

# JOURNAL

Focus On: Health Care  
Insurance, Disability Income,  
and Long-Term Care

OF FINANCIAL SERVICE PROFESSIONALS

SEPTEMBER 1999

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PUBLISHED BY THE SOCIETY OF FINANCIAL SERVICE PROFESSIONALS

A NATIONAL ORGANIZATION OF INSURANCE AND FINANCIAL ADVISERS

# No Load Insurance and Trustee Duties Under the Prudent Investor Rule

PATRICK J. COLLINS, PhD, CLU, CFA

**Abstract:** *Recent adoption of the Uniform Prudent Investor Rule by many states creates new standards of procedural prudence with regard to acquisition of trust-owned life insurance policies. As one segment of the life insurance industry begins to market no-load products, a variety of claims regarding their merits and liabilities are emerging in the course of struggle for market share. This article evaluates typical vendor assertions through objective application of capital market theory and research. The standards and duties imposed upon a trustee in the areas of risk evaluation, cost consciousness, and delegation of responsibility to agents make it important not only to examine critically vendor claims, but also to develop a framework for a sound, defensible decision-making process. Traditional insurance due diligence standards appear wholly inadequate to provide trustees and legal counsel with meaningful data for good decision making. New standards must be based on modern portfolio theory, the insights of which provide the theoretical underpinnings for the restatement of trust law.*

## Introduction

Selecting a life insurance policy can be a formidable task because of the complexities of the insurance contract and because of the large number of vendors in the marketplace. As a greater num-

ber of life insurance companies market no-load products, a variety of claims regarding their merits and liabilities are emerging in the course of struggle for market share. This article evaluates typical vendor assertions through objective application of capital market theory and research.

The availability of academically defensible standards of insurance policy evaluation is important in light of the Uniform Prudent Investor Act.<sup>1</sup> The Act, incorporating the principles of prudence enumerated in the Restatement Third of the Law of Trusts,<sup>2</sup> imposes certain duties in the areas of risk evaluation, cost consciousness, and delegation of responsibility to agents. The new standards for prudent asset management make it important not only to examine critically vendor claims, but also to develop a defensible framework for a sound decision-making process. Traditional insurance due diligence standards may be inadequate to provide trustees and legal counsel with a reliable framework for good decision making. New standards of insurance contract evaluation must be based on modern portfolio theory, the insights of which provide the theoretical underpinnings for the restatement of trust law.<sup>3</sup>

To date, the nature of trustee liability for grantor-selected insurance programs remains unclear. At one end of the spectrum, it can be argued that the trustee is merely carrying out

trust administration "in light of the purposes, terms, distribution requirements and other circumstances of the trust."<sup>4</sup> It is the grantor that mandates acquisition of a particular insurance policy; therefore, it is the grantor that bears responsibility for the integrity of the decision-making process employed for asset selection.

On the other hand, it can be argued that agreeing to the trusteeship brings with it the duty to evaluate the prudence and suitability of all assets to be included in the trust estate. Often, when new insurance is obtained by the trust settlor, it is the trustee who signs the application forms. Under these circumstances, because the trustee is such an integral part of the asset selection process, it would seem difficult to argue that the trustee is under no obligation to conduct a critical inquiry regarding the asset purchase. In certain states, the trustee is statutorily exempted from such duties for insurance assets. Therefore, in states that have adopted versions of the Uniform Prudent Investor Act, it is important to determine the extent of statutory relief enjoyed by the trustee. Absent such relief, where the trustee signs insurance application forms, there may exist fiduciary liability.<sup>5</sup>

*This issue of the Journal went to press in August 1999.*

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### **Arguments Advanced by Vendors of No-Load Insurance Products**

In reality, there is no such thing as a pure no-load insurance policy any more than there is a pure no-load mutual fund. Irrespective of the distribution system under which a financial instrument is made available to the public, the price of the product embeds the manufacturer's specific profit objectives. A product that contains no mark-ups to capture profits for the manufacturer would, in a capitalist society, never enter the marketplace. Therefore, on a preliminary basis, no-load insurance is defined as an insurance contract that does not include a mark-up on the retail (agent-selling-to-consumer) level to support the costs of a commission-oriented product distribution system. This definition of no-load insurance throws it into strong contrast with the traditional load contracts. Traditional contracts have numbers of marketing, field compensation, and home office expense factors not found in no-load contracts.

Manufacturers and distributors of no-load contracts are, of course, quick to point out the high costs of a commission-based system. Typically, agent commissions for a life insurance policy sale are between 30 to 90 percent of the first year's premium. Additionally, smaller service or renewal commissions are payable in future years. These commissions usually range from 2 to 5 percent of future years' premiums.<sup>6</sup>

The cash compensation payable to the insurance salesperson is only one of several significant loading factors in a traditional life insurance policy. In addition to agent commissions, the traditional contract must support many other expenses. According to one estimate, the total loading factors attributable to marketing through the commissioned-based distribution sys-

tem in a traditional whole life insurance policy average 165 percent of the first year premium. Term insurance loading factors average 130 percent of first year premium.<sup>7</sup> Traditional policy loads are high because, in addition to agent commissions, the policies must support the following:

- A series of overrides and bonuses to office managers, regional supervisors, and other second line management.
- Agency departments that are charged with the expenses of recruiting, training, and providing support materials for field agents.

The total costs required to develop, train, and replenish a life insurance field sales force can be formidable. The large turnover among insurance agents is costly to insurance firms that rely on commissioned-oriented distribution systems. According to the Life Insurance Marketing and Research Association (LIMRA), out of 100 agents who begin a career in the life insurance industry, 84 will leave before the end of their fourth year.<sup>8</sup> Over the four-year period, the industry's "cost-per-agent-retained" amounts to slightly over \$250,000 per year. When insurance actuaries price traditional policies, the premiums paid by consumers must be sufficient to compensate insurance companies for their agency development costs.

