CAPITAL FORMATION GROUP, INC.

Nurturing Acorns into Mighty Oaks:

The Need for Professional Review & Ongoing Management of Trust-Owned Life Insurance

THE ACORNS TO MIGHTY OAKS PROCESS

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About Capital Formation Group

CFG, working with our strategic partners at Valmark Financial Group, is a team of professionals dedicated to your financial well-being. Our team was founded on the premise that successful wealth management should be focused on a holistic, client-centered perspective: one that aligns your financial resources with the life you want to live.

While we provide a wide range of services for private clients, trustees and advisors, we view ourselves primarily as financial educators and coaches, guiding you towards potent and meaningful understanding of wealth accumulation and protection.

As an independent firm, we are always objective and unbiased, not tethered to proprietary products or aggressive sales goals.

Our passion is focused on developing long-term relationships built on trust, mutual respect and an unwavering commitment to placing your best interests at the forefront of everything we do.

Clients recognize and value these qualities. That's why the majority of our new business comes through referrals from the individuals and families we currently work with.

The Author

Industry-focused
Thought Leadership, Expert Analysis

John D. Williams

ChFC, CLU, TEP, Founder & CEO

John is a 35-year veteran of the financial services industry. He is one of the original co-founders of Capital Formation Group (CFG). He holds ChFC® and CLU® designations from The American College, and a Registered Trust and Estate Practitioner (TEP #255854) designation from The Society of Trust and Estate Practitioners. He also earned a BA from Creighton University and an MA in Theological Studies from the Boston College School of Theology.

He is the author of Charitable Estate Planning (1994) and co-authored Life Insurance 10X (2017), published by Valmark Financial Group.

John is a member of the Boston Estate Planning Council, The American Society of Financial Service Professionals and The Society of Trust and Estate Practitioners. John and his wife Mary Ann have two grown children, Jonathan and Anna.

Besides his professional and family endeavors, John served nine years as a Selectman in his hometown of Carlisle, MA. His avocations include running and playing music.

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Abstract & Professional Summary

Trustees of trust-owned life insurance are fighting an uphill battle, trying their best to properly manage this unique financial asset. These are the main drivers of this difficult situation:

1. A substantial percentage of trust-owned insurance contracts (we estimate 40 to 50%) have been sold by career agents employed by a single carrier. Those agents have a duty to their employer.

2. A high percentage of the products sold by career agents are outdated and are dramatically underperforming compared to their initial performance goal and to the projections made at their inception.

3. More "modern" products, while providing flexibility, are in trouble. An estimated 40% are shown (by the insurance carrier's own illustration) to lapse without value before the insured's life expectancy.[1]

4. Trustees are largely unaware of material differences in term insurance policies (the most common type of insurance policies) and the differences are critically important: some term policies may have value, even as the term period is coming to an end. Others have no value whatsoever.

5. At least half of trustees know little about the potential value of an unwanted, unnecessary or about-to-expire insurance policy in the life settlement marketplace.[2]

To solve these problems, Capital Formation Group has developed a proven process: The Acorns To Mighty Oaks Process™. Through this process, trustees are assisted in assessing and improving what they own, repairing or replacing what is broken. This process helps them better understand their vulnerabilities and opportunities, and to establish the best way to manage these assets proactively. This process does not impose the burden of additional fees.

The Problem & Its Ramifications

Outdated policies are underperforming, due to the sustained low interest rate environment. Even as rates rise, there is a lag time for insurers as maturing bonds are replaced with what the market offers on highly rated issues.

Because companies are currently earning in the four percent range on their general portfolios and are struggling to maintain dividend crediting rates above what they are earning, those policies are unlikely to perform significantly better for quite some time. This is a common, well- understood, objective problem that trustees must solve in order to succeed.

Let's take a step back for a moment and assume the trustee manages a securities portfolio. If the trustee had an investment performing poorly, they would know what to do and would have assistance executing the solution: if the trustee wanted to get out of the investment, the market makers, brokers, custodians and advisers would help by facilitating trades, providing research and more in order for the security to be sold and for another security to be purchased. This is common sense.

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What can be done when an insurance contract is performing poorly?

Here we see a major industry problem. In the case of products written by career agents, little to no help can be offered.

First, consider that a career agent is compensated by their employer to keep business on the books: The career agent receives W-2 income, health insurance, retirement benefits and a strong renewal stream of income – unlike an independent producer. Second, a career agent selling for one carrier is limited in the products they may offer.

