

ACTEC JOURNAL

THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL

3415 S. Sepulveda Boulevard, Suite 330 • Los Angeles, California 90034 • (310) 398-1888 • Fax: (310) 572-7280 • www.actec.org

Susan T. Bart, Editor / M. Read Moore, Assistant Editor / © The American College of Trust and Estate Counsel 2006

Table of Contents

Volume 32, No. 1, Summer 2006

President's Message	2
Editor's Page	4
Total Return Trusts—A Decade of Progress, But Are We There Yet? (Parts 1 & 2 of 4)	5
<i>Robert B. Wolf</i> The first two parts of a four-part article on total return trusts, including the newly issued revenue ruling 2006-26 and the final Treasury regulations.	
Standards of Prudence and Management of the Insurance Portfolio (Part 2 of 4)	66
<i>Kathryn A. Ballsun, Patrick J. Collins and Dieter Jurkat</i> The second in a four-part series on the administration of life insurance in a trust.	
Spotlight on Attorneys' Fees	91
<i>Compiled by Martin A. Heckscher</i>	
Calendar of Events; In Memoriam	C1
Highlights of the 2006 ACTEC Annual Meeting	C5
New Officer, Regents and State and Committee Chairs	C7
Committee Appointments 2007-2008	C15
<i>Daniel H. Markstein, III</i>	

Requests for 2007-2008 Committee Appointments

Interested in committee membership in the coming year? Whether as a new member or as a continuing member, you will need to contact President-Elect Danny Markstein with your interest no later than October 23, 2006.

Information on all of ACTEC's committees can be found inside this issue. To request an appointment, you may log on to the private side of the ACTEC website and submit an online committee appointment request (contact Bill Crawford at wlcrawford@actec.org if you need a user name and password), or complete and submit the committee appointment request form that accompanies this issue of the *ACTEC Journal*.

ACTEC's committees are one of the great engines that drive the work of the College, and we want committee members who will actively participate in the work of the committees.

We encourage you to submit your request today!

Editor's Page

by Susan T. Bart
Chicago, Illinois

This is my first issue as Editor of the *Journal*. Over the past year I have had the pleasure of working as Assistant Editor under Skip Fox. Notwithstanding Skip's sharp intellect, expansive expertise and well-deserved reputation as one of the nation's finest estate planners, Skip never fails to be charming and collegial.

Read Moore, of McDermott Will and Emery, has agreed to be my Assistant Editor for this year and Editor next year. Read frequently writes and speaks on estate planning issues. He brings valuable editorial experience from serving on the editorial board of *Estate Planning* magazine and the *Virginia Law Review*.

With sadness I announce the recent departure of Barbara Ravetti, the ACTEC Publications Manager. Barbara's experience, organization and calm demeanor will be missed. Fortunately for me, Gerry Vogt and Steve Albers, the Business Manager for the College, immediately stepped in to fill the gap created by Barbara's departure. They will soon begin to interview for the position of ACTEC Publications Manager. Please let one of us know if you know of any candidates with strong editorial and organization skills.

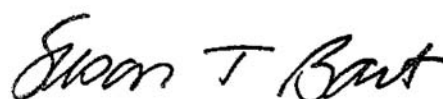
This issue is not exactly beach reading. Although generally I prefer shorter articles of ten to thirty pages, this issue contains portions of two extensive articles that are being published in parts in multiple issues of the *Journal*. I wanted to publish these articles in their entirety, notwithstanding their length, because they provide valuable and in-depth analysis of their subjects that is of practical importance to Fellows.

This issue includes part two of a four-part article on fiduciary administration of life insurance by

Kathryn A. Ballsun, Patrick J. Collins and Dieter Junkat. This provocative article seeks to shatter our complacency about the traditional manner in which life insurance trusts have been administered and to remind us that fiduciary duties apply as fully to insurance trusts as to any other type of trust. Part one, the appetizer, published in the Spring 2006 issue, discussed the duties of trustees under different models. Part two, in this issue, discusses the application of the prudent investor rule to trusts owning life insurance.

This issue also includes parts one and two of a very timely four-part article by Bob Wolf on Total Return Trusts. Revenue Ruling 2006-26, classifying and expanding upon the rules for qualified terminable interest elections where an interest in an IRA or defined contribution is payable to a marital trust, was issued after Bob's article was typeset and about to go to press. Bob agreed to revise his article, virtually overnight, so that we could include the latest developments on this topic without significantly delaying publication. Bob's article also discusses the final regulations on the definition of "income" and state legislative responses to the final regulations.

I have been delighted by the thoughtful and well-written articles submitted to me and am always on the lookout for excellent articles on topics of interest to Fellows. Please let us know if you are aware of any appropriate articles, whether authored by yourself or others.



Standards of Prudence and Management of the Insurance Portfolio (Part 2 of 4)

by Kathryn A. Ballsun, *Los Angeles, California*
Patrick J. Collins, *San Francisco, California, and*
Dieter Jurkat, *San Raphael, California**

The second of a four-part series on the administration of life insurance as an asset of a trust. The first part discusses the duties of trustees under different models for administering an irrevocable life insurance trust. The second part examines the impact of the Prudent Investor Rule

on holding life insurance in a trust. The third part will describe one approach that trustees may take in evaluating the appropriateness of insurance as an asset in a particular trust. The final part deals with decisions that will be faced by trustees when life insurance is held in a trust.

PART 2: STANDARDS OF PRUDENCE AND MANAGEMENT OF THE INSURANCE PORTFOLIO66

§2.1	HISTORICAL BACKGROUND REGARDING ADVICE TO ILIT TRUSTEES	67
§2.2	AN IMPOSSIBLE BURDEN FOR THE ILIT TRUSTEE	68
§2.3	OBSTACLES TO WORKING WITH INSURANCE AGENTS AND FINANCIAL PLANNERS	70
§2.4	DUE CARE ADVICE REGARDING SELECTION OF THE INSURANCE CARRIER	71
	§2.4.1 Back Testing Due Care Advice . . .	72
	§2.4.2 Rationale for Due Care: A Critical Examination	74
	§2.4.3 Do Safe Assets Make for a Safe Company?	76
	§2.4.4 Predicting Company Solvency . . .	78
§2.5	DUE CARE ADVICE REGARDING SELECTION OF THE INSURANCE POLICY	82
	§2.5.1 Linking Carrier Financial Data to Individual Policy Performance Predictions	83
	§2.5.2 Quantitative Methods of Performance Prediction	85
	§2.5.3 Testing the Policy Illustration . . .	88

PART 2: STANDARDS OF PRUDENCE AND MANAGEMENT OF THE INSURANCE PORTFOLIO

Part 2 of this article provides insight into the skill sets required by trustees wishing to retain investment management functions; Part 3 illustrates a tool that those charged with the task of policy evaluation can employ to facilitate prudent asset selection as well as ongoing monitoring and surveillance; Part 4 offers a method to document the prudence of asset management decision making, and to enhance the ability of the trustee to set and review the terms of the insurance asset management delegation.

Asset management responsibilities of an ILIT trustee commonly can be segregated into two distinct parts. The first part is the purchase of the life insurance policy. Often, the reality is that the trustee only nominally purchases the policy that the trust settlor selects. Given the proper documentation, the trustee's responsibility with respect to the purchase traditionally has been regarded as minimal because the settlor is the moving force behind the purchase. Such an attitude of well being, however, may no longer have a solid basis in fact or practice. In a modern day scenario, if the trustee is the listed purchaser, the trustee may have to bear the full burden for the purchase decision. The reality of the settlor's acts and words of assurance may not provide a sufficient shield to charges of trustee breach of duty.

The second part of asset management is the ongoing monitoring and evaluation responsibilities that the trustee assumes once the policy becomes an asset of the irrevocable trust. If future policy benefits are not

* Copyright 2006. Kathryn A. Ballsun, Patrick J. Collins and Dieter Jurkat. All rights reserved.

Kathryn Ballsun is a member of ACTEC and is a practicing estate planning, probate and trust attorney in Los Angeles, California. Patrick Collins is a principal in the Independent Investment Coun-

sel firm of Schultz Collins Lawson Chambers, Inc. in San Francisco, California; Baltimore, Maryland; and Washington D.C. Dieter Jurkat is director of information technology and senior actuarial consultant for Firemans Fund Insurance Company in San Raphael, California.

forthcoming, trust beneficiaries may make inquiries regarding the process by which the trustee managed the ILIT's assets, and may assess the trustee's use of care, skill and caution in the stewardship of wealth.

§2.1 HISTORICAL BACKGROUND REGARDING ADVICE TO ILIT TRUSTEES

A survey of the literature following the 1992 publication of Restatement Third reveals several articles suggesting that life insurance is a "fiduciary" asset that requires the trustee to devote a level of care, skill and caution comparable to other traditional investments (e.g., stocks and bonds).¹ With respect to Restatement Third, life insurance and annuity products are referenced in the Reporter's comment (*k*):

...an annuity may offer a reasonable means of seeking to assure that a trust's periodic distribution requirements can be met; or, the acquisition and maintenance of a life insurance policy may fit within the trust purposes as an appropriate type of benefit or protection for one or more beneficiaries....in selecting an investment with due prudence, the trustee must examine and weigh numerous factors about the asset and the trust circumstances, with care and skill, and with an eye toward an overall level of caution or conservatism appropriate to the trust at the time the investment is made. Among the characteristics a trustee should consider in examining a contemplated investment are the following: (1) Expectations concerning the investment's total return...; (2) The

degree and nature of risks associated with the investment...; (3) The marketability of the investment; (4) Transaction costs...; and, (5) Any special characteristics of the investment that affect its risk-reward tradeoffs and effective return...²

Although, in general, commentaries on management of trust-owned assets address the five investment characteristics, there is little written advice that explicitly and comprehensively addresses the practical implications for ILIT insurance policy management. The literature often leaves the trustee in doubt about how to determine the expected return of a life insurance program, the degree and nature of the risks associated with the program, the lack of marketability for life insurance contracts, the economic consequences of high transaction costs, and the special characteristics of the insurance contract. Although some articles on trust-owned life insurance provide insight into legitimate and important issues related to selection of insurance contracts, or into ongoing evaluation of policies, the discourse often reflects the perspective of insurance sales organizations seeking to increase new sales or policy replacement sales. Historically, insurance policy management articles advise trustees to consider the following questions:

- What is the financial condition of the carrier?
- Are the current premiums sufficient to support projected future benefits?
- When should a policy be replaced?

Many articles speak to the issues of reasonable care and diligence in the acquisition of new insurance policies. In the parlance of the insurance industry, this effort is termed "due care" analysis in order to distinguish it from "due diligence," which is a term associated with the securities industry.³

¹ See, for example, Maurer, David V., "Irrevocable Life Insurance Trusts: Good Business For Banks?" *Trusts & Estates* (May, 1992), pp. 24-32; Whitelaw, C. Markham and Culver, David M., "Managing Trust-Owned Life Insurance Policies," *Trusts & Estates* (April, 1993), pp. 46-48; Donohue, Mark T., "Unexpected Liability Awaits Many Trustees of Life Insurance Trusts," *Trusts & Estates* (April, 1994), pp. 43-46; Daiker, Stephen B., "Insurance Trusts Require Careful Set-Up and Follow-Up," *Taxation For Accountants* (August, 1994), pp. 106-112; Bertles, James B. and Yudenfreund, Joel H., "Limiting Fiduciary Liability for Investing in Life Insurance," *Journal of Taxation of Investments* (Spring, 1994), pp. 239-247; Schwartz, James D., Netzorg, Gordon W. and Bernhardt, Susan, "Due Diligence In Life Insurance Selection," *Probate & Property* (March/April, 1994), pp. 39-42; Steuer, Anthony, "A Duty to Advise," *Best's Review* (December, 1999), pp. 81-83; Rybka, Lawrence J., "Insurance Policy Selection for Irrevocable Life Insurance Trusts: New Challenges for Trustees and Advisors," *Trusts & Estates* (February, 2002), pp. 44-50; Leim-

berg, Stephan R. and Gibbons, Albert E., "Performing Due Diligence With Respect to Life Insurance Trusts is Crucial," *Estate Planning* (May, 2003), pp. 248-251.

² Restatement (Third) of Trusts: Prudent Investor Rule.

³ In addition to regulatory monitoring conducted primarily by state insurance departments, due care investigations with respect to a carrier's financial stability are also conducted by independent rating services such as the A.M. Best Co., Moody's, Fitch Ratings and Standard & Poor's. These companies issue evaluative reports based on both a quantitative and qualitative examination of carrier operations and financial disclosures. The Government Accounting Organization (GAO) detailed and evaluated rating company methodologies in their report to the House of Representatives Subcommittee on Commerce, Consumer Protection, and Competitiveness Committee on Energy and Commerce (Briefing Report, 09/29/94, GAO/GGD-94-204BR): *Comparison of Private Agency Ratings for Life/Health Insurers*.

Concern for due care greatly increased following the seizure by regulators of Executive Life of California in April 1991 and Mutual Benefit Life in July 1991. At the time of regulatory actions, both insurance carriers were among industry leaders with respect to both sales and assets. The public pondered the likelihood of a new Savings and Loan crisis, and the insurance industry faced the prospect of a disastrous sales decline due to erosion of public confidence. Insurance agents incorporated demonstrations of the financial health and long-term stability of insurance underwriters into their sales presentations lest their customers fail to give promised benefits sufficient credence.

Due care is therefore, in part, the attempt to pick a company that will outlive the insured by investigating a range of financial data and actuarial performance measures. As the perceived need for adequate due care investigation grew, so also did the burden on ILIT trustees. Life insurance vendors became eager to present selectively chosen financial and actuarial performance data while, concurrently, suggesting that critical examination of such data is crucial for making an informed insurance purchase decision. The ILIT trustee was now asked to put on an economic forecasting hat with the objective of picking good insurance companies. If selecting stock and bond investments under conditions of uncertainty is difficult, the task of projecting insurance company financial performance on the basis of publicly reported statutory accounting data is an even more formidable task.

Following the failure of major life insurance companies in the late 1980s and early 1990s, insurance industry representatives authored many due care articles. In general, several, usually implicit, assumptions inform the advice:

1. The letter and number grades assigned to carriers by independent rating agencies are of only limited value when comparing the financial strength of two or more companies;
2. Other publicly available information (*e.g.*, filings with state insurance departments or with the Securities and Exchange Commission) provides an expanded data set sufficient to formulate judgments about both insurance companies as well as about the products sold by them; and,
3. Agents, acting in the capacity as insurance counselors, can readily access this data and, therefore, are credible information sources for trustees.

