Comptroller's Handbook AM-UA

Asset Management (AM)

Unique and Hard-to-Value Assets

August 2012

FOREWORD PROVIDED BY:

itm INSURANCE TRUST MONITOR

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Office of the Comptroller of the Currency
Washington, DC 20219

Foreword

The OCC … "require[s] bank fiduciaries to follow 12 CFR 9.6(c) and 12 CFR 150.220 and to conduct annual investment reviews of all assets of each fiduciary account for which the bank has investment discretion. This review should evaluate the financial health of the issuing insurance company as well as whether the policy is performing as illustrated or whether replacement should be considered."

Insurance Trust Monitor (ITM) provides support for evaluating the financial health of the issuing insurance company and whether the policy is performing as illustrated and/or adequately funded. A growing number of life insurance brokerages are offering policy review services to evaluate replacements, but often employ life insurance industry marketing practices that are not consistent with, and in some cases actually violate, Prudent Investor principals important to fiduciaries,.

While this OCC Guidance is silent on the process steps by which bank fiduciaries should evaluate replacements, it cautions bank fiduciaries that "policy illustration[s are] subject to a high degree of fluctuation" and thus not reliable for determining whether a replacement should be considered. This caution against comparing illustrations is also consistent with guidance from other financial and insurance industry authorities and established case law.

Instead, evaluating replacements should to conform to generally-accepted risk management principles, to include, but not necessarily limited to: A) "only incur[ring] costs that are appropriate and reasonable in relation to the assets [and] the purposes of the trust" [UPIA Section 7] and B) "consider[ing] … the expected total return [from the] overall investment strategy having risk and return objectives reasonably suited to the trust" [UPIA Section 2(c)(5)].

The next 3 pages come directly from the OCC Handbook for Unique and Hard-to-Value Assets. This guidance imposes new duties on fiduciaries and makes it all the more important to do your due diligence on your due diligence providers. Ask us about how ITM and Veralytic can help you (support bank fiduciaries) in evaluating whether replacements should be considered.

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Life Insurance

Life insurance may be placed in a trust as part of an estate planning tool. Life insurance policies may be put into a trust to remove the policy from a grantor's estate for inheritance or estate transfer tax purposes. A life insurance policy frequently provides the surviving beneficiaries with a liquid asset to pay estate taxes and other final expenses, while enabling them to retain other less liquid assets in the estate. Bank fiduciaries are responsible for protecting and managing the life insurance policy for the benefit of the beneficiaries for the life of the grantor. A bank fiduciary must understand each life insurance policy that the trust accepts or purchases, or the bank fiduciary must employ an advisor who is qualified, **independent**, objective, and not affiliated with an insurance company to prudently manage these assets. In addition, the bank fiduciary must periodically review the financial condition and rating of the insurance company. The majority of these policies are deposited into the trust by the grantor. Many states have recently passed legislation to limit the liability of bank fiduciaries, in certain situations, by rescinding requirements under state law to perform due diligence on insurance companies as a directed bank fiduciary. The OCC, however, continues to require bank fiduciaries to follow 12 CFR 9.6(c) and 12 CFR 150.220 and to conduct annual investment reviews of all assets of each fiduciary account for which the bank has investment discretion. This review should evaluate the financial health of the issuing insurance company as well as whether the policy is performing as illustrated or whether replacement should be considered.

Life insurance trusts are frequently used as estate planning tools. These trusts involve ownership of a life insurance policy that is transferred to a trust by the grantor, and the trust is then identified as the designated beneficiary of the policy. If certain conditions are met, the policy proceeds may pass outside of the grantor's estate thus escaping estate transfer taxes. There are numerous scenarios, however, where IRS rules could result in a clawback of these policies to the grantor's estate preventing individuals, for example, from gifting assets to their descendants or other parties once death is imminent in an attempt to avoid estate taxes. These rules primarily focus on insurance policies or assets in which the deceased retains an interest. Absent an irrevocable life insurance trust (ILIT) or some other tax avoidance arrangement, the proceeds of the life insurance policy would otherwise be taxable.

Using an ILIT can result in a significant portion of an estate passing untaxed to the beneficiaries by avoiding federal estate taxes on the proceeds. In addition to transferring an existing policy to this type of trust, it is possible to create the trust and then have the trust apply for a life insurance policy. In this situation, the current federal tax code provides that there is no three-year waiting period before the tax advantages are achieved.

