INSURANCE PLANNING

Attention! Life Insurance Fiduciaries

By Ben G. Baldwin, Jr.

In my previous Insurance Planning column in this publication[i], we reviewed the *Cochran*[ii] case. The *Cochran* case involved an irrevocable life insurance trust that was funded in 1987 with whole life and universal life insurance policies. These policies were then replaced in 1999 with variable universal life (VUL) policies, and replaced again in 2003 with a guaranteed death benefit universal life policy (GDBUL). All three purchases were facilitated by the same agent, who used different insurance companies and, thus, received new first-year commissions each time. Note that the timing of each purchase coincided with what was popular and then unpopular in the various investment-related life insurance products. The 1987 policy selection involved conventional, general account whole and universal life policies (high interest rate environment). By 1999, the stock market and consequently variable universal life insurance policies (which came to market in 1986), had been showing very positive results in their equity subaccounts so VUL replaced the whole life and universal life contracts. The parties involved allocated the funds placed in the variable universal life insurance policy to the aggressive equity accounts just in time to participate in the market downturn of 2001-2002. The popularity and desirability of the stock market and variable universal life insurance took a hit. So it became popular to disparage VUL and sell "guarantees." The life insurance policy *de jour* became GDBUL, so it was chosen to replace the VUL contracts thus converting the entire remaining trust into a single premium GDBUL. GDBUL became very easy to sell and therefore it was sold to the trustees and those first year commissions were paid for the third time and the trust corpus went to zero.

The *Cochran* case provides a number of important messages for life insurance fiduciaries. The first, as shown above, is that various types of life insurance will go in and out of favor depending upon the current level of interest rates and the performance of the stock market. In fact, as a result of the current low interest rates and the second period of poor performance in the stock market in 2008 and 2009, the current easy-to-sell life insurance policy is now bond market driven, whole life insurance. The WALL STREET JOURNAL of May 28-29, 2011[iii] reinforces the popularity vs. unpopularity message by presenting bond market driven whole life insurance as the current popular product of the day. Just below that, and on the same page, is a column by Dave Kansas[iv] entitled *About That Bond Selloff* . . . Kansas' column pits bond guru Bill Gross, who anticipates that the coming inflation will be perilous for bond investors, against others who expect the bond market to do all right because they perceive that the economy is too weak for inflation and interest rates to go up in the immediate future. So there we have it, all on one page of the WALL STREET JOURNAL. Bond driven whole life insurance is popular today and easy for agents to sell and earn commissions. However, the bonds that the life insurance companies are investing in today, as the engine to drive the investment results of whole life insurance policies, will be hurt at some point when inflation returns and interest rates are driven up. When those interest rates go up this will drive down the value of the low interest rate bonds that life insurance companies are buying today. In that inflationary environment, whole life insurance is likely to be-

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come unpopular again. The cycle of popularity in life insurance policies that drives the replacement of one policy for another, along with the minority of commission-hungry agents who capitalize on consumers' fear and greed cycles, is very expensive for the consumer, and an embarrassment to the life insurance industry as well as to ethical life insurance fiduciaries and agents.

The bottom line is that life insurance fiduciaries cannot afford to be seduced and victimized by the cycle of popularity of various investment-related life insurance policies.

The solution for the life insurance fiduciary is a life insurance buyer with sufficient information and understanding to make an informed choice among life insurance options. I refuse to believe that this is an impossible goal. Buyers can understand. I will admit getting the buyer's attention and patience to gain the required understanding is a challenge but, in our evolving regulatory environment, it is necessary to make the good faith effort. Having made repeated efforts at providing this understanding of life insurance to buyers within an hour or less over the last over forty years or so I know it is not easy but, when the buyer *gets it*, it is rewarding for the consumer and their whole financial and estate planning team.

Providing Life Insurance Understanding–A Sample Discussion with a Buyer

The following, although it may appear to be a soliloquy, is intended to be a discussion with a prospective life insurance buyer. Each statement is to invite buyer feedback so that two way communications is achieved. Our objective is for the buyer to gain a general understanding of the choices available among life insurance contracts so that they can make an informed decision.

