12-STEP PLAN TO SUCCESS

By Daniel M. Isard

Step 7: Preneed in the Age of Pandemic

COVID-19 has significantly impacted existing preneed agreements.

The editor of *The Director*, bless his heart, wanted 2020 to be a time of vision and planning, a year during which this magazine might help lay out the future of funeral service. Given that we're neck deep in a pandemic, this year's goal must be scrapped because of COVID-19 – and because Henny Penny has risen.

In case you're not familiar with her, Henny Penny is a chicken featured in a European folktale who believes the world is coming to an end and runs around saying, "The sky is falling!" (In the United States, you might know this story as Chicken Little.)

Feeling a bit like Henny Penny as I write this, I'm slightly uncertain that I will live to see it published; people go from being alive and feeling fine to being dead within the span of a few days. So, morbidly, if this should prove my last article, I want to make it one with a moral. The subject is preneed, the theme is "in the age of coronavirus" and the conclusion, in case you're pressed for time, is, "It sucks!"

PRENEED PAST IS PROLOGUE

In the current age, preneed from a business perspective is subject to many unknowns, and that should scare the heck out of any business owner.

For those new to the intellectual pursuit of business ideas, as opposed to just doing what previous generations have done, allow me to establish a baseline. Preneed is when a consumer makes an advance arrangement for his or her funeral. Perhaps you're thinking, "How can this simple act get screwed up?" Well, boys and girls, it has, and the COVID-19 pandemic will multiply the ways preneed was previously screwed up by roughly a bazillion.

Preneed can be funded or not funded. That is the first way we screwed it up. From an accounting perspective, telling someone you will provide for their wishes upon their death is a liability. To alleviate that liability, someone smarter than me said, "Hey, if we get their money now, what can go wrong?" How about everything?

Most preneed is funded by consumers over age 65. In fact, according to most actuaries, the average preneed consumer's age is either 72 years old, when the consumer pays incrementally over time, or 78 years old, when he or she pays in a lump sum.

The money, which is the asset to pay for the liability, is funded and can be placed in the hands of a trustee. What can go wrong? Well, the assets could be lost!

Ah, now we've reached the crux of the matter. In the past, the only time preneed money was lost was due to theft. We saw Ponzi schemes take the money, funeral homes take the money and preneed salespeople or companies take the money. But we've also seen the value of trust deposits diminish due to poor investments (too many to name) and poor procedures (payout at a rate higher than that earned). We've also seen poorly operated insurers rely on state insurance guarantee funds, which paid back less than the full value of the account to the funeral home.

Now, here's where I will prove to you that the sky is falling, as Henny Penny famously proclaimed. Because of this pandemic, some well-managed insurers, banks and trust companies might not survive.

Why is that important to you? Because you promised to provide the service and merchandise! The consumer paid the money and you will be left holding the bag. (Your next tattoo should say, "Henny Penny was right!")

COVID-19's EFFECT ON INSURANCE COMPANIES

Preneed involves a specialty life insurance company, but, like all insurers, the business model is essentially the same – acquire more in premiums, plus investment earnings, than you pay out due to mortality.

All insurers set their premiums based on mortality tables that obviously did not take the pandemic into consideration. Every insurer used these pre-coronavirus tables to say, for instance, "If a person is 75 years old, we expect, on average, that he or she will die at age 82. Plus, we can assume the preneed money will compound at our average earnings

rate for the next seven years." But what happens if death occurs, on average, at age 78? What happens if the insurance company doesn't receive that extra four years of compounding? Calamity happens!

In addition, insurers establish their premiums based on the average interest earnings for their investments. Suppose they assume the average rate of interest during that seven-year period is 4.00%. What happens if their actual return is 2.00%? Calamity happens!

