

# Trusts & Estates®

The Journal Of Wealth Management For Estate Planning Professionals

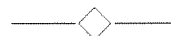
## Recognizing Excellence: The 1997 EPIC Awards Issue

DECEMBER 1997



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# Will Your Clients' Life Insurance Suffer From Failed Expectations?

**A**re your clients' life insurance policies ticking time bombs? Will they and their loved ones suffer from failed expectations within the next few years? If they purchased Universal Life policies sometime between the late 1970s and early 1990s — or in some cases even traditional Whole Life policies — they could be in for a big surprise!

While the problems experienced by life insurance companies and their clients in recent years regarding poorer-than-expected policy performance have been well publicized in the press, the general impression is that these problems have been adequately addressed and satisfactorily resolved. Unfortunately, that is not the case. True, the problems regarding delayed premium—"vanish" years under Whole Life policies generally have been acknowledged and dealt with, but the much more serious problem regarding Universal Life policies — that the policy itself may vanish before the insured dies — are still buried beneath the surface and, for the most part, are being ignored.

The authors recognize that, as the new regulations already promulgated by the National Association of Insurance Commissioners (NAIC) come into play across the country, policy illustrations in the future will provide much more detailed disclosure of what is and is not guaranteed in a policy. This

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*T*he problems experienced in the life insurance industry are monumental and have been well publicized in the media. In recent years, the issues surrounding failing Universal Life policies have come to the forefront. The general impression is that these issues have been addressed and resolved. Unfortunately, this is untrue. The serious problem regarding Universal Life policies — that the policy itself may vanish before the insured dies — is still buried beneath the surface, and for the most part, is being ignored.

article addresses only inforce policies sold in years past that were not subject to these new NAIC regulations, whether or not such policies have been the subject of a class action lawsuit against the issuing carrier. It is hoped that the full disclosure required by the new NAIC regulations will prevent a repetition of the problems discussed in this article.

Consider the example of a man in his mid-70s who purchased a \$100,000 Universal Life policy from a major carrier in 1986 when interest rates were still quite high. He was paying \$2,900 a year for the policy. The original illustration he had been given when he bought the policy showed that this payment schedule was adequate to keep his coverage in effect until the policy "matured" at age 95.

Much to the client's surprise, current policy illustrations showed that, due to lower interest rates, his policy would expire in just 12 more years at the current level of premi-

um payments. In order to extend his coverage to age 95 as originally illustrated, he had two choices: either (1) increase his premium payments immediately by 50 percent — up to \$4,400 per year, or (2) continue paying at the

current rate for 12 more years and then increase his premium payments to over \$13,000 per year! The sad part of this is that no one had informed this man of his serious problem . . . a vanishing policy.

Fortunately, the client was in excellent health, so he was able to obtain a new policy from another strong carrier whose Universal Life policies are more favorably priced. In fact, he qualified as a "preferred non-smoker," which is that carriers' very best underwriting classification. On this basis, the illustrated premium (with a tax-free rollover of the cash surrender value from the old policy) was only about \$3,100 per year for a policy which "matures" at age 100. This man was delighted with the results and decided to go forward with the new coverage. He was lucky, and his outcome favorable, but not everyone will be so fortunate.

We have seen several similar examples in recent years, with similar results.

All traditional cash value life insurance policies are built around carrier assumptions as to three key elements: mortality, expenses and earnings. The starting point, of course,

**By Alan J. Silver  
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is recent and current experience, but emerging trends must also be considered.

In pricing their products, carriers work with guaranteed numbers and illustrated numbers. The basic numbers are the policy guarantees. Since life insurance policies make promises which extend many years into the future, the guaranteed numbers are necessarily conservative. For example, the guarantees in most life insurance policies are built around an interest rate assumption around 4 percent to 4½ percent.

However, because the current experience of most life insurance companies is better than their guarantees, they not only show the guaranteed numbers, but also illustrate results based on assumptions that are much less conservative than the policy guarantees. While this makes the products more attractive to the buying public, it is here that the seed for future problems and disappointments can take root. Again using interest rates as an example, many policies, even today, illustrate results based on assumed interest earnings in excess of 7 percent. But what happens if the carrier does not earn enough to credit the illustrated rate? You guessed it: failed expectations!

To help demonstrate our point: first, a brief history of interest rates over the last 15 to 20 years, including rates illustrated by life insurance companies; and second, a brief explanation of the key differences between Whole Life policies and Universal Life policies.