Trustees want independent advice from professionals able to bring solutions from whatever carrier(s) make the best sense for the need at hand. Limited access to career agents leads to limited knowledge and limiting decisions. This is an antiquated system that didn't used to matter when all companies wrote virtually the same products. But today's market has changed and without independent advice, poor policy performance over the long term is all too likely.

Over 50

percent of policies **without** active management are underperforming.[3]

For more modern products, poor policy design can occur in at least two important ways:

1. Flexible premium policies can be underfunded. As the cash value in a policy goes down, the corridor between the cash and the death benefit increases. This means more insurance is being purchased. Because the cost of each dollar of insurance becomes more expensive as the insured ages, the difference between the cash and the death benefit matters more and makes the policy have less value as the insured ages. Without a death benefit guarantee, this compounding problem may become very expensive to repair, because enough additional cash needs to be put into the policy to keep up with the increasing insurance costs. This can lead to a policy lapsing, with no value to anyone.

2. The second important design flaw has to do with the length of a death benefit "secondary guarantee." This type of guarantee provides for (and reserves for) the original death benefit remaining in place, even if the cash value runs to zero, as long as the premiums agreed upon at inception are paid. We have found many cases where the guarantee is written for an inadequate length of time, and will often expire before the life expectancy of the insured.

Policies that lapse before maturity at death hurt beneficiaries. Underperforming policies waste the grantor's hard-earned dollars. Policies that don't pay also hurt the multi-generational profitability of the firms that serve as trustees where wealth management is a part of the firm's offerings.

40

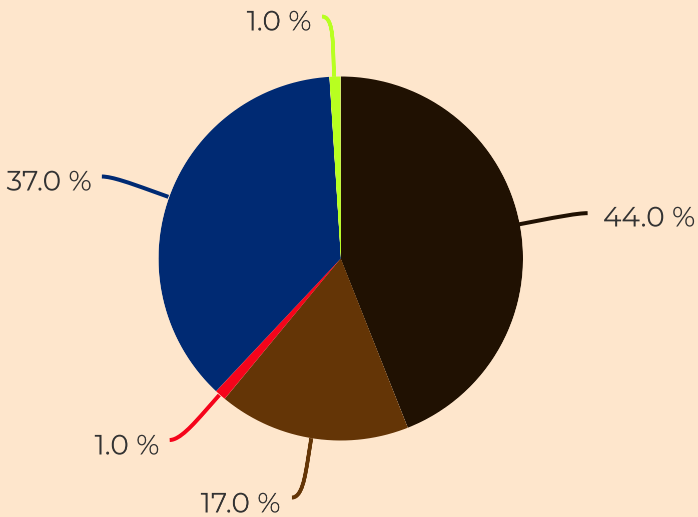
percent of flexible premium policies illustrated to lapse within insured's lifetime.[1]

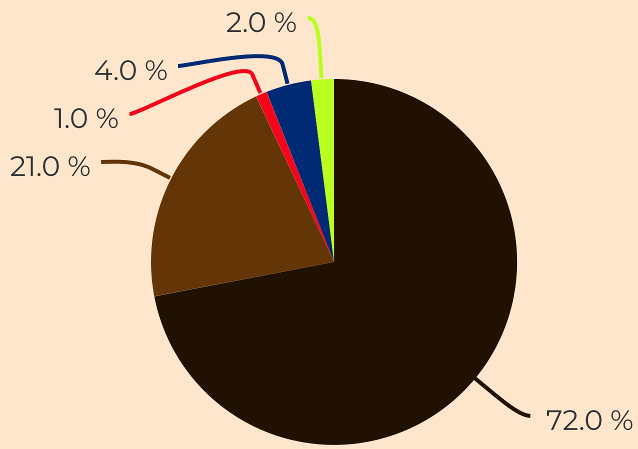
Term life insurance is the most common type of insurance. Most think of it as valuable only because of the low likelihood of a premature death period. However, term contracts vary significantly from carrier to carrier. The differences lie in the contractual guarantees regarding conversion, such as the right to exchange a term policy for a permanent one. This can be particularly important in the event that an insured experiences an adverse change in health that allows the trustee to exchange the term policy into a permanent one without medical underwriting guaranteed.

The term, **"conversion caution"** describes policies that have limited conversion periods, which commonly occur in the insurance industry. For example, a trustee might own a twenty-year term policy but the conversion period may end after seven years or at a particular age of the insured. If this is not understood and the conversion period passes, this may be both a surprise and a problem for the beneficiaries, the grantor, and the trustee.