When, in 1992, highly publicized hearings of the U.S. Senate Committee on the Judiciary confirmed that more than 90 percent of the insurance programs sold in the 1980s were unlikely to generate the values projected on policy sales illustrations, due care analysis expanded beyond the attempt to evaluate a carrier's financial strength, to an evaluation of the credibility of the carrier's sales illustrations.⁴ If mastery of insurance company financial statement analysis was a requirement for due care with respect to carrier solvency, the ILIT trustee was now asked to contemplate the reasonableness of actuarial assumptions underlying the pricing of individual insurance products. Due care standards for evaluation of individual policy illustrations were set, in part, by the Society of Financial Services Professionals (formerly, the Society of CLU/ChFC). During the mid 1990s, companies offering life insurance products voluntarily supplied information about their products and pricing assumptions on standardized questionnaires developed by the Society.⁵

§2.2 AN IMPOSSIBLE BURDEN FOR THE ILIT TRUSTEE

Due care was becoming a complex and formidable undertaking. In this atmosphere, the life insurance industry seized an opportunity to provide a greatly needed service by having its representatives write due care articles, present due care seminars, and provide financial statement information to prospective consumers. The insurance sales agent evolved into the insurance advisor; and, commissions are earned not solely because the agent motivates the client to "do the right thing" (*i.e.*, buy insurance) but because the agent is a source of and interpreter for due care information that is critically important to the life insurance buyer.

A curious phenomenon developed whereby the industry to be evaluated established the criteria for such evaluation. Presentations and interpretations of comparative financial and actuarial information enhanced the image of the insurance agent and provided a veneer of academic and professional responsibility that served to allay public concerns regarding the sales practices of insurance companies. But development of evaluative criteria had its roots primarily in the need to permit insurance purchases to continue in a marketplace saturated with skeptical consumers.

Anecdotal evidence suggests that trustees began to paper their files with the due care materials provided

⁴ "Consumer Disclosure In Insurance Sales," Senate Hearing 102nd Congress Subcommittee on Antitrust, Monopolies and Business Rights (June 23, 1992). See also McNamee, M., "Life Insurance: So You Think You're Covered," *Business Week* (August 30,

1999).

⁵ The Society of Financial Services Professionals (www.financialpro.org) has discontinued sponsorship of this program.

by insurance agents and carrier home offices.⁶ However, whenever commercially produced sales materials become the basis of a fiduciary's decision-making process, trustees may be invited to explain, in court, the prudence of their asset management procedures. Unfortunately, as many commercial and professional trustees followed the due care path laid out by the insurance industry, they gave themselves an impossible task. Trustees implicitly communicated to beneficiaries and other interested parties that they possessed the data and analytical skills sufficient to forecast carrier solvency and policy performance.

However, at the same time that due care advice flowed from the insurance practitioner community to the trust and estate-planning community, independent research studies published in academic journals indicated the great difficulties in solvency prediction and policy performance forecasting. Trustees and insurance agents worked collaboratively to pick the best insurance policy with little evidence that either group possessed the forecasting skills necessary to identify the companies or policies that will still exist twenty or thirty years in the future. ILIT administration entered into an era in which trustees attempt to do the impossible (pick winning insurance contracts) while forsaking the more fundamental tasks of prudent portfolio design, implementation and monitoring according to reasonable guidelines communicated, in writing, to interested parties. Although, by following the path laid out by traditional due care advisors, trustee success becomes a function of forecasting skills, the trustee

cannot always be right. The trustee, however, can always be prudent. ILIT administration should require prudence and not ask the trustee to shoulder an unbearable burden.

Much of the conventional, practitioner-oriented wisdom of due care was codified in the 1994 edition of *The Insurance Counselor: Life Insurance Due Care* published by the American Bar Association.⁷ The comprehensive 360-page text states that "due care enables the advisor to recommend an informed carrier and policy choice." It is important to reiterate that the majority of due care advice literature does not concern itself directly with the legal and academic ("modern portfolio theory") requirements for care, skill and caution enumerated in Restatement Third; and, in fact, *The Insurance Counselor* states that "it is not intended to express or imply a legal standard of due care."⁸

It was inevitable that the due care literature flowing from the insurance industry would have profound effect on trustees faced both with the task of administering a complex financial instrument, and with the need to assure compliance with fiduciary standards set forth in Restatement Third. If life insurance is a fiduciary asset, and if, as the Restatement Third states, "the duty of care requires the trustee to exercise reasonable effort and diligence in making and monitoring investments for the trust,"⁹ then it is reasonable to expect that failure to evidence reasonable due care may result in significant liability exposure. Avoidance of liability is a common theme within the

⁶ The authors (bound by confidentiality agreements) are aware of at least one case where a defendant (bank trust department) represented, in writing, to the settlor of an ILIT that they had performed "thorough due diligence" on the carrier that underwrote the coverage on a trust-owned insurance contract. The due diligence consisted of benefit projections on a carrier-generated computer illustration plus a ratings comparison and an unadjusted accounting data checklist provided by a software subscription to a turnkey information vendor. Based on this self-styled thorough and independent investigation, the trustee elected to place all coverage with a single company; and, as a by-product of the decision, collected substantial commission income from the carrier.

⁷ Schwartz, Richard A. and Turner, Catherine R., "The Insurance Counselor: Life Insurance Due Care Carriers, Products, and Illustrations," *Section of Real Property, Probate and Trust Law*, American Bar Association (Second Edition, 1994). At the New Orleans August 8, 1994 ABA conference on Understanding Sales Illustrations: How to Avoid Liability for Life Insurance Product Selection, *The Insurance Counselor* received the following endorsement: "If you decide to exercise the Highest Level of Due Care: You need to acquire expertise in life insurance. To do so, order 'The Life Insurance Counselor, Life Insurance Due Care, Carriers, Products, and Illustrations,' Second Edition...." This is a

curious statement because the book clearly states that it is not intended to make its readers experts in life insurance. Furthermore, the ABA conference course study material ("Checklist for Lawyers Working with Life Insurance Agents") continues, "If you plan to follow the Prudent Man Approach: Seek out local life underwriters who have the necessary expertise and rely on their advice." The Prudent Man approach, as embodied in Restatement Second, has an anti-delegation provision that would seem to invalidate this advice.

Chapter Seven of *The Insurance Counselor* is a particularly good example of customary methods used to compare life insurance policy illustrations. For additional examples of advice on evaluation of life insurance policy illustrations, see Puelz, Robert, "A Process for Selecting a Life Insurance Contract," *The Journal of Risk and Insurance* (March, 1991), pp. 138-146; Rubin, John, "How To Recommend A Policy To a Client," *Trusts & Estates* (May, 1990), pp. 49-53; Hill, Alfred H., "Insurance From The Estate Planners' Perspective," *Trusts & Estates* (June, 1990) pp. 73-77; Parrish, Stephen B. and Stephens, Dale R., "With All Due Care," *Best's Review* (June, 1992), pp. 59-117.

⁸ *Id.*, p. 3.

⁹ Restatement (Third) of Trusts, *supra* at Section 227, comment d.

advice literature and is an emerging issue for the ILIT trustees.¹⁰

§2.3 OBSTACLES TO WORKING WITH INSURANCE AGENTS AND FINANCIAL PLANNERS

The life insurance agents' rush to fill the need for due care analysis may cause difficulties for prudent ILIT administration because often the only easily accessible source of due care information is an agent who is pursuing a sales objective. Difficulties present themselves on several fronts:

1. High agent turnover makes it problematic that the trustee can rely on continued availability of the information source. One estimate is that approximately 95% of trust-owned life insurance policies have no assigned servicing agents;¹¹
2. Agents are not disinterested sources of information because they have a financial stake in the insurance programs under evaluation.¹² It is not certain that an agent will alert a trustee to the possibility that the policy may no longer be prudent and suitable;
3. Agents may have a primary duty to their employers as defined under the fair trade practice standards embodied in each state's Insurance Code. In some instances, the duty to pro-

mote and develop employer business interests may bear an uneasy relationship with a trustee's fiduciary duties;

4. Agents (as well as trust-service marketing departments) may have a vested interest in policy replacement;¹³
5. Agents are not trained in certain areas of financial analysis vital for preparation, interpretation and evaluation of relevant data.¹⁴

Although agents may present unadjusted financial statement data to prospective buyers, the mere presentation of unadjusted, vendor-disclosed data is neither informed interpretation nor critical evaluation. The import of financial information emerges only from the broader financial context from which the information flows. Consideration of bits of financial data in isolation from their appropriate context may lead to improper conclusions because insurance companies no longer share common approaches to product manufacturing, business development and company management. As Terence Lennon from the New York State Insurance Department remarks:

When companies were more stable and more comparable to each other, the regulators used ratios, for example, percentage of capital to assets. In those days, you could fairly say that a

¹⁰ See, for example, Maurer, D. V., *supra* at 28: "...if the trustee of the ILIT purchases a life insurance policy from a company which later becomes insolvent, the trustee could be held liable for the loss of the insurance proceeds. There might also be liability for the premium payments which have been made over the years.... As purchaser of the policy, the bank becomes potentially liable for the solvency of the insurer, just as it would if it had purchased stock." The problem of liability for commercial trustees is particularly acute: "If the trustee either possesses, or has represented that he possesses, greater skill than that of a person of ordinary prudence, liability will follow for losses resulting from a failure to use greater skill." Richwine, G. Michael, "How Individual Trustees Can Avoid Liability and Breaches of Trust," *Estate Planning* (December, 1997), p. 484.

¹¹ King, Carole Ann, "Are Agents Off The Hook on Trust-Owned Life?" *National Underwriter* (November 13, 2000). Roughly 70% of agents hired both by exclusive agency systems and non-exclusive ("broker") systems fail to stay in the industry beyond four years. Moore, James F. and Santomero, Anthony M., "The Industry Speaks: Results of the WFIC Insurance Survey," *Changes in the Life Insurance Industry: Efficiency, Technology and Risk Management*, Second Edition (Kluwer Academic Publishers, 2002), p. 52. Between 1998 and 2001, there was a net loss of 17,000 life insurance agents. Woods, David F., "The Future of Life Insurance," *Journal of Financial Service Professionals* (January, 2005), p. 45.

¹² Morgenson, Gretchen, "Don't Be Sold the Wrong Life Insurance," *Worth* (April, 1994), p. 37: "It's a given that consumers

can't count on getting the unvarnished truth from the roughly 250,000 insurance salesmen who make their livings on commission." See also Katt, Peter C., "A Perfectly Rational World," *Journal of Financial Planning* (October, 1994), p. 51: "...agents' performance standards focus on the amount of premium generated, not on the quality of purchase recommendations, accurate policy analysis, or servicing." For a brief history of the public's view of the life insurance agent profession, see Logue, Kyle D., "The Current Life Insurance Crisis: How The Law Should Respond," *Cumberland Law Review* (2001), pp. 33-34.

¹³ For a lucid discussion of agent replacement activities, see Hunt, James H., "Technical Aspects in Evaluating Cash Value Life Insurance Policies," *Financial Planning Association of Greater Hudson Valley* (September 28, 2001), pp. 4-5 at jameshunt@cs.com. See also Mehr, Robert I. and Gustavson, Sandra G., *Life Insurance Theory and Practice* Fourth Edition (Business Publications, 1987), p. 130: "...all too often the agent pushes one particular type of policy and represents only one insurer, a practice that may result in suboptimal decisions."

¹⁴ As one commentator writes: "Life insurance salespeople who use data supplied by their home offices to compare two or more companies do a disservice to consumers because they aren't trained to know what this data means. They make claims supporting their company or against a competitor that often are inaccurate or irrelevant. You should ignore comparative data selectively patched together by a competing salesperson to make a partisan point." Katt, Peter C., "Repainting an Old Canvas," *Journal of Financial Planning* (October, 1996), p. 28.

company with a 9 percent ratio was a stronger company than one with a 7 percent ratio. That was because there was a great deal more homogeneity between the risk profiles of companies at that time.... now a company with a 9 percent ratio might actually be a lot weaker than a company with a 7 percent ratio....¹⁵

Thus, it is difficult to see how collecting unadjusted information, taken at its face value, provided by a sales agent or commission-based financial planner, satisfies the care, skill, and caution standards of Restatement Third.¹⁶ Although commission-based agents or financial planners are a legitimate and important source of information regarding insurance policy rates and benefit provisions, it is the trustee that may be ultimately responsible for developing an objective and defensible criterion for carrier selection and policy design. Documenting prudence is something more than soliciting several bids in the form of biased sales presentations. Indeed, an important challenge for trustees is to implement reasonable procedures and safeguards so that they can develop productive relationships with life insurance agents and financial planners.

§2.4 DUE CARE ADVICE REGARDING SELECTION OF THE INSURANCE CARRIER

A prevalent theme in insurance advice literature is that trustees should seek to find the best company, or the best policy, or the best price. This type of treasure-hunting approach to asset management stands in stark contrast to modern principles of prudent portfolio management. During periods of insurance industry volatility, the advice literature focuses on how to select the

safest company; during periods of lower industry volatility, the literature directs the trustee to seek companies with insurance products yielding the highest returns.

Following the demise of Executive Life, Mutual Benefit Life and a host of smaller carriers in the late 1980s and early 1990s, warnings went out to insurance buyers to pay strict attention to a carrier's financial condition lest a financial collapse result in a loss consisting of policy benefits. It stands to reason that a trustee would want to purchase life insurance coverage from a company that receives high ratings from the independent carrier evaluation services. In addition to the assigned ratings, however, the due care process often encompasses analysis of financial statement data. Areas of interest include corporate surplus, asset quality, liquidity, corporate earnings, leverage, and so forth. Agent-delivered due care analysis attempts to:

- Discover how a carrier's financial statement information compares to its competitors or to insurance industry norms; and,
- Spot trends in critical accounting data or actuarial performance measures that could materially influence a carrier's long-term earnings and profits.

