PERMANENT LIFE INSURANCE AS A PORTFOLIO ASSET

GERRY GAETA, M.D. FINANCIAL PLANNER, FIRST REPUBLIC INVESTMENT MANAGEMENT

SEPTEMBER, 2019

Too often, people tend to focus on the premium *cost* of permanent insurance rather than on the *value received* as it relates to a comprehensive financial plan.

To clarify, "value received" refers to the many aspects of financial planning served by both the death benefit *and* the cash value.

People also too often perceive the benefits of life insurance to kick in only *after* they die. What can be of equal interest, however, are the lifetime benefits of permanent life insurance.

In fact, its cash value can play a key role as an asset on a policyholder's balance sheet to serve many financial objectives.

Here's how permanent life insurance can benefit policyholders, both during their lifetimes and after, as an asset to protect loved ones.

How life insurance death benefits play a role in financial planning

First, *any* policyholder who wants their financial planning objectives to continue beyond their lifetime is a potential candidate for permanent life insurance.

Having a policy in place can provide peace of mind and answers to a key question:

How can I take care of my loved ones and accomplish other legacy objectives if I die before accumulating the wealth needed to do so?

The value proposition of a death benefit is relatively simple: When a policyholder dies, a death benefit is paid to whoever is named as a beneficiary. There are plenty of financial objectives that can be served by a death benefit, including but not limited to the following:

- Income replacement (as salary and other income sources end or become reduced at the policyholder's death)
- Debt reduction or elimination for a spouse or other family members
- Equalization of heirs (e.g., as an alternative to sharing ownership of the family business)
- Funding kids' and grandkids' educations
- Charitable bequests
- Funding of estate and other taxes (especially when owned outside of the estate)

For business owners, benefits may include:

- Funding of "buy/sell" agreements (surviving owners buy out the heirs of the decedent)
- Cost recovery in executive benefit plans (death benefit reimburses company for benefits paid)
- Protection from loss of key employees
- "Stay" bonuses (incentives for key employees to stay after the owner's death)

PERMANENT LIFE INSURANCE AS A PORTFOLIO ASSET

GERRY GAETA, M.D. FINANCIAL PLANNER, FIRST REPUBLIC INVESTMENT MANAGEMENT

SEPTEMBER, 2019

How cash value life insurance can be an asset in financial planning

Now, consider the benefits of life insurance during a policyholder's long life. Cash value life insurance is a unique instrument that, when properly deployed, allows a cash value to grow tax-free.

Policyholders can also access this cash value accumulation tax-free during their lifetime for various financial needs[1].

Here are some ways this cash value accumulation can be used in the context of a comprehensive financial plan:

- Maintain cash reserves with a tax-free yield that can potentially earn significantly more than bank interest
- Supply funds for spending or outside investment opportunities through withdrawals or loans at a potentially lower net interest cost ("loan spread"[2]) than may be available at banks (loan interest can be paid outside of the policy)
- Maximize death benefits through larger cash value positions
- Provide tax-free income during retirement for life or a period of years (with a reduced death benefit later)
- Cover spending needs during post-retirement market downturns, instead of selling equity positions at a loss (not applicable to cash values tied to market returns)

Premiums paid at the appropriate levels can eventually result in cash values that significantly exceed the premiums paid. The higher taxable equivalent yield needed to match the performance of a well-designed permanent policy over a policyholder's lifetime makes this benefit especially attractive for those in higher-income tax brackets.

The table below shows the equivalent yield a taxable investment would need to achieve to match a policy that accomplishes a hypothetical 4% to 7% tax-free return:

Tax-Free Yield	**Tax-Equivalent Yield Per Marginal Tax Rate**		
	30% Tax Bracket	40% Tax Bracket	50% Tax Bracket
4%	5.71%	6.67%	8.00%
5%	7.14%	8.33%	10.00%
6%	8.57%	10.00%	12.00%
7%	10.00%	11.67%	14.00%

Because term life premiums do not provide a cash value, they can be considered a cost for the policyholder. Essentially, they are buying a promise from the carrier that a death benefit will be paid in the event their passing occurs while the policy is active.

