POINTS TO PONDER IN SELLING AND INVESTING IN INSURANCE POLICIES

By Peter Katt

Most people who wish to sell their insurance policy want to relieve themselves of having to pay the premiums for coverage that is no longer necessary. But eliminating future premiums can be done in many ways without selling a policy.

Viatical settlements are a financial scheme that became popular in the 1980s. They involve the sale of a life insurance policy by a terminally ill insured to an intermediary (a viatical firm) that then sells to investors either the policy itself or an irrevocable interest in the death benefits.

More recently, viatical firms have begun purchasing life insurance policies from healthy insureds who don't believe they need the coverage anymore.

The purchase of life insurance from terminally ill insureds needing money to pay for medical treatments may serve a public good. But all other aspects of this death-futures business are so troubling that healthy insureds selling their life insurance policies and investing in viaticated policies should avoid.

With respect to healthy insureds selling life insurance, the only way this can have a rational financial basis for sellers is if either the viatical firms were overpaying for their purchases or life insurance companies were not charging enough for their policies.

Since both viatical firms and insurance companies are in business to make profits, and employ financial analysts and actuaries to calculate such things, the loser in these transactions will be the seller who is ignorant about life insurance pricing. For healthy insureds, there will always be a better financial solution than selling a life insurance policy.

Every experience I have had with persons interested in selling an insurance policy relates to relieving themselves of having to pay the premiums for coverage that is no longer necessary.

But eliminating future premiums can be accomplished in many ways that don't require the sale of a policy. For example, a very healthy 60-year-old male with a large participating whole life policy purchased when he was 50 years old has sold his business and no longer needs the coverage for estate liquidity. He can withdraw all non-guaranteed cash values (up to his cost basis) tax free and distribute them to his beneficiaries. He can then change the policy to paid-up status. No more premiums will ever be required, and the policy will increase in value as non-guaranteed dividends are received.

This paid-up policy's rate of return will resemble a bond fund that is entirely income tax free. The financial value of this strategy will always be better than selling a policy to a viatical firm.

Regarding investing in viaticated policies sold by terminally ill insureds to viatical firms, a recent experience I had consulting with an Iowa widow is consistent with what has been reported on about such investments. Mrs. Smith was solicited by a local financial planner to invest in what was described as "A Sound Investment, A Humanitarian Gesture" offered by a Florida viatical settlement firm. The sales materials given to Mrs. Smith guaranteed her investment results, but a close and thorough reading of all the documents made it clear that they contained serious misrepresentations, non-disclosures, and deceptions. Some examples:

- The documents claimed a "total fixed return on investment of 128%." This statement is both deceptive and false. It is deceptive because the total return promised is actually 28%; 128% is the amount of the original

Peter Peter Katt, CFP, LIC, is sole proprietor of Katt & Co., a fee-only life insurance advisor located in Kalamazoo, Michigan (616/372-3497; www.peterkatt.com). His book, "The Life Insurance Fiasco: How to Avoid It," is available through the author.

investment (100%) plus the promised profit (28%). It is also deceptive because it refers to the investment return without regard to how much time it takes to obtain it. That is, a total return of 28% produces an annual rate of return of 13%, 8.6%, 6.4%, and 5% for two, three, four, and five years, respectively. And "the total fixed return on investment of 128%" is false because it hasn't turned out to be a fixed return at all, since the investor has had to supplement her original investment with additional investment amounts (premiums), which changes the total return.

- The documents misrepresented the certainty of when the insured will pass away. The length of time the insured will live dictates the value of this investment; it is critical information. Because investors aren't able to perform an independent evaluation of the insured's health status, they must depend on the viatical firm to honestly and accurately assess an insured's life expectancy.

The inherent problem with viatical settlements is that the middleman, the viatical firm, has the technical expertise to understand the very complicated assessment of the insured's medical prognosis, the life insurance policy's financial structure, and how these two things affect the viatical firm's profitability—none of which is disclosed to soliciting agents or consumers. Being in such total control of financial information is nearly the equivalent of having a license to steal. Viatical investors will always be at the viatical firm's mercy, which is why any astute investor should never even consider these death futures.