### **Interest Rates**

THE LATE 1970s and early 1980s saw just about the highest interest rates experienced in many years. Money market fund rates were as high as 17 percent to 18 percent. And where are money market fund rates today? Around 5 percent, if you're lucky, and that's considerably higher than even a year ago. The decline in interest rates started somewhere in the mid 1980s and continued steadily without a major break until quite recently.

During this period of high interest rates, in order for their products to remain competitive with shorter-

term financial instruments, life insurance companies generally based policy illustrations on the unusually high interest rates of the day. While new money invested by the carriers may have been able to earn those rates, it was unrealistic for the carriers to use such high rates as the basis for long-term projections. Why? Because history tells us that interest rates rise and fall over the years, so there was no reason to expect rates to remain that high over an extended period; in addition, the carriers already held large portfolios of investments, traditionally high-grade, long-term bonds with much lower rates, which tended to hold down their overall rate of return. The result of all this was some overly aggressive and optimistic policy illustrations (despite disclaimers, a form of "illustration abuse?") along with the development of a new type of policy, Universal Life, supported by new investment portfolios not burdened with pre-existing long-term investments.

### **Whole Life Or Universal Life**

WHILE BOTH Whole Life (WL) and Universal Life (UL) policies are constructed out of the same basic "materials" (guarantees and assumptions as to earnings, expenses and mortality costs), and both are considered "permanent" or "cash value" policies rather than pure term insurance, there are many important differences. A basic understanding of these differences is critical to the proper management of an individual's insurance policies. (Please note that the following is only a summary of some of the more important elements of WL and UL and is not intended as a complete description of all aspects of these policies.)

**Whole Life Policies.** Generally, WL policies are like an amorphous mass. Although they are comprised of clearly identifiable elements, those elements usually are not separately stated, and the policy cannot easily be broken down into its component parts. It either functions as a unified whole, or it doesn't function at all.

For example, WL policies have a fixed premium, payable for life,

based on the guarantees as to minimum earnings, maximum expenses and mortality charges. And, if that fixed premium is in fact paid for life, the policy is guaranteed to endow for its face amount (i.e., the policy's cash value will equal its face amount) at maturity, typically age 100. The minimum guaranteed earnings rate on which the fixed premium and the guaranteed cash value and death benefit are based is clearly stated in the policy, but it is often harder to determine the guarantees as to expenses and mortality.

As stated earlier, policy guarantees are necessarily conservative. However, every insurance company expects its earnings to be more than the guaranteed 4 to 4½ percent; it also expects its actual mortality costs to be less than the rates it guarantees and its expenses to be less than the guaranteed charges. With "participating" WL policies, this difference between "expected" results and guarantees is typically reflected in the company's current illustrated "dividends."

However these illustrated dividends are not guaranteed! For example, if the illustrated dividends are based on expected earnings of 10 percent, and actual earnings over the years average only 7 percent, then logic dictates that the actual dividends will be considerably less than the illustrated dividends.

WL policies contain several options as to the application of dividends. The most common are to reduce the premium that needs to be paid out-of-pocket, or to leave the dividends in the policy to buy additional paid-up insurance, which has its own cash value and develops its own dividends. Generally, under this "paid-up additions" option there comes a time when the cash value of the paid-up additions, together with expected future dividends, are deemed sufficient to pay the policy's fixed premium for the balance of the life of the policy. When this happens, the premium is said to "vanish," and the first year it is expected to happen is known as the "vanish year." However, since dividends are not guaranteed, the "vanish

year” is similarly not guaranteed. And even if premiums have already “vanished,” they can reappear if the assumptions on which future dividends are based are not met.

**Universal Life Policies.** Unlike Whole Life, a Universal Life policy is “transparent.” This means that each of its elements — interest earnings, expense charges, and mortality costs — is separately stated, and each functions independently to make up the whole.

Also unlike WL, UL “premiums” are flexible in both amount and duration, although there always is a minimum premium required in the first year to put the policy in force. After the first year, as long as the policy’s cash value, including earnings during the year, is sufficient to pay then current policy expenses and then current mortality costs, no additional premium dollars need to be contributed to the policy. However, since then current earnings, expenses and mortality costs are not guaranteed into the future, expected minimum premium payments to keep the policy in force in the future also are not guaranteed. (Remember our example at the beginning?)

Here’s how a UL policy works. Premium contributions, minus sales charges (if any), are deposited into the policy’s cash value account. That account guarantees a minimum interest rate of, say, 4 percent or 4½ percent, but usually pays a higher current rate, which is stated by the carrier and revised periodically as market conditions dictate. Then, during the year, expense charges and mortality costs are taken out of the cash value account, typically on a monthly basis, at then current rates.