[1] Assumes non-MEC policy, cash value accessed via withdrawals to basis, followed by policy loans, and policy is in force throughout.
[2] Loan spread is the difference between the interest charged and any amounts credited to the policy, less policy costs and expenses.

On the other hand, the cash value of a permanent life insurance policy is an available lifetime asset on the policyholder's balance sheet.

Why premium payment approach matters: "Short and fat" vs. "long and skinny"

Cash value performance is largely driven by the size of premium payments relative to the death benefit, the number of years the premium is payable, and the type of permanent life insurance chosen (see table below).

On one end of the spectrum, "short and fat" funding occurs when permanent policies are funded with a few large premiums paid in the first several years.

At the other end, a "long and skinny" approach is funded with much smaller premiums paid over the life of the insured. Policies can also be funded at rates anywhere in between these two extremes.

Let's consider an example of opposites.

Fred's premium approach:

Fred's goal is to pay the minimum premium allowable to keep the policy in force throughout his life expectancy. Therefore, he takes the "long and skinny" approach, spreading smaller premiums over his lifetime. This strategy leaves him more money to grow his business (or to pursue other investment opportunities).

Fred's cash value will likely never exceed the cumulative amount of all premiums paid.
Cash value from minimally funded policies, like Fred's, should rarely be accessed because the policy may face the risk of lapsing without adequate and ongoing premium and/or interest payments.

Linda's premium approach:

Linda, on the other hand, finds the long-term risk-adjusted return and favorable income tax treatment of the cash value to be attractive. Therefore, she chooses the "short and fat" approach, paying the largest possible premiums that can fund a non-Modified Endowment Contract (MEC) policy[3] within the first five years.

Linda's five-year funding strategy is much more likely to result in a positive internal rate of return, with her cash value potentially exceeding cumulative premiums soon after the premium period ends. Larger cash values relative to the death benefit make policy withdrawals or loans more suitable.

That said, even heavily funded policies, like Linda's, should be monitored on an ongoing basis by professionals well-versed in this area to avoid any risk of lapse. With the gap of a policy whose cash

[3] Failing the 7-pay test of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) would create a Modified Endowment Contract (MEC) with less advantageous tax characteristics.

value has grown beyond the total premiums paid, tax is due even if the cash value has been completely depleted (triggering phantom income tax). However, this risk is easily managed and mitigated by professional advisor oversight.

Permanent life insurance receives a tax-favored treatment

All versions of permanent life insurance share favorable income tax treatment of cash value and death benefits, as long as the MEC funding limits are not exceeded. For non-MEC policies, cash value growth in excess of premiums paid does *not* trigger a taxable gain event (unless the policy lapses).

Further, the first dollars withdrawn from the policy are tax-free as a "return of premium paid." This is what accountants refer to as the favorable FIFO (first in, first out) treatment.

If the policy owner wants to access an amount beyond the premiums paid (known as "basis"), the excess could be borrowed from the policy without triggering a taxable event.[4]

Borrowing from permanent life insurance policies

Policy loan provisions vary broadly from carrier to carrier and product to product. If a policyholder is interested in accessing the cash value of their policy in the future, then it is essential they understand the borrowing costs, including all factors that might impact cash value growth.

For some non-MEC policies, the cash value continues to grow unabated despite having an outstanding loan. This is true as long as the interest on the loan is paid with money held outside of the policy. For these policies, the net cost of borrowing is the interest charged less the amount credited to the cash value after expenses, referred to as the "spread."

Here are two examples:

Whole life policy:

Under its terms, a whole life policy charges an interest rate of 5%. Cash value increases that year by 4%, not including any new premiums paid and assuming the interest expense was paid with dollars from outside the policy. In this case, this policy loan's net cost (spread) would be 1%.