NON-VANISHING PREMIUMS

In the early 1980s, the life insurance industry began pushing the sale of whole and universal life policies that were projected to require a specific number of premiums, and after that, the policy would become self-sustaining. Premiums that lasted in the range of eight to 15 years were typical. This arrangement was frequently referred to as a "vanishing premium" or "premium offset."

Unfortunately, these limited-pay premium payment schemes were heavily sold during a time of historically high insurance company investment yields that have since returned to more conventional, lower levels. The investment component of whole and universal life directly affects the number of projected premiums needed, so nearly all of these limited-pay policies have not performed as advertised. More and more years of premiums are now needed before they will become self-sustaining.

The need to pay far more premiums than originally promised is causing many insurance agents considerable discomfort as they attempt to explain to their customers why things haven't worked out as planned.

In response to this, I have seen a considerable number of situations where the agent returns to redeem the situation by replacing the original whole or universal life policy (whose underlying investments are primarily bonds) with variable life. This way the policyholder can invest the cash values and premiums in potentially higher-returning but also higher-risk equities. The agent's hope is that the possibly stronger investment results with equities will cause the original limited-pay promise to come true. This hope is reinforced by tranquil-appearing variable life illustrations showing the policy becoming self-sustaining with only a few premium payments (frequently equal to the total premiums originally presented).

Unfortunately, the certainty conveyed by these illustrations with their constant investment results of, say, 10% is very misleading, because in reality equity results will always be very volatile and unpredictable, with the possibility of year-to-year losses—as last year and this year have amply demonstrated.

There are many good reasons to use variable life, but using them to rescue limited-pay whole and universal life policies is not one of them. Maintaining level death benefits with a limited-pay premium scenario using volatile equity investments is a recipe for smashing the policyholders' expectations again.

Substituting variable life is fine as long as the premiums-to-death-benefit ratio favors heavy premiums and lean death benefits that are expected to rise dramatically as investment results are booked. This design practically eliminates the problem associated with volatile investment results.

OVERLOOKED WHOLE LIFE

Repeatedly over the years, I have seen individuals near or in retirement who have participating whole life policies from excellent insurance companies stop paying premiums, letting the current dividend pay them. Unfortunately, these people are missing the wonderful savings/investing opportunity available with seasoned participating whole life policies, where the policyholder can pay the full premiums with dividends buying additional policy values. For example, Mr. Jones buys a $500,000 participating whole life policy at age 40 and pays the $9,300 annual premium until the annual dividends are large enough to pay the full premium at age 53. Dividends in excess of paying the premium are used to buy additional policy values. Mr. Jones is able to personally invest some $20,000 annually. He considers this more of a savings program, in that he is adverse to the gyrations of stocks that he owns in his employer-sponsored pension plan. The question is, considering Mr. Jones' desire to save some $20,000 annually, would he better off using his life insurance premiums as part of his savings? Depending on the mutual company he bought his participating whole life policy from, the rate of return under current pricing conditions—using the premiums for part of his savings—will range from 6% to 8%. This is measured by taking the difference in the total cash values produced without premiums beyond age 53, and the total cash values with premiums being paid every year. The 6% to 8% range is especially impressive because they grow tax deferred, and access to these savings can be tax free by withdrawing them from the policy. Furthermore, paying the premiums also enhances the death benefits that are income tax free.

Consider this scenario that uses a top-of-the-line participating whole life policy, assuming current pricing: Mr. Jones continues his annual premiums rather than using dividends to offset them. Mr. Jones pays the $9,300 annual premium until his retirement at age 68. He then begins withdrawing cash values at the rate of $13,000 a year for 20 years (all income tax free because it hasn't exceeded his basis) and passes away at age 88, with a death benefit to his family of $3 million.

Based on current pricing, this scenario represents an income-tax-free rate of return, combining Mr. Jones' withdrawals and his family's death benefit, of 7.6%—not a bad return for a fixed-income investment in today's environment, and an opportunity that should not be overlooked by policyholders. ✦