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 polices, 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.

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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 premium for 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 polices 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 moves 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.

Insurance Products Examination Program

Examination Objectives

To determine the adequacy and effectiveness of the trust department's administration of insurance products. Consider whether:

- effective policies, procedures and internal controls have been established for the acceptance and administration of irrevocable life insurance trust accounts, including an annual review of each insurance policy;
- an effective audit, risk management and/or compliance process is in place that reviews the decision making process regarding the use of affiliated insurance products in discretionary accounts;
- policies and procedures ensure compliance with governing instruments, applicable law and accepted fiduciary principles;
- management and staff have the necessary expertise to assess insurance products; and
- when deficiencies are identified, corrective action is promptly initiated.

Examination Procedures **Wkp. Ref.**

Level I

Level I procedures first focus on a review of the examination scoping materials. The next step consists of interviews with trust department personnel to confirm their qualifications and levels of expertise; to determine if the trust department's practices conform to written guidelines; to establish whether any significant changes in personnel, operations or business practices have occurred; or whether the new products and/or services have been introduced. If items of concern are uncovered during Level I procedures or if problems are identified during the preexamination monitoring and scoping; the examiner may need to perform certain Level II procedures.

1. Review examination scoping materials related to the administration of irrevocable life insurance trusts and the use of insurance products. Scoping material should include:
   - Risk profile
   - Relevant PERK documents
   - Previous trust and asset management examination report

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- Workpapers from the previous examination
- Examination reports of subordinate, functionally regulated entities
- Board and other applicable committee minutes

2. Evaluate the trust department's policies, procedures and practices related to irrevocable life insurance trust accounts and insurance products, noting any significant changes. Consider:

   - whether compliance with applicable law, standards of fiduciary conduct, governing instruments and policy are ensured;
   - the process, including documentation, by which nsurance companies and insurance policies are reviewed;
   - the use of affiliates or other third parties to administer life insurance trusts or evaluate life insurance policies or companies;
   - management of the conflict of interest issues surrounding the use of affiliated insurance products; and
   - the handling of exceptions to policies and procedures.

3. Determine whether management and staff have the knowledge and expertise to administer life insurance trusts and other types of accounts that are invested in insurance products such as term, whole life, universal life and variable life policies and annuities.

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4. Review and evaluate the analysis, selection, approval and removal process with respect to insurance companies and their products and services when the trust department has investment discretion.

5. If the administration or evaluation of life insurance policies and products is outsourced to third parties, assess management's selection and oversight process. Consider whether:

   - management's due diligence process is thorough, including assessing the qualifications and experience of the third party; and

   - the duties and responsibilities of the respective parties are set forth in a written agreement, including provisions relating to the content and frequency of reports and the authority to incur and pay expenses and compensation.

6. Consider management's process for identifying conflict of interest issues when affiliated insurance products are used in discretionary accounts.

7. If affiliated life insurance products are used in discretionary accounts confirm that there is a process to assure that all the provisions of OTS TB 76-2 are met regarding state conflict of interest and prudent investment statutes.

8. Consider whether the following risk contributors (if applicable) have been addressed:

   - Does management fully understand all aspects of risk with respect to irrevocable life insurance trust accounts and/or the use of insurance products in discretionary accounts?

   - Are policies and procedures adequate?

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- Does management anticipate and respond well to market and technological changes?
- Is investment research and analysis sound?
- Are management information reports comprehensive and credible?
- Is the internal control environment adequate?
- Does management satisfactorily review and assess exceptions to policy?
- Does management quickly identify weaknesses and take appropriate action?
- Are there unresolved insurance product issues noted in audit, compliance or examination reports?

The completion of the Level I procedures may provide sufficient information to make a determination that no further examination procedures are necessary. If no determination can be made, proceed to Level II.

Level II

Level II procedures focus on an analysis of trust department documents such as reports and outsourcing contracts. The examiner should complete the appropriate Level II procedures when the completion of Level I procedures does not reveal adequate information on which to base a conclusion that the trust department meets the examination objectives. Neither the Level I nor the Level II procedures involve significant verification procedures.

