

A Primer on Insurance Products

By Peter Katt

Article Highlights

- Practical commentary on insurance products, including best uses and risks.
- Current assumption and guaranteed universal life insurance have advantages when used in the right situations.
- Deferred annuities offer tax-efficiency, while income annuities also provide lifelong income.

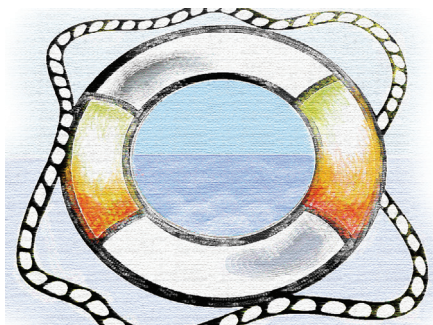
This column provides practical commentary on insurance products, issues and planning that I frequently encounter. I hope you can use it as a quick check to see whether the insurance or proposals you encounter make sense.

Long-Term Care Insurance

Long-term care insurance is a risk management asset designed to protect against the costs of needing care during old age. However, these policies do not cover medical or critical care situations. Long-term care workers assist insureds with the difficulties of daily living activities. Many plans pay a stipend, so it doesn't matter whether the care is received in an institutional or home setting.

Under the right circumstances, long-term care insurance is a bargain—but there are some cautionary issues to be aware of. Long-term care premiums have risen considerably, and may continue to rise, causing long-term care owners to terminate their policies. A number of companies have left this market and more will. I believe companies didn't think through long-term care insurance very well and now regret opening up this market. As a result, getting claim approvals could be tough, which is what happened with disability income insurance in the 1980s and 1990s.

I have found that some clients have a special fear of personally funding long-term care and are motivated to buy it regardless of cautions. Clients without these fears gener-



ally don't buy long-term care insurance.

Disability Income Insurance

Disability income insurance is a risk management asset that protects against financial disaster when earners lose income due to a disability.

Many executives have group long-term disability coverage that often covers up to 60% of pre-disability income for specified periods, often to age 65. Independent professionals (physicians, dentists, attorneys, etc.) should have individual disability income policies.

All disability income policies should have residual coverage that provides partial benefits when a disability isn't total, but income is affected. Personal policies have cost-of-living riders. They are expensive, but are well worth it if you become disabled. The most efficient cost/benefit design generally includes a 90-day waiting period.

A key to disability income planning is to forgo the tax deduction because if premiums are deducted, the benefits are taxable. If premiums are not deducted, the benefits are free of income taxes. Obviously, you are much stronger financially when able and earning a salary, so don't deduct the premiums from your taxes. This is a bit tricky for group programs that are paid for and deducted by employers. You may be able to work with your human resources department to receive 1099s in the amount of the premiums and pay taxes on this amount so benefits are tax-free.

Term Life Insurance

Term life insurance is the primary life insurance risk asset for most families, and is usually purchased at 10-, 15- 20-,

25- or 30-year level terms. Most clients are underinsured with term policies. Considering how inexpensive it is and the vulnerability of families when primary income earners die, a lot of term life insurance should be purchased.

Term policies are also used for business buy-sell funding. In addition, term policies can be used for short-term estate tax liquidity when estate assets will be liquidated.

Most term policies can be converted to permanent insurance without proof of insurability. This can be a very valuable right in the correct circumstances.

Participating Whole Life Insurance

Sold by the few remaining mutual life insurance companies, participating whole life has two excellent uses featuring death benefits that will increase significantly over time as dividends are earned.

The first use is for 30- and 40-something high-earning professionals wanting to accumulate cash value on a tax-deferred basis and add to their family protection life insurance. Later, the policy's cash value can be withdrawn tax-free (up to cost basis) for education purposes, to supplement retirement, or the like. The residual policy will continue, providing an inheritance for children.

The other use is for the wealthy who don't have an estate tax liquidity problem. Participating whole life is an excellent wealth transfer asset. Gifts are made to an irrevocable trust and are invested in the participating whole life policy. The proceeds are income tax-free.

Do not use participating whole life when level death benefits are needed because it lacks premium flexibility.

Current Assumption Universal Life Insurance

Current assumption (i.e., market-priced) refers to policy performance that will change as the interest rate credited to the policy changes. In most cases this will affect the target premiums.

Current assumption universal life should be used for level death benefits with target premiums adjusted as the

crediting rates change. Target premiums should also be adjusted if there is a significant change in the insured's health because this will impact mortality, or the timing on the maturity of the policy.

Universal life can be used for long-term buy-sell funding, permanent family protection and, most commonly, for estate tax liquidity.

Current assumption universal life has robust cash values and will do well when interest rates are high on a sustained basis.

Guaranteed Universal Life Insurance

With guaranteed universal life, the premiums and death benefits are guaranteed, but these policies usually have low to zero cash values. Guaranteed universal life is used for the same reasons current assumption universal life is used.

The advantage of guaranteed universal life is the guarantees; there are no moving parts. In other words, what you see is what you get.

The concern is the "too-good-to-be-true" aspect. Considering the historically low bond rates that could exist for several more years, I am more concerned about insolvency. At the very least, clients should be given the choice of current assumption universal life and guaranteed universal life with appropriate cautionary caveats. A recent case I reviewed had the current assumption premium at \$40,000 a year (and almost certain to go up) with the guaranteed life premium at \$10,000.

