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Life Insurance Policy Audits: Dispute Defensible Best Practices
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Adapted from the Life Insurance Policy Audit article series that originally appeared in the QuickRead (http://www.QuickReadBuzz.com) with permission from the National Association of Certified Valuators and Analysts™ and the Consultants' Training Institute™.

Many articles have been written about how to properly analyze a life insurance policy to determine its value. For a number of financial transactions, establishing an acceptable value for a life insurance policy is a very important need. However, the analysis needed for the majority of life insurance policies is not to ascertain value, but to determine viability.

Twenty-four years ago my partners and I developed a unique process for evaluating the viability of life insurance policies. Since that time, this process has been used by a select group of financial advisors, attorneys and accountants for the benefit of their clients.

At no time during this twenty-four year period have we seen such a dramatic rise in the need for this form of analysis, as in the past several years. Since the 2008 financial crisis several factors have led to an exponential increase in potential policy failures. This then begs for widespread consumer education and use of processes to evaluate policy viability.

For these reasons, in 2014 we established a consumer education website, www.PolicyAudits.com and a division of our company solely dedicated to auditing life insurance policies.

Avoiding Catastrophe

A successful outcome for ownership of most life insurance policies means the death benefit is paid at the insured's death, having required no more premiums than anticipated, and that the IRR (internal rate of return) at death was reasonably as good or better than other options in the marketplace.

In contrast, an unsuccessful outcome is a surprise which makes the result less desirable than previously stated. Examples:

- A policy that lapses before the insured's death because a premium was paid early.
- Filing a death claim only to learn that the carrier has lost all records of beneficiary designations and changes that have taken place over the life of the policy.
- Learning that your tax-free exchange under Section 1035 triggered $1,000,000+ of taxable ordinary income recognition.
- After owning a policy for just five (5) years, learning that your remaining premium payments have increased by 100%.
- Fifteen years into a life insurance funded SERP (Supplemental Executive Retirement Plan) discovering that your total outlay exceeds the accrued account values of the key employees you attempted to benefit.

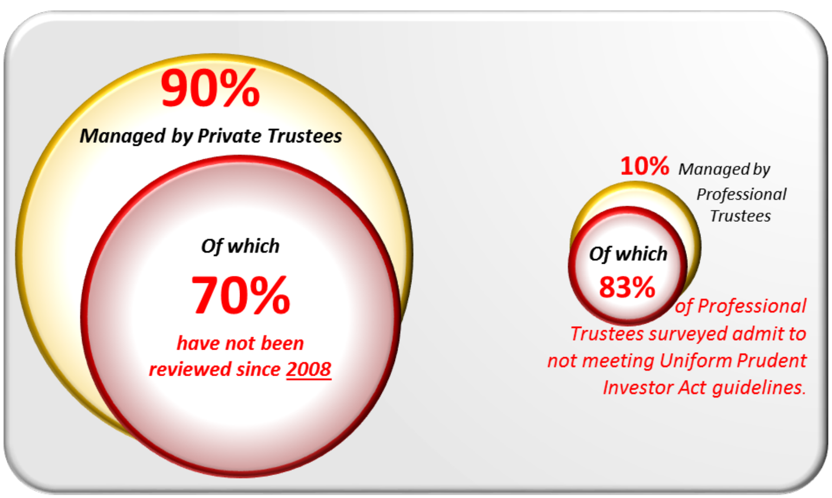
- Acting in good faith as trustee for a friend, client or family member, only to be sued by the trust beneficiaries because a greater amount of death benefit could have been received for the premiums paid by the trust.

Inattention by policy owners

It has been our belief that policy owners, including major corporations, have not given their life insurance policies the same treatment they might extend to other financial assets. To understand the extent of this behavior, PolicyAudits.com commissioned a national survey conducted by Harris Poll. The survey was conducted in May 2014 among holders of privately purchased life insurance policies. Sadly, our fears were confirmed by the survey.

- 29% said they have not reviewed their policy since they first acquired it.
- 60% think the policy terms are "set in stone".
- 60% believe their policy benefits are guaranteed forever.
- 44% do not view their life insurance policy as a financial asset or investment, like their 401(K).
- 47% say that their insurance agent has never encouraged them to review the performance of their policy.

