Meaningful Due Diligence in Life Insurance – What does it mean?

As life insurance advocates we have discovered that the life insurance acquisition process is flawed. Here is what we believe to be the truth in the market place:

- Agents only get paid if a sale occurs so the environment is very much a sales centric process. This does not allow for objectivity and transparency to occur.
- An acquisition is based on an illustration that takes current market conditions and projects them well into the future. To use the illustration as a predictive tool is a flawed method of acquisition.
- There is a lack of understanding of the Advisor business model and how that may affect the process
- The client is frustrated with the complexity and deemed lack of objectivity in the market place

So how does one create, for the benefit of their client, an acquisition process that will bring long term success to both the relationship and the product success?

The answer: a proper due diligence process focused on transparency and education! So what might be the criteria for a meaningful and effective due diligence process when looking to acquire life insurance property?

First of all, like any other investment, you need to know a few things:

- Life insurance is a complex financial instrument with many moving parts therefore; relying on illustrations only to make any investment judgment puts you at risk.
- We recommend engaging someone who uses the fiduciary standard as the very fabric of their business model. This means that they are required to work in the best interest of their client and not any one company.
- This fiduciary standard requires the following:
    - Complete objectivity
    - Full transparency of options, products, costs, etc.
    - Full disclosure of any conflicts of interest, incentives, commissions
- This is contrary to current market requirements where the only requirement for the insurance agent is to provide a <u>suitable</u> product without any concern for whose interests are first and foremost
- Like any investment you need to understand the risks and impact of all the assumptions used, how market movements and changes will impact the long term viability of the acquisition
- Understand that the investment in life insurance is a long term commitment and that this investment will require on-going management
- Look to engage a firm that will advocate for you in the market place and will represent you rather than look to "buy a policy"
- The financial commitment is generally quite substantial therefore there needs to be some intellectual curiosity on the part of the client and a willingness to "peel back the onion" on part of the firm you have engaged to represent you

What are the benefits to you and your family of a meaningful due diligence process?

- Uncover risks within the product, plan and adviser business model
- Will provide a relative basis for comparison between options
- Create for you and your team of advisors a new capability and structure of thinking about this investment
- Prevents making decision based on instinct, brand or relationship alone

What are the key criteria for an effective due diligence process?

- Industry
- Carrier
- Product
- Overall plan and funding
- On-going management process
- Advisor's business model

Industry

In the industry study you are looking for perspective about what is going on in terms of potential legislation, i.e. the estate tax and where Congress may be headed or financial reform and the impact it may have on the industry, it's pricing, and product development.

We also look to give you the overall view of the industry from an investor's perspective. We review CEO's letters to shareholders and general comments about the state of the industry. We make sure we review downgrades and overall profit outlook. Market sentiment is important to understand for the advisory team. Underwriting conditions in the market place and the types of companies that we would believe fit the risk to be examined.

We review of the ratings agencies and their commentaries about the industry and particular carriers. What accounting issues and economic conditions are impacting the industry?

Carrier

In regards to Carriers you need to do more than a cursory review of one or two ratings. You need to review all public information available for the carriers to be examined and build an "executive summary" to document the file. This includes analyst reports, CEO letters to shareholders, annual reports, business segment analysis, and profit outlook.

The kind of company structure is important and to understand why. Which carriers are mutual companies, multi-national holding companies, or domestic companies?

As mentioned above, part of the analysis should review balance sheet information and business mix of products. Business mix is very important to come to understand. The most recent economic crisis brought to light that companies whose focus was variable annuities got into trouble more so than a company whose business mix was more diversified.

Breadth of product offerings indicates commitment to a particular market. How long have they been in the particular product segment and their sales trends?

Retention capacity and if reinsurance will be involved. This can shed some light on how competitive the carrier will be and what kind of underwriting and latitude may be given to a particular case. Retention is how much the carrier can retain in terms of the amount of life insurance on a single or joint life basis. It is very important to know if the reinsurance market will be explored or if any carriers that are to be explored are in any way on the risk already via the reinsurance market if there is capacity already in play.