At death, any outstanding policy loans are paid off using funds from the death benefit. The beneficiaries are then paid the balance of the death benefit without incurring any income tax.

Universal life policy:

[4] Note that if the policy was a Modified Endowment Contract (MEC), LIFO (last in, first out), rather than FIFO treatment would result. For policies with more cash value than the total of premiums paid ("gain"), this would trigger a tax *and* a 10% penalty on the first dollars borrowed or withdrawn to the extent there is gain and the owner is an individual under age 59 1/2.

Loan spread in a universal life (UL) policy is defined a bit differently. Some policies charge and credit fixed interest rates to the amount borrowed. For example, a carrier might charge loan interest of 7% while crediting the policy 5% on outstanding loan amounts. In this scenario, the loan spread would be 2%.

If the loan and credited interest rates were the same, the spread would be zero, often referred to as a "wash loan" provision. Loan provisions vary widely depending on the policy and should be considered carefully before determining the policy of choice.

Some states offer life insurance asset protection

Many states have laws protecting life insurance policy cash values and death benefits (and perhaps annuities). These safeguards provide a higher level of protection from judgment creditors than may be afforded to other individually owned assets, such as stocks, bonds, and cash accounts.

These laws have exclusions and limitations, which change periodically. As such, advisors should share the regulations of their state with policyholders.

Why cash value may be viewed as a "portfolio asset"

Policy designs like Linda's (from the example above) have led some to refer to cash value in well-funded policies as "portfolio assets" with an associated death benefit. For instance, the cash value of a maximum-funded non-MEC variable universal life (VUL) policy might be viewed as "equity-like" to the extent equity-based "sub-account" investments are elected.

When funded in this way, the performance of the cash value will generally correlate with that of a similarly allocated mutual fund after subtracting the expenses and mortality costs of the policy and accounting for taxes on the mutual fund gains versus none for the non-MEC policy.

Whole life (WL) policies have been referred to as "bond-like" because the dividend credited to the policy is, to an extent, correlated with the bond portfolio of the mutual company issuing the policy. As such, cash value performance tends toward long-term "bond-like" returns. Note that in some ways, the cash value in a whole life policy may be less volatile than a bond portfolio. This is because, unlike a bond portfolio, whole life cash value does not immediately decrease when interest rates increase. Conversely, nor would it increase in value when interest rates go down.

Indexed universal life (IUL) does not fit as neatly into the stock or bond category because it is a structured product with attributes of both. An IUL policy may deliver a potentially higher upside, coupled with more downside risk than whole life. While unbiased, empirical data has not been readily available to consumers to compare the risks of whole life versus IUL, the appendix below addresses some of the factors to be considered.

The performance of a private placement variable universal life (PPVUL) policy is generally tied to hedge fund sub-accounts and hence could be considered "hedge-fund-like."

These and other types of policies are further discussed in the table and sections below. But regardless of the type of policy, the value proposition of adding a well- or "max"-funded policy to an asset mix is worthy of consideration by many affluent individuals and business owners. This is especially true for those expecting income tax rates to be higher in the future.

In summary:

- Life insurance can play a vital role in financial planning where a death benefit may serve any number of objectives, not the least of which might include providing security and income for loved ones.
- Properly funded permanent life insurance can provide tax deferral with potentially tax-free access to a cash value account during the lifetime of the insured, in addition to providing a death benefit.
- Residents of many states enjoy the added benefit of greater creditor protection over their life insurance cash value and death benefits than with other assets.
- Factors that may impact cash value performance and risk include the type of policy selected, the age and health of the insured, the design of the policy (including riders and funding levels), and the strength of the carrier.
- Whole life and universal life generally provide lower risk than what might be found with variable universal life, private placement life, and indexed universal life.
- Variable universal life, private placement life, and some indexed universal life policies can generally provide a higher return potential than whole life and universal life.
- The return potential of IUL is a complex matter, in part because it is dependent on carrier discretion over cap and participation rates, as well as expenses. As such, IUL returns are more difficult to project.
- Professional advisors can help clients evaluate their life insurance, considering their objectives.
- Permanent life insurance policies should be reviewed regularly. This is especially important for flexible premium products and policies with outstanding loans.

