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Cleaning Out the Attic, Analyzing My Life Insurance, and Other Tasks I Never Get Around To

Reasons, Benefits and Resources Associated with Evaluation of Existing Life Insurance Policies

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We have all heard the stories and wish it could be us. A woman in Albuquerque finds a rare gem in her grandmother's attic. A man in Toledo finds a family artifact in his basement. While we cannot promise a rare stone, we can offer a suggestion. Evaluate your clients' life insurance policies to uncover potential hidden value.

The Good News. When properly designed and implemented, life insurance plays an important role in a successful estate plan. It provides cash for heirs when most needed, creates liquidity for the estate, facilitates the buyout of a business and equalizes inheritance between heirs.

The Bad News. Despite its important role in the client's estate plan, life insurance often suffers from improper design, implementation and administration. It frequently carries a negative purchase and ongoing ownership experience for the client and the trusted professional advisers. It can be a sore subject to say the least.

The Irony. Clients often pay meticulous attention to important traditional assets—businesses, securities and real estate—and plan extensively for their transfer. Life insurance assets can equal or exceed the value of these traditional assets but may receive little or no attention and can be left in an underperforming state for years.

The Opportunity. Several major industry changes are causing policy owners, trustees in the case of trust-owned policies, to evaluate existing life insurance coverage and improve the quality of the life insurance portfolio. Evaluation can result in (1) a reduction of the premium needed to sustain the same coverage, or (2) a material increase in the amount of coverage for the same premium. Furthermore, evaluation of a client's life insurance can address the goals of a professional adviser by providing meaningful, valuable service and achieving superior results for the client.

Paying Attention Pays Off. Suppose your clients, a retired couple, are 69 and 74 years old and have put an irrevocable life insurance trust (ILIT) in place for planning and wealth transfer purposes. Many years ago, the trust purchased three joint-life insurance policies with a combined death benefit of $7 million. The trustee faithfully pays the annual premium as billed in the notices and files the carrier's policy statements. The projected premium, based on today's costs and interest rates, totals over $1.2 million by the younger client's age 100. Everything is going smoothly, and the situation requires no obvious action.

Now suppose an evaluation reveals that a rearranged policy could buy the same amount of coverage, $7 million, with 25 percent to 75 percent less premium. The lower premium results in less cash drain on the retired clients or more room to gift non-insurance assets. Cash savings alone can approach $1 million in this example. Paying attention benefits the clients and the adviser who helped uncover such a material improvement.

The Art of the Solution. The opportunity to improve an insurance policy is not obvious, as frequently the existing policy seems to be performing nicely. Bringing about these types of superior results may require creativity in combining life insurance with other financial instruments. The strategy results from a combination of deep understanding of the client's circumstances and broad access to the applicable financial instruments. The art of the solution requires collaborative thought on the part of the client's professional advisory team.

Why All the Recent Buzz About Reviewing Life Insurance Policies?

Simply put: circumstances change. To elaborate and to borrow terms from economics 101, "macro" trends (industry

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changes) and "micro" trends (changes in the client's particular situation) both drive the need to evaluate clients' life insurance policies. Such events can dramatically change the way life insurance companies price and construct their products. Such new developments also make reconfiguring existing policies particularly beneficial to the policy owner at this time.

Macro Trends Positively Affecting Newly Issued Policies

Premium and Benefit Guarantees. The description of such policies varies: "secondary no-lapse policies," "term to age 100," or simply "guaranteed policies." Whatever the title, the impact on the life insurance landscape, especially as it relates to life insurance trusts, has been significant. The policies employ a straightforward concept: the policy owner pays the contractual premium and the beneficiary receives the death benefit. In other words, "what you see is what you get." Delivery of the benefit relies upon two primary factors: (1) the payment of premium on time and in full, and (2) the solvency of the life insurance company at the time of claim. The effect of most other variables on policy performance diminishes dramatically.

Guaranteed policies accumulate little cash value, if any, which leads to another description: "death benefit only" policies. The policy owner should purchase the policy with the intention of paying premium until the death of the insured. The life insurance company charges a lower premium than a comparable policy that does accumulate cash value. While receiving significant value and benefit offered by guaranteed policies, the owner is foregoing other benefits and flexibility traditionally offered by life insurance, namely, tax deferral on the accumulation of cash value. Guaranteed policies are not suited for all clients' circumstances, but they certainly attract attention in the case of an irrevocable trust that primarily functions to provide death benefit to heirs.

Health and Medical Improvements. Life expectancies are increasing. For non-actuaries, that translates into "people live longer than they used to." A client's health may actually improve over time, either empirically (the client's cholesterol is lower than it was 10 years ago) or relative to the client's peer group (the client's health is deteriorating less quickly than the peers). The client may qualify for a better life insurance rate based on health and medical improvements alone.