Product – Life Insurance Design Questionnaire

You need to understand all the product types have their own strengths and weaknesses. This may sound daunting but as we deal with the client's advisory team (attorney, accountant, multi-family office representative, etc.) product design has to meld with the features that are important to the client situation and funding design. We have designed a questionnaire that will help define and guide the client's in their decision as to what features and benefits are important to them. I can't emphasize enough that life insurance is a complex financial product with many moving parts and assumptions that play a critical role in the long term success in the product performing as expected.

We will "walk" the client and adviser through the maze of products features to narrow down the discussion to those products that will fit their situation. The product discussion will begin with an understanding of the basic features of each product:

- **Term Insurance**
    - Pure death benefit protection for a set period of time (10, 15, 20 years)
    - Convertibility parameters
        - Term insurance may be converted to permanent life insurance without a medical exam but each company has their own guidelines as to how long of a period this feature is available
- **Whole Life**
    - Built on guarantees this product gives you the most comfort but it comes at a price
    - A basic understanding of Whole Life will allow you to better understand the other products

  - Once you move into all the other products the guarantees change and the product becomes more of a performance based contract where the assumptions used are the key to success
- **Hybrid Whole Life**
  - Many who have bought this product are unaware of how the moving parts impact each other
  - This product is a mixture of term insurance and whole life insurance
  - The more term blended into the product the less the premium but this increases the risk of the overall product performance over the long run
- **Universal Life (UL)**
  - General account UL where the crediting rate on the cash value is based off of the investments made by the insurance company in the short term to intermediate term bond area
  - Lack of guarantees in the product are a subject of much of the discussion
- **Guaranteed Death Benefit No-Lapse UL**
  - This is a relatively new product sometimes referred to as "term insurance for life"
  - The idea behind this product is to further reduce premium funding requirements but also subject you to risks of product performance if not monitored
  - The product can be designed many different ways. The most basic is for the insured to define a death benefit amount, and then a premium is calculated to guarantee a death benefit for a length of time as long as the insured pays the premium on time.
  - Having no long term cash value that needs to be supported in the product design allows the premium requirement to decrease but since there is no cash value there is a tremendous amount of inflexibility that the parties need to be aware of if they are to manage the policy effectively.
- **Equity Index UL**
  - This is a cash value type policy
  - The cash value crediting strategy is based off of an index which typically is the S&P 500 (ex-dividend, dividend return is included in the return calculation)
  - This strategy will give you a guaranteed return at the low end and cap the return on the upside. This crediting strategy uses the options market to "collar" the return.
  - It is an expensive strategy so proper funding is critical
  - Some product designs may even guarantee the death benefit even if the crediting strategy breaks down but you do pay for the guarantee type feature
- **Variable Universal Life (VUL)**
  - Success of this product depends on the market returns generated
  - This product does not have any guarantees so market volatility, sequence of returns will play a critical role
  - The management of these policies is quite difficult because the illustrations produced to review performance cannot take into account future market volatility
  - This product subjects the policy owner to many risks that can cause under performance and long term product viability if not managed properly

    - This product, if designed properly, may also offer the policy owner an inflation adjusted death benefit opportunity
- **Hybrid VUL**
    - The design of this product allows for the death benefit to be guaranteed regardless of the market returns
    - It may also be designed to blend in some term insurance

There are many other factors and considerations that go into how to design the right product fit. The due diligence process must include a discussion as to premium commitment, cash flow flexibility and strength, duration and guarantees. Death benefits duration and guarantees need to be part of the product design discussion as well as how a cash value type policy may offer more flexibility, control and liquidity.

Underwriting is very misunderstood. We have designed our process to include how it works "behind the scenes". We have broken down this discussion into the 5 levels of underwriting in order for the advisory team to best understand how to procure the best offers. Underwriting is as much of an art as it is a science.

What is often hidden in the product design discussion is how the internal costs impact the success of the product long term. How are they built into the product? What will the impact be if those costs change over time? Many questions can arise and a complete understanding of the risks is paramount.

What are the most common mistakes?

- Many believe there is a "best" product. The "best" product belief comes typically from the agent who has a bias as to the "flavor of the day" product. When the stock market was booming the "best" product seemed to be Variable Universal Life. When interest rates were high the "best" product seemed to be Universal Life. These products are not the best or the worse but if there was a more complete understanding of the risks more people's expectations would have been met.

