# Managing Life Insurance

*Ongoing Management is Vital to Ensure Policy Performance*

By Bill Boersma

Few life insurance policy owners understand how their life insurance actually works. Having received their insurance education from their life insurance agents, they are under various misimpressions. Even advisors may rely too heavily on and place too much faith in the industry. These people may have a sophisticated understanding of financial investments, but they seldom realize that their life insurance is complex and requires a higher level of knowledge and management than they possess.

In my capacity as a fee-based life insurance consultant, I often hear statements like:

"I'm a policy owner who has paid every premium on time for 20 years and have never taken out a loan and you're telling me that within two years, this policy from a top-rated carrier will collapse with no cash value and no death benefit? You're crazy! This is a guaranteed policy!"

"I just received a notice from the attorney for the beneficiaries of a life insurance trust for which I am the trustee. It's asking for the trust's insurance policy statement, policy management procedures, annual carrier prepared projections, independent policy modeling, recent carrier financial analysis, justification for the 1035 exchange done years ago and several other documents. What's going on?"

In addition, I've had to tell an 85-year-old gentleman that the policy into which he's pumped seven figures of premium for the benefit of a favorite charity will collapse with no residual value by Christmas. And a 40-year-old who bought a "10 pay" whole life policy for family income planning 10 years ago that he now has to pay until he's 96. And a middle-aged couple with a trust-owned survivor life policy for estate tax liquidity that they must at least double their $25,000 annual premium to $50,000 a year for the policy to have any reasonable chance of paying a death benefit. And the chief financial officer of a company with corporate owned cash value policies to fund executive non-qualified benefits that— far from being able to access the cash value of these policies— he isn't able to stop paying into them lest they collapse.

It's a documented fact that most modern life insurance policies are underperforming based on expectations at the point of purchase. This doesn't mean that most life insurance policies will fail, but it does mean that a majority of policies will perform differently from expected. Far too many policies will collapse with no benefit if meaningful action isn't taken.

Without regularly performing a thorough policy audit and performance analysis, it may be impossible to determine if a policy will perform suitably. A majority of life insurance policies, as sold, aren't guaranteed to pay a death benefit (as misunderstood by the policy owner) even if funded at the originally illustrated premiums. And there's no way they can perform as projected when the crediting rates fall as far as they have. Even a policy with an annually increasing cash value today may never pay a death benefit. The various types of cash value life insurance policies have more variables and fewer guarantees than you might think. There continues to be an unfortunate disconnect in the market regarding cause and effect in life insurance policies.

## Dispelling the Myths

What will it take to break through conventional wisdom about life insurance? A lot has been written over the past decade about life insurance performance and maintenance, the Uniform Prudent Investors Act (UPIA) and professional/fiduciary obligation, but little has changed in the way life insurance is treated as part of a client's portfolio of assets.

Few consumers and advisors (including many agents) understand that products and policy options in the market continue to evolve and that policies with non-guaranteed elements, including modern whole life, universal life and variable life may drastically underperform original projections or even fail completely.

Conventional wisdom is so pervasive that though policy owners nod in agreement as I explain how their policies work and that the declining money rates in the market over the years is causing their policies to lapse when the cash value collapses, they still look at me and say, "But my death benefit will be there, right?" As I search the room for a suitable hard object to strike my head against, I explain over and over that if the cash value goes to zero, or if the policy loan balloons out of control, the death benefit will disappear and the next place they'll be filing the policy is in the recycle bin they take to the curb every week. It's really that simple.

It's disheartening to witness the confusion, denial and anger when the realization that paying a scheduled premium and getting a death benefit don't necessarily go hand-in-hand sinks in.

## Financial Instrument

Today's life insurance products are amazingly complex and dynamic financial instruments. As a life insurance professional, I recognize the very attractive benefits of an appropriately procured, well-designed and regularly managed policy. However, when life insurance is included in family, business and estate planning, advisors must apply a higher level of understanding and discretion than they typically do.

As with other investments, insurance portfolio diversification by policy type, risk assumption and carrier may be appropriate. Shifting goals, changing actuarial assumptions, carrier efficiencies, product innovations, underwriting anomalies and the secondary market all play a role in the demand for consistent monitoring of policies, changes (when appropriate) and replacement when better options are available.

Market forces affect life insurance and drive insurance crediting rates in the same way that they affect other financial assets and transactions. We don't, however, manage life insurance to the same extent that we manage our other financial assets and transactions. It's this gap in traditional financial services we need to address to avoid catastrophic, sometimes irreplaceable loss of coverage or even devastating tax consequences.