The possible tax savings of an ILIT are its major advantage. There are, however, some specific requirements that must be considered before a bank trust department accepts and manages such assets:

- The trust must be irrevocable. Once the policy is transferred to the trust, the trust cannot be amended or revoked by the person setting up the trust (the insured).

- Allowing the policy to lapse can present a substantial problem. The fiduciary may be unable to obtain replacement insurance because the insured party has become uninsurable, or may only be able to obtain insurance coverage at a significantly higher cost because the insured party has moved into a different risk category.

- An ILIT typically includes provisions (called "Crummey Provisions" after an IRS case) that allow a beneficiary to withdraw any contribution made to the trust, e.g. contributions to cover premium payments. These special withdrawal powers must be very carefully drafted to avoid creating tax problems for the trust. See the "Personal Fiduciary Services" booklet of the *Comptroller's Handbook* for details on these types of trusts.

Adequacy of Insurance Assets

Bank fiduciaries need to have well-developed risk management practices to evaluate and administer accounts with insurance policy holdings. A bank fiduciary with discretion over the account must complete formal pre-acceptance, initial post-acceptance and annual reviews of the insurance policy. Independent of these reviews, a fiduciary bank must have risk management systems and reviews that address the following.

- **Sufficiency of premiums**: The bank fiduciary must determine whether current premiums are sufficient to maintain the policy to maturity or to meet the insured's life expectancy.

- **Suitability of the insurance policy**: Consider replacing an insurance policy if the bank fiduciary identifies concerns with the condition of the insurance provider or if that provider does not meet the needs of the grantor or beneficiaries. Also assess any tax changes that could affect the suitability of the policy.

- **Carrier selection**: The bank fiduciary needs to evaluate the carrier's financial condition. To the extent insurance carrier ratings are available, they generally lag corporate and market events, and should be used principally as indicators of a firm's creditworthiness.

- **Appropriateness of investment strategy**: The bank fiduciary must evaluate the appropriateness of investments of any segregated account to support the cash value.

For policies with flexible premiums and nonguaranteed benefits, the trustee should obtain the original policy illustration, which shows planned premium strategies. This policy illustration is subject to a high degree of fluctuation. Periodically, the trustee should obtain an in-force illustration. This provides a measure of performance of a life insurance policy against what was initially illustrated. By obtaining an in-force illustration, the trustee can monitor the effectiveness of the policy to date and project how the policy may perform in the future and plan for any potential shortfall in premiums. This process assists the trustee in monitoring the economics of the policy.

Generally, while insurance companies are regulated by the state and maintain a mandatory level of reserves, specific assets are not identified to support an insurer's promise to pay on a policy. Policyholders are subject to the creditworthiness and liquidity constraints of the company. It is important that a bank fiduciary perform due diligence on an insurance company issuing a policy to ensure that it is sound, viable and able to meet future obligations.

Cash value on permanent life insurance policies may be included as part of the account's assets if the bank has done a thorough review of the insurance company's financial condition and is satisfied with its soundness. The cash values for variable life and variable universal life policies, however, are supported by separate accounts and comprise assets selected by the policyholder and should be included as account assets. Other term type policies should be held at a nominal value because the payment and value of those policies is based on the payment ability of the insurance company at a future date. Insurance policies should never be reported at the face value of the policy. In some instances, the bank may just hold a policy for safekeeping.

About Insurance Trust Monitor (ITM):

ITM offers a complete turnkey solution to those managing the complexities of Irrevocable Life Insurance Trusts. Our one and only business is to provide personalized insurance trust administration services. Located in Cedar Falls, IA, ITM is considered the industry's premier ILIT administration and risk mitigation service. Leading banks, trust companies, law and accounting firms utilizing ITM's services have realized the benefits of adding value to their clients and increased profits to their firms. ITM provides a whole new level of trust monitoring and administration services.

About Veralytic:

Veralytic is an independent life insurance research company based in Tampa, Florida. Veralytic provides objective, innovative research solutions to help our customers reduce costs and risk, improve consistency, and document due diligence processes against possible lawsuits and regulatory requirements. Our clients include agencies, brokerages, independent insurance professionals and trust companies. Our research reports are based upon a patented "five star" rating system that benchmark suitability against an ever growing database. Veralytic has been endorsed by the New York Bankers Association (NYBA), accepted by the Financial Planning Association (FPA), reviewed by the chief regulatory body of the financial services industry, and trusted by dozens of brokerages and agencies across the United States.

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