A significant amount of life insurance is owned by trusts. The trustees are often family members or business associates and sometimes professionals in a bank's trust department. Unfortunately, the statistics for trustees meeting their fiduciary obligations for monitoring the performance of the policies held by the trust is no better than those realized in the Harris survey. The following chart illustrates the magnitude of this problem of inattention.



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Insurance industry issues

A multitude of problems systemic to the process of buying and maintaining life insurance plagues the insurance industry. Many have existed for decades; some have emerged due to the financial crisis.

The life insurance industry has long held the belief that agents are necessary to sell life insurance. Unfortunately, the number of agents has decreased since the financial crisis. At the same time, policy choices have increased and become more complex, with the changes occurring more frequently. The average shelf life for carrier products is now only 24 months.

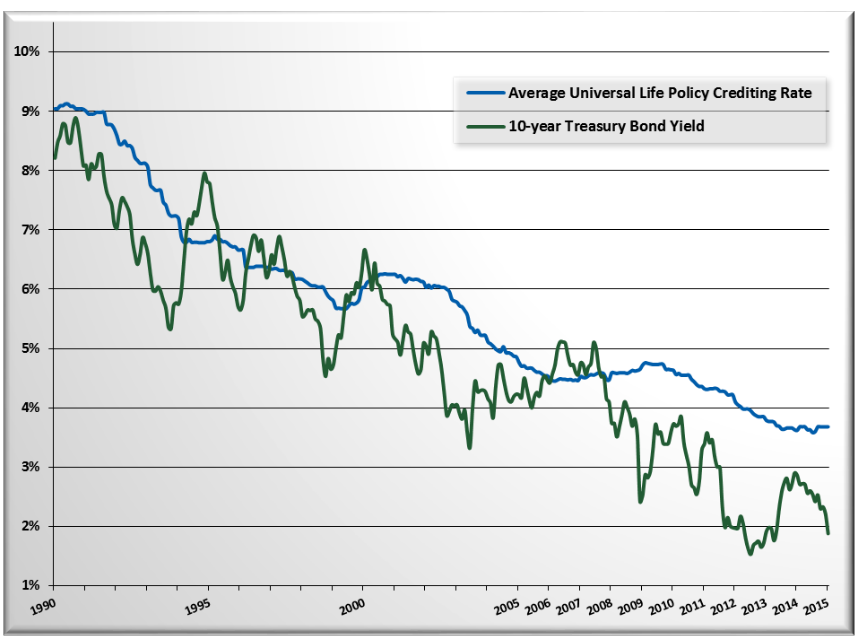
That agents do not encourage policy reviews, is not purposeful or by design. It is often because of their simple lack of knowledge about a complicated product's intricacies.

The carriers themselves have not been proactive in helping their customers review policy performance. Annual policy statements sent by almost all carriers make policy performance difficult if not impossible to understand. Adding to the problem, is the fact that many carriers reduced their policy service personnel following the financial crisis.

If these issues were not worrisome enough, four major insurance carriers recently announced "significant" increases in the mortality rates charged to non-guaranteed universal life policies. Although the reasons for this egregious behavior vary, the result is the same: policies previously funded properly, now require huge additional payments to maintain coverage for the life of the insured. Some of the increases were very targeted, affecting insureds age 70 and over disproportionately.

Unfortunately, there have also been multitudes of misleading sales practices throughout the industry.

- Under-funding – Many policies are funded only to maintain coverage for short periods of time, when the need is long-term. If the underfunding continues for too long, the cost of correction may be excessive. In fact, it is estimated that 35% of all policies issued between 1985 and 2005 will lapse before the insured dies.
- Unrealistic interest and dividend projections – Due to the type of financial assets held by carriers, anticipating declines in policy crediting rates (see chart) did not require genius.



- Agent bias – Some agents are required to place most or all of the policies they write with a single carrier. These career agencies often have contractual disincentives for agents to disclose policy underperformance that might risk replacement of the policies they have written.

These myriad issues have led to numerous failures for policy owners. If left unaddressed, the rise in the rate of these failures may threaten the viability of life insurance as a cornerstone of the planning for many a business and family.