Prospective policy owners make decisions on policy purchases based on ledgers illustrating the contract's current assumptions and projected values. These ledgers can be out of date by the time the policy is put in force, yet policy owners will fund contracts based on these out of date point-of-sale ledgers for years to come. There's little understanding that traditional guarantees have largely been replaced by computer modeling that assumes static crediting and expense charges when these variables are quite dynamic. Policy owners and their advisors are discovering the hard way that many policies on which they depend for family, business and estate security are collapsing and may provide a reduced death benefit or even no death benefit due to significant changes in financial markets and lack of policy management.

> Active management can protect against a wide variety of potential policy disasters.

Most people understand that if changing markets reduce the return on their retirement assets, they won't end up with the account balance they expected. Accordingly, you must, among other things, periodically review financial assets, rebalance your portfolio and review your risk tolerances. But this is exactly what most policy owners fail to do. When policy crediting rates decline, the cash value of the policies can't grow sufficiently to cover the high mortality costs during later years. Lower cash values also mean higher policy charges that reduce cash values even further. This scenario can quickly turn into a "death spiral" of sorts for unmanaged policies.

One big difference between life insurance and traditional investments is that over the past two to three decades, while investments in your 401(k) have gone up and down, the crediting rates for traditional life insurance policies have consistently gone down. Dividend rates and interest rates for whole life and universal life policies peaked at 10 to 14 percent in the 1980s and have plummeted to 4 to 7 percent today. And with current market rates even lower, crediting rates will only decline further. Too few policy owners understand that this has a negative effect on policy performance.

Many policies, which you and your clients believe to be sound if not guaranteed, will never pay a death benefit without a substantive infusion of cash or an alternate reengineering of the policy. I regularly see so-called "permanent policies," which after many years of dutifully paid premiums and not a single late payment, are thrown in the trash with no value and no death benefit.

Even the wealthiest and most sophisticated consumers, surrounded by the best counsel that money can buy, may be facing these issues and not know it. Take it as a lesson learned; don't assume another advisor is on top of it.

## Maintenance vs. Management

Policy maintenance involves, among other things, updating addresses, changing beneficiary designations and following up on premium due notices. After selling the policy, the agent takes on this role.

Policy management involves in-depth financial analysis of product performance relative to original assumptions and systematic benchmarking against market alternatives. It's about understanding the changing goals and risk tolerances of clients and managing them against the constantly shifting financial markets, dynamic product offerings and inconsistent policy performance.

Sophisticated tools and analytical services are available for effective policy management. This may involve creating a personalized mortality curve that allows for better premium efficiency, incorporating stochastic modeling that offers more statistically significant results, expense deviation testing that stacks your client's contract up against policy standards rather than the manipulatable carrier projections, discovering and utilizing product and underwriting anomalies, performing ongoing dividend option and loan-management analysis and more. In other words, life insurance portfolios can and should be managed in an actuarial defensible manner, in much the same way a financial analyst manages a portfolio and assesses market options. While annual statements and carrier-produced projections may be helpful, it's important to remember that if company-generated illustrations got us in trouble, we can't rely on more illustrations to get out of it.

Active management can protect against a wide variety of potential policy disasters, assure policy stability and gain maximum efficiency of invested resources. This can result in meaningful savings and/or increased benefits over the life of the policy as well as highlight problems which may otherwise not be evident until it's too late for solutions to be effective.

## Life Settlements

The discussion of proper policy management wouldn't be complete without at least the mention of life settlements. The life settlement may be one of the most powerful concepts available to policy owners regarding their options for managing an insurance policy or portfolio.

Whether working with clients to improve their overall insurance portfolio or developing an exit strategy for insurance policies no longer needed or affordable, the settlement market may offer the policy owner much more than the insurance company ever could. In fact, life settlements have been found opportunities, giving our clients millions of otherwise unattainable dollars.

I worked with an older couple on the verge of surrendering a $4 million survivor life policy due to changes in their planning. The cash surrender value was $10,000. We negotiated an offer in the market for more than half a million dollars. As of this writing, we have a $100,000 offer for a business owner's unneeded $1 million term insurance policy. Another policy owner, after discovering she needed to significantly increase policy premiums, sold her policy for multiples of the cash value and used the funds to purchase a new guaranteed policy for the same face value at half the price.

> Trustees with fiduciary responsibility have even more at stake.

Undoubtedly these are examples of genuine value that clients would not want to discover six months after they've made a different, possibly detrimental, decision.

