



Trust-Owned Life Insurance: Risk Management Guidance for Fiduciaries

The risk of liability for trustees who handle trust-owned life insurance (especially non-guaranteed policies) is a serious issue. This article explains how trustees can implement a 'best practices' standard of care with respect to TOLI risk management.

E. Randolph Whitelaw and Richard M. Weber

The Sarbanes-Oxley Act officially launched the 'risk management era' and served notice that past practices, such as those resulting in the corporate malfeasance crisis of 2000-2001, were unacceptable. Subsequent well-publicized investigations of, and settlements by, financial institutions recognized that outside intervention is needed and will be taken to eliminate embedded past practices. Harvey Pitt, former Chairman of the SEC, recently cautioned bankers that an environment of overlegislation, overregulation and overprosecution is here to stay for the foreseeable future. Further, he urged bankers to self-regulate and self-police their industry, warning that if they don't, New York Attorney General Eliot L. Spitzer or government agencies will do it for them.

Trust-Owned Life Insurance ('TOLI') and its unmanaged liability has been the subject of many cautionary articles since 1992. Surveys have shown that most professional fiduciaries either have not established TOLI – specific practices or have established meaningless practices that likely document an imprudent process. Fiduciary

law experts familiar with institutionally managed TOLI often suggest that financial institutions will take action "after a few good lawsuits". However, based on anecdotal evidence and dispute resolution services marketed by TOLI third-party administrators, TOLI disputes are settled, not litigated. As already demonstrated by well-publicized settlements, trustees prefer to avoid extended litigation costs and further damage to their reputations, especially when wealthy clients are involved.

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Equally important, an empty insurance trust file or one papered with meaningless analysis does not contribute to a strong defense in litigation. Trust beneficiaries, as a group, are fairly passive and generally prefer to avoid publicity. Because of this passivity and the many myths that seem to surround life insurance, financial institutions develop a settlement strategy based on the life insurance expertise of the plaintiff's attorney.

This "wait-and-see" settlement strategy seems an expensive alternative to simply implementing a legally defensible, administratively feasible, and cost-efficient "best practices" TOLI risk management program. The purpose of this article is to describe:

- How a 'best practices' standard of care can be immediately applied to TOLI. In the current environment, trustees and beneficiaries are concerned about reducing risk and, specifically, minimizing downside risk.
- How a skilled trustee can overcome *embedded* past practices, and can demonstrate adherence to principles of fiduciary law

and compliance with regulatory procedures for making determinations about accepting, managing, and restructuring TOLI policies.

- How professional advisors can offer guidance to personal or unskilled trustees that safeguards the interests of all parties involved in the insurance trust.

In describing the ‘best practices’ standard of care available today, we will address past practice rationales that usually defy logic and common sense. A check-and-balance process between the grantor’s attorney and the trustee is implicit in decisions regarding the acceptance and management of TOLI. For corporate trustees, regulatory guidance is also readily available for crafting TOLI-specific procedures that are appropriate for today’s environment. Insurance trusts remain a cornerstone of sophisticated wealth preservation and estate liquidity plans. Contemporary evaluation tools and products are available to achieve an insurance trust’s objectives – they just need to be used.

Overview of Irrevocable Life Insurance Trusts

The creation of an insurance trust usually results from a broader analysis of wealth preservation, estate liquidity, and income planning objectives. This economic analysis, prepared by the grantor’s legal and/or tax advisor, evaluates the cash flow, liquidity timing, and tax trade-offs of different planning options. Life insurance has evolved as the preferred option for implementing the trust because it offers both cost and risk transfer advantages and is ideally suited for trust ownership. This economic analysis confirms both the level of expected trust return (death benefit proceeds) and the expected level of risk (premium adequacy). While use of an irrevocable life insurance trust

requires third-party ownership of the policy, most corporate trustees accept insurance trusts as part of the professional asset management services available to “Private Client Group” customers.