There are guaranteed maximum expense charges and guaranteed maximum mortality rates, but current charges are almost always lower than the guarantees. Mortality charges are determined by applying mortality rates to the net amount at risk under the policy, which is the difference between the policy’s cash value and total death benefit.

Regarding the death benefit under a UL policy, there are always

two choices: a “level” death benefit equal to the stated face amount, and an “increasing” death benefit equal to the stated face amount plus the policy’s cash value. The reader may observe that, with the same stated face amount, the net amount at risk under the “level” approach will be less than under the “increasing” approach, with correspondingly lower mortality costs.

## The Problem

THE FOREGOING DISCUSSION of interest rates in recent years, coupled with the description of how WL and UL policies work, lays the foundation for understanding the serious, and often undisclosed, problems with many existing UL policies and some WL policies. For example, were your clients’ policies bought when interest rates were high, perhaps at 10 percent to 13 percent? If so, were the client’s expectations — as to the premium-“vanish” year under a WL policy or as to the minimum premium required to support a UL policy to maturity — based on those high interest rates? If the answer is “yes,” the chances are good that their expectations have not, or will not, be met.

As stated earlier, the problem is more evident, but generally less serious, under a WL policy than under a UL policy. The reason for this is that, with a WL policy, since payment of the fixed premium guarantees the promised results, about the worst that can happen with declining interest rates is that the premium will not “vanish” as soon as expected — or, if it has already “vanished,” that it will reappear in a few years, in whole or in part. And since the originally illustrated premium-“vanish” year already is upon us in many cases, these policyholders already know that they may have to pay a few more premiums. Yes, they may be suffering from failed expectations, but their problem generally is not fatal.

With a UL policy, on the other hand, particularly under the more common “level” death benefit approach, the problem tends to compound itself over the years, particularly in the later years when mortality rates are higher. This happens

under the following scenario:

With lower earnings, the policy’s cash value is lower. With a lower cash value and a fixed total death benefit, the net amount at risk under the policy becomes higher. With a higher net amount at risk, the mortality charges taken out of the cash value are higher, and with higher mortality charges taken out of the cash value, the cash value is further reduced, thereby further increasing the net amount at risk and causing even higher mortality charges, thereby further reducing the cash value . . . and round and round it goes until there is nothing left, and the policy itself vanishes.

If this occurs, generally it is too late to rectify the problem, because it would take much too much money to pay the ever increasing mortality costs under the policy necessary to support the death benefit. In effect, the policy has become a term policy — and, although term insurance may work well when one is relatively young, it becomes prohibitively expensive in the later years when death is most likely to occur.

## The Solution

IN ORDER TO DETERMINE what the best solution may be for a particular individual requires full knowledge of that individual’s circumstances coupled with a detailed analysis of his or her policies. The purpose of such an analysis is to ascertain the nature and extent of the problem and develop reasonable alternatives to the current situation. Usually there is a feasible and workable solution, but not always. It takes a highly qualified practitioner with sophisticated computer technology and special expertise to do this job thoroughly and meaningfully.

Perhaps a client’s own personal life insurance agent or financial consultant can perform this task. If not, you and your client should seek out the services of a qualified professional to provide this invaluable information. There are firms that will provide such an analysis on a fee-for-service basis. If the work is done properly, the end result will be well worth the modest expenditure of time and money. ♦

# Best Article

EPIC  
AWARDS

## **Alan J. Silver and Robert E. Burton**

*The Silver Group  
Alameda, CA*

The EPIC Award for "Best Article of the Year" has been awarded to the article entitled "Will Your Client's Life Insurance Suffer From Failed Expectations?" (July 1997) which was co-authored by Alan J. Silver and Robert E. Burton of The Silver Group in Alameda, Calif.

The article began with the startling wake up call: "Are your client's life insurance policies ticking time bombs? Will they and their loved ones suffer from failed expectations within the next few years?" The article proposes that if clients purchased Universal Life policies sometime between the late 1970s and early 1990s — or in some cases even traditional Whole Life policies — they could be in for a big surprise.

The article goes on to state that, although recent problems experienced in the life insurance industry have been well publicized in the media, it is only now that the issues surrounding Universal Life policies have emerged. The general impression is that these issues have been addressed and resolved. Unfortunately, this is not the case. The serious problem regarding Universal Life policies — that the policy itself may vanish before the insured dies — is still buried beneath the surface and, for the most part, is being ignored.