Not surprisingly, advocates of no-load insurance contend that the high loading factors of traditional contracts result in both higher premiums and diminished cash values. Glenn Daily, the New York-based insurance analyst, estimates that "selling expenses for a typical agent-sold cash value policy can range from 80 percent to 120 percent of the first-year premium, versus 30 percent or less of a low-load product. Lower expenses mean a higher cash value (given the same premium and death benefit), a higher death benefit (given the same premium and projected cash value), or a lower premium

for the same coverage."<sup>9</sup> Generally, traditional insurance policies have little or no cash value for the first two policy years, and do not usually reach a break-even point (total cash value equal to total premiums paid) until the policy is in force eight years or longer. Furthermore, if company-generated illustrations show early cash values, the cash may either be illiquid (i.e., unavailable to the owner via loan or withdrawal options) or subject to substantial surrender charges.

No-load policies have significant early cash values, and, in addition, they sometimes have lower projected premium costs. Moreover, early cash values may be fully available to the policyholder. In some cases, no-load policies have cash values that equal or exceed the premium paid by the end of their first policy year. The implication is, according to vendors of no-load products, that insurance products delivered to the consumer outside of the traditional agent-oriented sales system are superior to commission-paying policies.<sup>10</sup>

### **Arguments Advanced in Favor Of Traditional Life Insurance**

To date, only a small segment (less than 1 percent of all companies) manufactures and distributes no-load insurance contracts. Nevertheless, as the number of no-load vendors increases, the representatives of the agency distribution system can, more frequently, be expected to offer counter-arguments for the public to consider. To date, the counter-arguments are as follows:

1. Commissions are payments for the expertise and advice provided by the agent who assists the consumer to:

- appreciate the need for insurance,
- understand the financial complexities of the insurance contract,
- apply for and obtain specific coverage, and
- execute future policy options such as loans, beneficiary changes,

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settlement options, and so forth.

As such, commissions represent a payment for value received and are not an unnecessary or distasteful adjunct to the price of the product.

2. The older and larger insurance companies are the manufacturers and distributors of traditional agent-sold insurance policies. In many cases, these companies have the following advantages:

- Impeccable ratings from independent evaluation companies
- Substantial assets
- Long-term track records lasting through several business cycles
- Long-term underwriting, business management, and investment expertise
- Brand-name recognition for safety and stability

As such, it is alleged that they represent the prudent alternative to smaller and, in some cases, less well known no-load insurance companies.

3. The brand-name, top-rated traditional insurance manufacturers offer a product that has expected long-term values (cash values and death benefits) substantially higher than no-load products. The evidence mustered in support of this argument varies from company-to-company and includes some or all of the following observations:

- The size of the firm results in economies of scale that are reflected in low general expense ratios.
- The investment expertise of the company has proved to be capable of generating substantial returns on the invested assets of the firm.
- The underwriting policies of the company have resulted in very favorable mortality experience with the result that the policyholders can expect high long-term cash values and death benefits.

As such, it is alleged that the old-line, blue chip firms will deliver future values that are far in excess of the expected values of no-load contracts. Indeed, one often finds that the

values projected beyond the twentieth year in policy ledger illustrations are greater for traditional products than for no-load products. The implication is that the presence or absence of a commission to the agent is not particularly relevant when viewed from a long-term perspective.

### Restatement of Trust Law and The Standards of Prudence

Each camp has gathered and deployed seemingly persuasive arguments in support of its position. Fortunately, however, the new standards of prudence suggest several important dimensions that an unbiased, critical evaluation must encompass.

The Restatement Third of the Law of Trusts suggests that the presence of large commissions may be relevant to the policy evaluation process: "...the duty to avoid unwarranted costs is given increased emphasis in the prudent investor rule."<sup>11</sup> This is especially the case when payment of sales commissions has the effect of substantially reducing the cash values of the policy. At minimum, in order to document investigation into this area, commission payments should be disclosed, in writing, and retained in the trustee's records.<sup>12</sup>

Additionally, the Third Restatement indicates that a trustee must "act with prudence...in the selection and supervision of agents."<sup>13</sup> An uncritical sign-off — supposedly justified by the assumption that a traditional contract's projection of higher expected long-term value makes commission-related expenses irrelevant — is not a particularly defensible position in the event of litigation. It is a large leap of faith that puts credence in nonguaranteed values projected 20 years or more into the future. Even if the projection of values for the traditional contract is credible, the more relevant inquiry is whether a trustee can defend successfully the voluntary

election to pay a substantial sales load for product acquisition.<sup>14</sup>

By selecting a financial instrument that offers little or no cash surrender value to the policyholder for a lengthy period of time, the trustee assumes a significant liquidity risk. If the trustee determines that the extra risk is appropriate, then he or she must also be prepared to demonstrate the likelihood that trust beneficiaries will be sufficiently rewarded.

Given the choice between purchase of a high risk investment and a lower risk investment, each of which has the same expected return pattern, academic evidence suggests that the rational investor will select the lower risk investment, *ceteris paribus*. It is only the reasonable expectation of a larger future reward that can induce the investor to assume the additional level of risk and expenses. In the case of a decision between purchase of a liquid, no-load insurance policy or a nonliquid, commission-paying policy, the following questions need to be answered.

1. What is the magnitude of the risk?
2. How does illiquidity affect expected returns?
3. Assuming that it is appropriate to bear the risk, how much extra reward should be received?

Professors Amihud and Mendelson analyze the interrelationship between expected return and liquidity. Specifically, they examine the roles of time horizons and liquidity considerations on the pricing of capital assets. Focusing on stock market returns, they use the bid-ask spread on securities as a proxy for liquidity risk.