A trustee, skilled or unskilled, can accept a guaranteed death benefit policy and transfer all premium adequacy risk to the underwriting carrier, or can retain premium adequacy risk by accepting a non-guaranteed death benefit policy and actively managing policy values. Acceptance of premium adequacy risk implies the grantor’s approval to do so, expertise in TOLI risk management, and an affirmative election by the trustee to manage the insurance investment consistent with the trust’s objectives. If a trustee does not obtain the grantor’s approval or lacks TOLI risk-based procedures, or expertise in policy evaluation, the trustee must recommend restructuring¹ to a guaranteed death benefit policy.

‘Best Practices’ TOLI Risk Management

The basic duty of a fiduciary is to maximize the probability of a favorable outcome to the trust estate. All assets held in trust are defined as investments. The prudent investor rule instructs a trustee to design and carry out a reasoned investment strategy that will fit within the trust’s unique purposes and the expectations of the beneficiaries to make the trust property productive.

The critical asset management considerations applicable to insurance trusts are product suitability, premium adequacy and carrier selection. For guaranteed policies, premium adequacy is not a risk but the carrier’s size and ratings must be evaluated. For non-guaranteed policies, premium adequacy is the obvious risk that mandates active management using TOLI-specific risk management procedures and

expertise in evaluating premium adequacy. Actuarial evaluation must be used for all determinations regarding premium adequacy, as well as policy acceptance, management and restructure.

Issues in the transition from past practices. The transition to “best practices” must overcome embedded practices that:

- (1) Focus on a carrier’s size and ratings when product suitability and premium adequacy are the more critical and immediate issues to be evaluated.
- (2) Treat carrier sales and inforce illustrations as credible for determinations of premium adequacy risk management when they are not.
- (3) Assume that the interests of the agent, carrier, grantor, beneficiary, and trust are aligned when they may not be.
- (4) Approve acceptance of a policy without formally confirming all trust operation issues with the grantor’s attorney who drafted the trust document.
- (5) Approve acceptance of a non-guaranteed policy without (a) formally affirming the product’s suitability with the grantor and the grantor’s attorney, (b) evaluating the adequacy of the premium to sustain the policy for the insured’s lifetime, and (c) confirming that the policy will be managed consistent with

¹ Restatement of the Law Third, Section 229, Comment a, Duty to Restructure Trust Portfolio: “With the trust’s investment objectives in mind, the trustee must review the original investments and, if and as necessary, formulate a plan for restructuring the portfolio to achieve a suitable level of risk and expected return with appropriate degrees of diversification and income productivity...The trustee must also determine whether the trust terms direct retention or disposition of any of the inception assets.”

the insurance trust's Investment Policy Statement.

The single most important principle to understand in implementing a "best practices" standard is that carrier illustrations do *not* predict future policy values and certainly do *not* evaluate premium adequacy risk. Illustration-based methodology calculates the lowest premium required to achieve agent-controlled policy design assumptions based on a linear projection of carrier-controlled hypothetical crediting rates of return and assumptions about policy expense. As demonstrated over the past 20 years, this methodology has the highest probability of requiring restructuring, reassessing premium adequacy, and exposing the trustee to allegations of imprudence.

Unmanaged liability. It is estimated that over \$1 trillion² face amount life insurance is owned in trusts. A 2003 study³ revealed that 83.5% of professional trustees surveyed had no guidelines and procedures for handling TOLI and 96.3% had no policy statements on how to handle life insurance investments. Moreover, it is estimated that 35%⁴ of TOLI policies are non-guaranteed death benefit policies. The percentage of non-guaranteed policies has increased significantly over the past 10 years. Based on our experience, the larger death benefit TOLI policies are usually non-guaranteed policies.

TOLI's unmanaged liability refers to non-guaranteed policies managed by trustees who lack TOLI-specific active management expertise. The results of the 2003 study suggest that most skilled trustees have not developed any TOLI practices, much less risk management practices.