Currently, several data vendors offer trustees prepackaged information extracted from annual reports, (convention blank) filings with state insurance commissioners, as well as from public filings with the Securities and Exchange Commission. The vendors organize and present publicly available information on financial performance measures and on accounting ratios of interest. The critical assumption is that access to unadjusted accounting information improves the quality and accuracy of the due care process, which, in turn, improves the forecasting accuracy underlying the

¹⁵ Lennon, Terence, "Objectives and Expected Impact of Risk-Based Capital Requirements for Life Insurance Companies," *The Financial Dynamics of The Insurance Industry*, Eds. E.I. Altman and I.T. Vanderhoof, Irwin Professional Publishing (New York University, 1995), pp. 18-19. Firm vulnerability to interest rate shocks is a function not only of the ratio of capital to assets but also a function of duration mismatching of assets to liabilities. Many insurance firms are vulnerable to financial risks (*e.g.*, viable competitive business strategies) that cannot be evaluated via traditional ratio analysis.

¹⁶ Presentation of unadjusted data and accounting measures that lack comparability distorts the decision-making process. For example, a measure such as return on equity of a stock insurance company is not comparable to that of a mutual insurer. The denominator for many standard accounting ratios varies wildly for a company that has a history of merger and acquisition activity (goodwill may be a large intangible asset and may be valued as a financial statement balancing item rather than as a reflection of underlying value) as opposed to carriers without a M&A history.

Some insurance carriers may have good liquidity while their holding companies may have poor liquidity. Reinsurance treaties can shift capital and liabilities either on an aggregate basis or on a piecemeal basis; and, such treaties may be used to improve ratios as opposed to adding economic value to the firm. The existence of many financial covenants and reinsurance arrangements are subject to rating triggers, and accounting measures that do not adjust for the effects of reinsurance are largely without value. Atkinson, David B., and Dallas, James W., *Life Insurance Products and Finance* (Society of Actuaries, 2000), pp. 878-882; Bazer, Laura and Abusch, Marc, "Update: Rating Triggers in the U.S. Life Insurance Industry in 2004," *Moody's Investors Service* (July, 2004). Agents untrained in financial analysis may refer trustees to "financially strong" carriers, when, in fact, they have merely identified a set of companies with excess capital resulting from an inability to deploy resources optimally (a competitive disadvantage) or with an inability to find profitable new projects (a sign of future company decline). Accounting measures have, primarily, contextual significance not absolute meaning.

trustee's choice of carrier and policy form. However, the art and science of financial prediction is challenging even for the trained analyst. Generally, the analyst must restate publicly available information because, over time, companies modify their accounting and reporting conventions for depreciation, inventory accounting, mergers and acquisitions, pension liabilities, etc.; and, it is highly unlikely that accounting measures reported by any two companies reflect the use of similar calculation methods and reporting elections.

The task of comparative financial analysis for insurers is made even more challenging because of the use of Statutory Accounting Principles (SAP) conventions that are insurance industry specific as opposed to the more commonly used Generally Accepted Accounting Principles (GAAP). It is the task of the financial analyst to adjust the financial statement information to make sure that the data under evaluation are cross-sectionally comparable and serially consistent. Failure to perform this task makes trend analysis or company comparisons meaningless. Indeed, extracting unadjusted information and using it to communicate conclusions to the public regarding a firm's earnings prospects or its financial soundness would ordinarily constitute malpractice under the standards promulgated by the CFA Institute. The insurance agent, however, may not be trained to communicate to the ILIT trustee anything more than unadjusted data culled from public sources and arranged in boilerplate formats. Although many commercial trustees expend considerable time and resources investigating publicly traded securities, when it comes to insurance policies, they may rely merely on information provided by individuals untrained in the formal analysis of corporate financials prepared under SAP accounting conventions, or may rely on boilerplate presentations of unadjusted data provided by outside service vendors. Such information is the starting point for due diligence, not the ending point.

To illustrate the problem, we note that an examination of a firm's statutory (SAP) profit contemporaneously with its GAAP profit can lead to opposite conclusions regarding its financial health. Insurance companies may attempt to maximize statutory profit because this is the most common source of information used to evaluate the carrier's financial condition. However, because new product sales require the creation of a

reserve liability, a strong demand for a carrier's insurance products may strain its statutory surplus. The resulting lower statutory surplus is a basis for predicting the future vulnerability of the company to adverse experience and thus for a negative assessment of its future solvency prospects. GAAP reserve liabilities are calculated not on a statutory basis but rather according to an actuary's estimates. Because GAAP conventions match future expected profitability to the current activities that create this profitability, GAAP profits may be high during the period when the firm adds a significant amount of new business. The untrained observer may conclude that regulatory action is about to be triggered by a crisis in statutory profitability at the very time when GAAP profits indicate a company's overall financial success. Indeed, "...GAAP profits are often considered a better indicator of a company's overall well-being than statutory profits."¹⁷

§2.4.1 Back Testing Due Care Advice

Additionally, the prescribed methods of carrier due care analysis seem never to have been rigorously back tested. When a financial analyst develops a set of investment criteria based on examination of past stock or bond market movements, the first order of business is to back test them to see how well they would have worked under previous market conditions. Such a test (preferably on out-of-sample data) is no guarantee that the method will work under future market conditions; but, at a minimum, if a rule is designed to keep you from making a mistake it is a good idea to test it prior to recommending its use.

If we apply the current due care advice standards, constructed with the benefit of hindsight gleaned from the turbulence in the insurance industry during the past twenty-five years, it is difficult to see how there is any substantial improvement in the decision-making process. Consider, for example, the following data on Executive Life of California:

- Executive Life, by 1987 was one of the top insurance carriers. It received ten consecutive years of the highest rating by the A. M. Best Company.¹⁸ In 1988, Moody's raised Executive Life's rating from A3 to A1. In 1988 *Fortune* magazine ranked Executive Life in the top fifteen U.S. life insurance companies in

¹⁷ Easton, Albert E. & Harris, Timothy F., *Actuarial Aspects of Individual Life Insurance and Annuity Contracts*, ACTEC Publications (Winstead, CT, 1999) pp. 46-47. For a comprehensive discussion of the phenomenon of "new business strain," see Atkinson and Dallas *supra*, at 316-317: "Because of new business strain, an insurance company can actually become insolvent by writing too much profitable business." Atkinson and Dallas, at page 76, also discuss the reverse phenomenon known as "harvesting." This

occurs when an insurance carrier attempts to maximize profit at the expense of failing to protect its long-term competitive position. Harvesting may create favorable interim financial results as the carrier executes its exit strategies, but it is unlikely that the company will remain a viable entity in the marketplace.

¹⁸ Belth, Joseph M., "A List of Life Insurance Companies with Ten Consecutive Years of Top Ratings from the A.M. Best Company," *The Insurance Forum* (November, 1987).

terms of total assets and ranked it third in terms of its profitability. Throughout 1989, Executive Life also maintained the highest (AAA) rating from Standard & Poor's.

- Throughout 1989, independent commentators offered endorsements of the insurance company. For example, Bruce A. Bunner, California Insurance Commissioner from 1983 through 1986 states: "Clearly, high-yield bond investments are appropriate for a prudently managed investment portfolio of a life insurer." F. S. Townsend, actuary and partner in the prestigious Townsend Schupp Company (a Hartford, Connecticut based company that analyzes insurance carriers) states: "First Executive was in the right place at the right time, and management had the foresight to capitalize on opportunities."¹⁹
- In 1989 Executive Life's average policy size (\$300,000) was the largest in the U.S. insurance industry. At that time, the industry average policy size was below \$50,000.
- The *Forbes Annual Report on American Industry* ranked Executive Life as number one among all U.S. life and health insurance companies for its 1988 profits per employee. Additionally, it ranked Executive Life number three for five-year return on equity.
- Executive Life's adjusted statutory net worth (inclusive of mandatory securities valuation reserve) was 6.9% of total assets in 1989. This was better than eight of the top ten largest insurance carriers including Aetna, Metropolitan Life, John Hancock and Northwestern Mutual.

The above-listed information can now be evaluated against the currently recommended due care process. A good example of this process is found in "Due Care in Selecting Life Insurance Policies and Carriers" presented as part of the 1996 ALI-ABA conference on "Uses of Insurance in Estate and Tax Planning." The author recommends that, in addition to the letter and number ratings assigned by the independent evaluation companies, special attention should be devoted to:

- Surplus adequacy;
- Asset quality and liquidity;

- The history of and future prospects for stable earnings; and,
- Management quality.²⁰

In each category Executive Life earns superior marks.²¹ Furthermore, during the 1980s Executive Life was alone among major U.S. insurance carriers in advocating major reforms in the preparation of insurance company financial statements. For example, under SAP conventions, general account asset portfolios are carried at amortized cost rather than fair market value. Executive Life, however, voluntarily marked its portfolio to market value (a GAAP convention) and challenged other companies to do the same. Executive Life argued that this allows consumers to evaluate correctly a company's true financial condition. Executive Life's 1984 Annual Report remarks: "...Executive Life is the only company of the top 25 life insurance companies in the United States whose portfolio's value is above cost." In 1986, Executive Life's Annual Report states:

For a number of years, we have been suggesting to the various state insurance departments the need for insurance companies to adopt the discipline of 'marking to the market'; stating the true current market value of their investment portfolio on a consistent and current basis. This reform would not be easy. Statutory accounting requires insurance companies to carry their portfolios at amortized cost. This has long shielded the true market value of insurance companies' portfolios, and forcing a mark to the market could reveal large unrealized losses in many portfolios that would be difficult to deal with.

This period also saw uncertainty in the real estate markets; and plunging real estate valuations contributed to the national Savings and Loan crises. To the consternation of other major life insurance firms, Executive Life alerted consumers to the fact that the large insurance companies are not immune from the

¹⁹ Belth, Joseph M., "Executive Life and 'Broker World' Magazine," *The Insurance Forum* (February, 1989), pp. 8-9.

²⁰ Turner, Catherine R., "Due Care in Selecting Life Insurance Policies and Carriers," *ALI-ABA Course of Study: Uses of Insurance in Estate and Tax Planning* (San Francisco, 1996), pp. 31-66.

²¹ One cannot help but be struck by the strong similarities between the fall of Executive Life and the collapse of Enron together with its accounting firm Arthur Andersen in 2001. *For-*

tune magazine named Enron the "most innovative company" for six consecutive years; in 2000, *Worth* magazine named Jeff Skilling as the second best CEO in America; in 1999, *CFO* magazine gave Andy Fastow the CFO Excellence Award; and, in 2000, *CEO* magazine named Enron's board of directors as one of the top five in America. *Financial Engineering News* (September/October, 2005), p. 3.

economic forces at work within capital markets. Indeed, an independent study of the collapse of Executive Life estimates that:

All the top ten life insurers had very large investments in mortgages and real estate, ranging from 252% to 1,026% of statutory net worth. For half the top ten firms, mortgages and real estate exceed 700% of net worth, which is comparable to [Executive Life's] junk bond exposure at year-end 1989 and not that different from [Executive Life's] 1990 exposure.... Only a small percentage reduction in the statutory carrying value of mortgages and real estate would place all the top ten life insurers (except possibly New York Life) in the same statutory net worth position that [Executive Life] faced at year-end 1990, just before regulators took control in April 1991.²²

The study suggests that most major insurance carriers rode out the storm in capital markets in the early 1990s because their accounting practices allowed them to obfuscate the true condition of their surplus (net worth). Executive Life, on the other hand, was the only major firm offering enough transparency so that the public could reach an informed decision regarding its financial condition. The study concludes that Exec-

utive Life's accounting statement transparency, combined with an extensive public relations campaign orchestrated by the allegedly conservative and safe blue-chip carriers, led to the run on the bank that ultimately destroyed Executive Life.

Regardless of the ultimate reasons for its failure (it should be remembered that Executive Life's corporate officers were allegedly misleading regulators regarding the status of its reinsurance treaties),²³ the important point is that even a retroactive application of today's due care standards may not have persuaded trustees to avoid Executive Life during the 1980s. The benefit of carrier due care standards is that they have forced, to a limited extent, insurance companies to make their operations less opaque. Regulatory pressures and market forces are driving many industry reforms; and, as insurers demutualized to access the equity markets, investors demand financial statements prepared under GAAP conventions, as well as additional disclosure of relevant financial and operational data.²⁴

§2.4.2 Rationale for Due Care: A Critical Examination

Developers, promoters and vendors of insurance company due care systems have a heavy burden of proof. The claim, according to the ABA's *Life Insurance Counselor*, is that "failure to perform due care increases the risks of (1) buying a product that does not meet the actual insurance need, (2) facing one or more unanticipated future premiums after the payments were expected to stop, or (3) actually losing

²² DeAngelo, H., DeAngelo, L., and Gilson, S., "The Collapse of First Executive Corporation: Junk Bonds, Adverse Publicity, and the 'Run on the Bank' Phenomenon," *Journal of Financial Economics*, vol. 36 (1994), p. 310.

²³ Belth, Joseph M., "Executive Life's Bermuda Reinsurance," *The Insurance Forum* (November, 1986), pp. 137-138.

²⁴ Easton and Harris, *supra*, at 130-132. A number of statements of the Financial Accounting Standards Board (FASB) now regulate life insurance GAAP accounting standards. Mutual companies have an exemption from several of these standards (SFAS 60, 97 and 113). Upon release of FASB interpretation 40 in 1993, however, mutual companies no longer had an exemption from SFAS 12 (Accounting for Certain Marketable Securities). SFAS 115, which creates three classifications for debt and equity securities, supersedes SFAS 12. SFAS 115 creates rules for reporting the fair market value of securities and for the reporting of both realized and unrealized gains and losses. The three classes are:

1. Held to Maturity
2. Available for Sale
3. Trading

With respect to debt instruments, management is permitted to report Held to Maturity assets at amortized cost. Assets in other categories must be reported at fair market value; but unrealized gains and losses are recorded as adjustments against either equity (if Available for Sale) or income (if Trading). Thus SFAS 115 allows

asset values to be reported according to management "intent."

