

Introduction to Insurance Products

There are many types of insurance products that may be found in a trust department. Some insurance products may be more commonly sold to and held by private banking clients, while some trust department accounts may be solely invested in a life insurance product.

Examiners should consider whether insurance products held by trust department accounts are appropriate for the account and whether there is a system in place to analyze any conflicts of interest, if the account holds an the insurance product of an affiliate.

Irrevocable Life Insurance Trusts (ILIT)

Irrevocable life insurance trusts, commonly referred to as “ILITs” are becoming more widely used in estate planning as a means to transfer wealth without having to pay estate taxes on the transfer. Normally, the value of insurance policies, owned by a decedent, are included in the decedent’s estate for estate tax purposes. This is true even if the proceeds are paid to a designated beneficiary other than the decedent’s estate. However, if an ILIT is used to hold the “incidents of ownership” of a life insurance policy, it will allow the proceeds of the policy to escape being included in the grantor’s estate when he/she dies, thus avoiding the payment of estate taxes on the value of the life insurance policy. Many savings associations are providing trustee services to irrevocable life insurance trusts.

A conflict of interest for a savings association occurs when the life insurance policy is sold or underwritten by an affiliate of the savings association. In most cases, specific language will be present in the trust instrument creating the ILIT that will allow a trustee to purchase and/or hold an insurance policy sold and/or underwritten by a savings association, its subsidiaries or affiliates. Such language in the trust instrument resolves the conflict of interest but state law, a court order or consent of all the beneficiaries may also be utilized to resolve any conflicts of interest.

Savings associations performing trustee services for these ILITs must also meet their duties of prudence in regards to the selection and continued holding of the life insurance policy (ies) which represent a significant portion of the assets of the irrevocable life insurance trust. The savings association should document all the benefits that it, its affiliates and its subsidiaries receive in connection with the purchase, holding or sale of the life insurance policy as well as the benefits that particular policy presents to the life insurance trust. The subject of diversification of trust account investments must also be addressed under the applicable state’s prudent man/prudent investor statute. In most cases, the trust instrument creating the ILIT will direct the trustee to purchase and continue to hold a significant amount of trust account assets in life insurance policies, since the life insurance trust typically represents just one element of a diversified and integrated plan of family wealth management.

In an ILIT, the trust takes title to the life insurance policy, becoming its owner and the recipient of the proceeds of the insurance policy at the insured’s death. When the insurance benefit is paid after the death of the insured, the trustee collects the funds, makes them available to pay estate taxes and/or other expenses (including debts, legal fees, probate costs and income taxes that may be due on IRAs and other retirement benefits) and then distributes the remaining funds to the trust beneficiaries. The premiums of the life insurance policy are paid by the grantor/insured by making gifts, through the trustee, to the trust beneficiaries of the ILIT. Such gifts are generally made free of gift tax through the use of “Crummey” provisions.

The term “Crummey” provisions refers to the language in the trust document creating the ILIT that indicates that the grantor will make periodic cash payments to the trust. The cash payments are meant to be used to pay the premiums of the life insurance policy held by the trust but in accordance with the provisions of the trust document, the beneficiaries of the trust have a specified period of time (usually 30 days) to make a withdrawal of those cash payments. If the beneficiaries do not withdraw their respective amounts, the money is then used to pay the premiums due on the life insurance policy. The IRS has ruled that such an arrangement represents a gift of present value interest by the grantor. Since it is a gift of present value, the grantor may contribute up to \$10,000 (\$20,000 if the grantor and the grantor’s spouse join in the contribution) per year per beneficiary in premium payments and enjoy the gift tax exclusion.

Savings associations that act as trustee for ILITs assume certain duties in connection with these trusts. The first duty is administrative in nature and includes sending the required crummy notices before the payment of the premium and with sufficient time for the beneficiaries to choose to remove any funds and to also file an annual gift tax return to claim and allocate any generation-skipping transfer tax exemption. Savings associations may also be faced with decisions in regards to the demutualization of life insurance companies that have issued policies held by the trust. In these situations, savings associations should document its decisions regarding the demutualization election, the choice of receipt of benefits as a result of the demutualization and any investment decisions relating to the benefits received. As there may be estate, gift and income tax consequences relating to the demutualization, savings associations are urged to seek a reasoned opinion of counsel as to the tax effects on the ILITs as a result of its decisions, but such opinion need not be specific as to each account. The other duties that savings associations have in connection with these types of trusts revolve around the continued review of the life insurance policy (ies) to confirm that the policies held by the trust continue to be a prudent investment, taking into consideration any relevant language in the trust document or under applicable state law.

This review should be conducted on an annual basis and the savings association should document its decision making as to the continued retention of the policies in light of any premium payment option changes or conversion provisions of the policy that might be triggered by some event. The savings association should also document its review of the solvency and financial health of the insurance companies issuing the policies. In its review, the savings association should take into consideration certain assumptions that were made when the policy was originally purchased or the ILIT created, about the insured’s financial situation, life expectancy, health condition, number of dependents and other factors. Those factors can change while the insured is still alive, possibly rendering a life insurance policy inadequate, obsolete or no longer appropriate. Savings associations should be reviewing the policies to make sure that the trust does not continue to hold policies that have become inadequate or inappropriate.