Insurance Companies are Reducing Mortality Charges. As a result of health and medical improvements, life insurance companies may require lower premiums than before, especially on older age clients. Insurance companies statistically have longer to collect premium as those insured live longer. As a result, the insurance companies theoretically can charge less for the coverage and still meet their profit targets. Not all companies pass along this "mortality savings" to owners of older policies. A client may need to be re-insured under a new policy in order to benefit from this trend.

Macro Trend Negatively Affecting Older Policies

While the preceding changes have the general effect of lowering the cost of new life insurance coverage, clients with older policies frequently experience a different set of forces that increase the premium required to sustain existing policies.

Decrease in Interest Rates. The overall price of a permanent life insurance policy, namely whole life and universal life, relies on a number of factors, perhaps the most significant of which is the interest rate. Ten to 20 years ago, insurance agents designed policies under the assumption that interest rates, much higher at the time, would remain. But as rates have trended down, clients have paid more premium into the policies—sometimes a great deal more—than originally anticipated. In short, lower interest rates help borrowers but hurt savers. The cash value in a life insurance policy is a form of savings and, therefore, is receiving a historically low interest rate. Multiply this effect over the 30-year life of a policy. The result: a policy that fails to achieve the original plan because it lapses too soon or costs too much.

Macro Trend With Unknown Long-Term Effects

The emergence of the secondary market for life insurance policies has radically altered the life insurance landscape. Despite the relatively unknown long-term effect on the price of insurance, its increasing popularity and importance make it worthy of mentioning.

Emergence of the Secondary Market for Life Insurance Policies. This phenomenon, formerly know as a viatical settlement and now better known as a life settlement, may dramatically affect the value of an old life insurance policy. No longer should clients simply discontinue term policies without valuing them in the secondary market. No longer should clients allow unwanted permanent policies to lapse with zero value. And, no longer should clients accept the fact that existing policies achieve the best results possible for their planning purposes. Under the correct circumstances, a life settlement can extract significant value from an existing life insurance policy. This valuation difference between what the carrier will pay upon termination of a policy and what one could "sell" the policy for is forcing dramatic change.

Micro Trends: Changes in the Client's Situation

In addition to significant industry changes that drive the need to evaluate policies, clients face ever-changing personal circumstances. Suppose a policy was purchased five to 15 years ago to address certain needs. While the needs may still exist, the nature of the need may shift significantly. A partial list of events that clearly drives the need to evaluate the suitability of life insurance coverage includes: marriage; divorce; birth of children or grandchildren (resulting in additional heirs and additional room for gifting); death of a spouse; noticeable change in health; lack of desire or ability to pay premiums; change in value, nature or composition of assets; or change in estate tax liability. Essentially, any material change in the client's circumstances merits a life insurance evaluation.

Life Insurance Portfolio Management. The investment community widely accepts the concept of portfolio management, that is, the active management and regular review of investments to increase the probability of achieving the desired end result. The same concept applies to life insurance. Gone are the days of purchasing a policy and locking it away in the safe deposit box. Arguably those days never should have existed in the first place. But they did and perhaps still do in the minds of some.

In addition to the rapidly changing dynamics in the insurance industry, increasing fiduciary requirements cause owners and trustees to rethink their approach to the maintenance of life insurance policies. An appropriate response should include the active, regularly scheduled evaluation of policies. Owners should treat life insurance as an asset class that can, and often does, significantly impact the wealth transferred to heirs and beneficiaries.

The Unanswerable Question Posed to Advisers: "Is My Policy Good or Bad?"

Imagine your new client bought a whole life policy 18 years ago. No one has laid eyes on it, much less reviewed or evaluated it, in 12 years. He is frustrated and confused and decides to ask one of his trusted advisers for a professional opinion of the policy. He highly values objectivity and, like many, decides to ask his attorney. He proceeds with a set of predictable questions: Why do I have this life insurance policy? Do I still need it? Should it be in a trust or can I own it? How is this policy doing? Is there a better policy out there?

The client asks valid questions, but the situation needs a framework to bring all the issues into sharp focus. Evaluating a policy in a proper perspective and manner requires assessment from seven distinct perspectives. The Seven P's, as they are known, each have analytical questions and actions associated with them. Within each area, the policy falls in to one of three categories: concern, caution or desirable.

1. Purpose. What need is the policy addressing? Does the need still exist? Why was the policy originally purchased (does anyone remember)? Have the circumstances materially changed?

Action to correct, if necessary: Revisit the unfunded liability or desired result the insurance is supposed to address. Project increases or decreases in the liability over time. Consider non-insurance alternatives that adequately address the need, if any. Establish consensus among the client and advisers on the amount of insurance required. In effect, document the current logic for the coverage. Memories are short.

2. Placement. Is the policy in the right place? Are the ownership and beneficiary arrangements suitable based on the current facts? Is it properly integrated into the client's current plan? Is the policy documentation thorough, accurate and professional?

Action to correct, if necessary: Request hard evidence of the policy's current ownership and beneficiary arrangements and make sure they align with the estate plan. If not, examine moving the policy to the proper place, but watch out for "transfer for value" issues. Improperly moving a policy could make the death benefit income taxable.