Silver entered the life insurance business in 1965, joining New

York Life Insurance Company in its San Jose General Office. He transferred to the Oakland General Office in 1967 where he joined his uncle Ben Silver. The evolution of the business led to its present form, The Silver Group, with Silver, Burton and Silver's son Lloyd as principals.

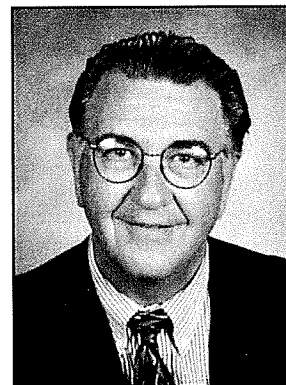
Alan Silver is a Life and Qualifying Member of the Million Dollar Roundtable, a six-time Member of "Top of the Table" and holds numerous company and industry awards.

Burton is a member of the bar in New York and California and practiced law in New York City for nine years, specializing in estate, trust and corporate work. As a senior advanced underwriting consultant for New York Life, he was a leader in all phases of the Company's Advanced Underwriting program. He retired early from New York Life in 1986 and, from 1986 through 1989, was vice president of Management Compensation Group/SF. He is now a principal of The Silver Group.

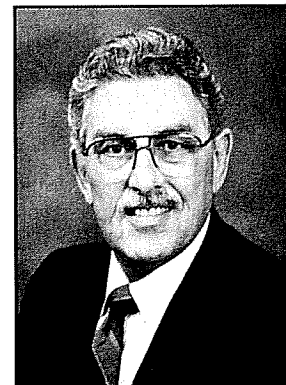
Burton is past president of both the San Francisco Estate Planning Council and the San Francisco Chapter of the American Society of CLU & ChFC, a principal contributor of Community Property materials to the CLU/ChFC Advanced Estate Planning Course and holds the Accredited Estate Planner designation.

Both Silver and Burton are very active in community affairs. Silver is a 17-year youth baseball coach and Burton is a past city councilman and two-term mayor of Mill Valley, a suburb of San Francisco.

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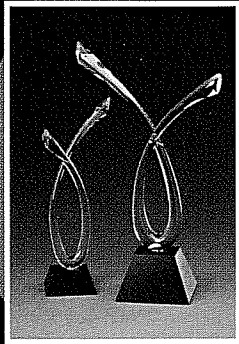


**Alan J. Silver**



**Robert E. Burton**

# '97 EPIC AWARDS



## Honoring Innovation, Vision and Effort

by **David Premo**

*Group Publisher  
Trusts & Estates*

### Presenting the 1997 Estate Planning and Investment Counseling Award winners

The EPIC awards developed, as so many good ideas do, from an offhand remark at a combined business and social event. Roy Adams, Mike Klim and I were at a dinner honoring the graduates of the American Bankers Association National Graduate Trust School in August 1996. Roy mentioned that with all the talented young people entering this field, our publication should honor the best young author with some award. That was the end of that conversation.

But throughout the year, the idea kept resurfacing in conversations. It also kept growing in scope. Why limit honorees to young authors? What about great ideas brought forth by more established contributors? Do we honor companies for making products that are of significant use in our industry even if they are not the subjects of articles? The questioning process continued for several months and culminates here, with the announcement of this year's EPIC Award winners.

What's in a name? We finally settled on EPIC, an acronym for Estate Planning and Investment Counseling, which comes quite close to our mission statement for the publication. The embodiment of the EPIC, pictured on the cover of this issue, was designed by world renowned glass sculptor Hans Frabel.

To get the selection process

started, we ran the call for nominees in several issues earlier this year. Editor Mike Klim first reviewed the nominations to be sure they met our criteria. Then, Mike conferred with the members of our editorial advisory board. After that, I met with Roy Adams to verify that each potential winner did indeed meet our strict criteria. Even at this final stage, there were two last minute eliminations. The entire process required each of the 11 winners to first be nominated, then screened, voted upon and finally verified.

In the following pages, you will learn what we considered justification for the honor. This year, there were a few winners we felt deserved recognition even though their contribution was not introduced during 1997.

Presentations will take place at a lunch honoring the recipients during our 9th Annual Conference on Estate Planning and Administration. If you join us at the Fairmont Hotel in San Francisco, Feb. 18-20, you'll be able to congratulate the winners after lunch on Friday. You will also probably get to meet some of next year's winners. They may very well be one of the speakers presenting new ideas to the audience or one of the firms demonstrating their new products and services to the attendees. Either way, there is a lot of talent out there. This is our way of recognizing it.