The bid-ask spread is the difference between the bid and ask (offer) prices quoted by a dealer who makes a market in a stock and bridges the time gaps between asynchronous public buy and sell orders. The bid-ask spread may thus be viewed as the price the dealer (or market maker) demands for providing liquidity ser-

## *A useful first step is to weigh the probability of a substantial loss of funds because of the liquidity risk.*

vices and immediacy of execution.<sup>15</sup>

Although an insurance contract does not contain an explicit bid-ask spread, nevertheless the insurance carrier acts as market maker with the right to receive the specified cash surrender value (a nonforfeiture contract provision) as the measure of the price for providing the policyowner with immediate liquidity. The role of the insurance carrier as market maker is thrown into more clear relief by contrasting the contractual rights to receive immediate and certain values (both lifetime and death-time) with the negotiated values received by policyowners seeking viatical settlements by soliciting offers from a variety of sources. Such negotiations may be time consuming and may result in offers that vary substantially from the stated amounts of the insurance policy's nonforfeiture provisions.

Amihud and Mendelson hypothesize that investors should require higher expected returns for higher spread, more illiquid assets. Longer holding periods reduce the onus of investment illiquidity because costs can be amortized over additional units of time. Investors with short planning horizons seek securities with lower bid-ask spreads because of the certainty of bearing transaction costs within the relatively near future. The longer the planning horizon or the lower the probability that the investor will want to liquidate his or her holdings before the end of the planning horizon, the lower the additional return required as compensation for liquidity risk.<sup>16</sup>

Given that substantial commissions payable to the insurance agent as well as additional agency expenses may prohibit any meaningful cash surrender value for a considerable period of time, how much extra reward should the policyholder receive in order to be compensated adequately for liquidity risk?

Assuming, for example, that the

insurance buyer has a required rate of return of 7 percent, Table 1 illustrates the theoretical returns that he or she must receive from the traditional commission-paying contract in order to bring both load and no-load contracts into equilibrium.<sup>17</sup>

There is nothing remarkable in the fact that traditional agent-sold products project high values in the distant future. A rational market demands an expectation of high future returns in order to entice a buyer to put current funds at risk. Once the check is written to the insurance company, there may be no opportunity to recover the outlay until many years in the future. Furthermore, there is nothing remarkable about the fact that the no-load contracts have lower projected long-term values. They do not need to offer consumers comparable inducements because they do not have a comparable level of risk. It is the differing risk characteristics of each product that inevitably determine expected future rewards.

Empirical evidence from the insurance marketplace corroborates the theoretical model that Amihud and Mendelson developed from security market data. For universal life policies, for example, the contracts

which project the highest future interest rate credits tend to have the lowest liquidity (i.e., lowest surrender value) in the early contract years. Additionally, surrender charges tend to be higher, the higher the interest rates. One study finds that "statistically, there exists a positive correlation between surrender charges and interest rates for durations one, five, and ten, with the correlation being significant ( $\alpha = 5\%$ ) at durations one and five."<sup>18</sup> On the other hand, the more liquidity risk assumed by the insurance buyer, the higher the future projected contract values.

### **Conscious Decisions Concerning Levels of Risk**

The prudent trustee who makes "conscious decisions concerning the levels of risk appropriate to the purposes... of the trusts they administer"<sup>19</sup> will take care to determine which types of risk are reasonable and defensible. A useful first step is to weigh the probability of a substantial loss of funds because of the liquidity risk. Historical evidence in the form of lapse rates on cash-value insurance products is available to help gauge the probability of loss. LIMRA

TABLE 1

| Load | 5 Years | 10 Years | 15 Years | 20 Years | 30 Years |
|------|---------|----------|----------|----------|----------|
| 165% | 26.49%  | 16.75%   | 13.50%   | 11.87%   | 10.25%   |
| 100% | 20.86%  | 13.93%   | 11.62%   | 10.47%   | 9.31%    |
| 50%  | 15.11%  | 11.05%   | 9.70%    | 9.03%    | 8.35%    |
| 30%  | 12.25%  | 9.62%    | 8.75%    | 8.31%    | 7.87%    |
| 0%   | 7%      | 7%       | 7%       | 7%       | 7%       |

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provides the following lapse rates for cash value insurance contracts.

- Between 13 and 15 percent are lapsed at, or prior to, the end of the first policy year.

- Less than 54 percent of contracts remain in force through the end of the fifth policy year.

- Less than 25 percent of contracts remain in force through the end of the tenth policy year.

- Less than 10 percent of the contracts remain in force through the end of the twentieth policy year.<sup>20</sup>

Presumably, the lapse ratios are substantially lower for insurance policies held in trust. The published lapse data encompasses all insurance transactions from the purchase of starter policies by college students to insurance purchased for intergenerational wealth transfers. Given the lack of specificity, it is difficult to estimate the statistically expected return (projected future values weighted for the probability of early contract termination and adjusted for applicable surrender charges) on a life insurance contract except in the most general sense. However, even at a very modest 3 percent yearly lapse rate, approximately half of the policies will be terminated by the end of 20 years.

It is easy, however, for the trustee to quantify the magnitude of the illiquidity risk simply by looking at a ledger illustration. The spread is simply the specified surrender charge levied on the cash value account on universal life or the amount of the nonspecified surrender charge on a whole life contract (i.e., the difference between premiums paid and the contract's cash surrender value).

Once the potential magnitude of the risk is determined, the trustee may adjust for the probability of incurring the risk (i.e., the probability that the grantor will discontinue funding). This is a "facts and circumstances" adjustment. If, for example, an irrevocable trust is funded with an insur-

ance product for estate liquidity purposes, the trustee may wish to evaluate the probability that future changes in the estate tax law may result in a decreased need for insurance coverage, or that future changes in income tax law may eliminate tax advantages unique to life insurance contracts.<sup>21</sup> The objective assessment of the trustee helps determine an acceptable risk/reward tradeoff. If the probability of lapse is high, or the detrimental effects of the illiquidity risk are unacceptable, then the trustee may be expected to acquire low-spread assets. Conversely, if the liquidity risk is acceptable, there may be valid reasons to capture higher long-term expected returns that come from purchase of a less liquid asset.