Early Payments may be worse than paying late

Some clients are quite conscientious about paying premiums. So much so, that they often pay premiums before the carrier has generated the premium notice. Who would think that such a prudent bill paying process could wreak havoc? Many Guaranteed Universal Life contracts issued prior to 2012 include premium accounting clauses that could trigger a significant loss of guarantees if premiums are paid *before* the due date, particularly in the early years of the contract.

One client had a $20 million policy through a major carrier. The original, carrier generated, illustration showed that this policy required ten annual payments to guarantee the coverage through age 115. When we audited this policy in the tenth (and last) year, we discovered that although the client had made all of the payments on time, the guarantee had been reduced to age 96. Our audit process includes obtaining a premium history and here we found the culprit. The second premium had been paid early, potentially costing this client 19 years of guaranteed coverage.

We worked with the carrier and were able to have the year two payment reapplied correctly. This restored the lost 19 years of guaranteed benefits.

A $1 Million Tax Blunder – Almost

We recently audited a Whole Life policy for a client planning to use the cash value for retirement income. His insurance agent recommended exchanging his Whole Life contract for a new Indexed Universal Life policy.

As they say, the devil is in the details, and the detail in this case was the policy's tax basis. Neither the client, who was fairly sophisticated regarding taxes, nor the agent had inquired about the tax basis. For our audit process however, this is S.O.P.

All involved had assumed the contract could be exchanged tax free – a common misconception. This exchange would have actually resulted in the new policy being deemed a MEC (Modified Endowment Contract). The future income generated by the current cash value of close to $1million would have been taxable as ordinary income.

After the audit, the client retained his Whole Life contract, avoiding a serious mistake.

Premium Increase

A young surgeon purchased a policy in 2010 to help replace his income for his family in the event of his death. The policy was originally projected to require 10 payments before the dividends (theoretically) would offset future premium payments. Our audit surprised this doctor however. After five years of payments, there were still 10 more payments projected, due to dividend reductions. Five remaining payments became ten; a 100% increase. And, no guarantee that additional payments won't be required.

Our suitability review also revealed a surprise, showing that the policy was not owned by the trust the doctor's attorney drafted, and as such would be reduced by estate taxes before the remainder could be used to support his children.

This policy was replaced with one owned by the doctor's trust that has a death benefit 25% greater than the previous policy and is guaranteed for life with the same 10 payments.

A Medical Issue Made Irrelevant

Due to excessive cost, a business owner client had half the coverage his buy/sell agreement required. Examining his medical history, our audit team could see no reason why carriers were treating him adversely. Upon further review of his medical records it was learned that he had a heart condition, and no recent testing to prove the condition was stable.

We recommended that he return to his doctor to have additional testing done, which resulted in proving the condition to be benign. With this new data we were able to double his coverage while reducing his costs by 10%.

Dispute Defensible Best Practices

Recently there have been a number of lawsuits against trustees of ILITS (Irrevocable Life Insurance Trusts). Hold harmless clauses of trusts and liability limits legislated by states to protect trustees are being challenged. Most trustees have accepted their role to help a friend or family member (the trust grantor). Typically the only responsibilities discussed with non-professional trustees are those of managing assets for the beneficiaries, *after* the death of the grantor. Rarely are lifetime policy management responsibilities explained by the grantor or the drafting attorney. This is not surprising, given that even professional trustees admit to falling short on their responsibilities.

So how does a trustee protect against an unanticipated suit by beneficiaries? Private trustees in most states are required to follow the guidelines of the Uniform Prudent Investor Act (UPIA). Corporate trustees must follow the OCC's (Office of the Comptroller of the Currency) Handbook on Unique and Hard to Value Assets.

UPIA compliance is determined by establishing and following a prudent process, not by the performance of the trust's portfolio. The Act provides guidance on the components of a prudent process:

- Monitor performance of trust assets.
- Investigate appropriateness of holdings.
- Manage assets to minimize costs and maximize benefits.