A survey of insurance company chief financial officers in 1997 for year end 1996 reveals that most companies held a larger proportion of assets in the Available for Sale category while only a small fraction were held in the Trading category. The median value of assets in the Held to Maturity category was 37 percent. It is interesting to note that "the held-to-maturity account was populated by private placements (35 percent), public bonds (28.5) percent, and mortgage-backed securities (24.5 percent). Although mortgages and real estate are not formally included in asset types covered by FAS 115, some ten companies reported that these assets represented 32.6 percent and 3.4 percent, respectively, of held-to-maturity assets. Cabanilla, Nathaniel B. and Brodie, Nancy S., "Survey of Chief Financial Officers on Company Practices," *Journal of Financial Service Professionals* (March, 1999) pp. 76-86. This can be contrasted to the available-for-sale account in which "private placements accounted for 9.5 percent. Mortgages and real estate represented 8.7 percent and 1.2 percent respectively." It thus appears as if a relatively large segment of assets that are not publicly traded are in Held to Maturity accounts. Although many of these assets may be rated highly by debt evaluation services, the marketability covenants surrounding these assets may restrict their liquidity. It remains difficult to form judgments regarding the financial stability of insurance carriers based on a simple survey of the types of assets that they own.

value through the life insurance carrier's insolvency."²⁵ Further, it advances the proposition that the "due care process is an ongoing effort. It begins with the selection of policies to be purchased. It continues while the policies remain in force, with periodic reviews of current status and reprojection of policy results."²⁶

It is worth spending a few moments on these claims because they form the rationale for much of the ongoing asset management activities of ILIT trustees. Having advanced the first rationale for a due care system, the *Life Insurance Counselor* quickly backs away from it: "Due care in this text does not address the appropriateness of the insurance marketing application for the specific need of the insured. The specific amount of insurance needed, and how the policy's ownership and funding are configured to meet a particular insuring need, are in the due care domain of the client and his or her advisors."²⁷ In other words, due care in this context is not really a due care analysis system so much as it is a careful consideration of whether insurance is needed in the first place; and, if yes, how much and what kind.

The second rationale for due care focuses on the initial credibility of the policy illustration and on the ongoing monitoring of the specific insurance product(s) owned by the trust. This is *policy* due care as opposed to *carrier* due care. There is, at best, only a tenuous relationship between carrier profitability and the performance of specific policy forms. Indeed, financial theory as well as some market research suggests that there may be an inverse relationship between a carrier's financial condition and the policy values it must offer to attract and retain policyholders.²⁸

The third rationale focuses on the need to protect the trust against loss of value because of a carrier default. Both state regulators and insurance compa-

ny analysts are interested in developing and implementing systems that exhibit predictive ability with enough lead-time to take remedial action. Unfortunately, no system has yet proved successful on a consistent basis. There are several underlying difficulties with current solvency monitoring and prediction models:

1. Disagreement regarding relevant variables: "...while these models are reasonably successful in identifying distressed firms, the models often suffer from 'statistical overfitting' and a lack of consistency over time with respect to the set of important variables related to bankruptcy."²⁹
2. Insurance companies can decline rapidly, and significant differences between solvent and insolvent companies begin to appear only a short time (no longer than one year) before actual insolvency;³⁰ and,
3. The relevance of past data is questionable given the constant and rapid shifts in the legal, tax, economic, and competitive environments in which the insurance industry operates.³¹

The sudden, and more recent, defaults at Confederation Life of Canada and General American Life provide some proof that high ratings from independent evaluation services may have little predictive value. More to the point, some research indicates that the default rate among lower rated companies is not statistically different from the default rate among highly rated carriers.³² This, of course, is not meant to be an argument for buying policies from poorly rated companies. Rather, it is meant to question the efficacy of launching extensive carrier due care analysis when there is little evidence that useful results will be forthcoming. The process of papering files with informa-

²⁵ *The Insurance Counselor, supra*, at 3.

²⁶ *Id.*, at 9.

²⁷ *Id.*, at 3. See, however, discussion of OTS regulations for savings associations at 49.

²⁸ For empirical tests of certain expectational hypotheses, see Carson, James M. and Forster, Mark D., "The Nature and Causes of Variation in Insurance Policy Yields: Whole Life and Universal Life," *Journal of Insurance Issues*, Vol. 23 (2000), pp. 30-47. The evaluation period for the study is 1988 through 1998.

²⁹ Carson, James M. and Hoyt, Robert E., "Identifying Life Insurer Financial Distress: Classification Models and Empirical Evidence," *The Financial Dynamics of the Insurance Industry* (Irwin Professional Publishing, 1995), p. 34.

³⁰ Klein, Robert W., "Solvency Monitoring of Insurance Companies: Regulators' Role and Future Direction," *The Financial Dynamics of the Insurance Industry* (Irwin Professional Publishing, 1995), p. 83.

³¹ *Id.*, at 93. Among the current crises facing the insurance industry is the rise of a secondary market enabling certain insureds

with health impairments to sell their policies to investors willing to continue making premium payments until the time of the insured's death. Prior to this option, the only liquidity option available to cash-strapped insureds not qualifying for benefits under terminal illness riders was to surrender the policy to the insurance carrier for a pre-specified value. Many insurance carriers claim that the existence of a secondary market makes it unlikely that they will realize projected economic benefits of policy surrenders. This, in turn, may mean that the insurance companies have mispriced the coverage and now risk insolvency if there is a substantial decrease in the policy surrender rate from the group of unhealthy insureds. See, for example, Doherty, Neil A., and Singer, Hal J., "The Benefits of A Secondary Market for Life Insurance Policies," *Working Paper, The Wharton School, University of Pennsylvania* (Modified 10/14/02).

³² Ambrose, J., and Carroll, A., "Using Best's Ratings in Life Insurer Insolvency Prediction," *The Journal of Risk and Insurance*, Vol. 61, No. 2 (1994), p. 323.

tion of dubious value does not evidence use of care skill and caution; and, in the opinion of John Langbein, is mere “proceduralism.”³³ As one insurance analyst states: “...an effective financial surveillance and regulation structure and system is needed. While everyone can agree that this is critical, to date no one has yet defined what constitutes an effective structure and system for financial surveillance and regulation.”³⁴

Although carrier due care systems, including software-based systems, provide reams of quantitative data, this information is often evaluated out of context.³⁵ It is worth reiterating that the letter and number grades assigned by rating companies are distillations from a comprehensive evaluation of the operations of the insurance carrier by trained analysts. There is little evidence that focusing on selected aspects of the rating company’s narrative report or accompanying financial and operational exhibits will yield useful insights that would materially change a prudent investor’s judgment regarding the analyst’s overall opinion on the insurer’s financial strength or claims-paying ability.

§2.4.3 Do Safe Assets Make For A Safe Company?

Focusing piecemeal on selected accounting information (often extracted from the rating company’s report and distilled by insurance agents with a transaction agenda) may lead ILIT trustees to make spurious conclusions. Some analytical methodologies used by the due care systems are poor fits with the modern portfolio theory underpinnings of the Restatement Third. According to modern portfolio theory, the basic unit of analysis is the portfolio as a whole rather than the individual investments from which the portfolio is built. A company with a portfolio built entirely from government guaranteed bonds, for example, may have a low risk rating in some due care systems despite the fact that it might be vulnerable to unanticipated interest rate movements. The reader may recall that Orange County, California was driven into bankruptcy while managing a portfolio backed primarily by U.S. government bond obligations. Looking at the individual assets, the portfolio appears to be safe;

looking at the portfolio structure reveals the opposite.

A carrier’s financial position can, in part, be measured by an analysis of the liquidity of its assets (can it unwind positions in assets should their value start to erode), and the variability of its surplus (will changes in the value of assets and liabilities suddenly create a crisis with respect to the adequacy of a firm’s surplus). The risk to surplus is a key measure of financial vulnerability and depends on a variety of critical determinates including the firm’s asset/liability matching strategies. Every sale of an insurance policy represents an added liability. Each new liability requires a reserve; and, to maintain financial solvency, assets with a market value sufficient to discharge the liability must back the reserve. Thus, insurance company solvency is a function not of its assets or of its liabilities; but, rather, of the dynamic interrelationship between them. This makes reliance on accounting ratios or asset categorizations wholly inadequate measures of an insurance carrier’s financial health:

In an economic sense, we need not focus on accounting concepts such as reserves, surplus, and risk-based capital. From a managerial viewpoint, these are best viewed as merely regulatory constraints. What is needed to cushion the liabilities against inadequate assets is actual money, as measured by the net tangible value—the excess market value of tangible assets over the present value of liabilities.... The present value of an insurance liability is not dependent on what assets the insurer holds nor on how its portfolio is structured. Rather, it depends simply on how much in default-free securities would be required today to meet its expected liability payments over time. Again, the present value must account for any interest rate sensitivities in the liabilities.³⁶

³³ “Proceduralism is a common retreat in fields in which substantive law provides inadequate guidance...” Langbein, John H., “The Uniform Prudent Investor Act and the Future of Trust Investing,” *Iowa Law Review*, Vol. 81 (1996), p. 662. The reporter for Restatement Third argues, in a similar vein: “The standard of prudence in the trust law, however, should not be without substantive content and principles by which to judge and guide a fiduciary’s conduct. That is, the law should call for more than a paper trail.” Halbach, Edward C., “Trust Investment Law in the Third Restatement,” *The Uniform Principal and Income Act and the Prudent Investor Rule* (California Continuing Education of the Bar, January 2000), p. 111.

³⁴ Rich, Sanford, “NAIC Solvency Agenda: An Overview,”

The Financial Dynamics of the Insurance Industry (Irwin Professional Publishing, 1995), p. 6.

³⁵ Turner, Catherine R., “Evolution Of The Life Insurance Industry,” *American Bar Association Annual Meeting, Real Property, Probate and Trust Law Section* (August, 1994), p. 5: “‘Spreadsheets’ on the basis of company financial statistics is often a common part of today’s sales proposals. Valuable information may be provided in this way, but financial ratios presented on an inconsistent or incomplete basis can be as misleading as current illustrations.”

³⁶ Babbel, David F. and Merrill, Craig, “Toward A Unified Valuation Model for Life Insurers,” *Changes in the Life Insurance Industry: Efficiency, Technology and Risk Management*, Second Edition (Kluwer Academic Publishers, 2002), pp. 261-263.

This is a very different solvency evaluation process than found in most traditional due care advice literature. Traditional due care encourages the ILIT trustee to focus primarily on selected actuarial measures (projections of lapses and mortality experience) as well as on earnings on assets (the presumption being that a firm that earns a yield on invested assets higher than that credited to policyholders is financially sound). The risk of a significant mismatch between assets and liabilities (or, equivalently, the risk of insufficient surplus) depends not only on the structure of state-contingent liability payments for deaths and surrenders, and not only on yields on invested assets, but, primarily, on the stochastic evolution of interest rates, path-dependent cash flows, and embedded options within the asset portfolio (*e.g.*, option to prepay mortgage obligations, extension and contraction risks of debt instruments, etc.). To a great extent, the Savings and Loan crisis occurred not because the lending institutions had bad or unsafe assets (residential mortgage loans); but rather because of a mismatch between the duration of assets (loans) and liabilities (obligations to depositors). This

is one of several risks inherent in the insurance industry for which public information is simply not available.

The safety of insurance company portfolios can best be judged from within the “portfolio context” that underlies modern portfolio theory. This is more than a simple parsing of the insurer’s assets. As noted, policy reserves are liability accounts the values of which are based on actuarial estimates of the present value of funds necessary to discharge the future obligations of the life insurance contracts under fixed and conservative assumptions. The key term in this sentence is “liability.” Unlike a common use of the term reserve (*e.g.*, I have a cash reserve against unforeseen emergencies) that suggests that a reserve is an asset, the opposite is true for insurance company reserves. Reserves are merely accounting constructs that are entered on the liability side of insurance company financials.³⁷ A company is solvent only when asset values balance the reserve liabilities. Classifying individual assets as “safe” or “speculative” gives little indication of whether the assets’ market values match up well with the reserve liabilities.³⁸

Although statutory solvency requires that the cash

³⁷ Just to make things confusing, certain policy acquisition costs are capitalized and put on the asset side of the Balance Sheet.

³⁸ A publicly traded insurance company will cease to be a viable firm under two general conditions: (1) it fails to earn sufficient profits to compensate shareholders; or, (2) it fails to maintain asset values sufficient to discharge its liabilities to policyholders. The first condition is also of concern to policyholders because the carrier may seek attention as a merger or acquisition candidate by boosting short-term profitability at policyholder expense. This is a classic “agency problem” between owners and policyholders. But the failure to earn sufficient profits may be a result of poor business strategies, regulatory rulings that change the nature of a firm’s market, unforeseen competition from other financial product and service providers, or a host of other circumstances that cannot be captured in actuarial performance data. Regulators protect the interests of policyholders and the public primarily by monitoring the second set of conditions; and receivership is the end result of a failure to maintain statutory solvency. The policyholder’s interest, however, is compromised by company failure under either set of circumstances.

This is also why variable life products using separate accounts are not necessarily the panacea that some of their promoters claim. Variable products not only shift risk from the carrier to the policyowner, they increase total risk—*i.e.*, risk to policyowner and to insurance carrier. The ILIT now bears the risk of inadequate investment performance; but the carrier’s financial results also become more sensitive to market conditions because profit margins are functions of asset-based fees. Declines in separate account values may drive revenues downward and increase the likelihood that the carrier cannot generate sufficient earnings to make this administratively expensive block of business profitable. See Panko, Ron, “Taking a Punch,” *Best’s Review* (March, 2003) pp. 65-70.

Additionally, with the introduction of new and more complex insurance products, economic viability of insurance carriers becomes more uncertain. Paradoxically, some new non-variable

products also create greater risk for the policyholder as well. The payoff of a life insurance policy is dependent on the performance of an underlying portfolio of assets; and, the insurance policy may be considered a derivative security with all of the attendant risks of options, futures and other financially engineered products. Thus, many new products (often used for replacement of older policies) do not merely shift or reallocate risk, but represent an increase in total risk both to the insurance carrier and to the policyholder. Risk is increased for the manufacturer because it is often the case that reserve liabilities must be hedged through use of complex financial products that are replete with optionality.

From the perspective of the policyholder (or regulator) concerned with type two conditions, the mathematics of insurance company solvency is of interest. In order to maintain solvency, the insurance company must maintain a surplus (market value of assets exceeds market value of liabilities). Risk management and monitoring activities that focus on limiting the variability of surplus subject to the constraint that surplus must always be positive are of paramount importance. But surplus variability is a function of (at least) four variables even assuming that actuarial assumptions (distribution of actual lapse and mortality experience matches distribution projected at time of issue) are completely accurate:

1. Surplus asset selection: The ability to forecast the returns of assets in the surplus investment portfolio;
2. Credit risk: The ability to forecast the credit risk spreads and default risks in the portfolio of assets backing the company’s liabilities;
3. Maturity mismatch: The ability to forecast the future term structure of interest rates (duration and convexity sensitivities); and,
4. Funding mismatch: The ability to forecast the relative performance of assets matches against liabilities with assets in the surplus portfolio.