> You have indicated that if you/another individual were to die it would cause financial harm to someone or something you care about and that this is an unacceptable risk to you.
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> So, you need or want life insurance to offset that risk. You probably are concerned about what death benefit would be appropriate and what it will cost. Well, my first thought is whether or not life insurance is obtainable. That is, is the proposed insured insurable? Will the insurance company want to issue life insurance on the life of the proposed insured?
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> Having discussed this and determined that it is likely that the insurance company will provide the needed coverage let's go back to your two questions. As to amount—that is a value judgment and can be very subjective but let me give you some rules-of-thumb. If it is liabilities that we need to offset we can add them up, round up the total, and even consider that amount with the help of the beneficiaries if you wish, and apply for that amount. However, if it is an income stream that will end at the insured's death that we wish to replace with life insurance, then let me suggest that we start with a death benefit twenty times the annual income stream we are trying to replace and see if that feels like it is too much or too little for you. We use that factor because if we could put that much money to work for the beneficiaries and earn five percent (no slam dunk task these days), it would provide earnings for the beneficiaries equal to the replaced income stream. Is this understandable? If so, let's shift to what kind of life insurance you might want to consider.

What Kind of Life Insurance?

> What kinds are you familiar with? What kinds have you heard or read about? What are your impressions of the various kinds that you have encountered? I bet that you have heard that term insurance is cheap and permanent insurance is expensive. Well, both statements are what I call misleading half-truths that do not lead to understanding. So, let me try and explain term and permanent, using other terms that I hope are more accurate and will facilitate understanding. I like to use the term "pure protection" instead of term insurance, which helps us understand that pure-protection life insurance is like our auto, homeowners or liability insurance. It stays in force just as long as we pay the cost of the coverage and the

insurance company accepts the payment. When we, or they, stop—the insurance protection stops and that is the end of it. We expect nothing more and get nothing in return, thus the name pure-protection.

Pure-Protection Life Insurance (COIs and Expenses Only)

The cost of pure-protection term life insurance not only depends on the insured's health, habits and the things the insured does for work and play, but also on the demands the policy owner puts on the insurance company. For example, the lowest demand, and thus lowest cost term policy would be one year term. The buyer pays just two costs for such a policy: the expenses to issue it and the death claims the insurance company expects to pay out of the policies like this that it has in force. The cost of the expected death claims may be referred to as the mortality costs or the costs-of-insurance (COIs). As we increase our requirements on the insurance company, such as extending the period of coverage for a level premium for 5, 10, 20 or 30 years, we will find that the cost (expenses and COIs) go up also. Having the policy renewable and convertible to an investment-related, commonly called permanent insurance, also adds cost. This is a valuable policy owner right that is typically exercised when coming to the end of a term policy's contractual life and the life insurance is still desired, but insurability may be in question. Today, it is also possible to buy term, pure-protection, life insurance for life. It is not called that. It is called guaranteed death benefit universal life (GDBUL). It can be purchased with a single large payment or with level annual payments for as long as a lifetime. It is designed to provide pure protection while providing no benefit to the policy owner other than the death benefit at death.

So, there you have it. You can buy life insurance promising the delivery of insurance company money to your beneficiaries at your death. It can be tailored for your individual needs and requires minimum initial cash flow since you only pay for two items, the expenses and the COIs. But, keep in mind that as age increases so do the COIs, until most buyers drop their pure protection policies because of increases in cost. Above certain ages insurance companies will not issue new life insurance because the risk of death has become too great.

I will bet you also have heard that permanent insurance, which I will refer to as investment-related life insurance, is more expensive than term insurance life insurance (pure-protection). This is another one of those half-truths that misleads consumers, which is one reason I prefer we use the term investment-related. Putting capital into a life insurance policy is optional. One puts money into a life insurance policy in excess of the policy expenses and COIs so that the money will earn a return which then can be used to offset the COIs and policy expenses. Calling life insurance investment-related, as distinguished from the no-investment pure-protection life insurance, is intended to help buyers understand that they do not have to put investment capital into a policy. However, if they are financially able to do so, they deserve to understand what kind of investment return they can expect from the capital they allocate to a policy. This is where we go into the various types of investment-related policies.