On the other hand, in instances where the term is no longer wanted or needed, having a better conversion option may make the term policy worth something to an institutional buyer in the Life Settlement markets. This option may make a seemingly worthless policy that's due to expire an asset that the trustee is able to sell and bring unanticipated funds to the trust. Not having this option, or being unaware of it, can be costly.

Reactive Policy Mgt. compared to PMC Professional Ongoing Mgt.





- Monitor/Manage
- Replacement
- New Coverage
- Recalibrate
- LIfe Settlement

Above, managed policies have a 25% need to be Recalibrated or Replaced

At left, over 50% of permanent policies are not meeting client objectives

Results and statistics comparing PMC Managed Policies to Well-placed Unmanaged Policies are sourced from Valmark Policy Management Company annual policy reviews completed since 5/23/2016

What is The Acorns To Mighty Oaks Process™?

This process was developed after working with trustees owning life insurance for many years. It is driven by the practical problems trustees face in real-world situations.

First, the more objective/fact-based problems are considered: numbers, contractual rights and responsibilities, guarantees, projection assumptions, life expectancy tables, tax rates and more.

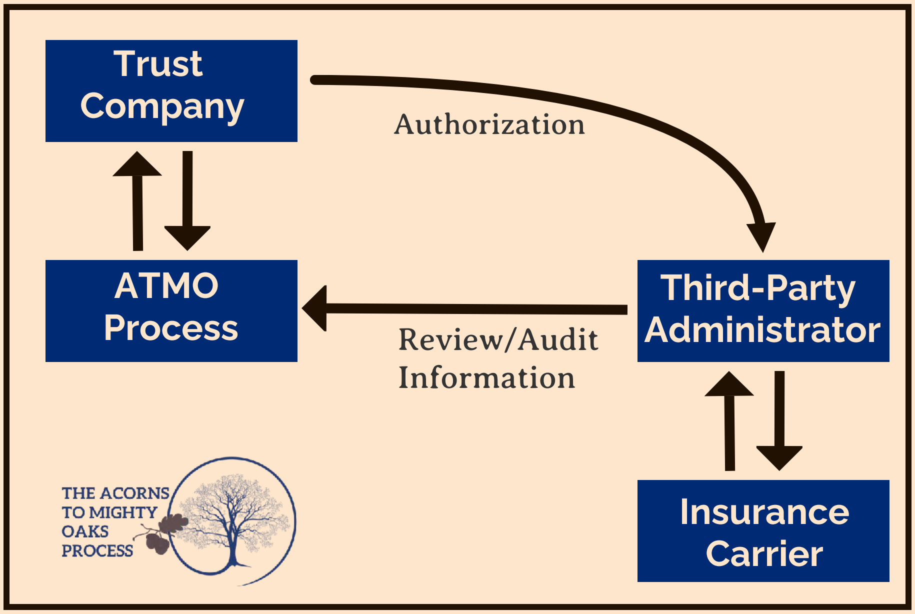
Next, more subjective problems are assessed. These include things like a lack of industry/product knowledge, prejudices about insurance, when the trustees' feelings of loyalty towards the grantor's insurance agent may keep trustees from seeing the best options, and more.

Those that fund a trust choose a trustee because they want that person to be there for loved ones and to hopefully make the same (or similar) decisions about who receives what and when, as the funder (Grantor or Settlor) would make themselves and for those decisions to be informed by the same values as the funders of that trust.

The trustee wants to manage insurance in the very best interest of the beneficiaries. However, in reality, the trustee is very often presented with insurance already purchased or is being educated by the insurance agent brought in by the client/grantor and many firms do not have a say at inception. They should, but it can be uncomfortable and is made harder by the complexity now inside insurance policies for the trustee to know what is best. Providing the education, knowledge, and expertise needed helps trustees in those situations.

How It Works

The process begins with the trustees identifying the policies to be examined. If the trust company has not engaged in a thorough audit of their policies, all policies should be included. Depending on the number of policies, the aim is to have initial recommendations completed for each policy at least 90 days prior to the policy anniversary.



If a third-party administrator is in place, the work of receiving the needed policy information is easier, because the third party would generally have in force ledgers from the prior year, which would allow us to begin. If additional policy information is needed (a ledger showing projections at one percent less, for example), the third party's request is easier, as they are already authorized by the trustees to obtain whatever is needed.

If there is not a third party involved, we are able to bring one in or simply work with the trustees, having them provide either authorizations or written letters of instruction to the carriers requesting what is needed. It is important not to be casual about the work involved in this situation: carriers do not have their best people on the front lines of policy owner service and starting cold (without a third party already authorized and able to obtain the information) requires a lot of administrative work.