1. If there are unresolved exceptions present from internal or external audit reports, compliance reports or examination reports, evaluate the reasons for their presence and management's plan for correction.

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2. Determine if there is a process to review discretionary accounts that have insurance policies as investments. Are policies reviewed to determine suitability? Are the following factors considered: the cost of the policy or product, unique terms, level of risk, financial stability of the issuer, liability issues and tax implications.

3. For irrevocable life insurance trusts, do the policies require that all crummy provisions are met, including timely notices to beneficiaries? Are the notices in conformance with applicable law and the governing document?

4. If third parties are engaged to administer life insurance trusts and/or products, is the performance of the third party periodically evaluated and the evaluation documented?

5. If necessary to validate an assertion, finding or concern arising from the completion of the Level I and II procedures, judgmentally select a limited number of accounts for review considering the degree of risk to the institution. Not all types of accounts need to be reviewed to arrive at a well-founded conclusion.

If the examiner cannot rely on the trust and asset management Level I or Level II procedures, or data contained in department records or internal or external audit reports to form a conclusion; proceed to Level III.

Level III

Level III procedures include verification procedures that auditors usually perform. Although certain situations may require that Level III procedures be completed, it is not the standard practice of Office of Thrift Supervision (OTS) examination staff to duplicate or substitute for the testing performed by auditors.

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1. From the discretionary account list, select a sample of accounts containing different types of life insurance policies or products. Consider the following:

   - The insurance policy is from a company on the trust department's approved list. If not, has a reasonable explanation been documented in the file?
   - Documentation is present to support the acceptance and/or purchase and ongoing analysis and valuation of the life insurance policy or product in view of the investment objective of the account.
   - Whether the purchase or retention of the life insurance policy or product is in accordance with applicable law. Does applicable state law remove liability from the trustee regarding life insurance trusts, and if so, to what degree?

2. Determine if the findings of the audit/compliance review are consistent with examination findings. If not determine the reasons for any discrepancy.

3. Determine if the trust department is holding any obsolete insurance policies.

4. Review a sample of policies from companies who are bankrupt, in default or have been downgraded by rating services to below investment quality.

5. Ensure that management purchases enough life insurance for the premiums paid.

6. Does management periodically review the client's health to ensure that premiums are not being paid for adverse health ratings?

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Examiner's UITRS Rating, Summary, Conclusions and Recommendations:

References - 870P

Laws

Code of Federal Regulations

12 CFR 550.240	Trust Powers
12 CFR 550.260	Investment of Funds Held as Fiduciary
12 CFR 563.41	Transactions With Affiliates
12 CFR 563.42	Transactions With Affiliates

Office of Thrift Supervision Publications

Other

Scott on Trusts, 3rd Edition
Bogert and Bogert, Trust and Trustees, 2nd Ed.
Restatement (Second and Third) of Trusts

Workpaper Attachments - 870P

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Optional Topic Questions

The following list of questions is offered merely as a tool and reference for the examiner and is not a required part of the examination process.

Policies and Procedures

• Do the policies and procedures provide investment guidelines for the use of insurance products in discretionary accounts?
• Do the policies and procedures address the criteria used in evaluating insurance companies, such as the rating agencies used and the acceptable ratings?
• Do the policies and procedures address how insurance policies are to be evaluated?
• Do the policies and procedures establish replacement/restructure criteria?

Acceptance and/or Purchase

• Is the financial stability and performance of the insurance company considered?
• Does management have sufficient expertise regarding insurance products when purchasing or evaluating policies and/or companies?
• Is the anticipated term of the trust considered?

Annual and/or Periodic Review and Evaluation

• Is an assessment of the life insurance carrier's solvency made?
• Is suitability considered in light of the client's and the trust's objective(s)?
• Has the grantor's medical condition remained the same?
• Has the actual policy performed similarly to the policy illustrations and similar policies of peer companies with regard to dividend, expense and mortality perspective?
• As part of the annual investment review for variable insurance products, is the savings association evaluating the underlying investment securities?
• When appropriate, has the savings association recommended insurance policy restructure/replacement?
• Do reviews comply with 12 C.F.R §§550.200 through 550.220?

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