FEATURE:
INSURANCE

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A Lapsing Life Insurance Policy Crisis

The need for dispute defensible advisor practices and a glidepath to safety

In recent years, much has been written concerning escalation of the lapsing[1] life insurance policy crisis, illustration abuse, increased carrier litigation and continued sales agent promotion of questionable policy administration and risk management schemes for flexible premium non-guaranteed death benefit policies. Cautionary warnings with corrective action guidance have been directed to all policy owners mindful that illustration abuse adversely impacts insureds of all ages and life insurance programs of all types. Special attention has been given to senior insureds as well as to trustees, both skilled and unskilled, of policies owned in irrevocable life insurance trusts (ILITs), to seek credible, dispute defensible policy risk management consulting. A litigation-tested[2] dispute defensible glidepath to safety is readily available—insureds just need to use creditable consulting.

The scope of illustration abuse is significant—it impacts every flexible premium policy type. The degree of impact is directly related to the policy investments and, secondarily, the cost of insurance (COI). After 40 years of cautionary warnings, the known questionable and problematic sales and risk management practices still persist, despite the fact that dispute defensible policy sales and management practices have been available for most of this time to safeguard the policy owner's best interests.

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 overlook the disclosure of annual policy administration and risk management evaluation services needed to maximize the probability of a favorable planning outcome. The usual response to "how could this happen?" is that agents are paid to sell new policies, and carriers don't offer policy risk management services appropriate for flexible premium products. Further, carriers financially benefit when policies are surrendered (a surrender charge is obtained and a death benefit isn't paid) or lapsed (a death benefit isn't paid).

Let's review both the illustration abuse questionable practices creating the lapse problem and the dispute defensible (litigation-tested) advisor practices that maximize the probability of a favorable planning outcome.

Parties to the Policy

Who are the parties to a life insurance policy purchase and subsequent policy administration and risk management, in addition to the owner?

- **Legal and tax advisors:** These advisors typically assist their clients in determining the need for life insurance, the face amount, the coverage time period (either period-certain or lifetime) and the beneficiaries. If the policy is to be owned in a trust, the legal advisors usually draft the trust agreement and any related documents. The trustee should be selected prior to policy purchase and delivery so that the trustee is fully aware of the reasons for the policy selection, the risks that need to be managed and the post-sales role of the sales agent in

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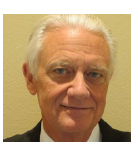
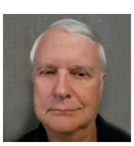




coordinating ongoing policy administration and risk management. If the agent confirms that his role doesn't include post-sales policy administration or risk management, the grantor and advisors should delay policy acceptance until the sales agent confirms how the annual management function will be provided in a form that safeguards the purpose of the trust and avoids illustration abuse.

- **Sales agent:** The agent is responsible for understanding the policy purchaser's need for life insurance, risk tolerance and medical history. Additionally, the agent is responsible for communicating his carrier appointments, product type knowledge/expertise and the need for and form of post-purchase policy administration and risk management. Finally, the agent has a fiduciary responsibility to make a suitability determination as to the basis for his carrier, product type and policy design recommendation. He should provide a copy of this suitability summary to the policy purchaser, including the trustee of an ILIT, and clarify how post-sales policy management services will be provided.
- **Policy administration and risk management advisor:** Sales agents are compensated by life insurance carriers to sell life insurance policies. It's the policy owner's (or ILIT trustee's) responsibility to clarify the post-sales role of the sales agent. If the agent affirms that he won't provide post-sales policy management services, then the owner or trustee should engage a third party to perform the administration and policy management functions. These functions are critical to achieving a successful planning outcome over a 10-to-40 year (or longer) time horizon. Further, these functions are usually delegated to third-party specialists. Hence, it's important to request assistance from legal and tax advisors in obtaining the names of these specialists and in preparing a request for proposal (RFP) for submission to these specialists. The RFP should require, at a minimum, an explanation of the specialist's dispute defensible policy risk management methodology.

Illustration abuse can be avoided by advising prospective policyowners that ultimate policy performance isn't influenced by sales illustrations.

What's Illustration Abuse?