It may be argued that the value of insurance obtained for estate planning purposes does not rest primarily on its cash surrender values (or the liquidity/illiquidity thereof); but, rather, on the cost/benefit ratios between receipt of policy death benefits and the outlay of policy premiums. This type of inquiry goes to the heart of the question of how much value an insurance program will add to a client's estate plan and is of critical importance in the development of defensible policy selection criteria.

The issue of whether insurance will add value, and if so, how much value, is beyond the scope of this inquiry.<sup>22</sup> However, exclusive focus on death benefit projections ignores the interrelationships between the projected future benefits and the underlying cash values which either support (via the reserve in whole life or the cash value account in universal life) or which fund the benefits via dividend or interest crediting mechanisms. The 1985 report of the Yield Index Advisory Committee of the National Association of Insurance Commissioners stated that calculating death benefit rates of return in order to determine the value of a life insurance contract

was misleading to the consumer.<sup>23</sup> The interconnection between cash values and death benefits has, if anything, become of increasing concern to trustees because of the tendency of insurance agents to recommend a variety of limited payment arrangements, the efficacy of which depends on maintaining sufficient cash value.

## Valuation of Insurance Contracts and Capital Market Research

Amihud and Mendelson suggest that required return is a function of the risk of an investment as well as the measure of the investment's illiquidity. Additional academic research suggests that other capital market factors may influence the pricing and long-term projected values of life insurance.

Several studies explain the variation in the price of insurance contracts (price variously defined as a function of discounted premium inflows, interest adjusted cost indexes, and so forth) by examining differences in insurance company characteristics. The assumption underlying many of the studies is as follows:

- That either consumers are willing to pay more (or receive less cash value/death benefit) for company A's policy when compared to company B's because they value company A's corporate characteristics (larger company/more assets/greater investment earnings); or

- That the insurance marketplace is inefficient (i.e., information regarding the full spectrum of risk/reward considerations is not embedded in a contract's price in a timely and reasonable manner) and, therefore, a host of mispriced products can be sold to consumers unaware of market conditions.<sup>24</sup>

A 1985 study confirms the existence of a potentially wide range of company characteristics and contract options that consumers value. The market pricing of insurance contracts reflects the pres-

## *A no-load product can, in fact, generate superior long-term performance for the policyholder...*

ence or absence of these valued features. For example, all else being equal, in an efficient market, a consumer should be willing to pay more for a contract with a 6 percent guaranteed loan rate than one with an 8 percent loan rate. A regression analysis attempts to identify those features that are valued by consumers.<sup>25</sup>

"Goods that contain more of the characteristics preferred by consumers will be in greater demand and, consequently, will have higher prices. Conversely, goods that contain less of characteristics preferred by consumers will be demanded less and will have lower prices.... One set of characteristics is the contract provisions of the policy. Since some contract provisions are more favorable to the policyholder than others, this perspective suggests that contract provisions will have an impact on policy price.... Another set of characteristics is related to the characteristics of the issuing life insurer. Two types of characteristics are important. One type is related to the risk of the insurer not meeting its claims. Policyholders will prefer less risky insurers, and such insurers will therefore command a price premium.... The second type of insurer characteristics is that related to service provided by the insurer. Policies from insurers providing more service that consumers value will command a price premium."<sup>26</sup>

With respect to the election to implement a no-load or commission-paying contract, the absence of a load may be viewed as a favorable contract provision. Therefore, if the price of a contract which has a favorable provision is, in fact, higher than a contract without such provision, this is, once again, not remarkable. Although the initial premiums for a no-load contract may be less than for an agent-sold contract, the projected long-term cost indices may, in fact, be higher for the no-load contract. This observation is merely a variation of

the argument advanced in favor of traditional insurance policies outlined earlier (i.e., most major commission-based insurance carriers project higher future values on their policy ledger illustrations). The higher values are both what the consumer would expect and may be what the market demands in order to compensate for assuming the risk of illiquidity. If the projections are correct (not necessarily in the nominal value sense, but relative to the values paid in the distant future), the extra benefits do not represent a free lunch.

### **Delegation of Responsibility to Agents**

The uncritical trustee may be inclined to default to a no-load product because of distaste for the compensation system under which commission-based agents operate. As Joseph M. Belth, professor emeritus at Indiana University, states:

"...the payment of substantial commissions creates a potential conflict of interest for the life insurance agent. The conflict arises because the amount of the agent's compensation may be influenced significantly by the advice the agent gives to the client..."<sup>27</sup>

The trustee may feel that the advice of the insurance agent represents an inflow of information that, while interesting and helpful, is ultimately shaped by negotiation strategies designed to induce product purchase. Whereas the trustee may be personally liable for imprudent decisions, and whereas the trustee may already feel that he or she is on uncertain grounds because of the complexity of the decision-making process, the trustee may seek to reduce negotiation anxiety by turning to vendors of no-load insurance. The rationale may be simply that a fee-based financial planner will provide a more credible and trustworthy source of information.

The trustee, however, must exer-

cise appropriate care to insure that he or she does not unwittingly or unnecessarily limit attention to only a small fraction of the insurance marketplace. This may be especially true if a fee-based adviser seeks to build credibility at the expense of traditional insurance products. At that point, the adviser shifts from the role of objective counselor to a spokesperson (implicitly or explicitly) for a segment of the insurance industry. The duties of loyalty and impartiality should temper the desire of the trustee to restrict the analysis only to a small number of insurance programs simply because it appears preferable to seek information from a person who will not be compensated by a commission.<sup>28</sup>

### **Duties of a Trustee: Due Diligence and Cost Consciousness**

Although the decision to fund a trust with either traditional or no-load contracts must reflect prudent selection criteria which incorporate adequate due diligence, the academic evidence, to date, does not provide clear cut answers as to whether a traditional or no-load contract is to be preferred. It is useful, however, to examine the traditional versus no-load insurance debate from the perspective of the Third Restatement's admonitions to avoid fees, transaction costs, and other expenses that are not justified and to make conscious decisions concerning the levels of risk.