The reader can note that traditional insurance carrier due care activities focus primarily on the second term and, therefore, may

flows from assets match the demand for cash created by the liabilities, cash flow matching is appropriate only if premium inflows are certain. With the advent of flexible premium products, asset-liability matching becomes more complex. An actuary can arrive at different conclusions regarding valuations depending upon which stochastic valuation methodology he chooses to use.³⁹ This explains why even the newer risk-based capital (RBC) standards adopted by the National Association of Insurance Commissioners in December of 1992 are not a good yardstick for generating predictive measures of the strength or safety of insurance carriers: "...the RBC formula emphasizes asset risk. Thus a company with only high-rated bonds and no mortgage investments may have a...high ratio. Yet the company's business strategy may be a risky one that could wipe out the company's capital quickly. Such a risky strategy may not be reflected in the RBC formula.... There is a poor relationship between RBC ratios and financial ratings."⁴⁰ An emerging concern is that insurance companies are managing their assets to appear in the best light with respect to risk-based capital ratios so that the company can secure high ratings from the independent evaluators and can project the image of safety and security to the public. The portfolio management strategies required to accomplish these objectives may, however, be suboptimal in terms of optimizing for the earnings and profits necessary for the company's future economic viability.

§2.4.4 Predicting Company Solvency

Another major risk to future financial solvency is product or actuarial pricing inadequacy, which can only be determined by looking at a company's asset share statements. Asset share statements are the actu-

arial models used by the insurance carrier to price its products. But this is proprietary information and extremely difficult to obtain.⁴¹ However, without the ability to obtain and evaluate this critical information, any due care analysis system merely tilts at windmills.

The Society of Actuaries defines four risk factors faced by insurance companies:⁴²

- C-1 risk is the risk of decreases in asset values because of adverse general market conditions, or a default by a borrower of insurance company funds;
- C-2 risk is the risk that the insurance products are not adequately priced to cover mortality and other cost factors, or that the frequency and magnitude of claims does not conform to original distribution assumptions;
- C-3 risk is interest rate risk that exposes a carrier to insolvency due to a mismatch between the value of assets and liabilities; and,
- C-4 risk is general business risk that includes changes in tax law and industry regulation, litigation arising out of fraud, malfeasance, and market misconduct, product obsolescence, etc.

C-4 risk encompasses, to a great extent, unique risks that are intractable to long-term prediction. These risks include changes in tax laws, fraud, run-on-the-bank episodes, misallocation of assets, and so forth. Historically, many insurer insolvencies derive from C-4 type of risk.⁴³

fail to consider most solvency risk factors. For a formal exposition of the mathematics underlying these concepts, see Plantinga, Auke and Huijgen, Carel, "Performance Measurement and Insurance Liabilities," *The Journal of Portfolio Management* (Spring, 2001), pp. 105-115. For a discussion of the risks of variable products, see Atkinson and Dallas, *supra*, at 106-107.

The reader may also note that the difficulties with undertaking a meaningful due care investigation of life insurance carriers rivals the difficulties in projecting the fiscal soundness of defined benefit pension plans merely by examination of publicly disclosed corporate financials. See, for example, Elton, Edwin J. and Gruber, Martin J., "Optimal investment strategies with investor liabilities," *Journal of Banking and Finance* (September, 1992), pp. 869-890; Ryan, Ronald J. and Fabozzi, Frank J., "Rethinking Pension Liabilities and Asset Allocation," *The Journal of Portfolio Management* (Summer, 2002), pp. 7-15; and, Sharpe, William F., "Budgeting and Monitoring Pension Fund Risk," *Financial Analysts Journal* (September/October, 2002), pp. 74-86. Corporate financial statements taken at face value did not indicate the magnitude of emerg-

ing funding deficits within the plans.

³⁹ Babbel, David F., "Asset-Liability Matching In the Life Insurance Industry," *The Financial Dynamics of the Insurance Industry* (Irwin Professional Publishing, 1995), pp. 239-255.

⁴⁰ Belth, Joseph M., "Risk-Based Capital," *The Insurance Forum* (August, 2000) p. 73.

⁴¹ Easton and Harris, *supra* at 33: "Asset share formulas are often quite complex, since they must take into account (at a minimum) premiums, death benefits, surrender payments, investment income, dividends, taxes, and expenses of all kinds. Depending on the intended use, asset shares may also take into account other experience factors, such as policy loan usage. Arriving at appropriate assumptions, and formulas that reflect them can be a challenge to the actuary who is responsible for their determination."

⁴² Babbel, David F. and Santomero, Anthony M., "Risk Management by Insurers: An Analysis of the Process," *Investment Management for Insurers* (Frank J. Fabozzi Associates, 1999), pp. 16-17.

⁴³ Black, K. and Skipper, H.D., *Life Insurance*, Twelfth Edition, Prentice Hall, New Jersey (1994), p. 296.

Insurance company risk assessment often considers only selected variables tractable to long-term prediction. Unfortunately, risk prediction models usually consider the variables in isolation rather than as dynamic factors operating in an environment characterized by complex and possibly non-linear interactivity. For example, financial strength ratios may be derived primarily from a univariate analysis of financial statement data. A company that demonstrates a five-year trend of increasing surplus seems to evidence financial strength. However, if surplus is increasing because declining sales mitigate the pressure of business acquisition costs, the trend may, in fact, evidence financial weakness. Only models capable of multivariate analysis can illuminate important interrelationships between financial variables. This type of high-level statistical model building has been largely confined to academic institutions,⁴⁴ although government regulators charged with protecting the public against carrier defaults have made significant advances both in solvency monitoring methodologies and in the effectiveness of regulatory oversight and enforcement structures.

Important advances in the area of solvency monitoring made by both regulatory agencies and independent insurance company evaluation agencies make it clear that most of the traditional advice flowing from the life insurance industry (*i.e.*, simplified methods of reviewing C-1 and C-2 type risks) may not be useful to trustees charged with the duty to manage insurance policy assets.⁴⁵ The history of attempts to develop solvency-monitoring models is a topic of some interest in that it also provides insights into how certain monitoring systems can be gamed by insurance carriers.

Historically, in environments characterized by low and stable interest rates and by fixed-income investment vehicles lacking complex optionality (unlike, *e.g.*, assets like Collateralized Mortgage Obligations with prepayment options that create future cash flow uncertainty), it sufficed for analysts to focus on credit risk monitoring. The process of risk management was primarily one of constant refinement in the ability to both monitor risks and to manage such risks to the insurance company's best advantage. With increases in (1) interest rate volatility; (2) the complexity of new investments placed on the asset side of the balance

sheet; and, (3) the uncertainty of cash flows from new types of insurance policies placed on the liability (reserves) side of the balance sheet, the simplified credit risk and financial strength monitoring formulae that informed the due care advice of the early 1990s are no longer adequate. One response of both insurance regulatory agencies and of the independent rating companies was construction of Risk-Based Capital (RBC) ratios. The RBC ratio developed by the NAIC in the early 1990s has at least two objectives:

1. Supplement the minimum capitalization standards of individual states with a more suitable capital standard reflective of an insurer's actual operational risk and investment strategies; and,
2. Supplement traditional default risk monitoring criteria with a tool that better reflects the riskiness of insurer cash flows (from both investments and premiums) in a more volatile economic environment.

The RBC calculation requires an adjustment or "charge" for each type of investment risk reported in the insurance company's annual statement. The amount of the charge depends on formulae developed through statistical analysis of historical variances in various risk categories of investments. Investments guaranteed by the U.S. Treasury have a lower charge than stocks, real estate, mortgage indebtedness, and so forth. The carrier's actual total capital (adjusted for certain investment reserving factors) is divided by the RBC amount to determine the RBC ratio. Regulatory action is forthcoming for companies failing to meet certain minimum capital standards. Whereas the NAIC RBC ratio is used as an objective regulatory monitoring tool, independent rating agencies like Standard & Poor's and A.M. Best developed capital ratio formulae that incorporate both objective information as well as qualitative assessments of other risk factors. Interestingly, the rating agencies use the formulae to judge the relative financial strength of insurance carriers. This is a very different objective than the regulatory measurements; and, not surprisingly, may yield vastly different results. A rating agency may evaluate management and corporate business strategies, liquidity and operating efficiency, prospects for future growth and competitive

⁴⁴ See, for example, the "ratio correlation matrix" developed by Borde, S., Chamblis, K., and Madura, J., "Explaining Variation in Risk Across Insurance Companies," *Journal of Financial Services Research*, Vol. 8 (1994), p. 188.

⁴⁵ The following discussion of carrier solvency monitoring and evaluation draws, in great part, from the following articles: Pottier, Steven W. and Sommer, David W., "Life Insurer Risk-Based Capital Measures," *Journal of Insurance Regulation* (Winter, 1997), pp. 179-196; Grace, Martin, Harrington, Scott and Klein, Robert,

"Identifying Troubled Life Insurers," *Journal of Insurance Regulation*, (Spring, 1998), pp. 249-290; Henebry, Kathleen L. and Diamond, Jeanette M., "Life Insurance Company Portfolio Composition and Investment Regulation," *Journal of Insurance*, Vol. 21 (1998), pp. 183-203; Klein, Robert W., "The Growing Sophistication of Solvency Policing Tools: From IRIS to Accreditation and Beyond," *Journal of Insurance Regulation* (Winter, 2000), pp. 235-258; and, Barth, Michael, "Risk-Based Capital: A Retrospective," *Journal of Insurance Regulation* (Winter, 2001), pp. 233-242.

strength relative to other carriers, conservatism in liability reserving, reinsurance arrangements, etc. Weaknesses in these areas can offset what might be high RBC ratios developed under the NAIC formulae; or, conversely, strengths in these areas might enhance what might otherwise be a low RBC ratio. Historically, there has been a low correlation between independent ratings and NAIC RBC ratios except in the very lowest of the rating categories.

NAIC RBC ratios do not convey much useful information in terms of carrier due care analysis. A carrier or a product selection or retention guideline based on a high RBC ratio is merely a formulaic exercise rather than evidence of a prudent decision making process. Additionally, there is a wealth of opportunities for an insurance carrier to bias the RBC ratio. On the asset side of the balance sheet, there is some evidence that insurance companies are decreasing investment exposures in areas with high RBC charges such as mortgages and stocks in favor of equally risky non-traditional investments that fall into the general category of "other" under the NAIC's classification system and for which the RBC charges are lower. On the liability side, there appears to be significant use of surplus notes not only among companies with low RBC ratios and higher default risk; but, more recently, among the major U.S. life insurance carriers. Just as there is a category of "non-admitted" assets (*e.g.*, the real estate value of a home office, the value of furniture, etc.), there is a category of "non-admitted" liabilities under statutory accounting principles. A surplus note is a debt obligation of an insurer that will not appear on the liability side of the balance sheet until or unless the insurer's surplus exceeds a level specified by the debt instrument.⁴⁶ Surplus notes allow a company to smooth the downside variance of its surplus (a positive surplus is a requirement for solvency) by placing assets on its financial statements without the need to book the corresponding liabilities.

Additional games are possible through the purchase of SEC Rule 144(a) private placements that are

transactions between qualified institutional buyers. Qualified transactions in the insurance industry usually involve placements of corporate bond issues that, although exempt from registration and lacking the usual liquidity found in capital markets, carry ratings and RBC charges that are equivalent to comparable issues registered for secondary transactions. Although the illiquidity of private placements can wreak havoc in recessions, it is difficult to develop the evaluative criteria required for effective predictive financial modeling for firms that carry such issues in their investment portfolios. The recent defaults of private placements from firms like Enron and WorldCom, for example, triggered a significant downgrade in the financial ratings of the U.S. insurance industry.⁴⁷

Concurrent with the implementation of a regulatory action system based on RBC ratios, significant advances were made with respect to improvements in detecting early warning signs of financial difficulties. Traditionally, a key regulatory monitoring tool was the system of performance measures and accounting ratios monitored by the Insurance Regulatory Information System (IRIS). However, the system seemed inadequate in terms of providing reliable indications of forthcoming carrier insolvency. The system was largely formulaic, based on data reported on annual statements filed with the states, gave many false positive indications, and failed to include variables that had important predictive value. In 1990, the Financial Analysis Solvency Tracking (FAST) system, designed to address some of the limitations, supplemented IRIS. Academic evidence indicates that, although the FAST system can identify companies in financial difficulty approximately one to three years prior to the onset of insolvency, models based solely on financial ratio analysis are reaching the point of diminishing returns. An endemic problem with the models currently in use is that the critical variables for past insolvencies may not have equal importance in the future. Past economic conditions are unlikely to repeat and certain financial ratios may be afforded weights that are not merit-

⁴⁶ Even at this point, only currently due interest and principal rather than the full obligation may be recognized. See Dumm, Randy E. and Hoyt, Robert E., "Surplus Note Utilization by Life Insurers: Empirical Evidence," *Journal of Insurance Regulation* (Spring, 1999), pp. 348-378; and Belth, Joseph M., "The Surplus Note Catastrophe at Lumbermens Mutual," *The Insurance Forum* (November, 2003), pp. 285-300.

⁴⁷ "Moody's Changes Rating Outlook for the U.S. Life Insurance Industry to Negative From Stable," *Moody's Investors Service* (September 6, 2002). This discussion suggests the difficulties faced by ILIT trustees attempting to document prudent asset management. The increasing sophistication of independent rating organizations such as Moody's makes the number/letter grading

systems more credible. However, the grading is often done "on a curve." The high current rating assigned to an insurance company may simply indicate that the carrier is relatively better off than its industry competitors; however the high rating should not mask the fact that the industry as a whole may be in difficult economic straits. Purchase of an insurance policy, guaranteed investment contract or annuity from a highly rated company may simply be the economic equivalent of purchasing a "highly rated" junk bond. In July 2004, Moody's changed the outlook on the U.S. Life Insurance Industry to stable from negative. "Credit Issues and Trends for US Life Insurance," *Moody's Investors Service* (July, 2004). Of the 177 companies evaluated by Moody's, only 2% received a "positive outlook."

ed under newly emerging economic regimes. The regulatory system is based on retrospective examination of certain historical indicators of financial difficulty. This backward-looking focus largely ignores the financial risks inherent in the insurer's business and asset management strategies; as well as the probability and magnitude of exogenous economic shocks including unexpected interest rate volatility.