The Life Insurance Excerpt of The OCC's Handbook requires that fiduciary banks have risk management systems and reviews that address the following with regard to policies:

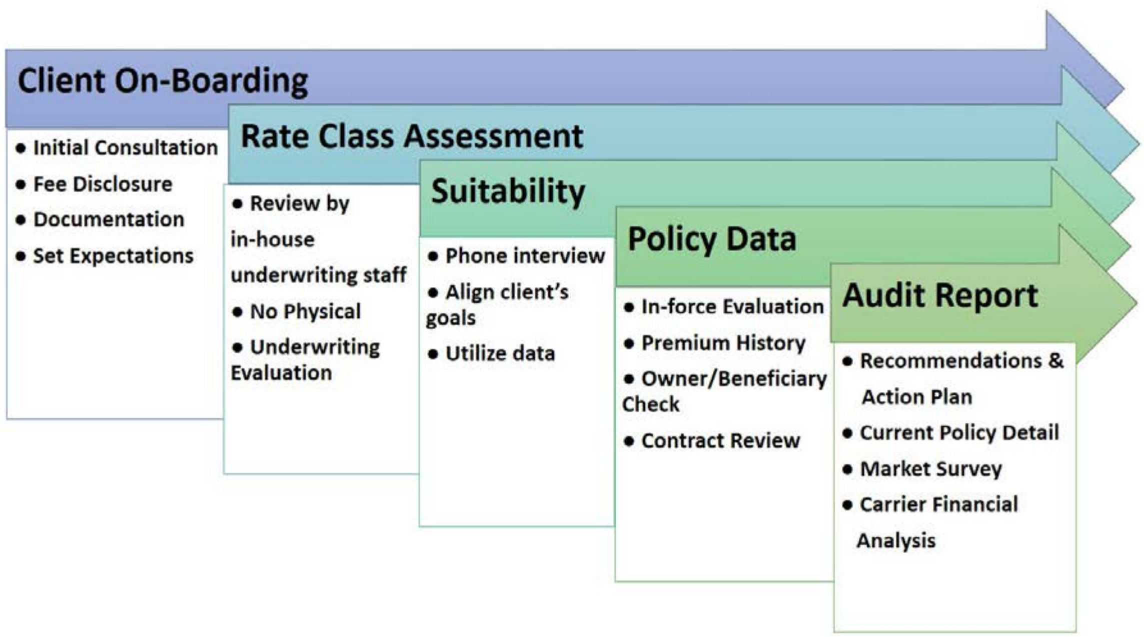
- Sufficiency of premiums.
- Suitability of the insurance policy.
- Carrier financial condition.

The Dispute Defensible Process: A *Comprehensive* Policy Audit

A process that meets the primary fiduciary responsibilities of both the UPIA and OCC goes a long way toward establishing a defense in the event of a dispute. A *comprehensive* policy audit, updated periodically, fulfills this obligation. More importantly, if shared with trust beneficiaries, policy audits may help to avoid disputes. Here are the primary elements of a comprehensive policy audit. Note how they align with the UPIA's and OCC's guidelines:

- Performance review – Establishes sufficiency of premiums for desired objective.
- Suitability review – Assures policies are appropriate to meet objectives for beneficiaries.
- Underwriting-based market survey – Provides cost and benefit comparative analysis based on client medical and financial underwriting assessment. Also provides benchmarking of returns versus alternative investment opportunities.
- Carrier financial review – Ratings and data from reactive and proactive rating services for the in force carrier and those utilized in the comparative analysis.

Comprehensive Policy Audit Process



Policy audits can help to assure a successful policy outcome by proactively monitoring both the contract status and the owner's goals and objectives. It can help to avoid disputes with beneficiaries. It can also provide the foundation for a strong defense if a dispute does occur. It will not however provide these benefits if it is not *comprehensive* and carefully crafted.

Comprehensive Policy Audits – Preliminary steps

There are three important preliminary steps to complete before preparing a policy audit report:

- Rate class assessment
- Suitability review
- Gather policy data

Rate class assessment

Everyone's medical history changes over time. It is important to assess what effect the changes for a particular client will have on how they might be treated in formal underwriting by carriers. This can limit or expand opportunities to minimize costs. If a client's rate class has worsened, the policy being audited may be significantly more cost effective than alternatives. In contrast, if a prior condition is now treated more favorably by carriers, or has become benign (see Part 2) more cost-effective opportunities may present themselves.