The arguments advanced by proponents of no-load policies are, intuitively, very appealing. Some primary assumptions made by no-load insurance vendors, however, remain unproved. A no-load product can, in fact, generate superior long-term performance for the policyholder only if the following were true:

- The expenses associated with a non-agency marketing and distribution system are inherently lower

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than those found in the traditional agency system; and

- The favorable contract provisions allowing for liquidity and the favorable distribution systems allowing for conveyance of information to the consumer outside of a commission sales dynamic do not allow the insurance company to command a price premium in the marketplace.

The ability to charge a price premium and the extent of such a premium cannot be predicted *ex ante*. Certainly, no-load insurance advocates do not argue that the profit objectives of this segment of the insurance industry are lower than the other parts of the industry.<sup>29</sup> Therefore, reasonable judgments can be made on this point only with the passage of time. There is, however, some evidence *ex post* which suggests that no-load insurance product delivery systems are not necessarily *significantly* more cost efficient.<sup>30</sup>

In 1992, an extensive study of 423 U.S. life insurance companies found that "...for a given scale and mix of outputs and an equal proportional increase in all outputs, agencies incur higher incremental costs than do non-agencies." However, despite the fact that the two types of insurers exhibit differing cost structures, statistical analysis indicates that the magnitude of cost differential is not significant at standard levels.<sup>31</sup> Thus, the academic evidence, to date, is inconclusive. Ambiguity may arise for a number of reasons including: (1) the relatively small sample of nonagency insurers, and (2) the fact that the nonagency group consists of both mass marketing or mail order firms with large advertising fixed expenses and other no-load manufacturers who seek to utilize an existing unsubsidized fee-based adviser/financial planner distribution system.<sup>32</sup> Future research may allow the trustee to make more well-informed judgments. Until such time, however, competing

claims between the two segments of the industry must, in large part, be considered to be unproved assertions.

If many of the underlying assumptions of the advocates for the no-load segment of the insurance industry are tenuous, the same can also be stated for the larger agent-based segment of the industry. Earlier, three lines of argumentation advanced by commissioned agents in support of the traditional product and distribution systems were identified: (1) commissions are a payment for value received; (2) agents work for older, more established blue chip firms and, therefore, offer safe and time-tested programs; and (3) the accumulated business operations and investment expertise of the blue chip firms translates into an expectation of superior product performance.

To assume that commissions are, in fact, a payment for value received, one must also assume that:

- consumers judge that commissions are a proxy for agent advice and, therefore, valuing such advice, they will be relatively insensitive to the pricing of the insurance contract; and
- agents will generate advice that is in the consumer's interest rather than sales hype designed to sell the product paying the highest commission.

Part of the folklore of insurance is that it is a product that is sold rather than bought. Conventional wisdom states that even right-thinking individuals must often be motivated into purchasing insurance; therefore, commissions are a reward for persuading individuals to contemplate the economic consequences of their death and to take appropriate actions (i.e., buy insurance) in order to mitigate adversity to family and to business. This viewpoint continues to stand in the face of research suggesting that "insurance cost appears as a principal determinant in the consumer demand function."<sup>33</sup> Specifically, an examination of an empirical model designed to identify major de-

terminants of demand for insurance products by examining newly sold whole life insurance contracts from 27 insurance companies selected at random from a population of 66 companies for which continuous comparable data exists from 1953, indicates that the real price of insurance coverage was determined to be statistically significant with price negatively correlated to new purchases. Indeed, "a change of one standard deviation in the price variable was linked to a movement of from 26-32 percent (for participating) to 49-50 percent (for nonparticipating) of a standard deviation in new insurance in force written."<sup>34</sup>

These results are expected where consumers do not view the pricing of insurance contracts with indifference because of a perception that the value of agent advice and service overwhelms cost. The price elasticity of the product suggests that, if insurance prices can be reduced because of the elimination of cost-generating factors such as agent commissions, quantity demanded may increase significantly. As information regarding agent training standards and industry emphasis on high commission earnings becomes more widespread, the public's perception of the value of a commission-based distribution system may change. For example, in a discussion of the independent insurance agent, Andrew Tobias cites a study published in 1977 which found that 47.9 percent of the time an independent agent's recommendations on where to place a customer's business were based on which company paid the highest commissions.<sup>35</sup>

Other claims of agents and companies selling traditional insurance products are also subject to revision under the light of objective analysis. During the 1990s the press emphasized the rapid financial deterioration and ultimate insolvency of several old-line or blue chip firms. Increased



## *Trustees, in order to mitigate liability for their insurance decisions, need to develop appropriate selection and retention criteria for insurance contracts.*

merger activity contributed to the disappearance of other blue chip firms with long track records; therefore, the degree to which the interests of policyholders is protected is not always clear.<sup>36</sup> More recently, gradual deterioration in many of the blue chip companies' ratings has garnered attention.

As economic events unfold, it is becoming increasingly clear that the large brand-name companies are not immune from rapid changes in their financial positions and are not automatic proxies for safety and stability.<sup>37</sup>

The trustee will have to evaluate how prudence may best be achieved. This evaluation may, in part, take the form of deciding whether safety is best assured by the availability of highly liquid, easily transferable cash within a no-load contract, or by policies issued by blue chip carriers that subject account values to large surrender charges over many years.

If longevity of operations or the size of balance sheet assets may not always be reliable indicators of safe and suitable insurance companies, it is also true that operating results (investment yields, mortality experience, lapse ratios, etc.) may not always translate into superior product performance.<sup>38</sup> There may be an inverse relationship between an insurer's operating profits and the values it provides to its policyholders. In a competitive marketplace, favorable operating characteristics may increase the cost of insurance because such characteristics will be in greater demand and will therefore command a market premium.