The new frontier in solvency monitoring incorporates both the traditional types of credit risk analysis as well as the formulaic "cash flow" risk and accounting ratio analysis of RBC ratios, IRIS and FAST. However, current models supplement this information with asset/liability matching analysis based on simulations of thousands of interest rate paths.⁴⁸ The primary concern is to assure that an insurance company capable of passing traditional regulatory tests will remain a viable economic entity that produces a positive net present value for its shareholders. Risk is primarily measured in terms of the variability of an insurer's true surplus. Statutory surplus, based on mandated static mortality and interest rate assumptions, is largely unaffected by changes in inflation or interest rates. Ultimately, however, statutory surplus must reflect any mismatches between assets and liabilities either via adjustments to reported earnings or, more directly, through increases and decreases in reserves. A company that is solvent under the conservative Statutory Accounting Principles may go out of business because it cannot provide sufficient return to its owners. Thus the distinction between true surplus—and the risk factors to which it is subject—and statutory surplus (book value of assets minus book value of liabilities) is critical. One study, using a simple duration measure, suggests that matching short-term liabilities with a long-term portfolio of Treasury Bonds could result in a ten percent decline in asset val-

ues based on only a one percent rise in interest rates.⁴⁹ If a company attempts to increase its competitive position by reaching for high yields on invested assets, it may incur significant risks that do not register on regulatory radarscopes. Whereas the surplus of many life insurers usually does not exceed 10% of legal reserves,⁵⁰ small changes in interest rates that magnify asset/liability valuation differentials can thrust a company that is, by all appearances and measures, financially sound, perilously close to financial ruin.

For many years the life insurance industry seemed to be an exception to the Schumpeterian definition of Capitalism as a process of creative destruction. The industry flourished in the 1950s and 1960s in a stable interest rate environment; the risk of business failure for reasons other than fraud or gross mismanagement was practically nonexistent; and profit margins were assured by pricing products on a spread or cost plus basis. Today, the picture is much different. The speed of competitive, economic, and regulatory regime change is far greater than ever imagined and the magnitude of the financial consequences flowing from these changes all but invalidates trustee asset management approaches designed to find the single best policy or the single best company based on track records compiled under past operating procedures and economic conditions. Track records generated under previous tax, regulatory, competitive, and economic regimes may be poor predictors of future success.⁵¹ Benefits ultimately flow to policyowners from insurance carriers who will either flourish or decline depending on their competitive advantages among a wide range of financial institutions vying for the consumer's savings and protection dollars. The insurance industry faces business and financial risks that have profound consequences for its economic viability. Trustees can no

⁴⁸ Atkinson and Dallas, *supra* at 895: "Even when assets and liabilities are perfectly matched, there may still be interest rate risk, because of accounting quirks. This can happen when assets are marked to market value and liabilities are not. A substantial increase in interest rates could cause financially strong company to appear financially weak or even insolvent."

⁴⁹ Arnott, Robert D. and Flynn, David P., "Controlling Insurance Risk and Consumer Costs: Asset Risk under Risk Based Capital Requirements," *Journal of Insurance Regulation* (Fall, 1993), pp. 81-87. For a detailed history of attempts to model the economic viability of insurance firms based on asset and liability cash flows that evidence interest rate sensitivities as well as path dependencies, see Babel, David F., "Asset/Liability Management for Insurers in the New Era: Focus on Value," *The Journal of Risk Finance* (Fall, 2001), pp. 9-17.

⁵⁰ Mehr and Gustavson, *supra* at 581.

⁵¹ The sea-change in pricing for participating (dividend paying) insurance policies is nicely summarized by two actuaries: "Years ago, par premiums were typically based on the net premi-

ums calculated for reserve purposes plus a margin for expenses. This meant premiums were based on the same conservative mortality and interest rates used for reserves. Dividends made up for the difference between actual mortality, interest, and expenses and those built into the premiums. Today, par premiums and dividend scales are more likely to be developed using pricing models. Pessimistic assumptions might be used to establish premiums that will be adequate under adverse conditions. The level and slope of the dividend scale are often part of the product design. In other words, dividends have become more than just a mechanism for returning excess earnings and ensuring equity among policyholders." Atkinson and Dallas, *supra* at 13-14. This commentary suggests the reason why it is difficult to predict future superior performance through examination of the historical track record. In the case of dividends, for example, the historical record reflects a strong inter-relationship between dividends paid and the differential between reserve assumptions and actual experience. Current dividend projections, however, may have a stronger relationship to current marketing objectives dictated by competitive imperatives.

longer remain confident regarding the solvency of insurance carriers simply because they pass regulatory examinations and actuarial performance checklists. Policy performance and carrier solvency are, ultimately, a function of corporate business strategies and the competitive environment in which they are executed. The risks of conducting business in the insurance industry have increased substantially, and it is not at all apparent that the industry will be able to meet a myriad of new challenges.⁵² Although the industry-recommended due care process for ascertaining carrier financial stability and product illustration credibility undoubtedly influences standards of practice for ILIT trustees, there is little evidence that the current due care methodologies actually yield useful results.

What then is the value of the traditional due care process with respect to carrier safety? It appears as if the primary value is that it provides something to put in the file to demonstrate the veneer of trustee procedural prudence. But if the primary value of creating an impressive looking paper trail is for liability protection, the process may be counterproductive.⁵³ Formal (or formulaic, pre-packaged commercial information programs) due care procedures undertaken by trustees with little or no background in modern portfolio theory, financial economics, or corporate financial analysis may not constitute a substantively prudent process.⁵⁴

The wave of due-care advice literature emanating from the insurance industry is, in large measure, a reaction by marketing departments to the sales crises initially brought about by the failure of several large insurance companies, and subsequently, by the failure of insurance policies to perform as illustrated. Life insurance practitioners saw a way to transform their image from the insurance salesperson to the insurance counselor. Although, in general, lacking the background, training and skill sets required for a genuine

metamorphosis, the sales agent appears to don the mantle of the financial analyst merely by presenting selected accounting information to his prospects. The agent becomes a counselor because he cautions buyers to avoid financially unsound carriers and to place all of their coverage in an excellent company. One is tempted to recall Will Roger's advice to investors: "Buy only good stocks that go up in value. If they don't go up, don't buy them." Trustees, concerned about the economic hardships inflicted upon policy owners in the event of company failure, quite correctly looked for legitimate methods to control insurance policy risk. The insurance industry had a compelling solution: use our agents/counselors to assist in due care analysis. The due care sales solution became the standard of practice for ILIT trustees. The difficulty is that it forces the ILIT trustee to represent that it can make financial and performance forecasts the accuracy of which are highly uncertain.

§2.5 DUE CARE ADVICE REGARDING SELECTION OF THE INSURANCE POLICY

Insurance policy due care is a process intended to enable the trustee to make informed decisions regarding the likely future performance of the trust-owned insurance program. *The Insurance Counselor* defines insurance policy due care for initial policy selection as "setting reasonable expectations for the range of results that may develop at the time a policy is purchased." The text observes:

Due care also continues after issue. As actual experience emerges, premium payments may need to be adjusted, or additional coverage applied for, to continue to meet the original objectives.... Sensitivity to experience

⁵² See Schott, Francis H., "Toward Financial Services: Life Insurance at the Turn of the Millennium," *Journal of Financial Service Professionals* (November, 2000), pp. 80-85, for a good review of the competitive challenges facing the industry. Schott notes "safety and competitiveness clash in the world of expanding financial service providers."

⁵³ Maloney, Eugene F., "The Investment Process Required by the Uniform Prudent Investor Act," *Journal of Financial Planning* (November, 1999), p. 84: "A paper trail will be of little value unless it reflects an understanding and consideration of risk in accordance with the basic tenets of modern portfolio theory."

⁵⁴ A series of recently court decisions in New York have been especially critical of defenses based on "proceduralism." The court, in the *Matter of the Estate of Janes*, 630 N.Y.S.2d 472 at 477, rejected a defense that offered evidence of yearly meetings to review the trust portfolio: "To assert that mere review, analysis, and monitoring satisfies the standard of due care by a prudent person

where action and activity are indicated, tests the Court's sense of reason and logic and more importantly flies in the face of the surcharge cases heretofore cited." The New York Surrogate Court [Testamentary Trust UW Dumont, 2004 WL 1468746 (June 25, 2004)] determined that the annual asset review "was little more than a reason for the trust officers to pick up the file, and possibly to communicate to each other in order to generate paperwork for an amalgamation of superiors to almost blindly sign their approval." One commentator, upon reviewing these decisions, concludes: "Having a record of annual Regulation 9 reviews is not sufficient to save a trustee from a claim of failure to follow procedures, when the content of the review is not spelled out in detail and where the failure to act indicates that this was a mere formality rather than an incisive and prudent analysis." Campisi, Dominic J., "Litigation Update," *ALI-ABA Course of Study Representing Estate and Trust Beneficiaries and Fiduciaries* (San Francisco, California, July 21-22, 2005).

changes varies widely depending on product structure and funding choices. The same is true of the post-issue alternatives for managing those effects.⁵⁵

Although there is some agreement among commentators regarding the information required to monitor an existing life insurance policy, there is little agreement on how to evaluate the likelihood that a policy will remain a prudent investment both in terms of the probability of actual values matching the values projected at the time of policy issue, and in terms of the ongoing suitability of the investment to the purposes, terms, distribution requirements and other circumstances of the trust. The former is an issue of illustration credibility while the latter is an issue of replacement or surrender suitability.⁵⁶ Probably the best statement ever written on insurance policy due care comes from insurance consultant Glenn Daily:

There is no simple way to compare or analyze life insurance policies. If there were, fee-only consultants would have written a short article explaining how to do it and then moved on to other occupations. You can certainly find charlatans who claim to have a simple method, but you will find no support for these claims in the voluminous academic literature on this subject. Therefore, fiduciaries who use these methods will have some explaining to do if they are ever invited to appear in court.⁵⁷

A review of ILIT advice literature indicates that suggested standards for policy evaluation (due care)

proceed along several dimensions:

- 1) Examination of carrier financial and operational data with the objective of extrapolating company performance to policy performance;⁵⁸
- 2) Quantitative rate of return analysis;⁵⁹ or,
- 3) Examination and testing of policy illustrations (either sales illustrations for new insurance or in-force illustrations for existing insurance) to determine the plausibility of projected values.⁶⁰

Although the above-listed standards are not mutually exclusive, for clarity of exposition we consider each policy due care method in turn.

§2.5.1 Linking Carrier Financial Data to Individual Policy Performance Predictions

It is tempting to extrapolate a carrier's success in meeting its earnings and profit objectives to policyholder success in meeting policy benefit projections. Consider, for example, the following advice:

...high ratings are not the be all and end all of determining that a carrier is a proper steward of the client's money.... Read the reports, looking beyond the carrier's ability to cover a claim. Talk with the agents about how the carrier is doing in the critical areas of mortality experience, investment management and expense control. Look at trends in distribution, growth and profitability from all lines of business.... Try to glean from the reports a sense for whether the carrier is well positioned

⁵⁵ *The Insurance Counselor*, *supra* at 145. Note, also, that the observation implies that the trustee is responsible for determining the adequacy of coverage relative to the economic objectives of the settlor. Many ILIT trustees administer the trust portfolio based on premium gifting constraints rather than on a periodic analysis of the amounts of insurance necessary to achieve grantor objectives. For example, if a settlor's objective is to provide funds for business succession or continuation purposes, is the trustee responsible for a failure to conduct a yearly business appraisal, for a failure to recommend purchase of additional coverage to match the company's growth rate, for failure to elect to surrender a cash value policy for a term policy providing a higher death benefit?

⁵⁶ The issue of how the trustee determines the prudence of policy replacement is outside the scope of this article. See, however, Collins and Jurkat *supra*.

⁵⁷ Daily, Glenn S., "Danger: Fiduciary Liability Ahead," <http://www.glennndaily.com/fiduciaries.htm>, p. 5. The lack of com-

parability between insurance products is a pervasive theme in the academic literature. See, for example, Atkinson and Dallas, *supra* at 67: "Life insurance is not well understood by most consumers. Except for term insurance, most products are very difficult to compare, even for insurance professionals. Permanent life insurance policies have so many elements that can differ (such as premiums, cash values, dividends, and death benefits) that it is impossible to rank them."

⁵⁸ Davis, William B., "Life Insurance: A Fiduciary Time Bomb," *Trusts & Estates* (May, 1992), pp. 35-38.

⁵⁹ Bohannon, David, "Methods of Evaluating Life Insurance," *Journal of Financial Planning* (April, 1996), pp. 20-22.

⁶⁰ Katt, Peter C., "Detecting Illustration/Policy Performance Abuses," *Journal of Financial Planning* (February, 1996), pp. 18-19. Alexander, Neil, "Understanding Life Insurance Illustrations," *Journal of Accountancy* (February, 2003), pp. 70-72.

by virtue of current strength and past performance to deliver on the illustration. Does the carrier's record, in terms of dividend (or credited interest) history and results in mortality, interest, lapses, and expenses suggest it has delivered in the past and will continue to do so in the future?⁶¹

This certainly sounds like good advice and seems to be exactly what the grantor and beneficiaries would expect the ILIT trustee to do. However, insurance policies don't underperform because the carrier fails to achieve its line-of-business profit objectives. They underperform because the carrier credits the policy an amount insufficient to support ongoing administrative and actuarial costs that the policy (not the carrier) must bear. There is no necessary relationship between the accounting data on the financial statements of the carrier and the future values that can be reasonably expected by the policyholder. In short, the advice is misguided.