Insurance Products and Services

Life Insurance

Life insurance is a tool that can be utilized relative to an individual’s overall financial plan. The primary purpose of life insurance is to financially protect the insured’s survivors in the event of the insured’s premature death; however, life insurance products can be utilized for other planning purposes as well. There are four primary types of life insurance policies, term, whole-life, universal and variable.

Term insurance

Term insurance is a contract that obligates the insurer to pay the policy’s face value if the insured dies within a specified period. If the insured survives the contract period, the contract expires without any value. Term

insurance is temporary and at some point in time it disappears. There are various terms available, such as straight, yearly renewable, convertible, combination or the usual form, level term. Premiums are usually inexpensive in the beginning and tend to increase with age.

Whole life insurance

Whole life insurance is a type of permanent insurance with cash-value accumulation. Whole life provides resources after death regardless of when the insured dies. It can be used as a savings plan for emergencies or for funding a retirement income. Generally, no cash is available for the first three years of the policy and it takes about seven to eight years afterward to break even. The client can borrow against the policy, can alter the policy and can quit at any point in time.

Universal life insurance

Universal life insurance is also a type of insurance with cash value. Life insurers developed this policy to combine the advantages of cash-value life insurance with the higher yields possible through investment vehicles. Universal life divides death protection and cash-value into separate components. It is distinguished from traditional cash-value policies, which are indivisible contracts with unified death protection and cash-value accumulations. With universal life, more competitive rates of return can be guaranteed and greater flexibility can be achieved by adjusting the amounts of savings and protection to the needs of the insured. The flexibility is an important advantage as the policy owner passes through the life cycle. There is no premium guarantee.

Variable life insurance

Variable life insurance provides a minimum face amount of insurance but allows the policy proceeds to increase beyond this amount if the value of the investment portfolio supporting the policy increases. Cash values fluctuate with investment returns. The insured directs the investment portion (usually mutual funds); therefore, the owner is taking the risk not the company. As the cash value decreases, the death benefit also decreases. The premium is comparable to universal life policies.

Variable universal life policy

Fairly new, a variable universal life policy combines features of variable and universal life policies. The holder of this policy enjoys the investment risks and rewards characteristic of variable life insurance, coupled with the ability to adjust premiums along with a death benefit that is characteristic of universal life insurance.

Disability Insurance

Private disability insurance is sold in a variety of plans to meet personal and business needs when the insured is unable to work and suffers a loss of income as a result of sickness or injury. This type of insurance provides a periodic payment on an “occupational” basis when the insured is unable to perform specific job related duties or on a “residual” basis when the insured is at work at reduced earnings. Personal disability income insurance is available from commercial insurance companies. Most business disability income insurance is sold only on an individual basis.

Long-Term Care Insurance

Long-term health care insurance is not an income replacement but a supplemental policy that pays above and beyond Medicaid and Medicare. It is purchased in ten dollar increments depending on the extent of nursing

home care desired. Nursing homes offer three types of care, custodial, intermediate and skilled. A physician determines the services needed. In addition to the policy purchased, a home health care rider can be purchased that will allow the purchaser to remain in their own home for treatment. The typical age to purchase long-term care insurance is between the ages of 45 and 65.

Homeowner Policies

There are five form types of homeowner policies, differing based on the terms of the perils covered under the policy. The five forms are: broad form coverage (for dwelling, other structures and personal property), open peril coverage (for dwelling and other structures), renter's policy (coverage for personal property), condominium unit owners policy and modified coverage form.

Variable Annuities

Variable annuities have become a part of the retirement and investment plans of many clients. A variable annuity is a contract between the client and the insurance company under which the insurer agrees to make periodic payments to the client, beginning either immediately or at some future date. A client purchases a variable annuity by making either a single purchase payment or a series of purchase payments. Variable annuities offer investment features similar in respect to a mutual fund. A typical variable annuity, however, offers three basic features not commonly found in a mutual fund; tax-deferred treatment of earnings, a death benefit and annuity payout options that can guarantee income for life.

Variable annuities are designed for long-term investments for retirement. Withdrawals prior to the age of 59 ½ are generally subject to a 10 percent penalty under the Internal Revenue Code. Many variable annuities assess surrender charges for withdrawals within a specified time period after purchase. Variable annuities assess various fees including fees related to the insurance features.

A variable annuity is an insurance contract that is subject to regulation under state insurance and securities laws. A client's premium payments to purchase a variable annuity are allocated to underlying investment portfolios, often termed subaccounts. The value of the underlying subaccounts will fluctuate in response to market changes and other factors depending on the underlying investment(s). Because the contract owners assume the investment risks, variable annuities are securities and generally must be registered under the Securities Act of 1933. A distributor of variable annuity contracts to individuals is required to register as a broker-dealer under the Securities Exchange Act of 1934 and become a member of the NASD. The distribution of variable annuity contracts is subject to NASD rules for suitability and replacement sales.