Finally, using past performance history to project the future performance relative to other companies in the industry is of questionable value: "...about one-third of the companies in the top quartile of whole life performance for 1970-80 were not in the top quartile for 1980-90."<sup>39</sup> Using past company operating performance to suggest that a specific insurance product has a high probability of superior

future performance is outright folly. Each product line is developed and actuarially priced to achieve its own profit objectives (technically, its asset share). This is accomplished by development of a set of assumptions (mortality assumptions, lapse assumptions, and so forth) that are specific to the product. The attempt to translate general company performance history into a forecasting tool for a specific product line assumes that corporate profit objectives, actuarial assumptions, policyholder utilization of loan options, cash flow characteristics, investment performance, and many other variables are, and will continue to be, frozen in time and fully reflected in the specific product line.<sup>40</sup>

### **Conclusion**

Trustees, in order to mitigate liability for their insurance decisions, need to develop appropriate selection and retention criteria for insurance contracts. Final decisions, if they are to be defensible, will best rely on written criteria (insurance policy statements comparable to investment policy statements) and will rest on objective analysis as opposed to vendor-supplied information. Most importantly, compliance with the standards of prudence promulgated by the restatement of the law of trusts requires that trust-owned life insurance contract evaluation and selection must (1) employ the generally accepted standards of objective quantitative and statistical analysis, and (2) be conducted according to the financial evaluation principles embodied in modern portfolio theory.

Additionally, given the substantial difference in the risk/return characteristics of load and no-load products, the trustee should explicitly address the decision to assume or not assume liquidity risk and should document the decision-making process as thoroughly as possible. The newly en-

acted standards for trust-owned assets will help clarify the trustee's obligations and should help shape a sound decision-making environment. J  
(UR Code No. 4400.00/1900.00)

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**Patrick J. Collins, PhD, CLU, CFA, is a financial adviser with over 20 years' experience. Mr. Collins received a PhD from the University of California at Berkeley and a Chartered Financial Analyst designation from the Association for Investment Management and Research. He also holds a professional designation in financial planning from U.C. Berkeley.**

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(1) See, e.g., Cal. Prob. Code §§ 16045-16054 effective January 1, 1996. A review of state statutes can be found in William L. Hoisington & Rozlyn L. Anderson, *Practical Applications of the Prudent Investor Standard*, 56 Inst. On Fed. Tax'n §29 app. D (1998).

(2) Restatement (Third) of Trusts: Prudent Investor Rule § 227 (1992), at 5,8.

(3) James B. Bertles & Joel H. Yudenfreund, *Limiting Fiduciary Liability for Investing in Life Insurance*, 11 J. Tax'n Inv. 239, 240 (Spring 1994): "As with other investments, when insurance is held in trust as part of an individual's estate plan, the trustee has certain fiduciary duties and responsibilities that must be satisfied. If the trustee is a professional (e.g., a bank, trust company, or attorney), it will be held to a higher standard of care than would apply to a nonprofessional. The established fiduciary standards for investments by a trustee...are now set out in the Restatement of the Law Third of Trusts." See also, C. Markham Whitelaw & David M. Culver *Managing Trust-Owned Life Insurance Policies*, Tr. & Estates, April 1992, at 46: "...life insurance has the same risk characteristics and requires the same due diligence and annual performance monitoring considerations as other investments." David V. Maurer *Irrevocable Life Insurance Trusts: Good Business For Banks?* Tr. & Estates, May 1992, at 24: "...trust departments should realize that selecting the appropriate life insurance policy to purchase and hold in trust is like any other investment decision made by a trustee. It must be selected based on a certain level of expertise, and it should be monitored regularly, as if it were any other investment."

(4) Restatement (Third) of Trusts § 227 (1992).

(5) John A. Hartog & Paul Sanderson *A Trustee's Crime and Punishment: Managing Fiduciary Liability Under the California Uniform Prudent Investor Act*, 4 Cal. Tr. & Estates

# No Load Insurance and Trustee Duties Under The Prudent Investor Rule

Q. 5.6 (Summer 1998).

(6) See also, Joseph M. Belth, *Life Insurance: A Consumer's Handbook*, 132 (1985).

(7) Melissa Gitter, *Insurance Goes High-Tech: Will Agents Survive?*, *Fin. Plan. Mag.*, Fed 1995 at 39. Other estimates of the sales-related load on insurance are "acquisition costs of 150 to 200 percent of first-year premium..." Andrew M. Wray & William B. Howard, *Fee Insurance Benefits Clients and Planners* *J. Fin. Plan.*, Oct. 1992, at 151; David F. Babbel & Kim B. Staking, *A Capital Budgeting Analysis of Life Insurance Costs in the United States: 1950-1979*, *J. Fin.*, Mar. 1983, at 160 estimate a "markup" (i.e., cost in excess of actuarially fair value) ranging from 48 percent in 1950 to 279 percent in the last year of their analysis — 1979; Brian Foster, *Distribution Reform Cuts Direct Path to Efficiency*, *Best's Rev.*, Sept. 1995, at 78 states that "the primary and most serious weakness of the agency distribution system stems from its inherent cost inefficiency.... According to Limra International, new business distribution expenses range from 120 percent to 165 percent of first-year premiums depending on the type of agency distribution system used; Stephen P. D'Arcy & Keun Chang Lee, *Universal/Variable Life Insurance Versus Similar Unbundled Investment Strategies*, *J. Risk & Ins.*, Sept. 1987, at 477 estimated that sales loads on Universal/Variable Life contracts averaged 15 percent for the first year and 7.7 percent for all future years. These loads did not include surrender charges (averaging 53.1 percent of cash values in the first year) nor did they include "markups" on mortality charges within the contracts.

(8) According to the California insurance trade publication CALUNDERWRITER, Jan. 1995, at 6: "The current retention rate among new ordinary life agents is about 18 percent...." Brian Foster, *Distribution Reform Cuts Direct Path to Efficiency*, *Best's Rev.*, Sept. 1995, at 79 points out that "at an industry-wide average annual attrition rate of 23%, no other sales-dominated industry suffers a defection rate as high as insurance carriers. An attrition rate of 23% translates into an average agent tenure of almost five years. This is hardly enough time to pay back recruiting and training costs let alone to add value to the carrier."

