

# Lightening the Financial Load of Life Insurance Products

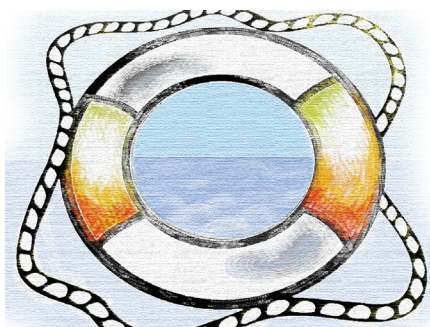
By Peter Katt

**I**n hard economic times, investors look for ways to lighten their financial load—and life insurance has its role to play.

There are four helpful ways of managing life insurance in such periods.

- First, instead of buying higher-cost permanent policies that generate cash values, many individuals can stick with much lower cost term insurance.
- Second, when cash value policies are acquired, make sure they are low-expense so you can have immediate liquidity.
- Third, to save cash flow, existing permanent policies' premiums might be skipped.
- Finally, if investors need funds, they may be able to withdraw or borrow from cash values of permanent policies.

Here are some examples that explain these approaches.



Bob and Jean are both 55 and in good health. Bob is a real estate developer. He astutely stopped building slightly ahead of the housing collapse, but his inventory of land is not liquid and his cash flow is relatively poor. He and Jean need \$10 million of survivorship life insurance for estate tax liquidity.

A low-expense market-priced survivorship universal life (SUL) policy has target premiums of \$70,000 for lifetime coverage. This is more than Bob wants to commit in these rough real estate times. But he can use the same low-expense SUL policy as a surrogate joint-life term by paying premiums to keep it in force for 20 years. The target premiums for this design are \$9,000.

By comparison, a true 20-year term policy insuring Jean has premiums of around \$22,000 a year. Using the low-expense SUL policy gives Bob and Jean the flexibility to increase the funding when they have the cash flow to make the policy last their lifetimes.

## Stick With Lower-Cost Term

Dave and Anne have their first child. Anne has lost her bank position, and Dave has been let go from his auto company position. He is fortunate to sign on with a consumer products company, but at a lower salary.

Dave and Anne realize their family income is down and want to maximize the amount of life insurance protection each of them has. Both are 35 and in very good health. Dave acquires a 20-year level term policy for \$2 million with an annual premium of \$1,100, and Anne is insured for \$500,000 with an annual premium of \$260. Term insurance lets them maximize protection within their budget.

## Cash Value Policies

### Universal Life

Tom, 62, already purchased his permanent estate tax liquidity life insurance: Five years ago his trust purchased a \$15 million no-lapse universal life insurance policy.

No-lapse universal life policies have guaranteed premiums and death benefits—they are like term insurance for life. These policies are very different from other permanent insurance policies that don't have these aggressive guarantees. I refer to the no-lapse policies as static-priced because the premiums won't change regardless of interest rates and mortality trends.

Conventional permanent insurance is market-priced because its value and premiums do depend on interest rates and mortality (see my July 2003 *AAIL Journal* column at [www.peterkatt.com](http://www.peterkatt.com) for details about no-lapse policies and their differences).

A drawback to static-priced universal life insurance policies is that they have low to zero cash values compared to market-priced policies that have robust cash values.

Tom's estate soared during the housing boom due to his ownership of a mortgage company. However, now he is having cash flow problems. His combined annual life insurance premiums are around \$245,000. Because of low cash values, Tom has little leeway in skipping premiums. He can skip the next two years and then the policy will lapse. (Of course, skipping premiums means higher premiums will need to be paid later when they are resumed.) In two years if Tom still doesn't have the resources to pay the \$245,000 annual premiums, his static-priced policy will terminate.

This lack of liquidity is a serious drawback to static-priced universal life. Had Tom purchased a market-priced universal life (low-expense version) with slightly higher target premiums in the first place, the loan or surrender value would be about \$1 million and he could continue the policy or surrender it for the cash.

### Whole Life

Greg, a 59-year-old surgeon, purchased a large amount of term insurance and a smaller amount of low-expense high-premium whole life 15 years ago in an integrated plan of family protection and tax-deferred savings. The annual contract premiums are \$44,000 and the cash values are now about \$1.8 million.

A golfing buddy broker convinced Greg to invest in two residential homes with mortgage payments of some \$120,000 a year. The idea was to flip them within two years. However, the

house prices have tanked.

Greg has decided to wait for a market turnaround, but he needs liquidity to finance this delay. Unlike a universal life policy where premiums can be missed, whole life premiums need to be paid. But they don't need to be paid by the policy owner. Dividends *from the policy* can easily pay Greg's \$44,000 premiums, and he can withdraw or borrow cash values if necessary to fund the \$120,000 annual mortgage payments for a few years. Cash value withdrawals are tax-free if they don't exceed Greg's cost basis (the sum of his premiums), and his cost basis is \$988,000.

Whether withdrawing or borrowing cash values is best depends on whether they are likely to be repaid. If repayment is likely, a loan should be taken because it can simply be repaid. Withdrawals can't be repaid. But if repayment is not expected, it is better to take a withdrawal so there is no loan interest associated with it.

### Variable Universal Life

George, age 62, sold his business in 2000 for \$2.5 million. He invested the down payment on the business in a variable universal life policy, and also expected to invest half the 10-year payments from the business sale into the variable universal life.

At age 65, the policy was illustrated to allow him to take out \$100,000 a year for life with a large inheritance for his children from the death benefit.

However, eight years later, the business has failed (and payments have stopped) and the variable universal life cash value is 60% less than illustrated due to the volatility of the stock market (which the policy "illustrations" never illustrate despite the obvious risk). George's retirement is in great jeopardy.

A realistic option for George is to transfer his policy's cash values to an income annuity to take advantage of the much higher cost basis and receive a guaranteed income for life. Combined with Social Security, George can receive

about \$75,000 a year.

With its high expenses and volatility of investments, George seriously risked losing his entire nest egg with the variable universal life—a flawed life insurance concept, especially in the situation described above.

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### Liquidity

Term insurance has no cash value. It has no liquidity component.

Whole life, universal life and variable universal life policies have cash values. But remember that no-lapse universal life has much less to zero cash values. The lack of cash value is Tom's problem (above) and variable universal life is such a flawed concept that it should almost always be avoided.

Whole life and conventional universal life's cash values in the early years are dependent on the amount of first-year expenses. The lower the expenses (almost entirely commissions), the higher the cash values. Although high early cash values (liquidity) are always a good thing, this fact is emphasized during hard economic times.

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### Summary

Financial assets and decisions come under stress in difficult economic times. Decisions about life insurance during such periods are important.

Term insurance is much more relevant because of its simple, low costs. Low-expense survivor universal life should be used for term insurance when estate tax liquidity is the problem.

Static-priced universal life policies with low to zero cash values show their significant weakness when liquidity is needed, and might be rejected for that reason alone.

Variable universal life is a poor life insurance choice during all economic periods.

Finally, the amount of early whole life and conventional universal life cash values can be improved by buying low-expense versions. ▲