Rate class assessment begins with the client completing a medical questionnaire. An experienced underwriter speaks with the client to determine if the information provided is sufficient, or warrants further investigation. If additional information is needed, the client's medical records (with their authorization) may be ordered and reviewed. No physical examination is necessary at this stage, nor are any tests needed.

Informal inquiries are made to carriers for tentative for rate class assessment. This informal process has proven to be to be more than 90% accurate in determining the probable rating class for clients prior to taking a physical, blood tests or going through formal underwriting.

Suitability Review

If there is a single most important element of a policy audit, it is the suitability review. If an audit focuses on policy cost without considering its suitability for stated objectives, it may be without merit.

In the investment industry, the SEC (Securities Exchange Commission) and FINRA (Financial Industry regulatory Authority), make suitability the most important consideration in recommending an investment. For trust owned life insurance, the OCC specifically references suitability and the UPIA refers to appropriateness, when discussing a trustee's fiduciary responsibilities.

A questionnaire and telephone interview are used to determine objectives for the coverage. The client may also offer documents for review:

- Insurance trust
- Divorce settlement agreement
- Buy/sell agreement

Information gathered is reviewed to determine the suitability of the coverage for the client's objectives. If necessary, and with the client's authorization, their attorney may be consulted for clarification of specific points.

Gather Policy Data

Gathering the *right* policy data is integral to minimizing costs, maximizing benefits, determining suitability and creating a plan of action. Not surprisingly, few people obtain the necessary information for a full evaluation of a life insurance policy. Mostly this seems to be due to a lack of understanding regarding how different pieces of information can become important throughout the analysis. Sometimes it is just because it is quicker to gather only the basic information.

Some carriers have moved to automated policy service systems which can only address the typical policy owner requests. Too often live service representatives are under-trained, with little ability to navigate their company's computer records to access important information. Some of the oft-missed information needed for a comprehensive audit includes:

- Extended maturity (coverage beyond age 95 or 100) and requirements to secure the same. Today it is a reality that our clients may live past age 100.
- Riders. The audit report discussed later in this article was prepared for a policy with a "cost-of-living" rider, which significantly impaired its cost-effectiveness.
- Premium history
- Dividend option utilized
- Cost basis & gain position. The premium history, dividend option and cost basis were pieces of information that saved one client $1,000,000 in unnecessary tax liability (see part 2). The cost basis raised a red flag, the premium history explained the problem and a proposed policy exchange was halted, avoiding the tax recognition.
- In force illustrations. Typically multiple illustrations are obtained to determine various funding options to maintain and/or improve coverage.

Audit report components

Only after assessing the client's rate class, reviewing suitability of the coverage and gathering data for the policy, will the audit analysis begin. At this point the pieces of the puzzle come together to form a picture that will make up the audit report and action plan. What follows is taken from an actual policy audit report, with identifying information for the client and carriers removed.

Executive Summary

The summary below is for a policy maintained as a requirement of a divorce settlement agreement. The owner's stated objective could be summed up as "maximize cost effectiveness". These facts, disclosed as a part of the suitability review, were integral to helping this client.

The audit determined that the cost-of-living rider, due to no automatic mechanism to increase the outlay, was eroding the policy's value and reducing its cost-effectiveness. Guideline premium limitations prohibited the premium from being increased enough to maintain the coverage to maturity.

STATED GOALS

- Ensure that life insurance required under Settlement Agreement is as cost effective as possible.

RESULTS

- As a result of increases to the existing policy triggered by the Cost of Living rider, the current death benefit ($497,712) exceeds the $386,459 amount stated in the Settlement Agreement.
- The current premium ($5,199) is only projected to maintain the policy for 11 more years (Age 73).
- Due to Guideline Premium limitations, it is not possible to fund the policy to maturity.
- Based on preliminary underwriting feedback, it may be possible to reduce the overall cost of the required coverage.

SUGGESTED MODIFICATIONS

- Reduce the ABC death benefit to $386,459.
- Transfer the policy cash value to XYZ's Guaranteed Universal Life policy (guaranteed level premium to Age 95, annually increasing premiums thereafter).

