PRENEED

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Debunking the Trust Myth

How the Preneed Cookie Crumbles

We've all seen the headlines about preneed fraud. In January, the AARP reported that a funeral industry scandal was fleecing thousands of Americans. It was just one of many negative stories in the press.

At first, one might conclude that the preneed industry offers fertile ground for fraudulent activity. But, take a closer look and you'll discover that it's not the preneed industry. Rather, the predominant problem is under-regulated preneed trusts. If you don't believe me, read the AARP article and review every fraudulent example cited. You'll quickly see that the examples universally involve trust situations.

In fact, on March 4, a member of the Indiana House of Representatives decided to support House Bill 1026, which makes it a Class C felony for managers of a funeral trust fund to disperse money for any purpose not related to a funeral, burial or cemetery upkeep. It's only a matter of time until other states follow suit in tightening trust standards.

Despite all the bad press, there are some rules of thumb for when to use trusts and when to use insurance-based preneed contracts. Allow me to break it all down in terms that even the Cookie Monster can understand.

Let's start with the cookie.

In this case, the cookie is $5,000 allocated to cover the cost of a future funeral. If the $5,000 is set aside by using an insurance policy, all commissions and administrative costs are paid in addition to the $5,000. On day one, the beginning value of the insurance policy is $5,000. In contrast, when a trust is used, administrative costs and marketing costs are taken out of the $5,000. So, $1,000 might immediately be used to pay for sales counselors and funeral home administration. In this case, on day one, the beginning value of the trust is $4,000.

Many argue that trusts grow at a faster rate than insurance policies. This is sometimes true, depending on a number of factors. But, as chart No. 1 indicates, even when the trust grows faster than the insurance policy, it rarely makes up the initial bite out of its value.

This example illustrates the performance variance between various trust

Process	Pre-Paid Funeral Trust	Preneed Insurance Policy
Deposits of funds and/or premiums	■ Deposits are processed through the funeral home	■ Premium payment is processed through the insurance company ■ The funeral home never handles the money
Interim withdrawals	■ Funeral home is allowed to hold the percentage of funds allowed by each state's law, ranging from 5 percent to 30 percent ■ In some states, funeral homes can also withdraw annual interest growth. Some states provide little to no governance	■ Mid-policy withdrawals are non-existent with preneed insurance policies ■ All of the funds, plus interest, are available and are used only at the time of need. However, the funeral home is only entitled to the funds if it provides the services outlined in the contract
Death claims	■ When the insured dies, the family receives funeral services ■ Generally, no money is refunded because of the funeral home's early withdrawals	■ With the submission of the insured's death certificate, the funeral home or the family collects the face amount of the plan with interest growth ■ The funeral home guarantees to provide the prearranged funeral even if its costs exceed the accumulated policy value
Transferability and cancellations	■ Depends upon each funeral home and the applicable state laws	■ Policies are guaranteed cancellable and the death benefit can be used at any funeral home ■ Families can change funeral homes without risk of losing policy value

options and an insurance policy for a 72-year-old man with normal life expectancy. The example assumes that the trust will incur 15 percent sales costs upfront, which is conservative for an active preneed program. It also assumes that the trust's options have a 25 percent higher interest rate than the insurance policy, with insurance growing at 3 percent and the trust growing at 4 percent.

As you can see, the insurance outperforms the trusts by a minimum of 6 percent (for single pay) to a maximum of 35 percent (for 10 pay). Even if insurance growth is slower, it begins and ends with more money in the cookie jar.

The bite out of the trust gets even bigger when you consider taxation. Trusts must pay taxes on interest earned. If a trust earns 4 percent growth, that growth will diminish to 3.4 percent after taxes are paid. If the trust earns 3 percent growth, it will actually earn 2.5 percent after tax. This is a significant bite because after taxes, many trusts perform worse than inflation, which has been growing at 3 percent for the past four years. In contrast, all preneed insurance growth is tax free.

Now, let's look at the cookie jar.

Have you seen those cookie jars that sound an alarm whenever the lid comes off? That's the kind of jar most consumers want for their preneed cookies. And that's the kind of jar they get when they buy a preneed insurance policy. That's because unlike trusts, insurance policies are heavily regulated. The insurance company can only release money if the funeral home supplies a death certificate and/or a completed goods and services sheet. Falsified death certificates are extremely rare. Generally, the fraud is quickly discovered and there is little or no damage to the consumer. Historically, we've seen that tight insurance controls do the best job of deterring fraud and protecting consumers.

In contrast, trusts have much less regulation. Generally, there's no alarm on the lid and in some states, there is no one looking for thieves. As a funeral director, it's best to recommend a private trust company or a state association-managed trust. This minimizes the chance of employee fraud or consumer suspicion. In other words, it's best to avoid the role of trust money management if at all possible.

What about the hungry people?

In every preneed transaction, there are two people who need to be fed — the consumer who wants the biggest cookie possible when the need arises, and the funeral director who needs funds to pay for his counselors and to maintain operations.

Insurance preserves the money invested and prevents big surprises. The only question for the consumer is how much the policy will grow over time. Insurance policies immediately pay funeral homes a commission to offset sales and administrative costs. In

Criteria	What to Look For
A.M. Best Rating	The A.M. Best rating is an independent third-party opinion of an insurer's financial strength and ability to meet ongoing obligations to policyholders. Look for A- or better.
Surplus ratio	The surplus ratio is a leading indicator of ability to pay claims, and it reflects the company's level of cash reserves in comparison to its written policies.
Length of time serving the funeral industry	Families and firms should buy policies from companies with demonstrated commitment to the funeral industry.
Sufficient policy growth	Look for growth that is tied to an inflation index or better than 3 percent currently. Choose compound rather than simple growth.

other words, with insurance policies you don't start with just one cookie — you start with more than one cookie!

Trusts sometimes grow faster, but they're also less regulated and come with greater inherent risk. The sales and administrative costs come out of the initial investment. One cookie must be shared by all.

A recipe for success

I recommend using trusts for passive preneed programs, short-term situations and Medicare spend-downs. This includes situations in which the funeral home is simply serving families who request the opportunity to pre-fund funerals. In these cases, firms have minimal sales costs and the need is usually short term. Trusts work better for short-term situations because sales and administrative costs are minimal. This means that all or almost all of the funds received go into the trust. The initial bite is small or nonexistent, so performance is optimized. As stated before, protect your firm and your families by using trusts that are managed by a third party.

Use insurance policies for active sales programs; healthy, younger clients; multi-pay situations; and long-term single-pay. Insurance works best in long-term situations because commission income offsets sales costs. If you're interested in growing your business, insurance-based preneed is a must. There's a big difference in profitability between trusts and insurance when one considers the high cost of sales for younger ages and the high percentage of families who request payment plans. Be selective when choosing your insurance partner.

The bottom line is that we all want to make sure preneed cookies are ready and waiting when our families need them. Following these guidelines will help you ensure that no one ever steals cookies from your firm's preneed cookie jar! •

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