APPENDIX

General categories of permanent life insurance*:

Type of Policy	Performance Driver	Flexible Premium	Min CV	Max CV
Whole Life	Variable Dividends	No	Guar CV	Correlated with Bonds
Universal Life (CP)	Variable Interest	Yes	Minimum Interest	Variable Interest
Universal Life (NLG)	Interest Rate at Time of Purchase	No	N/A	N/A
Variable Universal Life	Mutual Fund-Like Sub-Accounts	Yes	No*	No

Indexed Universal Life	Index Subject to Participation, Caps	Yes	Yes, Variable Cap	Yes, Variable Cap
Private Placement Life	Fund-of-Fund Sub-Accounts	Yes	No	No

*Riders might be available to limit downside risk. Answers in cells are generally speaking and apply to most such policies, but there are exceptions.

Whole Life (WL)

Benefits:

- A guaranteed death benefit over the whole life of the insured (hence insurance carrier bears the investment risk), and a cash value account where performance is based on dividends that are not guaranteed.
- A guaranteed cash value accumulation level based on a specified premium amount; not dependent upon dividends.
- Less flexibility than UL (current assumption version), IUL, and VUL.
- Generally, bond-like cash value performance (over time, though not guaranteed).
- Dividends (assuming a dividend-paying policy) are:
  - Correlated to the carrier's bond portfolio.
  - Impacted by carrier performance and mortality experience.
  - Not guaranteed.
- Policy designs, including "pay forever" and "pay for a fixed term of years."
- Whole life is generally issued by mutual companies, which are owned by their policy holders. This may be an advantage of a mutual company over a publicly-traded carrier when it comes to carrier discretion in increasing insurance costs (and/or for IUL carriers in decreasing caps or participation amounts).

Performance upside and risk:

- Upside to cash value performance: Generally, expected to perform over time at "bond-like" rates of return, outperforming bonds in some market cycles and underperforming in others.
- Risks to cash value performance include rapidly rising interest rates (generally, not favorable to WL), and poor investment or claims experience on the part of the carrier, but with guaranteed cash value at the worst.

Universal Life - Current Assumption[5] (CA UL)

Benefits:

- A death benefit that remains in effect as long as premiums paid plus interest credited are adequate to support the policy and prevent a lapse.
- More flexibility than whole life in that the policy owner decides the timing and amounts of premium paid into the policy, and the ability to customize the death benefit and length of coverage.
  - This flexibility requires a greater need to monitor the "health" of the policy on an ongoing basis to assure the policy is adequately funded and avoids lapsing.

[5] Current Assumption policy cash value is correlated to the variable interest rate credited to the policy.

- Current interest rates to illustrate cash value accumulations.
- A guaranteed minimum interest rate.

Performance upside and risk:

- Performance upside is tied to a variable interest rate credited over the life of the policy.
- Generally, performs best in high or upward-trending interest rate environments.
- With the flexibility in premium payments, comes the need to monitor the policy to ensure the funding level is adequate to avoid the risk of lapse (when the cash value is reduced to zero).

Universal Life - No Lapse Guarantee (NLG UL)

Benefits:

- A guarantee that as long as the required premiums are paid, the death benefit will be payable until the stated age is reached (the higher the age of the guarantee, the higher the premium cost).
- Generally, low to no cash values.
- An attractive option where interest rates are downward trending or expected to remain at low levels.
- Essentially, eliminates interest rate risk to the detriment of cash value performance (compared to CA UL).