One analysis used to determine if an insurer is financially secure is its surplus ratio, which divides the insurance company's balance sheets into three categories: assets, liabilities and surplus. Assets equal liabilities plus surplus. You compare the company surplus to its liabilities to determine its surplus ratio. For example, imagine "Lloyds of Lubbock Insurance Co." has assets of $1.1 million and liabilities of $1 million. Therefore, Lloyds' surplus is $100,000, and its surplus ratio is 10%.

But is that good or bad? What happens if Lloyds' liabilities increase from $1 million to $1,050,000 while assets remain $1.1 million? The company's surplus ratio is now about 5%. And what if assets decline in value to $1 million? Lloyds' surplus ratio drops to 0%.

All types of life insurance companies try to maintain or, ideally, surpass different thresholds. For preneed companies, we generally like to see an 8% or higher surplus ratio. Do you know what your preneed company's surplus ratio is right now?

Trusts face a similar concern. As I write this article, the Dow Jones Industrial Average has fallen 20% since New Year's Eve. If a death occurred today, might the face value of your contract decline? Who is going to make that up? The difference is that trusts are not adversely affected if mortality increases. At worst, the trust will have to sell assets to pay off your claim.

Trusts and insurance companies are similar in one big way – how they invest. Most preneed trusts and preneed insurers invest their portfolios in four investment categories: bonds of substantial corporations, secured mortgages of commercial properties, publicly traded stocks and a catch-all called other assets.

Usually, insurers and trusts invest about 80% in bonds, 15% in mortgages, 3% in stocks and the balance in other assets. (I use the word "usually" because some companies have very different portfolios.)

Considering COVID-19, how comfortable are you with the corporate bond market? How about secured mortgages on commercial buildings? How happy are you with the stock market? Remember, you have a liability on the books, and your assets (whether invested in insurance or trust) are meant to protect that liability.

FINAL HENNY PENNY THOUGHTS

Hopefully, this manic market will be short-lived. But what happens if people die sooner than the actuaries thought? You cannot delay services or claims until the market comes back. Servicing preneed contracts is a liability to *your* business.

I write this article to warn you about the possibility that legitimate preneed companies might find themselves caught in the crosshairs of COVID-19's effect on the U.S. financial market. At best, you'll want your preneed efforts to prove a break-even transaction, i.e., receiving the value of previously selected goods and services at their present value.

My final Henny Penny alert concerns preneed contracts that are made due to Medicaid spend-downs. People may have visited you in the past and, with their last dollars, made decisions concerning their funeral and cemetery goods and services. Can these consumers now modify their contracts because of COVID-19? And if so, can these consumers (or their children) convert these contracts from burial to cremation?

Moreover, what happens to any refunds? For instance, suppose a Medicare consumer prearranged for a visitation during a service but, due to COVID-19, his or her state mandated "no gatherings," and the refund is $1,000. To whom do you pay it?

Preneed is a matter of state law, not federal. That money probably becomes "escheat" (the reversion of property to the state if the owner dies without legal heirs). That money should go back to the state. We have rarely seen funeral homes do this. If there are heirs, they often give the preneed excess or refund to the heirs, or the funeral home helps the family spend the excess.

COVID-19 is changing everything; therefore, you must rethink everything. My sincere wish for anyone reading this article is that you will survive these challenging times and later yell at me for being overly dramatic!

Dan Isard, MSFS, is president of The Foresight Companies, a Phoenix-based business and management consulting firm specializing in mergers and acquisitions, valuations, accounting, financing, human resources services and family surveys. He is author of several books and hundreds of articles in industry magazines. Isard can be reached at 800-426-0165 or danisard@theforesightcompanies.com. Check out his new video blog at theforesightcompanies.com/video-blog. *For copies of this article or other educational information, visit* theforesightcompanies.com. *Connect with Isard and The Foresight Companies by following them on Twitter at @f4sight, LinkedIn and Facebook.*

Financial/tax advice contained in this article is for informational purposes only and may or may not apply to your individual position. Readers are strongly encouraged to seek the counsel of qualified advisers before undertaking any action based on this information.