Multiple scenarios to improve cost-effectiveness were explored for the existing policy and with potential replacement carriers (determined as a result of the rate class assessment). The most cost-effective was "Alternative #1" in the chart below. Its combination of premium and coverage for life, could not be matched by the current policy.

	ABC		ALTERNATIVE #1	ALTERNATIVE #2
	As Is	Modified	XYZ	XYZ
Total Face Amount:	497,712	386,459	386,459	386,459
Death Benefit Option:	Level	Level	Level	Level
Illustrated Premium:	5,199	10,630	8,201	10,630
Paid to Age:	Age 74	Age 82	Lifetime	Age 98
Policy Lapse				
Current Rates:	Age 74	Age 89	Lifetime Coverage	Age 98
Guaranteed Rates:	Age 67	Age 76	Lifetime Coverage	Age 88

If the client decides to pursue recommended modifications (in this case Alternative #1) an action plan has been provided to guide them.

ACTION PLAN

- Confirm that the Settlement Agreement does not limit the ability to reduce the current death benefit and/or transfer the policy to a different insurance carrier.
- From the plan options, choose the one that best fits your needs.
- Satisfy the underwriting requirements requested by the insurance carrier.
- Coordinate anticipated payment(s) with gift tax and or lifetime exclusion rules.
- Owner takes delivery of the policy, signs required delivery documents, and pays the initial premium (if required).

Performance summaries

A performance summary for the subject policy is prepared. Such summaries are also prepared for each modification or alternate scenario in direct comparison to the subject policy. As seen in the chart below, policies are analyzed at life expectancy, and five years before and after (in this case ages 82, 87 & 92). While this chart is based on projected (non-guaranteed) values, in another chart, guaranteed performance is also reviewed.

The right hand columns of the chart show the IRR (rate of return) at death. Since life insurance death benefits are generally received free of income tax, an approximation of a pre-tax equivalent, is given for comparison to other investment opportunities, which is illustrated later.

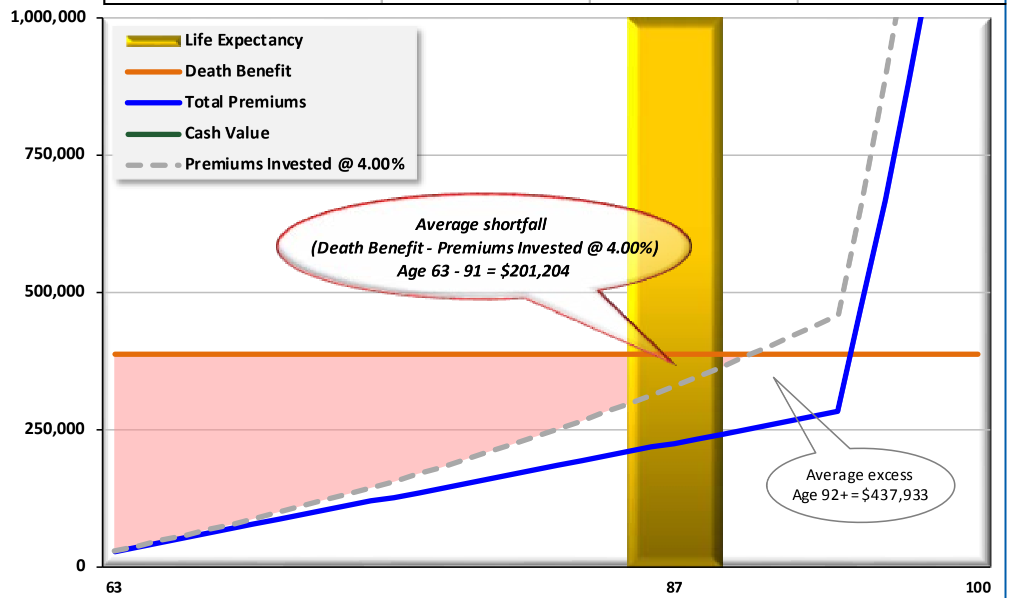
PERFORMANCE (PROJECTED)	Mortality Rate	Annual Premium	Total Cost[1]	Death Benefit	Net Policy Leverage[2]	Cash Value	Return at Death Net	Return at Death Pre-tax[3]
Year 19 / Age 82								
XYZ ($8,201/Life)	**27.1%**	8,201	175,502	386,459	2.20	0	6.7%	10.4%
ABC ($10,630/19 yrs)		0	213,793	386,459	1.81	153,093	5.0%	7.7%
Year 24 / Age 87								
XYZ	**48.1%**	**8,201**	**216,507**	**386,459**	**1.78**	**0**	**4.0%**	**6.2%**
ABC		**0**	**213,793**	**386,459**	**1.81**	**79,926**	**3.6%**	**5.5%**
Year 29 / Age 92								
XYZ	**73.5%**	8,201	257,512	386,459	1.50	0	2.4%	3.7%
ABC		*lapsed*	224,423	*lapsed*	*lapsed*	*lapsed*	n/a	n/a