Performance upside and risk:

- NLG has little to no cash value upside.
- NLG is generally more suitable than CA UL where interest rates are not expected to increase.
- The primary upside is death occurs before policy lapse. Hence the upside is in the form of the guaranteed death benefit at a predetermined premium level.
- The primary risk is living beyond the guarantee period.
- Violating contractual requirements (such as missed or late premium payments that might void the guarantee).

Indexed Universal Life (IUL)

Benefits:

- A death benefit that remains in effect as long as premiums are paid and amounts credited are adequate to support the policy and prevent a lapse. The amounts credited are generally tied to a stock index(es), such as the S&P 500 and a fixed account option, and may be subject to caps, floors, and participation rates.
- A similar level of flexibility as afforded CA UL policies in terms of premium payments and death benefit customization.
- A "floor" that can protect the policy from negative returns.
- Participation limits are typically in the form of interest and/or index participation and cap rates.
    - Carriers generally have the option to change the cap and participation rates after the policy is issued.
    - Stock dividends are ignored in determining participation rates.

Performance upside and risk:

- Upside is generally limited by participation rates and/or caps ("floor" and "ceiling"), with ceiling and participation rates subject to change by carrier.
- Upside is arguably higher than UL or WL, but at some level of cap and/or participation limitation, this is no longer true.
- Most carriers offer a guaranteed "floor" that protects policyholders from negative index performance.
- The floor does not account for insurance costs and expenses. As such, a floor of 1%, for example, would cause cash value to perform at 1%, minus the cost of insurance and other policy expenses.

Variable Universal Life (VUL)

Benefits:

- A death benefit that remains in effect as long as premiums are paid and sub-account performance is adequate to support the policy and prevent a lapse. The sub-accounts are akin to mutual funds.
- A similar level of flexibility as afforded CA UL and IUL in terms of premium payments and death benefit flexibility and customization.
- Cash value that increases or decreases in alignment with the performance of the sub-accounts selected.
- A prospectus detailing all policy charges, fees, and sub-account expenses.

Performance upside and risk:

- Unlimited upside driven by sub-account selection and performance.
- The possibility of losing all cash value and lapsing the policy; however, some policies offer guarantees, while others may provide downside protection in the form of riders.

Private Placement Life Insurance (PPLI)

Benefits:

- Availability to Qualified Purchasers and Accredited Investors (see Endnotes).
- Sub-account offerings that include hedge funds or "fund of funds."[6]
- An ability for clients to grow their invested assets on a tax deferred (potentially tax-free) basis.
- A dramatic reduction in taxation, possibly increasing net portfolio return.
- Potential access to the investment gains income tax-free during clients' lifetimes.
- Elimination of K-1s and other tax reporting generated by the underlying investments.
- Typically, no surrender charges.

Performance upside and risk:

- Generally, lower costs and fees than retail life insurance, but performance fees can impact the upside.
- Combines investment flexibility and institutional pricing with beneficial tax treatment.

[6] Hedge "fund of funds" is a pooled investment fund that invests in other hedge funds to provide investors access to a variety of fund managers, while generally spreading the risks over a variety of funds.

- Tax deferral on underlying investments and an income-tax-free death benefit.
- Wealth manager plays an important role in helping clients optimize sub-account performance.
- Generally, unlimited downside.

Endnotes

Qualified Purchaser:

- A person with no less than $5 million in investments.
- A company with no less than $5 million in investments owned by close family members.
- A trust, not formed for the investment, with no less than $5 million in investments.
- An investment manager with no less than $25 million under management.
- A company with no less than $25 million of investments.

Accredited Investor:

- Has earned income that exceeded $200,000 (or $300,000 with a spouse) in each of the prior two years and reasonably expects the same for the current year, *OR*
- Has a net worth over $1 million, either alone or together with a spouse (excluding the value of the person's primary residence).
- Any trust, with total assets in excess of $5 million, not formed specifically to purchase the subject securities, whose purchase is directed by a *sophisticated* person, *OR*
- Any entity in which all the equity owners are accredited investors.