'Best Practices' Standard of Care
In 1992, the prudent investor rule

replaced the prudent person rule in order to accommodate modern portfolio theory and contemporary investment strategies that best serve the purposes for which private trusts were created. Professor Edward Halbach, reporter for the Restatement (Third) of Trusts, emphasized, "a major purpose of Restatement Third was to make sure fiduciaries could not escape liability for inadequate investment strategies."

Modern portfolio theory assumes that investors will act rationally in making decisions based on maximizing investors' return for the level of risk that is acceptable to them. The prudent investor rule's "Introduction to Investment of Trust Funds" comments: "Risk and return are so directly related that trustees have a duty to analyze and make conscious decisions concerning the level of risk appropriate to the purposes, distribution requirements, and other circumstances of the trusts they administer."

The prudent investor rule sets out general requirements of care and skill in the administration of a trust:

A trustee is liable for losses resulting from failure to use the skill of an individual of ordinary intelligence...If the trustee possesses a degree of skill greater than that of an individual of ordinary intelligence, the trustee is liable for a loss that results from failure to make reasonably diligent use of that skill. So also, if a trustee, such as a corporate or professional fiduciary, procured appointment as trustee by expressly or impliedly representing that it possessed greater skill than that of an individual of ordinary intelligence, or if the trustee has or represents that it has special facilities for investment management,

the trustee is liable for a loss that results from failure to make reasonably diligent use of that skill or of those special facilities.

A skilled trustee is held to a higher standard than is an unskilled trustee. For example, national banks must also demonstrate compliance with OCC Reg. 9 (i.e. Office of the Comptroller of the Currency⁵) risk standards. Therefore, a national bank knows that a trust-owned life insurance policy is a concentrated investment requiring "special facilities for investment management" that include TOLI-specific procedures necessary to demonstrate compliance with OCC Reg. 9.5 and 9.6a⁶. If a bank accepts a non-guaranteed policy, then it must demonstrate the expertise to evaluate the risk of premium adequacy pursuant to OCC Reg 9.6b⁷, or it must recommend restructuring to a guaranteed death benefit policy. Finally, if yesterday's "special facilities" are not adequate for today's "best practices" and the trustee can no longer administer a non-guaranteed policy, the trustee must recommend restructuring or obtain beneficiary approval to do nothing.

An unskilled trustee generally relies on the grantor's legal or tax professionals for guidance about the operation of the trust. Over the past 10 years, numerous commentators have noted that these professionals serving in this capacity have the same basic fiduciary duties as a skilled trustee. Hence, this article

² William M. Arnold, Jr. and Jeffrey C. Harper, "Trust-Owned Life Insurance Poses Hidden Risks", *American Banker*, February 3, 1998.

³ Richard L. Harris and Russ Alan Prince, "The Problem with Trusts Owning Life Insurance", *Trusts & Estates*, May 2003.

⁴ Portfolio and Compliance Management Considerations Impacting the Administration of TOLI, TrustBuilder Services, November 14, 2003

suggests a “best practices” standard of care intended to safeguard the interests of all parties involved in an insurance trust, including the trustee, grantor, beneficiaries, and professional advisors.

Evaluating the risk of premium adequacy. Common sense reinforces the notion that a death benefit will be realized only if the premium payments sustain the policy until the insured’s death. Life insurance policies are designed based on life expectancy actuarial tables. In turn, actuarial evaluation uses common standards, impartial analysis, and objective data to assess a non-guaranteed policy’s premium adequacy until contract maturity and/or an assumed life expectancy.

If a trustee elects a premium adequacy risk tolerance less than 100% probability, actuarial evaluation can determine the risk-appropriate premium amount. If an existing TOLI policy is under-performing its acceptance benchmark, actuarial evaluation can determine the needed premium adjustment. If under-performance poses a risk that the policy may lapse, actuarial evaluation can calculate the insured’s age at the earliest probable lapse in order to compare this age to the insured’s assumed life expectancy. If a policy warrants restructuring, actuarial evaluation facilitates a credible analysis of restructuring options, including comparison to the fixed premium for a guar-

anteed death benefit policy. Because of an actuarial evaluation’s long-term time horizon, periodic reassessment is appropriate to take into account actual policy experience.

