurance contract issued in the 1980's is in danger of expiring prematurely. These universal life or variable universal life insurance contracts, unlike their more expensive whole life counterparts that have lifetime guarantees, are not guaranteed for a lifetime. This is because their performance was tied to an anticipated annual interest crediting rate, or an anticipated stock index performance, neither of which was guaranteed, and neither of which were achieved.

In the mid-1980s, when prevailing interest rates were as high as 18% and life insurance companies were crediting guaranteed policies much lower rates, thousands of astute policy holders switched the accumulated cash value in their whole life contracts into higher yielding bank deposit instruments.

In order to stop these outflows, the life insurance industry created a new product called "Universal Life Insurance". These policies paid an interest rate based on prevailing market interest rates instead of a fixed rate, as had been the case in their traditional whole life contracts. If interest rates increased, then the scheduled premium could be decreased or remain unchanged for policy coverage to remain in force. What was not 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 in order to prevent an early expiration of coverage.

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 90-95. Next an interest rate assumption was made for the time period between the insured's current age and this age 90-95 target in order to generate a computer illustration calculating the anticipated annual premium needed to keep the policy in force. However, this scheduled premium amount was not guaranteed.

While the introduction of this interest-sensitive product solved the outflow problem for the insurance industry, it has created other problems for policy owners in the last ten years due to policy owner misunderstandings and inattention. Few policy owners or "amateur" trustees understood that they carried performance risk. Moreover, they did not know which risks to monitor or have the tools to do so. As interest rates declined, they simply paid the scheduled premium unaware that the policy would lapse much earlier than insured age 90-95 unless the scheduled premium amount was increased. This fact has created a crisis of lapsing policies that requires corrective action.

To avoid lapse risk, a policy performance evaluation of a universal life, variable universal life or indexed universal life contract should be independently conducted to determine, at a minimum, (1) the probability the current premium will sustain the policy to the insured's life expectancy, (2) the insured's age at policy lapse, (3) the competitiveness of the policy charge, and (4) the needed correcting premium to sustain the policy to the insured's life expectancy. In-force carrier illustrations disclaim predictive value. Hence, an actuarially certified evaluation should be obtained. Also, for older insured's, a life expectancy report should be considered so that the premium payment period is based upon the insured's medical history and current medical condition.

The more advance notice an insured or trustee has about a potential premium shortfall, the less additional monies are needed to adjust the coverage back to its originally projected level. Since cost of insurance charges increase annually, annual performance monitoring and periodic premium adjustment avoids a lapse notice 'surprise' that requires a significantly higher premium to maintain the policy in-force.

Whether there was transparency and full disclosure in the initial marketing and ongoing annual policy statements for these products can be debated but performance risk rests with the policy owner. The combination of low interest rates and the fact that the octogenarian demographic is the fastest growing segment of the population has created a ticking time bomb for lapse. Corrective action is needed and it can only be taken by the policy owner.

If the policy is owned in an irrevocable life insurance trust (ILIT), the trustee has the sole duty and responsibility to manage the trust asset. Inattention poses reputation and litigation risk for corporate trustees, and reputation risk for legal and tax advisors to amateur trustees, especially family members serving as an accommodation and relying solely upon these advisors for all trust administration functions. It is estimated that 90% of in-force Trust-Owned Life Insurance (TOLI) policies are administered by unskilled amateur trustees, meaning that credible professional assistance is needed to create a prudent and reasoned process that maximizes the probability of a favorable outcome to the trust estate.

In regard to corporate trustee duties, the OCC offers excellent prudent process guidance. For example, policy performance evaluation should examine the financial health of the issuing insurance company, and consider 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 a trustee lacks the expertise to evaluate the premium adequacy risk or the contract's appropriateness to fulfill the beneficiary's objectives, the trustee has a duty to delegate and engage the necessary experts to make these determinations and assist in the suggested remediation steps.

In addition to regularly evaluating and monitoring a life insurance contract, individual policyholders should also consider the availability of newer products which were not available when the contracts were initially purchased. For example, a chronic care rider which first became available at the end of 2011, allows an individual to withdraw up to $116,000 tax free in 2013 (adjusted annually for inflation), from the death benefit of a life insurance contract to pay for qualifying long-term care expenses. There is no reason not to have this benefit available in any life Insurance contract.

Finally, the need for in-force TOLI policy attention usually triggers uncertainties as to how to get started in implementing a prudent process. Establishment of an Investment Policy Statement (IPS) is just as important for life insurance as it is for fixed income and equity investments. An IPS should:
- Update death benefit requirements
- Summarize ILIT parties and their responsibilities
- Identify trustee risk management criteria
- Identify policy and product evaluation duties and how they will be provided
- Affirm beneficiary communication requirements

An Investment Policy Statement and credible in-force policy evaluation can help ensure the longer-term planning objectives of a policy owner as well as provide safeguards for the trustee. The tools for prudent and reasoned life insurance policy performance monitoring are readily available - they just need to be used.

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