## Agent, Product and Carrier

Insurance agents are predominantly in the sales and maintenance business. Many represent a specific insurance carrier and these carriers often limit the range of products and strategies an agent can present. Carriers also provide strong financial incentives to guide agents to clearly represent the carrier's best interest. A respected insurance company and an agent with an impeccable reputation shouldn't automatically translate to assumptions of policy soundness or planning success. Agents in general simply aren't trained or paid to utilize the tools, techniques and analytics available to astutely manage life insurance portfolios.

Policies sold in the 1980s, even through the most conservative and highly rated carriers, had unsustainably high crediting rates. Today these policies are earning roughly half of their original projections and the effect on policy value is tremendous. Even policies issued in the past decade have suffered meaningful reductions in crediting rates. Reality has robbed the cash value from many policies, despite the reputation of the company or agent who sold them.

Given the nature of the life insurance sales and marketing process, it's all but impossible for most advisors to view in-force policy ledgers and competing proposals for new policies and take away any kind of meaningful conclusion about which is "best." Agents exert much time and effort arguing about the benefits of their carrier or a certain contract, but these arguments often stem from institutional indoctrination. There's nothing inherently right or wrong about whole life, universal life, variable life or term insurance. Each class of insurance has strengths and weaknesses and the client's situation and goals should determine which is most appropriate. However, each type of policy needs to be managed and market forces have affected all life insurance.

## Professional Advisor's Role

What's the professional advisor's role in all of this? Attorneys, accountants, trustees and financial advisors have a professional duty to their clients, and trustees have an added fiduciary obligation to the beneficiaries of the trusts they administer. The difference is real enough, but in today's litigious world, a disgruntled client or beneficiary can name many advisors in a lawsuit. Regardless of fault, real time and money may be lost handling such lawsuits.

Whether professional advisors don't want to rock the boat, would rather not step on the toes of an agent who is a reference source or simply don't understand the magnitude of the consequences, few are tackling this difficult issue. If you value the financial well-being of your clients, you will serve them effectively by being proactive about their life insurance. After all, if you knew they were driving a car after a recall notice for failed brakes, you would probably pick up the phone and warn them. Why not warn them if their life insurance is bound for failure?

Trustees with fiduciary responsibility have even more at stake. A disconcerting number of trustees don't understand the life insurance policies of their clients. Yet, by law, they must demonstrate policy suitability through acceptance, management, remediation and restructure. This applies to changing tax laws, risk tolerances, product evolution, health changes, financial market shifts and more. The UPIA is crystal clear when it comes to fiduciary liability, and case law has shown what it takes to protect oneself.

Relying on the agent who sold the policy isn't sufficient. A trustee may lean on the agent for certain information, but policy decisions and the rationale behind them are solely the trustee's responsibility. Arguing that the agent is responsible isn't going to mitigate the trustee's fiduciary responsibility. Bear in mind that even involved, conscientious agents usually don't manage a policy as required by the UPIA's standards.

When a trustee spends most of his time managing the $1 million of investments in an account, and the $5 million life insurance policy falls off the books due to lack of attention and active management, I don't think the beneficiaries of the trust are going to really care that he outperformed his peers by a hundred basis points.

The trustee can accept some risk and actively manage non-guaranteed policies, or the trustee can choose to shift all risk to the carrier by accepting a guaranteed premium/guaranteed death benefit policy. Unfortunately, many trustees believe they have guaranteed policies when they don't.

In light of the real requirements in the UPIA for managing life insurance policies, sending out *Crummey* notices and cutting premium checks seem like a quaint administrative task. The good news is that the UPIA allows this work to be outsourced to specialists, and doing so could be a wise decision. Using a qualified fee-based life insurance consultant can offer valuable service in this area. They can identify rescue strategies for policies that are crashing, and may improve the performance of policies that are marginal. Clients may not be happy to learn their policy is underperforming or needs an infusion of cash to remain viable, however, an informed client has options, unlike the client in blissful ignorance until the day his policy becomes worthless.

## Lessons Learned

Life insurance policies need to be analyzed as a part of the comprehensive financial portfolio and the role they play in accomplishing stated goals. From an estate perspective, layering in life insurance has the potential to increase portfolio returns while lowering risk. It's unfortunate that the benefits of a tool this powerful may be lost through inattention.

If there are a few things I could impress on the minds of professional advisors they would include: (1) life insurance mechanisms are complicated and not very transparent; (2) don't take anything, especially conventional wisdom, for granted regarding life insurance; (3) life insurance requires ongoing, active management; and (4) understand the value of an objective, third party. ■

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