TOLI Illustration Primer

Trust files filled with non-guaranteed carrier illustrations and illustration-based performance reports are evidence of an imprudent process. Such illustrations are not credible for the reasons explained earlier. It is difficult to imagine that a professional familiar with contemporary life insurance practices would assert that non-guaranteed illustrations and illustration-based methodology are meaningful for predicting policy performance, much less evaluating the adequacy of the premium, in light of the following:

1. In 1992, the Society of Financial Service Professionals introduced the Illustration Questionnaire (“IQ”) and clarified, “... illustrations have little value in predicting actual performance or in comparing products and companies...So the risks associated with the possible inability of a product to achieve the higher illustrated benefits, or lower illustrated costs, than those generated by the guarantees are borne by the policyholders.⁸”

2. Also in 1992, the Society of Actuaries published an extensive examination of illustrations and illus-

tration practices associated with the purchase of life insurance⁹, and concluded that there are two major uses of illustrations:

- *Type A usage* is intended to show the consumer the mechanics of the policy being purchased and the policy values or premium payments change over time. The emphasis is a matter of **how** and **what** rather than **how much**.
- *Type B usage* tries to project likely or best estimates of future performance and compare cost or performance of different policies. It attempts to show **how much** on the premise that the **hows** and **whats** are comparable enough for this to be meaningful.

The report of the Society of Actuaries report went on to explain, “Most illustration problems arise because illustrations create the illusion that the insurance company knows what will happen in the future, and that knowledge has been used to create the illustration...To summarize, the Task Force endorses the use of illustrations for Type A purposes. We do not believe they are appropriate for Type B purposes.”

Over the years, various “predictive” systems have been developed that rely upon carrier illustration data. Ben G. Baldwin, author of the *CTFA Life Insurance Reference Guide*, comments in his book, *The*

⁵ For more information on the OCC Regs. As well as the OCC asset management handbooks, please access the OCC website, www.occ.treas.gov. and then click on (1) Publications – Comptroller’s Handbook, (2) Asset Management Booklets, (3) Personal Fiduciary Services August 2002, and (4) refer to pages 25 through 36.

⁶ *Pre-Acceptance Review*. “This review must document whether the bank can effectively administer the account. The bank must determine whether it has the expertise and systems to properly manage the account and whether the account meets the bank’s risk and profitability standards. A bank is under no moral or legal obligation to accept

all business that it is offered. The early identification of risk will help the bank control the amount of risk it accepts and price risk accordingly. Bank policy should provide guidance on the types of fiduciary accounts that are desirable and should define specific conditions for accepting new accounts. Procedural controls should be established to ensure compliance with account acceptance policies.”

⁷ *Initial Post-Acceptance Review*. “Upon the acceptance of a fiduciary account for which the national bank has investment discretion, the bank must promptly review all assets of the account to evaluate whether they are appropriate for the account. The appropri-

ateness of each asset will depend on the purpose of the account and the needs and circumstances of account beneficiaries. An investment policy statement should be created that establishes the account’s investment objectives and strategies. It is the fundamental duty of a fiduciary to administer an account solely in the interests of clients. The duty of loyalty is of paramount importance and underlies the entire administration of personal fiduciary accounts. A successful administration will meet the needs of clients in a safe and productive manner while equitably balancing the interests of each beneficiary.”

New Life Insurance Investment Advisor,¹⁰ “predictive illustration-based methods are doomed to failure because the numbers used in illustrations are filled with assumptions that are not comparable company to company and that are more and more flawed, and less and less reliable, as they project further into the future.” TOLI requires credible determinations of premium adequacy for ten to 50 years.

Policy acceptance. It is not uncommon for the underwriting of a life insurance policy application to begin at the same time a corporate trustee is deciding whether to accept the insurance trust (under 9.6a pre-acceptance review). Shortly thereafter, the trustee is faced with a perceived ‘*fait accompli*’ decision – accepting a policy without necessarily understanding the economic analysis prepared by the grantor’s professional advisors or related decisions concerning the selection of the agent, the product, and carrier. However, the trustee is under no legal or moral obligation to accept either the policy or an account that does not meet the bank’s risk and profitability standards.