Illustration abuse[3] refers to the use of insurance policy sales illustrations that appear to promise future financial performance levels that are unrealistically higher than the levels guaranteed by the underlying insurance contract. These illustrations are based on assumptions that aren't creditable. Abuse occurs when the prospective policy owner is permitted or encouraged to believe that the unrealistic numbers in the illustration reflect reality or is given reason to expect that the illustration is a promise that the insurer will or must fulfill.

Illustration abuse can be avoided by advising prospective policyowners that ultimate policy performance isn't influenced by sales illustrations. It's been observed that for the most competitive insurance products, there's less than a 10 percent probability that the product's actual performance will meet or exceed its illustrated values.[4]

Reason for Lapsing Policy Crisis

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] 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. The universal life (UL) family includes guaranteed UL that warrants annual policy administration attention that's typically overlooked because the scope of the guarantee either isn't explained by the sales agent or isn't understood by the policy owner, especially if the policy is owned in an ILIT having an unskilled trustee.

Carrier illustrations make full disclosure that non-guaranteed policy illustrations only show how the product works and don't serve a predictive value purpose. In turn, an agent's misuse of non-guaranteed

life insurance policy illustrations in suitability determinations and sales presentations can reflect illustration abuse and can be described as deceptive, misleading and, occasionally, predatory.

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 UL and equity-indexed UL products is an investment decision 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 are available for flexible premium products.

Actuarial Evaluation

A credible dispute defensible option—Actuarial Evaluation (AE)—has been available for over 15 years but not offered by life insurance carriers or traditional sales agents, brokerage general agents, most producer groups and third-party illustration-based administrator distribution channels. AE 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, at a minimum.

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

Premium adequacy: What's 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 percent, what's the risk-appropriate correcting premium adjustment?

Lapse: Assuming timely payment of the scheduled premium, what's the age of the insured when the policy is projected to lapse? AE combines with Monte Carlo simulation using 1,000 randomized trials to calculate the 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, AE facilitates a creditable analysis of carrier-illustrated restructure options, specifically the premium appropriate for the selected duration period, typically the insured's life expectancy at a minimum or life expectancy plus "X" years. That said, it's important to remember

TOLI policies often warrant more expanded evaluation especially if the trustee is unskilled, the sales agent doesn't provide 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.

that the annual life insurance mortality costs increase with age, and the increase is significant over age 70. The insured should obtain a life expectancy report to help determine the duration period.

Three Insurance Distribution Channels

There are three basic channels. Two are ideally suited for the prospective policy owner, and one isn't. 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. The traditional retail channel that markets fixed premium guaranteed death benefit policies. Most of these sales agents have longstanding contracts with carriers such as Northwest Mutual, The Equitable and Prudential, and many may be described as "captive" agents depending on their carrier contract.

2. The institutional channel. This is comprised primarily of specialty producer groups having relationships with several larger carriers that offer specialty products and support services based on the specific needs of each producer group. This channel also has 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 corporate-owned life insurance and bank-owned life insurance programs. In recent years, it's commenced marketing institutional life insurance to affluent families and family groups, a product that's significantly more efficient and favorable to policy owners than traditional products.

3. The fire and forget channel (also described as the "churn and burn" channel). This channel markets 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.

Risk Management Services

Post-sales policy risk management services have been minimal. Policy owners, in general, weren't notified that they needed to reset the scheduled policy premium at a higher amount and consider future resets as the crediting rate declined and/or the COI charges increased. Today, the crediting rate for policies issued prior to 2005 is the contractual 4 percent to 5 percent guaranteed minimum before consideration of increased COI charges. Creditable risk management services are essential to implementing a glidepath to safety.

Steps to Take

Legal and tax advisors should recommend that policy

owners take the following steps to ensure a credible inforce policy evaluation:

- Establish simple defensible policy performance criteria, starting with policy sustainability (typically insured life expectancy at a minimum or life expectancy plus "X" years depending on risk tolerance).
- Understand that carrier illustrations show how the product works and provide the source data for AE.
- Evaluate every flexible premium policy using Monte Carlo simulation and AE 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.

AE Reports

Here are two examples of how an AE report can help a policy owner initially evaluate and subsequently monitor and re-evaluate policy management alternatives consistent with initial and changing planning objectives.