Investment-Related Life Insurance (COIs, Expenses and Investment)

Needless to say, for a buyer who has no excess capital or income to invest, there is no reason to go here. But, for those who do have the financial resources, they have a right to understand why some think life insurance is a pretty good place to accumulate and store capital. Let me provide a true life example to illustrate why some buyers prefer to store money in a life insurance policy. A 75-year old insured has a policy in which the insurance company has about $325,000 of its money at risk. It is a transparent policy so our 75-year old can see the amount of the monthly COIs that the insurance company deducts from his policy investment account each month for that amount at risk. The amount deducted is $620 per month. To make sure that monthly cost is covered, this policy owner has put some $263,000 into an account in the policy that guarantees the principal and pays 4.5-percent interest on the account (you are right it had better be a strong insurance company because they are to sole guarantors of all of the policy guarantees). That account is earning $980 per month. $620 is deducted for the COIs per month, an amount that will increase each year as the insured gets older. The account currently is currently earning about $360 per month of excess interest. In this case, this 75-year old is paying for the insurance company's amount at risk, which he values, with $620 of earnings he has never, and never will, have to pay income tax on. The tax-free earnings paying the cost of the pure-protection part of his life insurance is just one reason why this 75-year old has chosen to store money in this life insurance policy. We will get back to this type of policy later, but this illustrates just one reason why one who is able might choose to store money in a life insurance policy.

Whole Life

This is the original "permanent" investment-related policy, built in an era of no computers, little consumer financial sophistication relative to today, and during the time when most consumers chose to store their money in bank savings accounts. Built by actuaries, this whole life insurance policy promises the policy owner that it will do what it promises if the buyer does what the contract requires. The insurance company guarantees to pay the death benefit. The insurance company also guarantees that the stipulated amount that the buyer must pay to continue the policy in force (the premium) will remain the same over the life of the policy. The insurance company can never ask for more than that stipulated amount. However, the buyer needs to guarantee that he or she will pay the stipulated amount when due.

By the time the insured reaches the age of 95 or 100, the insurance company will no longer have any amount at risk at that time. The death benefit will be made up entirely of policy owner capital by the stipulated age no matter what the financial marketplace does over the insured's lifetime.

To make such a long term commitment, the actuaries have to be pretty conservative, so most insurance companies that sell whole life today promise policy owners that if fewer people die earlier than they estimated, and/or expenses of service are less than expected, or the company earns a net investment return greater than they estimated, the insurance company will find a way to share the good fortune with its policy owners. This usually is done by paying dividends that can be used to reduce the required premium payments or leaving them within the policy to increase policy account cash value and the death benefit above what was originally promised.

To manage your expectation of return on whole life policies, it helps to know what they invest in, that is, what their portfolio looks like. According to the American Council of Life Insurers[v], the composite of the general accounts of insurance companies is invested 71 percent in bonds, 10 percent in mortgages and real estate, four percent in policy loans, 13 percent in miscellaneous assets and two percent in stock. In other words, the investment engine of whole life insurance is primarily bond driven. Most investment professionals would advise you not to expect a long term return on such an investment of more than five to seven percent. This is about what policy owners with good insurance companies have experienced as a result of complying with their policy requirements for thirty to forty years. Two points to make, if this is your insurance choice, insurance company selection is important. You want a financially strong company to support the guarantees and to provide the best return possible. That success comes only over the long term.