If the policy is a “flexible premium” current assumption insurance product, the trust document rarely sets forth premium management guidance for policies that do not have defined premiums. What happens if:

- The policy incurs higher than expected expenses and/or lower returns than suggested in the simplistic sales illustration that establishes benchmark values for policy acceptance?
- The grantor can’t or won’t increase the gift? Should the death benefit be reduced to keep the policy in force?
- The policy is no longer suitable due to changed trust objectives?

Should a policy exchange or a life settlement be considered?

These basic questions must be addressed and guidance regarding the operation of the trust must be confirmed before the trustee accepts the policy.

Most trust agreements are silent about these complexities and give discretion to the trustee. As a practical matter, the trustee can communicate with the grantor’s attorney to clarify uncertainties about trust operation in the context of the trustee’s TOLI-specific risk management procedures. For a national bank, OCC9.6b sets out standards of identifying asset acceptance risks. If a trustee lacks expertise in evaluating the risk of premium adequacy, or if the proposed policy does not meet the trustee’s criteria for product suitability and carrier selection, the trustee has an *affirmative* duty to inform the grantor and recommend restructuring the policy.

Policy management. If a trustee subsequently determines that it lacks the expertise to evaluate the premium adequacy risk or that the asset is inappropriate for the objectives of the account and the needs of the beneficiaries, the trustee has an *affirmative* duty to inform the beneficiaries and recommend restructuring to achieve a suitable level of risk and expected return in accordance with OCC Reg 9.6c¹¹. Unless otherwise agreed, grantors and beneficiaries may reasonably assume, at the time the trust policy is accepted and at all times during which the trustee maintains management control, the trustee has determined that (1) scheduled premiums are adequate to sustain the policy for the insured’s lifetime, and (2) the insurance product and the underwriting carrier are suitable to successfully achieve the trust’s objectives under the trustee’s risk

management procedures.

Life Insurance: A real world primer

Because flexible premium non-guaranteed policies anecdotally represent at least 35% of in-force TOLI policies and because trustees have accepted the responsibility to actively manage the risk of premium adequacy, a trustee must understand the nuances of a policy that does not have a defined (i.e. guaranteed) premium.

Universal, variable universal, and adjustable life insurance products are prime examples of flexible premium policies, meaning the policyowner has a contractual right to pay essentially “what he wants, when he wants.” All such policies have a guaranteed schedule of insurance charges but allow the insurer to charge *less* than the guarantees when the insurer’s management deems it appropriate to the carrier’s experience, marketing and profit goals. Some policies (universal and adjustable life) have a guaranteed interest crediting rate, while allowing the insurer to credit *more* than the guaranteed rate when management deems it appropriate to the carrier’s experience, marketing, and profit goals.

In the case of *whole life* insurance, the carrier stipulates a premium for which it will guarantee coverage. In contrast, it is the responsibility of the flexible premium policy owner to pay sufficient premium into the policy to maintain a positive account value balance. Because most trustees and professional advisors

⁸ “Illustration Questionnaire,” Society of Financial Service Professionals, Bryn Mawr, PA.

⁹ The Society of Actuaries, “Final Report of the Task Force for Research on Life Insurance Sales Illustrations under the auspices of the Committee for Research on Social Concerns,” © 1992.

¹⁰ 2d edition (McGraw-Hill, 2002)

do not have the tools or skills to make those calculations, they mistakenly rely on the policy illustration for this calculation. The dilemma, though, is that the illustration assumes *constant* interest rates or investment returns and a *constant* schedule of insurance charges, whereas market volatility dictates *actual* interest/investment returns, and incurred claims and changing profit targets dictate *actual* future insurance and expense charges.