- Using the illustration as the only tool for reviewing expected performance. Using the illustration as a predictive tool means trouble. The only thing that an illustration can do is to educate the consumer as to how the policy works under a set of assumptions. The problem lies in the fact that the illustration takes current market conditions and projects them into the future. We describe this as a linear analysis which lacks any meaning. The world and markets change and move. This has a tremendous impact on the performance of life insurance.

- A strong carrier does not necessarily mean that they have a strong competitive product that fits best. Many factors and questions need to be understood before a complete market analysis can be performed to review all the options from a multiple set of companies. Each of the insurance company products have been built with many pricing assumptions, profit targets, underwriting parameters so a particular company whose financial condition is strong may not be the best fit.

- Life insurance is a complex financial instrument. We know that there is a lack of objectivity and transparency in the market and that advisers and clients are frustrated by these conditions so what happens more often than not is that the least common denominator is price. If price is the sole determining factor this minimal funding can have a severe impact on the long term viability and it is why life insurance fails many families and businesses.

- The idea or belief that if I pay my premium I am entitled to the death benefit is a paradigm that has to be rectified. Over the last 25 years+ the predominate type of life insurance sold has been performance based life insurance which rely on a certain set of market conditions that are projected 20,30, 40 years into the future. Policies and their performance are impacted by all the economic and financial conditions that affect the world. There are a lack of guarantees in many of these policies and with the fact that they are not managed properly leads to failure of the policies.

- One of the biggest mistakes made is in the application and underwriting process. Once the decision is made to procure life insurance then there is the process to qualify for coverage, a determination of the health class, the funding and the structure. Once you make an application to one particular insurance company the information is owned by the insurance company not you. We have determined that there are 5 levels of underwriting that need to be understood so that the best offer can be made. You want to control the process and own all the information.

- The advisory and client community believe that the agent has a duty to "act in the best interest" of the client but in fact they do not. They are only obligated by law to provide a ***suitable*** product. They are under no obligation to perform their duties to the client in the manner of a fiduciary like their attorney or CPA. We choose to operate at The Efficient Edge under the fiduciary standard which requires complete objectivity, transparency and to provide full disclosure of all conflicts of interest. This is quite a different mindset than the general industry and the right thing to do.

Case Metrics to be determined

We have access to proprietary stochastic modeling technology which is not available to the agent and industry distribution market place. We can, if we find it necessary, to include in our analysis the following:

- Price deviation analysis
  - Our proprietary technology includes data from 85% of the policies sold in the market
  - We can stress test internal cost structure based on this data to produce a report that will tell the team how much costs within certain products deviate from what we expect
- Monte Carlo/stochastic modeling
  - We can randomize returns on variable life and undulate interest crediting rates on universal life in order to develop a probability of success based on certain premium flows
  - This capability corrects the flaw within the life industry in how illustrations are produced and used as a predictive sales tool
- We have determined that there are 5 levels of underwriting and have as part of our network, Health Negotiators who can, outside the purview of the industry, develop, for best pricing, the underwriting package separate and apart from the life industry underwriting “black box”

Plan and Policy Management

We work predominately with Irrevocable Insurance Trusts and the trustee of many of them is generally almost always a family member. They need to understand what is expected of them under the Uniform Prudent Investors Act (UPI Act).

The prudent investor standard is a “standard of conduct not of outcome or performance”. The key to fulfilling your overall responsibility and duty to the beneficiaries as trustee is to understand that prudence is a process not a result.

The UPI Act requires the trustee to fulfill many duties. The trustee has the duty to exercise reasonable care, skill and caution. This is the very essence of your responsibility but in reality very seldom is a process in place to document that you are actually fulfilling this basic duty.

There are a few other duties beyond this core standard that should be noted and that need to be met to manage your trustee liability as a trustee of an ILIT:

- The duty of diversification is relatively difficult to apply to a life insurance asset. The intention of the Act is not to require that every life insurance acquisition needs to be diversified among different companies or of different types of insurance. The process of prudence would dictate that a thorough market analysis based on established metrics would be prudent or that a large acquisition be done with the top echelon of the insurance carriers defined by some metrics. A due diligence process is recommended to be documented.