(9) Glenn S. Daily, *The Individual Investor's Guide To Low-Load Insurance Products* 38 (no date).

(10) Andrew M. Wray & William B. Howard, *Fee Insurance Benefits Clients and Planners*, *J. Fin. Plan.*, Oct. 1992, at 150 "...without the added expenses of the general agent, agent housing, and recruiting, they could provide a superior product that would be good for the policyholder...."

(11) Restatement (Third) of Trusts: Prudent Investor Rule § 227 (1992), at 6.

(12) For a more complete discussion on liability management see Patrick J. Collins & Kristor J. Lawson, *Managing Attorney and Trustee Liability for Life Insurance Contracts*, *J. Asset Protect.*, Sept.-Oct. 1997, at 47.

(13) Restatement (Third) of Trusts: Prudent Investor Rule § 227

(14) The issue at hand mirrors, to a certain extent, the load/no-load debate in the mutual fund sales community. The commentary to the restated law of trusts states: "Concerns over sales charges, compensation, and other costs are not an obstacle to a reasonable course of action using mutual funds and other pooling arrangements, but they do require special attention by a trustee. Because the differences in the totality of the costs described above can be significant, it is important for trustees to make careful cost comparisons, particularly among similar products of a specific type being considered for a trust portfolio." Restatement, *supra*, note 2 at § 227.

(15) Yakov Amihud & Haim Mendelson, *Liquidity and Stock Returns*, *Fin. Analysts J.*, May-June, at 43.

(16) Yakov Amihud & Haim Mendelson, *Asset Pricing And The Bid-Ask Spread*, *17 J. Fin. Econ.* 224 (1986).

(17) Calculation based on algebraic formula developed by Yakov Amihud & Haim Mendelson, *Asset Pricing And The Bid-Ask Spread*, *17 J. Fin. Econ.* (1986).

(18) Yosup Chung & Harold D. Skipper, Jr., *The Effect of Interest Rates on Surrender Values of Universal Life Policies*, *J. Risk & Ins.*, June 1987, at 341.

(19) Restatement (Third) of Trusts: Prudent Investor Rule § 227 (1992), at 5.

(20) Daily, *supra* note 9 at 9,10 provides a table based on "typical lapse rates for cash value policies" which, for each 100 policies in force, shows 85 in existence after 1 year, 56 after 5 years, 42 after 10 years, 33 after 15 years and 25 after 20 years. It is clear that Daily's numbers apply to universal life policies. However, in their analysis of whole life policies sold between 1950 and 1979, Babbel and Staking conclude "the rate of voluntary policy surrender during the first two policy years has hovered around 20 percent during the past 10 years. Even though lapse rates are high in the first two policy years, the median duration of whole life policies has been...19 years using the more recent lapse rates...." David F. Babbel & Kim B. Staking, *A Capital Budgeting Analysis of Life Insurance Costs in the United States: 1950-1979*, *J. Fin.*, Mar. 1983, at 155.

The American Council of Life Insurance indicates that the 1994 lapse rate for all policies in force was 7.1 percent. The lapse rate for policies in force two years or more was 5.1 percent. American Council of Life Insurance, 1995 Life Insurance Fact Book Update at 30.

(21) The importance of mitigating liquidity risk may be inferred from the fact that the ratio of death benefits paid by the insurance industry in 1994 to surrender benefits paid to policyholders was 31.7 to 59.6. American Council of Life Insurance, 1995 Life Insurance Fact Book Update, at 14. The assessment of tax-risk by the trustee is a two-edged sword. Policyholders may decide to terminate coverage because of changes in tax regulations affecting federal estate tax law. Of equal concern, however, is the likelihood of changes in both the tax treatment of insurance products to individuals (i.e., elimination of the tax favored buildup of cash values within insurance contracts) and the tax treatment of insurance companies. For commentary on the former subject, see, Kenneth Black, *The Future of the Life Insurance Business*, *J. Am. Soc'y CLU & ChFC*, Jan. 1996, at 9. For commentary on the history of the tax treatment of insurance companies, see, Keith P. Ambachtsheer, et al., *Determination of Portfolio Policies: Institutional Investors, Managing Investment Portfolios: A Dynamic Process* (John L. Maginn & Donald L. Tuttle eds., Warren, Gorham & Lamont (1990)).

(22) See Patrick J. Collins, *Is It Prudent and Suitable? Estimating the Value of a Trust-Owned Life Insurance Contract*, *Cal. Tr. & Estates Q.*, Winter 1998, at 4.

(23) Walter N. Miller, Report of the Yield Index Advisory Committee, 1 NAIC Proceedings 647 (1986).

(24) See, e.g., S. T. Pritchett & R.P. Wilder, *Company Characteristics and Policyowner Cost Structures for Cash Value Life Insurance*, *J. Risk & Ins.*, Sept. 1997, at 355 (regression analysis studies); R. R. Kamath & C. Lin, *Factors Affecting the Cost of Participating Whole Life Insurance*, *Neb. J. Econ. & Bus.*, Summer 1981, at 55. Pritchett and Wilder found a positive relation between price and an insurance company's expense ratio and a company's profits (for mutual companies only). Price was negatively related to investment returns and premium income. Kamath and Lin found a positive relation between price and five-year average policy size, ratio of policy loans, current year investment expense ratio, and return on admitted assets. A negative relation exists between price and five-year average investment expense ratio and current year's average policy size.

(25) Michael L. Walden, *The Whole Life Insur-*

ance Policy as an Options Package: An Empirical Investigation, *J. Risk & Ins.*, Mar. 1985, at 44. (26) *Id.* at 46, 47.

(27) Joseph M. Belth, *The Quandary of the Life Insurance Agent in a Time of Uncertainty*, *J. Am. Soc'y CLU & ChFC*, May, 1992, at 78. For a more extensive discussion of the interrelation between advice and agent compensation systems as well as a suggested protocol that attorneys can employ to document the procedural prudence of their role in an insurance transaction, see Patrick J. Collins and Robert F. Curran, *Ethical Considerations And Malpractice Claims Tr. & Estates Q.*, Nov. 1995, at 39, 53.