Consider the trend of interest rates over the past 25 years and the resulting portfolio income of a life insurance company. Ten-year government bond rates (a reasonable proxy for an insurer's investment portfolio supporting this type of policy) peaked at 15.32% in September 1981 and bottomed at near 3.33% in June 2003.¹² As a result, universal life crediting rates have generally declined from a high of 14% in the early 1980s to guaranteed minimums of 4% in 2004 and 2005.

Relating this trend to premium adequacy, assume that a *flexible premium* was calculated in 1982 at an assumed 14%. If high inflation and bond interest rates had continued, the premium might have been sufficient. But, if the flexible premium was not adequately adjusted upward as rates dropped, the flexible premium could not possibly sustain the policy as originally illustrated.

Indeed, most flexible premium policies sold through the late 1990s under an illustration system that calculated a "just sufficient" premium based on then-current assumptions, will now reflect an account value inadequate to sustain the policy to life expectancy -- unless the premium was increased.

Sample case – Expectation versus reality. The carrier illustration for a level death benefit \$10 million vari-

able universal life policy purchased in 1995 and underwriting a 63 year old male and his 61 year old wife suggested an annual scheduled premium of \$99,000 to sustain the policy to age 100 and beyond, based on a "conservative" 10% long-term investment return for an all-equity allocation. (See Exhibit 1.)

While investment returns often exceeded this 10% benchmark from 1995 through 1999, the all-equity allocation suffered significant negative returns between 2000 and 2003. As a result, the 2005 Accumulation Account Value is \$300,000 less than the originally illustrated \$1,339,414. Since the \$10 million death benefit is defined as the accumulation value plus whatever amount of *net amount at risk* is necessary to equal the death benefit, a decline in account value causes an automatic increase in pure insurance accompanied by the associated increase in insurance expense charges.

This combination of lower investment returns and increased insurance costs can cause the policy to lapse in as few as five years at ages 75+. An *in force* illustration suggests that the policy should still be sustainable into the couple's late 80s; however, joint lives mortality tables indicate that in more than 50% of similar-aged couples, at least one spouse will still be alive into his or her 90s. Anticipated improvements in medical care could extend practical life expectancy another three to eight years. Corrective action is needed. (See Exhibit 2.)

A corporate Trustee accustomed to managing fixed income and equity investments as well as using credible portfolio modeling knows that investment returns are *never* constant. Based on modern portfolio theory, policy illustration methodol-

ogy is an inappropriate basis for a trustee's decisions. Considering the volatility of an all-equity portfolio over the last 40 years, Exhibit 3 indicates only a 50% probability the policy will successfully be sustained to age 100. The earliest age predicted for lapse, based on a series of 1000 randomly generated trial illustrations, occurs at the wife's age 80. Because the policy was purchased to be sustainable at least to age 100, most trustees, grantors, beneficiaries, and their professional advisors would consider a 50% chance of failure to be an unacceptable risk. We find that most fiduciaries use 90-100% as a preferred probability of success and 75-80% as a minimum before considering restructuring. To achieve a 90% probability to age 100, the annual premium beginning 2005 should be doubled to \$200,000.

This unpleasant surprise (and its unfortunate gifting implications) can be avoided by clarifying the grantor's premium risk tolerance, by confirming the trustee's evaluation standards at the time of trust and policy are accepted, and by calculating the risk-appropriate premium. If this methodology had been used in 1995, the scheduled annual premium would have been \$155,000; such a premium would likely have required little - if any -

¹¹Periodic Account Reviews. "At least once during every calendar year, a bank shall conduct a review of all assets of each fiduciary account for which the bank has investment discretion. The review must determine whether account assets are appropriate, individually or collectively, for the account. The review should consider the account's investment policy statement, analyze investment performance, and reaffirm or change the investment policy statement, including asset allocation guidelines. If certain assets are no longer appropriate for the account, those assets should be replaced consistent with prudent investment practices. Items to consider include account objectives, the needs of the beneficiaries, and income tax consequences."