Sample AE 1. An inforce $1.2 million UL policy current illustration for a male age 61 shows that the scheduled $18,368 annual premium will only sustain the policy to insured age 79, eight years prior to the insured's estimated age 87 life expectancy. Actuarially certified evaluation calculates the policy lapse between insured ages 77 and 81 and calculates that a $24,854 correcting premium is needed to sustain coverage to insured life expectancy. Also, the evaluation calculates the inforce policy COI is less favorable (more expensive) than the policy standards average. (See "Inforce Policy vs. Policy Standards," this page.)

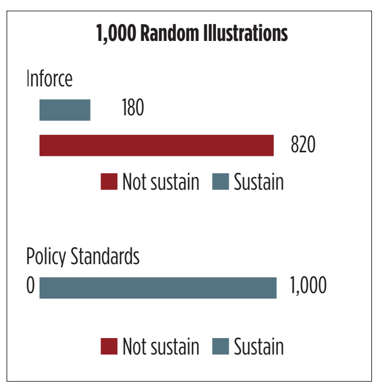
Sample AE 2. Trust-owned life insurance policies often warrant more expanded evaluation especially if the trustee is unskilled, the sales agent doesn't provide post-sales service, the ILIT grantor (insured) wants to assure trust gifting is adequate to pay annual premiums and the family attorney is expected to quarterback timely premium payment and communication with all parties. This example shows how an AE report can provide information to differing life expectancy ages. The example pertains to a variable UL policy and assumes an 80 percent/20 percent asset allocation. Differing asset allocations are evaluated the same as differing life expectancies.

The inforce $4 million death benefit policy issued in

Inforce Policy vs. Policy Standards

A correcting premium is needed to sustain coverage to insured's life expectancy

	Inforce	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	83
Current modal premium concentration of predicted lapse age(s)	77-81	88-92
Policy standards pricing deviation (+/-)	-.73	.00
Correcting modal premium to sustain current death benefit at premium adequacy risk tolerance	$24,854	$10,655



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2011 was reviewed as of its 2018 policy anniversary date. The insured is currently age 74 with a life expectancy until age 84. The carrier-provided inforce illustration showed the current $92,596 annual premium would only sustain the policy to insured age 80, while our corrective premium showed $96,978 as the right amount. 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. (Note: Other equity/bond asset allocations such as 60 percent/40 percent can be included so that all risk management options are reasonably considered. Also, a life expectancy report can be obtained, based on the insured's medical records to determine the age-appropriate reset/age 84.) Our conclusion: The premium needs to be increased to $122,233 to sustain the policy to age 84. (See "What's Needed to Sustain the Policy?" this page.)

New DOL Guidelines

Finally, as set out in the new Department of Labor (DOL) guidelines, the advisor must comply with the impartial conduct standards that:[7]

- Provide advice that's prudent and meets 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.

Endnotes

1. Thirty-five percent of universal life and variable universal life policies are currently estimated to lapse prior to insured life expectancy or five years thereafter, based on The TOLI Center, LLC client policies.
2. "Litigation-tested" refers to multiple subject matter litigation cases summarized in E. Randolph Whitelaw and Henry Montag, *The Life Insurance Policy Crisis: The Advisors' and Trustees' Guide to Managing Risks and Avoiding a Client Crisis* (ABA Book Publishing 2016). "Dispute defensible" refers to the findings of these cases. "Glidepath to safety" refers to the appropriate use of these litigation-tested findings.
3. *See* Ben G. Baldwin, Jr., "Between a Rock and a Hard Place: NAIC Regulators—Life Insurance Intermediaries—State and Federal Regulators" (April 19, 2018 CCH Incorporated and its affiliates). 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 compensation arrangements. However, the post-sales scope of policy administration and risk management services often weren't provided unless the sales agent expected policy replacement and a new commission.
4. Burke A. Christensen, "The Perils of Life Insurance Sales Illustrations," *Probate & Property* (1993).
5. *Ibid.*
6. *See* Whitelaw and Montag, *supra* note 2, which includes an in-depth discussion of creditable practices, litigation-tested practices and litigation.
7. Society of Financial Service Professionals "On the Call" program (June 2, 2017).

What's Needed to Sustain the Policy?

Insured needs to increase the premium to $122,233

	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

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