Universal Life

This iteration of investment-related life insurance came to market and became popular when interest rates were high, because that is when they perform the best. The investment capital in universal life policies is in the insurance company's general account and normally pays prevailing current interest rates that it adjusts to current conditions each policy year. When interest rates go up significantly, it makes those old long-term bonds paying the earlier low interest rates look bad. At that point we see the cycle of popularity of investment-related policies begin to move from whole life back to universal life again. Universal life was previously popular when these policies were paying 12-percent interest, then they became less popular as interest rates came down. Buyers thought that the high interest rates would continue at that level because they were led to believe that by those terrible, affirmatively-misleading, minutia-laden, linear illustrations which are not only regulator approved, but required. These illustrations show the interest rate *de jour* continuing at that level for thirty and forty years into the future, which we all have seen cannot happen. Those 12-percent illustrations caused people to become quickly disenchanted with their policies and their insurance companies. However, since the insurance company was guaranteeing a specific interest rate each year, it had to show actual results each year and thus we have our first transparent and flexible life insurance policy. It is transparent, because the insurance company has to show the interest being credited and the expenses and COIs being deducted. And, it is flexible because, in this policy, the insurance company did not insist on a specific amount to be paid into the policy, but would continue the policy only as long as the COIs and expenses could be deducted from the policy account each month. Also, since the policy owner was not committed to pay a certain amount into the policy, the insurance company could not guarantee the death benefit. This flexibility caused both agent and policy owner misbehavior. Agents sold it with legally misleading illustrations showing high interest rates, which they translated to mean cheap insurance. Buyers paid too little into their policies because they did not understand that the reason to invest in investment-related life insurance was to put as much capital into it as they could in order to enjoy the current returns. Since the interest they were earning was not sufficient to cover the current expenses and COIs being deducted each month, any excess capital in the policy was quickly used up paying these expenses and policy owners received a call on their policies. That is, they had to pay more into the policy or the policy would terminate. The current exceedingly low interest rate environment has resulted in older universal life policies (particularly those that are beyond their surrender period so that capital can go in and out of them without constraint), being a relatively attractive place for policy owners to store capital in financially sound insurance companies. This is because the minimum guaranteed interest rate by contract in some of these older polices issued in the days of high interest rates is 4.5 percent. If the cost of putting money into the policy is not too high, the net return on contributed capital could be better than what is available in CDs or money market funds in 2011.

So, what do you like and not like about universal life? Yes, insurance companies have cut back on their minimum guaranteed interest rates and the rates they are currently paying, so today this kind of policy is relatively unpopular due to the very low interest rate environment.

Indexed Universal Life Insurance

When interest rates were coming down and people were becoming unhappy with the universal life interest rate *de jour*, some insurance companies sought a way to capitalize on the buyer's desire for the positive returns of the stock market and their fear of the stock market's negative returns. They decided to build a policy—called indexed universal life—that could pay higher interest rates if the market went up but did not generate negative returns if the market went down. If some equity index, such as the S&P 500, went up policy owners would receive somewhat higher interest rate crediting. If the index went down during the period applicable to their policy they might be credited with no interest at all, but their account value would not go down except for the required deduction for COIs and expenses. Indexed universal life insurance does not have a long track record, but in managing a buyer's expectation one would be wise not to expect more than a five to seven percent long-term return as a result of the constraints the insurance company puts on the amount of interest it will pay. The insurance company has to make sure that it has enough money to manage the working parts of this type of policy.

Are you ready for one more generic description of an investment-related life insurance contract?

Variable Universal Life

Variable universal life (VUL) insurance is built the same as the universal life policy, but with the addition of a separate account which holds a number of subaccounts (possibly thirty, forty, or more) that operate similar to mutual funds and provide the opportunity to create a diversified portfolio within a VUL policy.

What have you heard about variable universal life? Have you ever heard anyone say that it is "risky?" That VUL did not do well during 2001 and 2002 and 2008-2009? Generally speaking that is true, but again misleading. VUL is only as risky as the policy owner chooses to invest. Remember that seventy-five year old we were talking about earlier? The one who had $263,000 in the insurance company's general account option earning 4.5 percent interest that was sufficient to cover his COIs and expenses, plus providing excess interest earning of about $360 per month? Do you consider that a "risky" policy? OK, let me share with you that the policy this 75-year old owns is a VUL policy and, in addition to the $263,000 that he has in that guaranteed principal account, he has elected to put $150,000 into a portfolio of seven diversified equity sub accounts. This makes his total portfolio in his policy 65-percent guaranteed principal, guaranteed interest, and 35-percent diversified equity. Does that arrangement seem unduly risky to you?