3. Professional. Is there a trusted insurance professional who is actively involved, creative, product-neutral and capable of handling complex concepts?

Action to correct, if necessary: Interview the existing agent and review the service history on the policy. Define expectations going forward for service and communication. Ask if the agent can facilitate a life settlement of the policy if necessary (some are precluded from doing so). Find out if the agent is truly independent or has a relationship with a "primary" company (ask if the agent receives a W-2 and benefits from a particular life insurance company). If necessary, change the policy to a new "agent of record" who will be more helpful to the client. It is easy to change the agent of record. Work with someone you like and trust. It usually just takes a simple letter from the policy owner to the carrier to designate a new agent, as long as the agent is licensed with the carrier.

4. Product. Was there a process for matching the product type to the need? What was the process and is the product still suitable? Carriers continually redesign existing products or introduce new ones to the market. The capabilities of a specially designed product may be particularly well suited to meet the specific needs of a client.

Action to correct, if necessary: Define the client's need for product flexibility, time horizon for the coverage and overall tolerance for risk. Ask the agent to document the connection between these elements and the attributes of the product in place. If substantial disconnects exist, revisit the product type and consider making changes.

5. Performance. When looking back to the inception of the policy, how has the policy performed against original expectations? Is it materially behind or ahead of plan?

Action to correct, if necessary: Though important to know, little can be done to correct past underperformance by the

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insurance carrier. Missed premium payments during the life of the policy may contribute to underperformance. Consider making up missed premiums with interest. If a policy loan is deteriorating the policy's quality, consider paying off the loan.

6. Price. What will it cost to get this policy to do what we need it to do? Performance (#5 above) is retrospective, whereas Price is prospective. Starting today and looking forward, how does the premium requirement compare to the cost of a new policy that accomplishes the same end result? This step requires general knowledge of the client's health situation. A client in extremely poor health may be uninsurable and unable to purchase a new policy. By default, this renders the existing policy "better" than any current alternatives. To the extent that premium seems high, policy owners often score Price as an area of "concern" until more thorough testing can be done.

Action to correct, if necessary: Order an "in-force illustration" using the carrier's current interest rate and cost assumptions. Also ask the carrier to calculate the premium required to extend the policy to age 100. Use this as a base case scenario against which to measure appropriate alternatives. If the existing policy does not compare favorably, consider alternatives based on the parameters outlined in #4 (Product) above.

7. Provider. Has the financial rating or credit quality of the insurance company changed materially? How large, sound and well-established is the insurance company? The size and corporate rating parameters can be set based on the evaluator's preferences. A smaller, lesser-known carrier might receive a scoring downgrade due to concerns about size.

Action to correct, if necessary: Ask the agent to provide a report of the current financial condition of the carrier in question as compared to peer companies. It is unlikely that any carrier would not be able to pay a death claim. The relevant concern is the ability of a less financially stable carrier to deliver a competitively priced product over the life of the policy.

Scoring a Policy. The scoring system (concern, caution, desirable) combines both subjective and objective criteria. Not all necessary tools are readily available to the public. However, the system can act as a framework for breaking a relatively complex financial instrument down into a manageable number of core components. The evaluator can sharply focus on each core component, develop a sense for which areas are in most need of action and address the areas of concern first.

Certain concerns can be addressed by making changes to the existing policy: change a beneficiary to address a concern in purpose; change the owner (after full consideration of possible tax consequences) to address a concern in placement. Other concerns can only be fully addressed by purchase of a new policy, including price and provider.

Policy Improvement Tools. A carpenter carries more than just a hammer. A skilled craftsman has access to a mind boggling variety of tools and techniques. Similarly, perfecting a life insurance portfolio may mean more than just adjusting the old policy or exchanging for a new policy. Sometimes fixing an "underperformance" problem calls for radical alteration of the insurance in place. A myriad of creative possibilities exist when reformatting a client's life insurance. Considering these may be helpful next time you see a client who needs to make changes to their life insurance:

- Request improvement of the risk rating on an existing policy
- Reduce an existing policy down to its most efficient core and couple with a new policy
- Couple a life insurance policy with a life-only annuity
- Sell (life settle) the existing policy and consider alternatives for the proceeds, including the purchase of a new policy
- Use a combination of term insurance and permanent insurance
- Preserve flexibility with a new $0 surrender charge policy
- And so on . . .

As circumstances change, life insurance needs change, too. Actively managing a life insurance portfolio and evaluating the seven core components of a policy can help surface and address areas of concern. Addressing a life insurance need requires creativity from and collaboration among the client's trusted advisers. The result can pay off for the adviser in terms of value delivered and can certainly pay off for the client. And that leaves only cleaning and treasure hunting in the attic left to do. ■

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The Life Insurance Scorecard ™

1. Purpose (need)
2. Placement (owner)
3. Professional (agent)
4. Product (policy type)
5. Performance (review)
6. Price (projections)
7. Provider (size, ratings)