Although everyone can readily agree that the attempt to judge the merits of a car's automotive engineering by examining the financial statements of its manufacturer would be complete folly, nevertheless, advice on policy evaluation seems to recommend a comparable procedure. But what is the rationale for undertaking such a procedure if the academic evidence indicates that it does not provide meaningful information that enables the trustee to make judgments with predictive accuracy? Superior track records in the insurance industry are as ephemeral as those in the money management industry. This should not be surprising because insurance carriers invest in the same capital markets as other institutional money managers; and, it is rare in even moderately efficient markets to find investments that offer more than zero net present value when properly adjusted for their risk. Just as the persistence of abnormal returns generated by top-ranked money managers into future periods is often no better than chance, so also, the predictability of investment results from insurance carriers is low. Indeed,

modern portfolio theory suggests that the best track record may merely reflect the fact that the winner assumed the highest amount of risk (and was fortunate enough to have the bets pay off during the period under evaluation).⁶²

The above-quoted commentator offers another commonly offered piece of advice: namely, testing the credibility of policy illustrations by comparing the illustrated interest/dividend crediting rates against the published rate on investments currently earned by the company.⁶³ The logic of this advice rests with the assumption that illustrated rates in excess of the actual rate of return on the carrier's general investment portfolio are not sustainable. The general portfolio of an insurer, however, is merely an aggregation of segmented portfolios, each of which may back separate policy forms and each of which may have substantially different actuarial characteristics and competitive objectives. Indeed, in 1985, the National Association of Insurance Commissioners cautioned: "Sometimes a company's net rate of return on its investments is referred to in such a way as to suggest that the figure represents the yield on the 'savings' component. This practice should be avoided because the company's rate of return on its investments is not indicative of the yield on the savings' component from the buyer's viewpoint."⁶⁴

A carrier's rate of return on invested assets cannot be used to predict the performance of any particular type of policy because of the segmentation of the investment portfolio. Given the rate at which new policy types come into the marketplace, it is unlikely that even policy forms launched in the recent past would have the same profit objectives, expense assumptions, compensation structures, and so forth that are embedded in the new products.⁶⁵ Insurance companies establish asset management (*i.e.*, risk/return) objectives not only by line of business but also by segmented policy types with each separate form managed according to a strategy specific to its unique characteristics. As one study notes: "Each segment has its own return objective, risk parameters, and liquidity characteristics. A few companies have seg-

⁶¹ Ratner, Charles L., "Life Insurance Policy Replacements: Real Peanuts Or Just A Shell Game?," *Trusts & Estates* (April, 2000), p. 26.

⁶² Atkinson and Dallas, *supra* at 177: "Differences in interest rates earned by various companies are often more a function of the degree of risk-taking than differences in investment acumen."

⁶³ See also Gallo, Jon J., "Use of Life Insurance in Estate Planning," *Drafting And Administering A Life Insurance Trust*, Continuing Education of the Bar Berkeley, California Program Handbook (March/April, 1998), p. 15: "Using the Best's report for the company in question, determine the company's current net return." [The authors should also point out that there is only a tenuous relationship between dividend interest crediting or credited

interest to Universal Life Policy accounts and the actual yields which depend on policy cash values.]

⁶⁴ "Report of the Yield Index Advisory Committee," NAIC Proceedings, (Vol. 1, 1986), p. 648.

⁶⁵ It has also been noted that product lines reflect historical changes in the tax code: "Product creation is based on the tax laws." Frinquelli, M.A., "Analyzing the Insurance Market—Internal and External Factors," *The Financial Services Industry—Banks, Thrifts, Insurance Companies and Securities Firms*, (AIMR, 1992), p. 76. See also Atkinson and Dallas, *supra* at 36: "Tax rules can make or break a particular type of product;" and, Collins, Patrick J. "Tax Motivated Life Insurance: An Exciting and Helpful Tool," *ACTEC Journal* (Fall, 2003), pp. 107-113.

mented by product line and in some cases have established as many as 40 different segments.”⁶⁶

The above discussion on the futility of establishing a linkage between the rate of return on an insurance company’s general account investments and the rate credited to policyholders can be generalized to other measures of profitability. Consider, for example, the widely cited measure of company profit margin. Profit margin is the present value of profits divided by the present value of premiums. It is tempting to hypothesize that companies with higher margins are better able to provide customers with superior product performance. Profit margin, however, “...is affected to a considerable degree by the choice of assumptions for the present value, and comparison of one company’s profit margins with another’s can be misleading unless there is some uniformity in the choice of assumptions. Unfortunately, there is no consensus on the appropriate assumptions, although many companies simply discount using the current rate of earnings on assets.”⁶⁷ Similar difficulties occur when assessing other key ratios such as return on equity (depends on how a company defines the components of equity) and return on assets (depends on how a company carries asset values on its financial statements). Common measures of profitability and return are simply not comparable from company to company and cannot be reliably used as predictors of returns credited to individual policies.

Indeed, at the risk of pointing out the obvious, the opaque nature of the insurance contract makes it difficult even to determine the true interest rate that is being credited to the policy, not to mention comparing this “true rate” to the reported yield on the carrier’s invested assets. Opportunities for interest crediting gamesmanship abound, for example, in new money universal life investment contracts. In new money contracts (as opposed to portfolio rate con-

tracts), the credited rate depends on when the money was received; and, therefore, more accurately reflects the returns that were available in capital markets at the time of its investment. However, some insurance carriers debit older (higher interest) money pools with the contract’s cost of insurance and administrative charges thus creating large discrepancies between the advertised interest crediting rate and the effective rate.⁶⁸

Much academic evidence suggests that the predictability sought by due care commentators who seek to link carrier performance with individual policy performance may be elusive. Until more objective research can demonstrate the efficacy of this method of policy evaluation, it is difficult to see how an ILIT trustee can justify spending much time or effort pursuing this line of due care inquiry.

§2.5.2 Quantitative Methods of Performance Prediction

Some commentators recommend evaluating life insurance policies relative either to other policies or to other investment options by calculating projected rates of return. If the rate of return on an existing policy is unsatisfactory, the trustee, according to this advice, may want to consider:

- Acquiring a replacement policy; or,
- Exercising the option for policy surrender.

The implication is that rate of return calculation is a satisfactory way to document that the trustee executed a procedurally prudent decision making process; and that the quantitative nature of the process provides strong evidence that the trustee employed the requisite levels of care, skill, and caution demanded by UPIA.

When using quantitative analysis, however, it is important to use appropriate methods with sufficient integrity and explanatory power. This is a particularly troubling area because of the propensity of some com-

⁶⁶ Ambachtsheer, Keith P., Maginn, John L., and Vawter, J., “Determination of Portfolio Policies: Institutional Investors,” *Managing Investment Portfolios: A Dynamic Process*, Eds. John L. Magninn and Donald L. Tuttle (Warren, Gorham and Lamont, 1990), pp. 4-57. See also Cabanilla and Brodie, *supra* at 78: “An overwhelming majority of the surveyed companies...used segmented assets as the primary method of determining net investment income by line of business.”

⁶⁷ Easton and Harris, *supra* at 48.

⁶⁸ This is not, however, a justification for selecting, without critical examination, a Whole Life or Universal Life contract because it credits policyowners based on portfolio yields rather

than new money yields. One of the more common myths of the insurance industry is the contention that, in the long run, portfolio yields and new money yields should produce equivalent expected values. This is true only when a company’s asset portfolio is devoid of investments with interest-rate optionality. When new money rates decline, portfolio rates do not adjust slowly. Call options and prepayment options force companies to invest significant amounts of “long term” capital at the new short-term rates. Thus, the company’s portfolio rate is more likely to adjust downwards towards a declining new money rate than it is to adjust upwards towards an increasing new money rate. This is another variation on the general risk of asset/liability management.

mentators to employ inappropriate methodologies that lead to incorrect conclusions.⁶⁹ The best example of a faulty quantitative policy evaluation methodology is the calculation of a policy's death benefit internal rate of return. The internal rate of return (IRR) expresses the relationship between projected death benefits and premiums paid. In policy replacement sales pitches, this often takes the form of a question along the lines of "if I could obtain a policy that offers 40% more death benefit for the same premium, would you be interested?"⁷⁰ The IRR is a single number that expresses the rate at which money committed to the insurance policy (and remaining in the policy) compounds. As such, IRR is comparable to the rate earned on a savings account. If beneficiaries receive an early death benefit after payment of only one or a few of the scheduled premiums, the IRR will be very high. If they must wait many years for receipt of policy proceeds, the interest rate that equates premiums paid to benefits received will be lower.

Trustees are sometimes told that policies can be compared and evaluated based on the calculated IRR. However, with respect to a life insurance policy, the IRR measure is *inappropriate* because it ignores both the scale of premium commitment as well as risk of future contract lapse due to underperformance. To a great extent there is an *inverse* relationship between a high IRR and the cash-value base upon which the contract depends for its future integrity. Therefore, the higher the IRR, the greater the risk of lapse because future interest or dividend credits may be insufficient. Furthermore, changes in premium inputs and time horizons can sometimes lead to widely varying IRRs with the result that inferior products may actually

replace adequately performing policies simply because the sales illustrations are manipulated by agents.⁷¹

Although reductions in scheduled premiums will, all else equal, enhance the death benefit IRR, premium reduction simultaneously increases the risk of lapse due to insufficient cash value. Indeed, the 1985 report of the Yield Index Advisory Committee of the National Association of Insurance Commissioners stated that calculating a death benefit internal rate of return was misleading.⁷² However, the death benefit IRR calculation is sometimes the basis for advice to dump policies that are, allegedly, outdated and underproductive. For example, the following commentary on managing trust-owned life insurance (TOLI) policies notes: "few trustees have provided the requisite review and management." It continues:

...the primary purpose of an irrevocable life insurance trust is to maximize the death benefit. Cash value accumulation is only a premium financing decision which should closely be considered and documented by the trustee.... For an existing TOLI policy, grantors, beneficiaries and their legal advisors expect the trustee to address two obvious questions through the annual monitoring function:

- Can more death benefit be purchased for the same premium outlay?
- Can the same death benefit be purchased for less outlay?⁷³

Based on this somewhat single-minded view of the role of the life insurance trust,⁷⁴ the authors "prove" that up to "74 percent of single life policies

⁶⁹ The Federal Trade Commission under President Carter, mindful of this problem, encouraged states to adopt a "Linton Yield" method for insurance cost disclosure. The Linton Yield method selects a particular planning horizon (*e.g.*, twenty years) and compares cash value insurance with a term insurance policy plus a side fund. The rate of return that brings the fund into equilibrium with the policy's cash value is the Linton Yield, which is an implied rate of return on the policy's cash value component. The Linton Yield cost disclosure method remains in use, although the states adopted NAIC recommended interest-adjusted cost indices. For a comprehensive discussion of the Linton Yield's merits and disadvantages, see Auxier, Albert L., "The ABC's of the Linton Method," *CLU Journal* (October, 1981), pp. 44-49. For a discussion of methodologies appropriate for determining the merits and disadvantages of policy replacements, see Carson, James M., and Forster, Mark D., "On the Merits of In-Force Cash Value Life Insurance," *Journal of Financial Service Professionals* (2002), pp.69-75.

⁷⁰ One actuary estimates: "the cannibalizing of existing whole life policies reached a zenith in the mid-1980s when one in every two sales of a cash value policy was a replacement." Hunt, James, H., "Life Cost Disclosure: Prospects for True Reform," *Journal of Insurance Regulation* (Summer, 1995), p. 406. Hunt is a former insurance commissioner; and he provides a life insurance policy

evaluation service under the auspices of The Consumer Federation of America (www.consumerfed.org/orflyer.pdf). Mr. Hunt prefers a "Yield Index" method of cost disclosure comparable to the "Linton Yield" method of calculating the investment return on the cash value component of life insurance.

⁷¹ An excellent review of quantitative methods of insurance cost measurement is found in Bartlett, Dwight K., "Life Insurance Cost Disclosure: A Regulatory Viewpoint," *Journal of Insurance Regulation* (Summer, 1995), pp. 432-439. Bartlett describes the history of cost disclosure calculation methods as well as several common and egregious methods used to manipulate them.

⁷² NAIC Proceedings, Vol. I., 1986, p. 647.

⁷³ Whitelaw, C. Markham and Reis, William C., "Managing Trust-Owned Life Insurance Revisited," *Trusts & Estates* (April, 1999), p. 38.

⁷⁴ By contrast, Donato and Benesh list eight rationales for establishing and maintaining an ILIT. See Donato, Linda F. and Benesh, Bruce K., "Irrevocable Life Insurance Trusts," *The Tax Adviser* (July, 1994), pp. 395-396. For additional creative uses of ILITs in estate planning see Fogel, Bradley, "Life Insurance and Life Insurance Trusts: Basics and Beyond," *Probate & Property* (January/February, 2002), pp. 8-15.

and 85 percent of Survivorship policies” are candidates for replacement. As the line of thought is pursued to its end, the authors give professional trustees the “good news” that a replacement campaign can be a marketing tool to expand the trustee’s business. A new standard of prudent asset management, based on the morals of the marketplace, emerges: “Properly structured, TOLI management is *a marketing program* bringing multiple services to the client while documenting procedural prudence” [emphasis added].⁷⁵ Even if the conclusions of the authors are correct (although most academic commentators suggest that replacement is usually not warranted), there is the possibility that a marketing-oriented trust administrative system might leave trustees vulnerable to a perceived failure to uphold the duty of loyalty because of collusion and self-dealing sales activities.⁷⁶ This is an emerging and important liability issue for commercial trustees with linkages between banking services, trust services, and life insurance carriers.

Even when appropriate rate of return methods are used, the trustee still confronts at least two problems:

1. How credible are policy projections that pro-

vide the data for the return calculations?

2. How credible are the results of calculation methodologies based on point estimates rather than range estimates?

The most precise calculations cannot assist the trustee to make good decisions if they utilize unreliable data. Additionally, many of the common methods of quantitative analysis are based on solving equations to calculate either returns or present values based on point-in-time estimates. For example, the Yield Comparison Index method calculates an equivalent yield (*i.e.*, rate of return) on insurance policy cash value assuming that the contract is surrendered in a specific future year. Such a calculation requires a precise dollar estimate of cash surrender value many years into the future. The likelihood of accurate estimation, however, becomes increasingly poor as the time horizon of the analysis expands.⁷⁷

Generally speaking, the traditional quantitative methods for determining life insurance policy costs divide into:

1. Event specific methods; or,
2. Group average methods.

⁷⁵ Whitelaw and Reis, *supra* at 43. There may be emerging a cottage industry of “independent advisors” offering their services to trustees based on the pitch that policy reviews can generate additional sales commissions for banks affiliated with life insurance carriers. See, for example, Barney, Austin D., “TOLI Due Diligence Can Yield Sales,” *National Underwriter* (April 13, 1998). Despite the fact we do not address the topic of policy replacement directly in this article, it is, nevertheless, important, and has generated an increasing amount of litigation. Virtually all states have adopted some version of the NAIC Model Replacement Regulations which direct that the replacing agent must provide the policyowner with a Replacement Notice warning of possible disadvantages, must notify the carrier of the policy to be replaced, and, in some states, must provide a Comparative Information Form projecting the relative performance of each policy. Hunt, “Life Cost Disclosure: Prospects for True Reform” characterizes replacement regulations as “How-to-do-it Kits” for agents and brokers, *supra* at 406. For a review of litigation issues surrounding policy replacement activities as well as other “market misconduct” allegations against the life insurance industry, see Egler, Frederick N. and Malak, Paul J., “The Individual Life Insurance Sales Practice Case: A Litigation Primer,” *FICC Quarterly* (Fall, 1999), pp. 1-28.