I am fine with a client taking the guaranteed universal life policy, as long as they understand that the risk needle is higher.

Indexed Universal Life Insurance

Indexed universal life policies claim to provide crediting based on the performance of various stock indexes.

My concern is that indexed universal life is mostly an illustration advantage over current assumption universal life and is not real. The few experiences I have had reviewing the actual performance of indexed universal life policies supports my concern.

When I write about these concerns, the indexed universal life sellers get very angry with me. I repeat here what I have asked from them: Send me redacted annual statements for at least seven years showing the performance of the surrender value that is equal to the appropriate indexes, and I will provide my mea culpa.

One significant potential problem I have seen with indexed universal life is when it is combined with premium financing. The higher illustrated rates for indexed universal life make it appear that the policy's cash values can cover the loan's collateral—but I'm betting they won't.

Variable Life Insurance

Variable life insurance is a permanent policy whose cash value investment is controlled by the policyowner, who can select among various bond and equity sub-accounts.

Except for (very) special situations, I don't recommend variable life because the effect of the investment's volatility on the policies in the medium and long term is simply not understood by buyers, the agents that sell it, or the companies that provide variable life. Many of these policies implode because the market losses overwhelm the market gains within the variable life policy. This often causes these variable life policies to be terminated.

The only variable life insurance I accept is a policy where death benefits are as low as possible, premiums are as high as possible, and its design allows for death benefits to go up or be moved down in response to equity gains and losses. This type of variable life policy, however, needs to be managed by someone who knows how to do it.

Premium Financing

In order to make selling life insurance easier, some agents propose the financing of premiums and interest costs. I have never seen this work when insureds live to near their life expectancy. The loan costs overwhelm the policy's cash value collateral and personal collateral is required.

In a recent case, a healthy 79-year-old is on the cusp of having to put up significant collateral and within seven years of the entire program collapsing, which would wipe out his net worth of \$25 million. The cost of terminating such a policy is paying for all the free life insurance clients have had. (The policy is paid for by a loan with the intent that the death benefits will exceed the cost of the loan.) If policyholders don't die soon enough, the program collapses.

Financing of premiums only with interest paid out-of-pocket is a six-of-one-half-dozen-of-another proposition. There may be unique circumstances where this might be desired, but financing premiums *and* interest should never be used.

Deferred Annuity

A deferred annuity is an asset that defers recognizing income until the annuity matures.

A deferred annuity can be continued and transferred to a spouse at death without tax consequences. Ultimately, a

deferred tax annuity can be transferred to children, and they will receive income relative to their life expectancies with the appropriate taxes paid. Contract owners can also exchange the deferred annuity for an income annuity at retirement to receive income for life.

An investor should use deferred annuities to absorb taxable income or otherwise unused cost basis from life insurance policies that are being terminated because tax-neutral exchanges are allowed. I recommend using a fixed annuity instead of a variable or index annuity.

Deferred annuities usually are not an appropriate asset for the wealthy because they have no need to convert to an income annuity, but do need greater flexibility in asset distributions to assist with estate planning strategies.

Income Annuity

An income annuity provides income for life with a specified certain period, say 10 years, if this is desired. (The income can be guaranteed for 10 years.) Usually,

a portion of the income payment is taxable, but the remainder is the tax-free return of principal.

In combination with deferred annuities for early accumulation, income annuities are tax-efficient vehicles that can be used when qualified retirement plans have been maxed out. You cannot outlive annuity income.

For those who are in great health, have family longevity, and who live beyond their estimated life expectancy, income annuities can provide a significant return.

Life Settlements

A life settlement is the sale of a life insurance policy by the policyowner when the insured's health has deteriorated and he is desperate for cash. Other than insureds in this situation, a policy won't sell or shouldn't be sold.

Clients I have assisted with a policy sale have found it quite distasteful, so a life settlement should only be considered when there is no other alternative. ▲

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Stock Strategies

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ago because I just wanted a bank that I could truly trust, more than anything else. If you give up a little bit on the upside, then that's okay, as long as you have somebody you can trust.

And, conversely, if you're getting just a little bit of extra return, no matter where it is, you have to ask yourself: Why am I getting that extra return? Because when you get more return, there's more risk. There's no free lunch. And the biggest mistake people make is chasing the fast buck, thinking they

can get something for nothing, and then finding out about the price they have to pay later on.

And I just want to reiterate one theme from my book about trust: I think the biggest problem with the financial crisis was the overseers getting paid by the companies that they oversaw, a situation that's still in place today. That's true with rating agencies or the accounting firms or the regulators or politicians or Wall Street. While there are all sorts of checks and balances, the checks are skewed in favor of the large companies.

So if we want to fix the system, we need to improve the incentives, which would then result in a better version of capitalism, or a sustainable capitalism.

CR: *And until that point, I guess, an investor should look at the adviser's track record and go with someone who has a good track record?*

MM: If you have to pay a little bit extra, if you have to get a little bit less return, if you have to do a little bit more homework to find the right financial institution or person you are going to rely on, do it—it's worth the effort. ▲

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