- The duty to monitor or manage the trust asset embraces the thought that the trustee has the continuing responsibility for oversight, namely the long term viability and stability as it relates to life insurance
- Another duty closely aligned with the duty to monitor is the duty to investigate. This means that the trustee has the responsibility to examine information like to bear importantly on the value or success of the life insurance property.
- A very important duty that seems to missed all to often especially as it relates to life insurance is that the trustee may only incur costs that are appropriate and reasonable (Section 7 of the UPI Act). This becomes very difficult to assess for life insurance without the proper tool. The costs we are referring are the internal costs associated with the mortality. The trustee, as part of a prudent process, must be able to how they have been benchmarked to make sure they are reasonable and appropriate.

Let me educate you in on a few statistics that will make your job even more interesting[1]:

- 95.4% of ILIT trustees do not have a Life Insurance Property Management Statement akin to an Investment Policy Statement
- 83.5% have no guidelines or process that is documented to protect there liability.
- 70%-90% have no assigned agent
- 71% have not done a policy review within the last 5 years

[1]Teitelbaum, "Trust-owned Life Insurance: Issues Trustees Face; Decisions Trustees Need to Make" J. of Financial Services Professionals 38 (July 2005)

Best Practices

Documentation

As trustee or anyone else responsible for managing the trust assets needs to adhere to the trustee responsibility of documenting their process of management. The first 3 steps in our unique process called **The Efficient Edge Advantage™** involve proper documentation.

When we are initially engaged we are going to have an Insight Interview which will provide the necessary information to build our **Policy Metric Roadmap™** which is Step #1. Working with your advisory team we outline specific goals and risk tolerance metrics.

We discuss purpose of the coverage. How we should document the reason for the coverage in specific terms. How we should document your goals? Premium constraints, gifting issues, cash flow issues, Death benefit amounts, in- depth product discussion (understanding the pros and cons) are all explored. Policy performance expectations documented. Life expectancy to be used; tabular or Actuarial Longevity Analysis (ALA) report (personalized life expectancy).

Based on these metrics we then go on to Step #2 and develop an **Opportunity Matrix™.** In the procurement process we go through a life insurance design questionnaire, a complete market analysis, the confirmation and documentation of risks associated with each different type of product to be considered.

Based on your vision and metrics developed in **Policy Metric Roadmap™** and the realty based on the market and underwriting considerations developed in the **Opportunity Matrix™** we would put together as a final step, the **Policy Action Protocol™** which will be the "operating manual" to follow for future management purposes. One piece of this document is to include a Life Insurance Property Management Statement which will act as the trustee's investment policy statement which must be documented.

The final action to be discussed and documented is the annual reporting needs of the trust. We would examine in our annual review process would be the following:

- Carrier
- Management of expectations
- Monte Carlo simulation (if necessary)
    - Premium funding analysis
    - Net amount at risk analysis
- Review all non-guaranteed elements that impact performance
- How economic conditions may impact performance
- Premium financing, loan updates and impact on long term viability – re-projections through proper modeling
    - Exit strategy analysis in premium finance cases

Meet the Players

- Agent
    - Legally obligated to act on behalf of insurance company
    - No obligation for transparency or disclosure
    - If captive, may be contractually obligated to provide company's products before others
- Broker
    - Represents multiple carriers
    - No obligation for transparency and disclosure
    - Experience
- Registered Rep
    - Requires higher level of disclosure (outlined in prospectus, ADV)
    - Suitability standard
- Fiduciary
    - Legally obligated to represent client and act in their best interest
    - Must provide full transparency, disclosure regarding advantages/disadvantages, risks, conflicts of interest, alternatives/options

Advisor Selection

In your selection of the advisor we believe one that operates by the Fiduciary Standard will best serve the advisory team. Families, entrepreneurs, business owners and their advisors should contemplate the following:

- The Fiduciary Standard – Acting in the best interest of the client
    - Do you contractually bind yourself to do so?
    - Do you provide full transparency and disclosure of all risks and conflicts of interest?
    - Do you provide complete objectivity?
    - Do you provide options to optimize return on the current life insurance property and compare that to new market alternatives while minimizing costs and commissions?
    - Do you bind yourself to a process as we do through The Efficient Edge Advantage™?

In conclusion, our due diligence methodology is the very fabric of our firm. We help people come to valued outcomes for their families.