¹²Financial Forecast Center, LLC "10 Year Treasury Constant Maturity Rate" <http://forecasts.org/data/data/GS10.htm>

EXHIBIT 1
Initial Policy Illustration

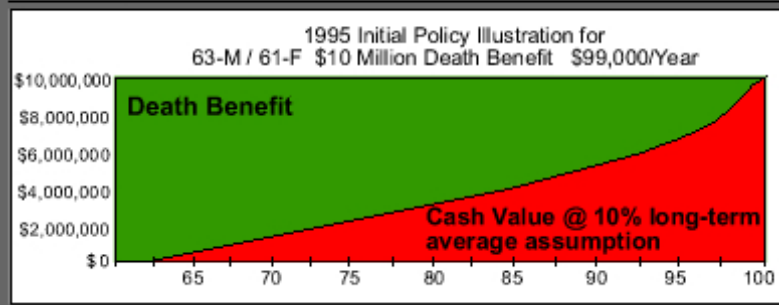
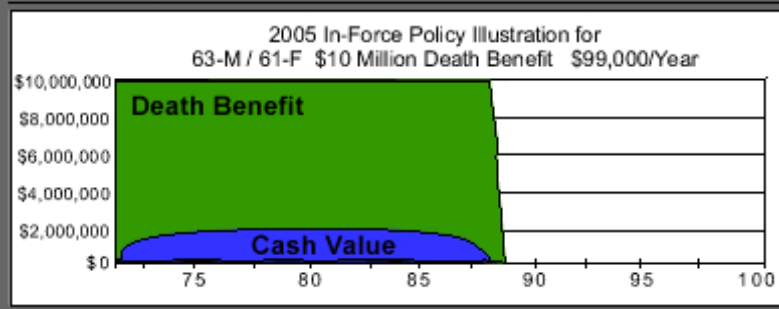


EXHIBIT 2
In-Force Policy Illustration



modification in 2005 because “down market” experience was factored into the forecasting model at the outset.

Exhibit 4 shows the value of determining an appropriate premium and the importance of active management. Over time, the higher premium projects death benefits and cash accumulation in excess of initial death benefit. If down market conditions are experienced, the risk of premium adjustment is reduced, and any adjustment amount that is necessary should be lower. If the policy performs consistently with its benchmark but the excess death benefit is not needed, the death benefit option can be changed and/or scheduled premiums reduced. These routine considerations of active policy management require credible evaluation of premium adequacy, which is not available using carrier illustrations.

Additional issues

Policy restructure - TOLI rescue.
As noted earlier, 35% of existing TOLI policies are flexible premium non-guaranteed policies, and most

are significantly under-performing their benchmark values for acceptance. To replenish the Accumulation Account, scheduled premiums must be increased, which requires a determination of the premium adequacy risk as well as formal communication with trust beneficiaries and, if appropriate, their professional advisors.

Clients and their advisors who are contemplating policy restructuring should consider contemporary policy options, which in turn often depend upon the age and health of the insured. For example, it may be more effective from the standpoint of ongoing premiums/gifts to consider exchanging account values (assuming the insured is insurable on a favorable basis) into a “no-lapse” guarantee universal life policy. At best, no-lapse guarantee policies provide the advantage of an attractively low, guaranteed premium, and seemingly offer the best features of whole life (guaranteed premiums) and universal life (lower premium outlay).

While such policies may well resolve the crisis of a failing policy,

it’s critical that the trustee understand what the policy is and *is not*. It *is* equivalent to a level premium term insurance policy with little or no cash value. It is *not* likely to develop any more death benefit than the stipulated death benefit, long-term cash values will be minimal or non-existent, and because these “secondary guarantees” may produce a strain on the carrier’s reserves, only insurers with very strong financial strength ratings should be considered. These trade-offs require confirmation of current trust objectives and product suitability by the trust beneficiaries.

Using the facts of our earlier sample case, the 2005 exchange value of \$1,039,414 will secure a guaranteed \$10 million death benefit for a guaranteed annual outlay of roughly \$140,000, assuming both insureds can be favorably underwritten. Restructuring requires less premium and eliminates the need for active policy management.