(28) For a comprehensive analysis of this issue see Hugh Gravelle, *Remunerating Information Providers: Commissions Versus Fees in Life Insurance*, *J. Risk & Ins.*, 1994 at 425. Gravelle concludes "Intuition suggests that, when advice and the product are sold separately, welfare would be higher than when the reward to advice-givers is included in the product price. Potential consumers gain from advice even if they do not buy the product when informed. Thus, it might seem that it would be better to have a system in which the price of the product is determined solely by the costs of the product, rather than also reflecting the costs of advice. Once consumers are informed, their decision to purchase should not be influenced by the bygone costs of providing them with information. This type of argument is incomplete. It neglects the fact that consumers will not become informed under a fee-for-advice system unless they first pay the fee. The fee set by brokers will reflect the weak market position of consumers... Too few potential consumers become informed under the fee regime. On the other hand, too few informed contacts buy the product under the commission regime because its price exceeds marginal cost... If the commission system results in poorer quality advice than the fee system, there is still no presumption that a fee system is preferable. Although the quality of advice is poorer under the commission system, its price is lower and consumers may be better off on balance even though some of them will make mistaken purchases." *Id.* at 452, 453. The trustee, on the other hand, has duties the scope of which are informed by legal requirements. Therefore, the issues of advisor selection and delegation of duties are multidimensional.

(29) The profit objective of non-agency insurers may, in fact, be higher than the industry norm. The reasoning behind this hypothesis stems from the fact that expenses for salaried representatives and advertising costs are fixed expenses as opposed to commissions which represent a variable

cost. Therefore, non-agency insurers have a higher degree of operating leverage and may "...require a greater profit (or risk) loading than agency insurers because of the risk associated with the increased operating leverage. If so, the cost of insurance products sold by non-agency insurers could not be expected to be lower than those for agency insurers unless the expense savings for non-agency insurers were sufficient to offset the increased profit (or risk) charge." Scott E. Harrington, *Operating Expenses for Agency and Non-agency Life Insurers: Further Evidence*, *J. Risk & Ins.*, June 1982 at 234.

(30) S.T. Pritchett & B.Y. Brewster, *Comparison of Ordinary Life Operating Expense Ratios for Agency and Non-agency Insurers*, *J. Risk & Ins.*, Mar. 1979, at 61. Analysis of 49 companies finds no statistically significant difference between the two types of distribution systems and concludes that knowledge of the distribution system is of no value to the consumer who seeks low cost life.

(31) Martin F. Grace & Stephen G. Timme, *An Examination of Cost Economies in the United States Life Insurance Industry*, *J. Risk & Ins.*, Mar. 1992, at 72.

(32) Belth, *supra* note 6, at 137. The author divides non-agency organizations into savings bank vendors (for Massachusetts, New York and Connecticut residents only), organizations that direct market programs for designated groups (i.e., Teachers Insurance and Annuity of America) and "direct response" (i.e., mass marketed) companies. Speculating on why more non-agency distribution systems like those found in East coast savings banks are not available to the consumer, Belth states: "...agents have political influence. Some of them serve in state legislatures, and their prominence in local communities is a source of grassroots strength... Over the years, agents' organizations have been at least partially successful in persuading lawmakers to enact and retain restrictions that make it difficult to market life insurance other than through agents." *Id.* at 131.

(33) David F. Babbel, *The Price Elasticity of Demand for Whole Life Insurance*, *J. Fin.*, Mar. 1985, at 225.

(34) *Id.* at 234.

(35) Andrew Tobias, *The Invisible Bankers: Everything The Insurance Industry Never Wanted You to Know*, 164, 165 (1982). "Nor can you rely upon the training programs of most life insurance companies, because they generally emphasize sales techniques rather than technical knowledge." Belth, *supra* note 6, at 132.

(36) Joseph M. Belth, *Farewell To New England Mutual*, *Ins. Forum*, Nov. 1995, at 273.

(37) Harry DeAngelo, Linda DeAngelo, & Stu-

art C. Gilson, *The Collapse of First Executive Corporation: Junk Bonds, Adverse Publicity, and the 'Run On the Bank' Phenomenon*, 36 *J. Fin. Econ.* 311 (1994); Burton G. Malkiel, *Assessing the Solvency of the Insurance Industry*, *J. Fin. Serv. Res.*, 1991, at 167; House Committee on Energy and Com. Subcomm. On Oversight and Investigations, *Wishful Thinking: A World View of Insurance Solvency Regulation*, 1994. In a discussion of the difficulties in transitioning from Statutory accounting to GAAP accounting, a financial analyst for the A.M. Best Co. remarks "Since the sudden rise in interest rates experienced during the first quarter of 1994, many insurers continue to experience significant erosion in GAAP equity. Some are now reporting negative GAAP equity..." Derrick Vializ, *Best's Rev.*, May 1995, at 31.

(38) See also, Patrick J. Collins, *Myths and Realities Regarding Life Insurance Advice*, *Ca. Tr. & Estates Q.*, Fall 1998, at 5.

(39) Glenn S. Daily, *Life Insurance Sense And Nonsense* 30 (1992).

(40) National Association of Insurance Commissioners Report of the Yield Index Advisory Committee 648 (1985) 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." For a description on the trend towards segmentation of general portfolios to accommodate specific return requirements for various lines of business, see Keith P. Ambachtsheer, John L. Maginn & Jay Vawter, *Determination of Portfolio Policies: Institutional Investors*, *Managing Investment Portfolios: A Dynamic Process* § 4-56, 4-57 (John L. Maginn, & Donald L. Tuttle eds., Warren Gorham & Lamont) (1990). "Each segment has its own return objective, risk parameters, and liquidity characteristics. A few companies have segmented by product line and in some cases have established as many as 40 different segments."