You are right, if that portfolio is consistent with his risk tolerance it works for him. We will be working hard to determine your comfort level and risk tolerance as we work together.

I have two more questions for you and then a little additional information that you need to have.

- First: Do you view policy owner control as a feature that increases or decreases risk?
- Second: Do you now feel that you have a general understanding of life insurance and, should you be financially able to do so and wish to use investment-related life insurance, that you have enough information to make an informed decision among the various kinds?

Next on our agenda today is:

Commissions Optional

Today commission-free and surrender charge-free life insurance is available. That does not mean that insurance companies that do not pay commissions do not have agents and agent expense. What it means is that typically you deal with a salaried agent on the phone. Since they will know less about you than the typical commissioned agent, they will expect you to know what you want. In other words, you may get less help from the insurance company. It is your choice as to whether you wish to hire someone to help you manage no-commission life insurance or not.

When you pay commissions, it is typically with the expectation of receiving more help from a competent professional life insurance agent who informs you of any constraints on the services the agent can provide, and compensation and any conflicts of interest that may impair his or her ability to work solely in the your best interests.

A problem with commissions today is that they were built for whole life insurance, which typically took more effort at policy inception and relatively little work on future maintenance as a result of limited flexibility. The commission structure thus was designed with higher first-year commissions and relatively small renewal commissions. Unfortunately, though the high first-year followed by low renewals is still the norm today, it does not fit well with the flexible, policy owner-controlled policies of today. As the capital in the policy grows over the years, advice of a competent agent becomes more important. Also, as the policy owner ages and the opportunities and risks of a policy change, not having an adequately-compensated commissioned agent to look after a policy owner's interests is a big disadvantage. The 75-year old we have been talking about has hired a 50-year old money manager to help him with his investment-related VUL policy.

One other commission caution: As a result of the 2011 regulatory environment, commissions are getting a lot of attention. They are being considered by some as a conflict of interest with a need for disclosure to, and acceptance by, the consumer. In an effort to gain a competitive advantage, some are finding ways to lower commissions. One of the techniques to lower commissions is called "blending." Blending involves combining a higher face amount, low-commission life insurance policy, such as term insurance, with a normal commission, but lower face amount investment-related policy. Be aware that the lower commission blended result is not the same as an unblended product and will have different risks and rewards. Do not be fooled.

Conclusion

It is hoped that the preceding will help you help others understand and buy life insurance adaptable to their long term needs and avoid being victimized by the cycle of popularity. Your feedback is important to improving an effort such as this. Your criticism is most important. Also, other consumer tools such as the Menu of Life Insurance Products, a Policy Owner Bill of Rights, and short consumer quizzes to test a buyer's understanding of the various life insurance products can be made available upon request. Please let me hear from you at benbaldwin2@gmail.com.

ENDNOTES

[i] ESTATE PLANNING REVIEW—THE JOURNAL, March 24, 2011, Volume 37, No. 3, *The Cochran Case: Not Understanding VUL Can Be Costly*, pages 47 through 51.

[ii] *Stuart Cochran Irrevocable Trust, Chanell and Micaela Cochran, Appellants-Petitioners v. KeyBank, N.A., Appellee-Respondent*, 901 N.E. 2d 1128 (Indiana Court of Appeals, March 2, 2009.

[iii] THE WALL STREET JOURNAL, Saturday/Sunday, March 28 – 29, 2011, page B7, *Honestly, What's the Best Policy?*.

[iv] *Ibid, About That Bond Selloff . . .* , by Dave Kansas, page B7.

[v] ACLI Life Insurers Fact Book 2010 of 11/15/2010, page 14. The 2010 Fact Book provides statistics and information on trends in the life insurance industry. Specific topics covered include assets, liabilities, income, expenditures, reinsurance, life insurance, and annuities.