A recent example of how UPIA language can be misused for the purposes of advancing a transactional agenda (in this case, policy replacement) is found in Whitelaw, Randolph E. and Weber, Richard M., “Trust Owned Life Insurance: Risk Management Guidance for Fiduciaries,” *Estate Planning Journal* (September, 2005). The authors, although protesting that they do not intend “...to suggest that the wholesale replacement of life insurance is appropriate,” nevertheless strongly suggest that approximately 35% of in-force TOLI policies should be replaced by no-lapse guarantee products in order to mitigate trustee risk of determining and managing premium adequacy for policies with non-guaranteed premiums. UPIA phraseology is manipulated into prescriptive

statements implying that the sole path to prudence lies along the track of greatest financial advantage to the trust investment “consultant”: “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 restructuring to a guaranteed death benefit policy.” Although mitigating trustee risk may be a laudable goal, prudent asset management for the benefit of trust beneficiaries is a paramount fiduciary obligation. A more balanced and thorough discussion of the risks of selecting no-lapse guarantee policies for trust owned policies is found in Bannen, John T., “No Lapse Guarantee Life Insurance Policies: The Answer to an Insured’s Prayer or a Fiduciary Nightmare?” *ACTEC Journal* (Spring, 2005), pp. 246-250; and Bannen, John T., “No Lapse/Secondary Guarantee Life Insurance Policies,” *ALI-ABA Sophisticated Estate Planning Techniques* (Boston, Massachusetts, September 8-9, 2005). Robert Stein, chairman of Ernst & Young’s Global Financial Services department, sees “...a disturbing parallel between the current-day presentation of no-lapse products and the sale of vanishing premium products in years past. Each represents an easy sale.” Stein hypothesizes that the litigation fallout from such sales could trigger the next “debacle for the life industry, raising the specter of lawsuits and damaging allegations regarding the insurance sales process.” Stein, Robert W., “No-Lapse Policies Pose Risk,” *Best’s Review* (April, 2005), p. 74. See also Collins and Jurkat, *supra*.

⁷⁶ Although constraints on trustee self-dealing and other conflicts of interest vary from state to state, OCC regulation 12 CFR §9.12 prohibits self-dealing between national banks and their subsidiaries and affiliates including insurance corporations. See also Moore, Donald F., “The Duty of Loyalty and the Responsibility of the Fiduciary—A Regulator’s Perspective,” *Trusts & Estates* (May, 2000), pp. 40-41 and p. 79.

⁷⁷ Collins, “Is It Prudent and Suitable?” *supra* at 6.

Event specific methods are the more common methods used to calculate life insurance costs. They focus on the customized and specific insurance illustration prepared for the policyholder. Generally, event specific methods seek to determine the cost of an insurance policy (and, by implication, to compare competing policies) by taking illustrated dollar benefits at their face value. Examples of event-specific methods include the Death Benefit IRR and the Yield Comparison Index methods as well as Linton Yield (implied rate of return on projected cash values); Equivalent Level Annual Dividend method (for participating whole life contracts); and net present value cash flow calculations.⁷⁸ The key point, however, is that event specific methods can determine the true cost of life insurance only if every assumption underlying the product illustration (either sales proposal or in-force policy illustration) occurs exactly as predicted for the individual buyer. At the end of the day, this method generates a precise cost expectation that ILIT trustees should never expect.

Group average methods, by contrast, do not measure the insurance cost for individual buyers but rather the average cost for the group of consumers electing to purchase the policy. The Group Average method generates an expected average, and does not forecast the exact cost of insurance for any individual. This said, however, group average methods may be superior to event specific methods for a variety of important reasons. When considering, over time, the total experience of a group of policyholders, the method incorporates critical dynamic variables such as lapse ratios, survival probabilities, non-forfeiture values, etc. Thus, a group average method includes multiple “discounting” operations for interest, policy retention, and mortality experience. The dimension of time incorpo-

rates factors for time value of money (similar to the Yield Comparison Index method), and provides a more comprehensive year-by-year picture of insurance policy costs and benefits.⁷⁹

§2.5.3 Testing the Policy Illustration

The National Association of Insurance Commissioners, in 1994, stated, “Illustrations are not and cannot be predictions or estimates of future performance.”⁸⁰ However, despite this caveat, much due diligence advice tries to tease out future performance parameters by using the illustration as a kind of base case: “Always ask for an alternative illustration with reductions of 100 basis points or a 1% drop in the rate and 200 basis points or a 2% drop in the rate.”⁸¹ However, critical evaluation of the proposed insurance plan requires examination of the timing, risk, magnitude, and probability of all cash flows according to generally accepted standards of statistical and quantitative financial analysis. Unfortunately, this involves something more than having the agent recalculate illustrated values using alternative interest rates.⁸²

Most of the illustration testing procedures consist of multiple scenarios or “what if” analyses. What if the credited interest rate dropped by one percent; what if the costs of insurance coverage rose to their maximum guaranteed level? This type of testing provides limited information to the trustee. Actual insurance policy dollar values are generated by the dynamic interaction of many return variables operating in an environment of interactive complexity.⁸³ Such environments are often characterized by conditional probabilities and non-linear results. Thus, a “what-if” analysis may miss the mark. A “what if” analysis takes an illustration and examines

⁷⁸ Mehr and Gustavson, *supra* at 135-143. See also Bohannon, *supra* at 20-22.

⁷⁹ The 1979 report of the Federal Trade Commission (*Life Cost Disclosure: Staff Report of the Federal Trade Commission*) that calculated a return of only 1.3% for whole life policies was based on a group average calculation methodology. Although each insured’s return is unique, on average, the life insurance buyer fares poorly because of the propensity to lapse or surrender policies obtained in the face of high acquisition costs.

⁸⁰ See also “Final Report Of The Task Force For Research on Life Insurance Sales Illustrations Under The Auspices of The Committee For Research On Social Concerns,” *Transactions of Society of Actuaries* (1991-92 Reports), p. 140: “How credible are any nonguaranteed numbers projected 20 years into the future, even if constructed with integrity? How does a consumer evaluate the credibility of two illustrations if they are from different companies or even from the same company if different products with different guarantees are being considered? 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.... Within North America in other

financial products such as mutual funds, it is recognized that future performance cannot be illustrated. The emphasis of these illustrations is to disclose expense charges, not the performance of the underlying fund. Life insurance policies are complex financial contracts. There is no simple measure or analysis to compare future performance of unpredictable events. This fact is well understood in the securities industry and needs to be assimilated into the life insurance industry as well.”

⁸¹ Gallo, Jon J., “Use of Life Insurance in Estate Planning,” *Drafting And Administering A Life Insurance Trust*, Continuing Education of the Bar Berkeley, California Program Handbook (March/April, 1998), p. 15.

⁸² See, for example, Carson, J.M., “Determinants of Universal Life Insurance Cash Values,” *The Journal of Risk and Insurance*, Vol. 63, No. 4 (1996), p. 678: “The results of the multivariate analysis indicate that ignoring expense, mortality, and surrender charges within universal life policies is likely to lead to erroneous conclusions when attempting to identify competitive universal life policies.”

⁸³ As well as by the way the carrier elects to allocate expenses and interest rate credits.

changes in dollar values resulting from changes in isolated determinants of return (increase or decrease in lapse rate, interest credits, and so forth). Additionally, the variable of interest is usually changed in a predetermined fashion with all other variables held constant.

Even if “what if” methodologies could yield useful insights, they may fail when applied to insurance policy illustrations. The determinants of illustrated policy dollar values cannot be disentangled. You cannot, for example, assume that the interest rate crediting component in a universal life policy illustration reflects only interest earnings on underlying assets. Although clear disclosure regarding important policy elements was a marketing promise made by insurance carriers when Universal Life products first appeared, “not only are high early expenses now covered by a surrender charge, but mortality charges may frequently include expense or income tax, and interest rates credited may even be reduced by expense costs other than investment expense.”⁸⁴

Fortunately, projections for new insurance coverage must depict the worst-case scenario in the guaranteed values column of the sales illustration. Additionally, most insurance carriers can illustrate guaranteed values for existing policies on in-force illustrations. Therefore, some of the “what if” tests indicate the degree to which policy values are sensitive to small changes in relevant variables. However, the actual assumptions that underlie policy illustrations are proprietary information; and, without knowing the underlying assumptions, it is difficult to determine how single variable changes illuminate actual policy risks.

Actuaries, in part, focus on the risk that the assumptions underlying product development and pricing are misspecified or incorrectly determined. Actuaries term the risk that a pricing model’s flaws preclude corporate profitability objectives “pricing risk.” If there is a high degree of pricing risk (*e.g.*, each relevant variable can be at the upper bound of “reasonableness” at some time but the assumption that all variables exhibit favorable interaction for most or all of the time may be unreasonable), then there is a high probability that the insurance contract will fail to deliver adequate return on equity to the carrier; or will

fail to deliver projected values to the policyholder absent additional premiums.

The NAIC approved the Model Regulation of Life Insurance Illustrations in 1995. It provides for the appointment of an Illustration Actuary responsible for certifying the reasonableness of non-guaranteed elements in the product illustration. The regulation specifies rules for construction of a “Disciplined Current Scale” and requires a set of testing procedures in order to determine the viability of the product illustration.⁸⁵ Actuarial Standard of Practice #24 governs the methodology to determine that the product illustration is self-supporting. Actuarial assumptions must be based on “recent historical experience.”⁸⁶ Thus, a reasonable assumption is merely one that corresponds to the limits of current experience for the product line being illustrated. With the continuous creation of new product lines backed by segregated investment portfolios, there is little long-term experience history; and, illustrated values may bear little resemblance to actual future outcomes: “Life insurance contracts usually extend over many years, and it is impossible for the issuing company to predict the actual cost of insurance on a reasonably accurate basis.”⁸⁷ Additionally, regulations for allocation of expenses (“fully allocated” vs. “marginally allocated”) permit great latitude in future dollar value projections on an insurance illustration.⁸⁸

The uncertainties that characterize this state of affairs are nicely captured in a story that circulates at actuarial conferences:

In the old days ... it was easy. The CEO used to give a profit goal for a product. Then the marketing man would tell you the product design. The actuary knew what the assumptions were and solved for the premium. Now...it’s a lot different. The CEO still gives me a profit goal, and the marketing guy not only gives me the product design, he gives me the premium, and I have to solve for the assumptions.⁸⁹

⁸⁴ Easton and Harris, *supra* at 17.

⁸⁵ *Id.* at 150-151.

⁸⁶ *Id.* at 226-227.

⁸⁷ *Id.* at 135. See also Atkinson and Dallas, *supra* at 114: “Actual experience is not always credible....”

⁸⁸ Atkinson and Dallas, *supra* at 910: “In order to field competitive products, some companies knowingly price using unit costs below their actual unit costs. To compensate, such companies simultaneously pursue an expense reduction campaign, with a goal of bringing actual unit costs down to the level of assumed unit costs, at some time in the not-too-distant future. In some cases,

this may be wishful thinking.”

⁸⁹ Lennon, *supra* at 17. This humorous anecdote underscores the fallacy of another common myth regarding life insurance—namely, insurance pricing is a function of strict actuarial expectations. Atkinson and Dallas, *supra* at 71-72, for example, discuss pricing options available to manufacturers of insurance products. While it is true that regulators prohibit predatory pricing practices, nevertheless, many products are priced according to adaptive (“eventually, most companies in this category will exit the business or be acquired”) or opportunistic pricing strategies (“profit margins will be thinner”) that may have little to do with the input of the actuary.

Although intended to be humorous, this tale is not too far off the mark. The ILIT trustee purchases a contract that promises only the guaranteed values. Additional projected benefits are forthcoming if the assumptions that underlie the pricing model unfold, as predicted, over time. The likelihood that such additional benefits will unfold exactly as predicted is remote; and, this is a reason why some quantitative rate of return methods are not as helpful in policy evaluation as might be expected. One commentator sums up the current state of policy illustration credibility in the following terms: "...the NAIC's attempt to eliminate illustration abuses is producing underwhelming results...the regulations apparently can be interpreted to allow companies to continue the game of illustration liar's poker by making unsupported exaggerated policy values promises."⁹⁰

Academic studies provide a caution to trustees who must carefully evaluate the credibility of projected dollar benefits either on new sales illustrations or on inforce policy illustrations. The trustee is faced with a

seemingly insurmountable task because it is impossible to obtain a road map through the myriad of assumptions underlying such illustrations; and, therefore, impossible to know in which direction you are moving as you make changes in individual variables. Conventional wisdom regarding the value of and the strategies for testing product illustrations appears to be largely inadequate from the standpoints of both methodological correctness and legal defensibility. We find, however, that the typical insurance advice literature places the trustee squarely in the middle of an insoluble dilemma. The trustee, according to life insurance counselors, must evaluate the costs and benefits of new or existing insurance policies lest the beneficiaries be shortchanged because the trustee invested in inferior products. But such evaluation necessarily involves forecasting costs and benefits that, according to actuaries, the product manufacturers themselves cannot predict with a reasonable degree of accuracy. The next section explores the nature and magnitude of the trustee's quandary.

⁹⁰ Katt, Peter, "Deciphering Cash Value Life Insurance Illustrations," *Journal of Financial Planning* (October, 1997), p. 33. The response of the insurance industry to the NAIC model illustration legislation is of particular interest. We reproduce an

announcement released on December 11, 1996 by a major insurance company regarding how the new NAIC regulations alter their marketing as of 12/31/96. Names of specific products are changed to "generic" labels:

PRODUCTS TO BE REPLACED, WITHDRAWN, OR NOT ILLUSTRATED:

Product A & Product B and Product C will be withdrawn in the states adopting the rule...In states with a 1/1/97 effective date, applications for the ... products must be received in [company's name] office no later than December 31.

Products D and E will no longer be available in any state. Applications must be taken by 12/31/97.

Product F will continue to be available in all states but will only show guaranteed elements on the illustrations.

Product G will be designated as a "non-illustrated" product in adopting states. Software support will no longer be available.

Announcements such as this leave one to wonder about the integrity of the product lines available for sale up through the end of 1996. The announcement regarding the shake-up in product availability does not suggest that owners of past policies will be alerted to the fact that such products have been withdrawn from the

market; nor does it suggest that agents have been instructed to inform their clients regarding these developments. If anything, it suggests that agents should hurry to complete sales of Products D and E before they are regulated out of existence. *Caveat Emptor.*