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Why Life Insurance Portfolios Must Be Audited

While companies have good reasons to buy insurance on executives' lives, lax monitoring of policy performance can destroy much of the value.

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» Buying life insurance policies on key executives is a good strategy for certain companies. Crossing that task off a checklist and then ignoring the policy for the next 20 years isn't.

Why buy such insurance? For one reason, so-called "key person insurance" is designed to compensate a company for financial losses that might arise from the death of an executive.

Life insurance is also frequently a tax-advantaged type of compensation for executives in lieu of traditional deferred-compensation arrangements. Some execs prefer whole life policies, which typically are designed to build up a large cash value. Others, focusing on estate planning, value universal life policies, which use a greater share of the premiums to buy death benefits rather than build cash value.

There's a problem brewing with company-sponsored life insurance, however, and the problem seems to be worsening.

Each life insurance policy "illustrates" at the time of purchase its expected future performance, which will be driven by the insurer's returns on its investments of the insured's premiums as stipulated in the policy.

But, because life insurance policies can be in force for decades, the illustration may —in fact, it likely will — prove inaccurate.

If a policy initially illustrated at, say, a 7% annual return but is performing at only a 4% rate, the policy won't achieve its goals for the company or executive.

And indeed, many company-sponsored policies, purchased 20 or 30 years ago when interest rates and investment returns were substantially higher, are significantly underperforming today, expert observers say.

Companies could have mitigated or eliminated that problem by regularly watching a life insurance policy's performance starting with the policy's inception. Then, if necessary, adjustments could have been made, such as putting more cash into the policy or limiting the portion of returns that could be extracted from the policy to pay for premiums.

But companies often failed to do that, and their lax monitoring is ongoing.

"What happens much of the time is that brokers sell these insurance arrangements and then nobody looks at them," says Andrew Liazos, leader of the executive compensation practice at law firm McDermott Will & Emery. "People think they're just naturally going to operate the way they were illustrated, and then years later there are big issues with these policies."

It's an odd failure, considering the money potentially at stake. In particular, it's not uncommon for owners of closely held companies to hold $50 million or $100 million life insurance policies, according to Liazos.

For such owners, life insurance placed into an irrevocable trust can be a very practical estate-planning investment. For example, the company can assume responsibility for paying the premiums. Then, upon the executive's death, the company can get back a portion of the premiums under what's known as a split-dollar arrangement. The rest of the policy's value is distributed to the executive's beneficiaries.

That will result in "a very small compensation tax and virtually no gift tax," Liazos says.

His advice for companies is simple. "If you have an insurance policy portfolio, have somebody come in and audit them to see whether they're doing what they're supposed to be doing," he says.

Trust the Experts

Consultants, rather than law firms, typically perform the auditing services.

"If you bought an investment portfolio 20 years ago," says Tobi Silver, president of life-insurance consultancy Sterling Resources, "and then stuck it in a drawer and pulled it out today, you would have no expectation that it had performed well, or that you hadn't missed opportunities to manage and modify the portfolio in response to what was happening in the market.

"But interestingly," she adds, "people have no hesitation about doing that with their life insurance portfolios. They want to check that box because their lawyer or accountant told them they needed to buy that coverage. Then they put it away. It is a very prevalent problem."

While part of that problem, as manifested today, is indeed traceable to the flatlining of interest rates in recent years, Silver also places a share of the blame on the life insurance industry. "Traditionally, life insurance is not serviced well," she says. "Most of the brokers are on commissions, so their compensation is based on whether something sells, and there's not much focus on servicing."

Auditing a life insurance portfolio involves requesting lots of information from the insurance carrier or carriers. That starts with the simple matter of who owns the policy and who the beneficiaries are. "You'd be amazed how often that what the company thinks is the ownership and beneficiary structure, isn't," Silver says.

The audit also includes looking at the premium history from the outset of the policy; an analysis of how long the policy would stay in force if lower premium payments were made; what premiums would be necessary to keep the policy in force through different age thresholds for the insured; and analysis of the carrier's financial strength.

A worst-case scenario is a policy that lapses before the expected life expectancy of the insured. Poor policy performance is often a contributing factor. Among the ways a policy can lapse: As an insured ages, the insurer annually takes "mortality charges" out of the policy's cash surrender value, reflecting the insured's increasing risk of mortality. At a point in time when there are insufficient funds in the policy to pay for such charges, the policy lapses.

In a recent and somewhat typical case of why portfolio audits are crucial, a closely held company was still paying life insurance premiums on a policy for an elderly co-owner, a client of Silver's who was extremely ill. An analysis showed that if no more premium payments were made, the policy would still remain in force for four years with no reduction in death benefit. The executive was very unlikely to live for four years, so the company ceased payments, saving more than $2 million.

Silver works closely with many CFOs, because most of her clients — high-net-worth families and individuals — are involved in closely held businesses. There, the CFO often is responsible for both corporate insurance and personal insurance matters on behalf of company owners.

The prevalence of life insurance policies taken out on executives at publicly held companies has declined since 2002, Silver notes. That's when the IRS implemented strict new regulations covering split-dollar arrangements at such companies.

But, she opines, such arrangements "may make a comeback in the new tax environment."

To the extent that companies do buy life insurance for the benefit of executives, the corporate purpose is to reward them and thereby retain them, Liazos notes.

But problems with policies often begin even before they're purchased, he adds. Many companies do insufficient comparison shopping among insurers, which is influenced by the fact that some brokers can sell for only one particular insurer.

Also, companies tend not to perform adequate "stress testing" on policies, Liazos adds. The process involves mapping out how the policy will perform under different return scenarios.

Beware of Equity-Indexed Policies

One type of life insurance product that's particularly troublesome is called equity-indexed universal life (IUL). It's not necessarily a poster child for the kinds of servicing issues discussed above, but it's a complicated product with important details.

With IUL, the carrier allows the policy owner to select a stock index, such as the S&P 500, from a menu of options. The index's price movements are then used to measure the cash-value growth of the policy.

IULs are structured with growth caps and floors, so that insureds can't lose more in a year than a specified amount or gain more than another fixed amount.

"But when you look at those arrangements, what they purport to do and what they actually do are two very different things most of the time," Liazos says.

That's because the products give carriers the flexibility to adjust the caps and floors annually. As a result, the carrier's reserve costs are significantly less than other product lines — and, according to Silver, lower reserves generally mean less risk to the carrier and more risk to the policyholder.

The cap adjustments are not normally disclosed but are usually driven by the cost of options and derivatives securities — i.e., it's a moving target that limits the upside and is solely within the carrier's control, Silver says.

Another issue with IULs is that their valuations are usually "point to point" even though they are marketed based on index averages. So, if the index happens to be down on the valuation date (which is driven by the policy date), the fact that the index average may be more favorable to the policyholder is irrelevant.

"Policyholders think they are participating in market gains that will exceed the performance of a more traditional life insurance policy," says Silver. "They think they are guaranteed returns because a floor is established. In reality, not only are the gains capped, but policyholders won't necessarily achieve the index averages due to the point-to-point nature of the valuations."

IULs should therefore be stress tested before purchase, according to Silver. "If not, the policy owner is unlikely to understand the potential risks and likely to be disappointed with the ultimate results," she says. CFO

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