1 Total cost includes $27,884 surrender value of existing policy.
2 Amount of Death Benefit purchased by each $1 of Total Cost
3 Pre-tax return required on premium outlay to equal Death Benefit (assumes 35% income tax rate).

Policy detail analysis

Values (death benefit, premiums and cash value) for the subject policy, modifications to the same and alternative options are graphed to show their progression before, during and after the life expectancy range (-5 years to +5 years), represented by the gold column in the below chart. This is compared to an arbitrary investment earning 4.0%, to determine any shortfall or excess vs. the death benefit.

XYZ, PROJECTED VALUES	Age 82	Age 87	Age 92
Death Benefit:	386,459	386,459	386,459
Total Cost:[1]	175,502	216,507	257,512
Cash Value:	0	0	0
Net Leverage:[2]	2.20	1.78	1.50
Return at Death			
Net:	6.7%	4.0%	2.4%
Pre-tax:[3]	10.4%	6.2%	3.7%

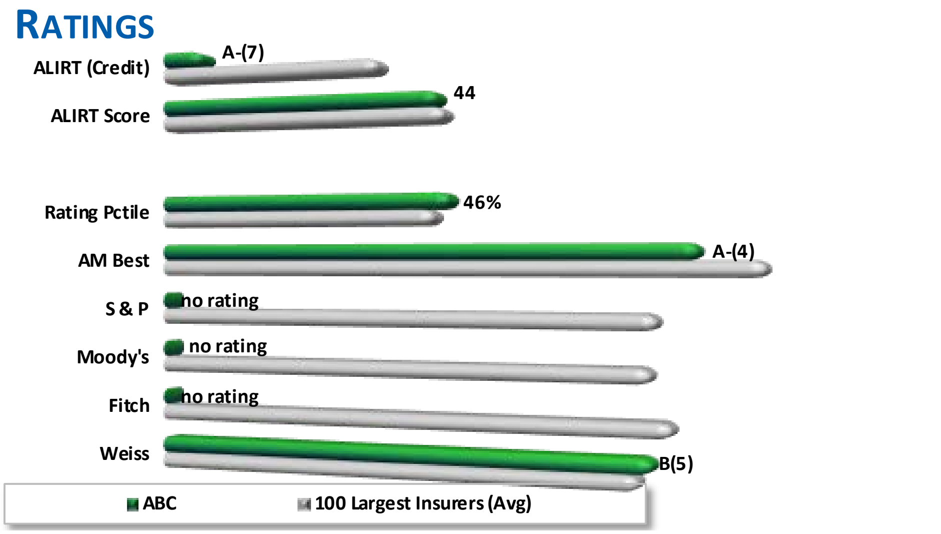


Carrier ratings and financials

A synopsis is provided of the financials of each carrier mentioned in the report, and compared to the average for the 100 largest life companies, representing over 80% of total industry invested assets. Ratings from the major rating services is given along with ALIRT, a rating service usually familiar only to insiders of the insurance industry.

ALIRT is a proactive service monitoring the financial performance, quality and stability of life insurers for institutional stake-holders. ALIRT uses historical comparative analysis, rating agency biases, and benchmarking ranges to provide a credit rating and financial performance score. Continual monitoring assures notification if significant changes occur.