On the other hand, trust objectives can change and a TOLI policy may no longer be needed. For insureds age 65 and older, a life settlement should be considered as an alternative to surrendering the policy or continuing premium payments. A life settlement involves the sale of a life insurance policy for fair market value in the secondary market. The proceeds of a life settlement can be reinvested in traditional fixed income and equity investments or can be used to purchase a new life insurance policy, or a combination of both.

Finally, TOLI rescue should prioritize larger death benefit policies, as they are frequently purchased based on a spreadsheet comparison to select the lowest illustrated premium. Enlightened common sense suggests the lowest premium has the highest probability of under-performance. Enlightened common

sense also suggests that using an illustration to fix a problem created by an illustration simply “adds fuel to the fire”. Restructuring requires expertise in evaluating premium adequacy risk and, if appropriate, efficient access to contemporary guaranteed and non-guaranteed life insurance products as well as institutionally funded life settlements.

Breach of trust. “Hold harmless” is frequently suggested as a defense to a claim of breach of fiduciary duty. Any trust officer with a CTFA designation or TOLI manager with either a CLU designation or life insurance industry training knows that non-guaranteed illustrations are not credible for making predictive performance decisions *and* do not evaluate the adequacy of the premium. If a trustee had knowledge of a fact and failed to take appropriate action based on its ownership of the policy, is the trustee acting with the care, skill and caution described in the prudent investor rule and OCC Reg. 9? Stated differently, can a skilled trustee reasonably use ignorance, lack of experience and/or failure to be informed as a defense to an allegation of breach of trust in today’s environment?

TOLI disputes are settled and not litigated for reasons discussed earlier. As a practical matter, disputes should be resolved using credible analysis, not illustration methodology.

Conclusion

A ‘best practices’ standard of care for managing TOLI is long overdue. The grantor, beneficiaries, and professional advisors all expect 100% premium adequacy. A trustee’s acceptance of an insurance trust and non-guaranteed policy implies TOLI-specific special facilities. If such facilities and expertise are not available, they can be readily accessed to provide the expected standard of care. Alternatively, a

trustee can recommend restructuring to a guaranteed death benefit policy and monitor carrier ratings. This article’s focus on a trustee’s prudent TOLI fiduciary risk management process, and specifically product suitability, is not intended to suggest the wholesale replacement of life insurance is appropriate.

The unmanaged TOLI liability is real. Past TOLI practices created the problem. Insurance trust files likely document an imprudent decision-making process. Financial institutions are frequently described as consensus decision-makers – “if they see the issues, they will act”. Failure to act is not an option. Attractive and cost-efficient contemporary tools are readily available to resolve documented insurance trust file problems.

In light of today’s risk management era, the Comptroller of the Currency’s Handbook, *Personal Fiduciary Services*, clarifies: “The board and senior management are responsible for ensuring that the fiduciary risk management system includes sound internal controls and an adequate and effective audit program.” A “best practices” TOLI risk management standard must demonstrate a process of market conduct that takes into account modern portfolio theory, contemporary life insurance practices, Patriot Act requirements to “know your client”, and Sarbanes-Oxley requirements for internal risk management systems. Proper TOLI risk management should minimize complaints and threatened litigation.

Practice Notes

The single most important principle to understand is implementing a ‘best practices’ standard is that carrier illustrations do not predict future policy values and certainly do not evaluate the risk of premium adequacy.

EXHIBIT 3 In-Force Opportunity Probability Analysis

2005 In-Force Opportunity
Probability Analysis
(\$99,000 / year assessed with
randomized returns)



Policy Performance Statistics

Does not sustain: 499 50%
Earliest age policy lapses: 80
Sustains: 551 50%

EXHIBIT 4 In-Force Opportunity Probability Analysis

1995 Initial Opportunity
Probability Analysis
(\$155,000 / year assessed with
randomized returns)



Policy Performance Statistics

Does not sustain: 113 11%
Earliest age policy lapses: 87
Sustains: 887 89%

Avg DB @ Life Expectancy: \$31,900,000
Avg DB @ Age 100: \$55,200,000