Track 1: Permanent Insurance Policies

For permanent policies, the main question to ask is:

"Are they performing as designed?"

Considerations include:

- **Was the policy design done well in the first place?**
- **Is the contract funded properly?**
- **Are there changes in internal charges?**
- **How different is the crediting rate (for more traditional whole life) from inception and how dramatic is the effect of the difference?**
- **If guarantees are in place, how long do they last?**
- **If guarantees are designed to be too short, can they be contractually extended without underwriting and with reasonable premium increase?**
- **What is the financial performance of the policy from a Return on Investment (ROI) point of view?**
- **What is the Internal Rate of Return (IRR) of the cash values compared to the same of the death benefit?**
- **Is the policy a good candidate for the Life Settlement marketplace?**

Track 2: Term Insurance Policies

In the process for term policies, the following are taken into consideration:

- **Is the contract convertible?**
- **Is the policy convertible for the entire period of the term coverage or for a shorter period?**
- **Is the conversion product any of the suite of permanent policies offered by the carrier at the time of conversion or is the conversion product limited to a substandard product?**
- **If a suite of products, does the insured receive the same underwriting category as is in place with the term policy, without any medical underwriting?**
- **Is the policy a good candidate for the Life Settlement market?**

After the policy or policies have been examined as they stand, they're compared to the current market to discover if the premium dollars could be otherwise deployed to better achieve the aim(s) of the policy or policies. In other words: **Is the trustee able to do significantly better with the same or less money at work?**

The Process Continues

After that, the trustee is presented with preliminary findings. Up to this point, the trustee has not been engaged (except to sign authorizations, if need be). This is where the real value of this process begins.

Up to this point, the trustee has not been engaged ...

Here is where the real value of this process begins.

Next, the trustee is provided with a summary report as a basic education about how the policy or policies work(s), the "pros" and "cons" of the policy or policies, and what, assuming the same underwriting category/categories, the marketplace offers today that may be better or worse.

There may also be a discussion, conceptually, of whether or not the product would be valuable in the life settlement marketplace. This education is to open all reasonable possibilities in order to inform the trustee and to begin a conversation about the needs of the clients and beneficiaries. It may even include approaches that are diametrically opposed to each other.

At this point, we are simply beginning to ascertain the trustee's knowledge and concerns pertaining to their specific client/clients (the insured or grantor).

The Acorns To Mighty Oaks Process™: A Case Study

Consider a policy on a woman 82 years of age. The policy was a universal life contract with secondary guarantees written by a high-quality carrier. It was unknown if the coverage was still wanted or affordable. The guarantee was designed to last until age 94 — not long enough for a healthy 82-year-old, given an approximately 52% chance of her outliving the guarantee. The policy would have no cash value at age 94 and would have lapsed with no value to anyone in that instance.

The trustee was approached with both the amount of premium increase needed to extend the guarantee from age 94 to lifetime and an approximation of the value to the trust in the life settlement market.

After conversations with the trustee and his subsequent conversations with the grantor/insured, it was determined that the policy was still wanted and affordable, so there was no need to pursue the life settlement auction process.

The most important discovery from this process: the increase in premium needed to guarantee the death benefit for life was *less than one percent* of the premium being paid and no underwriting was needed. The costs of the guarantee were embedded at current pricing — then already unavailable for new policies in the marketplace. This meant that the policy owner had the better option, even if the the carrier would not offer the same on a new policy. In this instance, given the small increase in grantor gifts needed, the trustee had an easy and informed talk with the insured. The necessary paperwork was obtained and the new premium — now paid by a satisfied trustee — executed.

12 percent of guaranteed policies have compromised guarantees — like the one discussed in this hypothetical case.[3]

Closing Thoughts

The process is helpful because it begins where other services end. The communication and common understanding of the role that trust-owned life insurance plays in the overall financial and estate planning of a trustee's client is critical. The essential element of trust is at the heart of The Acorns To Mighty Oaks Process™ and that trust is the essence of a successful relationship as a co-adviser with the trustee.

The process … begins where other services end.

1 Whitelaw and Montag, June, 2017.

2 The Hidden Value In Your Life Insurance, 2016.

3 Policy Management Company review results from 5/2316-10/1/2017

4 Whitelaw and Reis, "Managing Trust Owned Life Insurance Revisited," Trust and Estate (4/99): 38-39.

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