CARRIER RATINGS AND FINANCIALS



ABC Life Insurance Company

Time Series ■ Five Years and Current Year

	2003	2004	2005	2006	2007	6 Mo's 2008
TIER 1 - INVESTMENT PERFORMANCE						
Max. Score: 13	◆ INVESTMENT LEVERAGE, CREDIT, AND DEFAULT RISK					
COMPANY	6	6	6	5	3	2
INDUSTRY	7	8	8	8	8	8
Max. Score: 9	■ INVESTMENT INTEREST RATE RISK					
COMPANY	4	4	3	4	3	3
INDUSTRY	5	5	4	5	4	4
Max. Score: 6	▲ MARKET RISK					
COMPANY	5	6	6	3	0	0
INDUSTRY	3	2	2	1	1	1
Max. Score: 12	● INVESTMENT RESULTS					
COMPANY	2	0	0	2	2	1
INDUSTRY	6	5	4	6	5	2
TIER 1 ALIRT SCORE (Maximum Score = 40)						
COMPANY	17	16	15	14	8	6
INDUSTRY	21	20	18	20	18	15
TIER 2 - OPERATIONAL PERFORMANCE						
Max. Score: 17	CAPITAL GROWTH AND BUSINESS LEVERAGE					
COMPANY	10	14	13	12	10	10
INDUSTRY	10	12	12	12	13	11
Max. Score: 11	PROFITABILITY AND EARNINGS					
COMPANY	9	6	7	3	2	1
INDUSTRY	8	9	6	6	8	6
Max. Score: 7	REVENUE VITALITY AND LIQUIDITY					
COMPANY	5	5	3	2	2	2
INDUSTRY	4	6	5	5	5	4
TIER 2 ALIRT SCORE (Maximum Score = 35)						
COMPANY	24	25	23	17	14	13
INDUSTRY	22	27	23	23	26	21

	2003	2004	2005	2006	2007	6 Mo's 2008
TIER 3 - GROUP PERFORMANCE	GROUP: ABC Corporation					
Max. Score: 2	COMPANY AS % OF GROUP					
COMPANY	1	1	1	1	1	1
INDUSTRY	1	1	1	1	1	1
Max. Score: 5	REVENUES & LIQUIDITY					
COMPANY	5	5	4	3	3	3
INDUSTRY	4	5	5	5	3	3
Max. Score: 4	FINANCIAL LEVERAGE, COVERAGE & PROFITABILITY					
COMPANY	4	4	2	4	2	0
INDUSTRY	2	4	4	3	3	1
TIER 3 ALIRT SCORE (Maximum Score = 11)						
COMPANY	10	10	7	8	6	4
INDUSTRY	7	10	10	9	7	5
TIER 4 - SIZE & RATINGS						
ALIRT	AAA	AAA	AA+	AA+	AA-	AA-
MOODY'S	Aa2	Aa2	Aa2	Aa2	Aa2	Aa2
S & P	AA	AA	AA	AA	AA	AA
FITCH	AA+	AA	AA	AA	AA	AA
WEIGHTED COMPOSITE	AA+	AA+	AA+	AA+	AA	AA
TIER 4 ALIRT SCORE (Maximum Score = 14)						
COMPANY	13	13	13	13	12	12
INDUSTRY	9	9	9	9	9	9
TOTAL ALIRT SCORE (Maximum Score = 100)						
COMPANY	64	64	58	52	40	35
INDUSTRY	59	66	60	61	60	50

Every score is compared against an industry composite average.

Dispute defensible reports

A comprehensive policy audit provides an in-depth analysis of a policy and the carrier securing the benefits. More importantly, it provides actionable information to help maximize the probability of a successful outcome, meeting the policyholder's objectives.

The report documents a prudent process to help fiduciaries meet their responsibilities. Sharing the report with beneficiaries may avoid conflicts. If a dispute should arise, the audit report provides evidence of due diligence and a rationale for the game plan followed.

The audit report makes sure that the policy your client thinks they have, is the one they actually own.

Gary DeVicci heads CPI Companies' planning team, with responsibility for the suitability elements of their PolicyAudits.com services.
PolicyAudits.com is designed to help policyholders save money and improve their benefits or guarantees. It is independently operated on behalf of the policyholder; it is not allied with any life insurance company.
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