COLVA
INSURANCE SERVICES

The Hidden costs of Permanent Insurance Policies revealed by an Actuary
By Rajiv Rebello, Principal, Colva Insurance Services

For first time buyers of life insurance, the plethora of choices available can be daunting: Should I get permanent or term life insurance? If I get permanent insurance, should I get Whole Life or Universal Life?

For those unacquainted with this insurance jargon, the thought of trying to digest all the information can be painful. So let's start with defining the two basic types of life insurance policies: Term Insurance and Permanent Insurance.

Term insurance describes a type of life insurance policy that provides only death benefit protection for a predefined number of years (e.g. 5-year Term, 30-year Term, Term-to-100, etc). The entire premium paid by the policyholder goes towards covering the insurance carrier's risk that the insured dies within the term period and the expenses associated with administering the policy.

Permanent insurance describes types of life insurance policies that provide lifetime death benefit protection as well as a tax-deferred investment vehicle. Part of the policyholder's premium goes towards covering the insurance carrier's risk that the insured dies and related policy expenses, and the remaining portion goes towards a "cash value" account that grows tax-deferred and is available for the policyholder to withdraw or borrow against if certain funding levels are met. Since the premium for these types of products go towards providing both a death benefit and an investment account, the premium for these permanent insurance products are significantly more than a counterpart term product with the same death benefit. For example, while the premium for a 30 year term product with a two-million dollar death benefit may be only a couple hundred dollars a year, a permanent product with the same death benefit might be a couple thousand dollars.

With such a disparity in cost, the future policyholder often wonders whether he really needs a permanent insurance product or the tax-deferred cash-value investment vehicle that comes with a permanent insurance product. After all, couldn't the policyholder just buy the term product and invest the rest in an investment plan of his own choosing outside of the life insurance product?

Agents selling these policies will often try to sell a future policyholder on the value of permanent insurance by mentioning the following points:

1. The value of a tax-deferred investment plan
2. Interest rates of the permanent policy which are comparable to market rates.
3. Lack of future insurability as at the time the term period expires the policyholder may have fallen ill and no longer be able to get affordable life insurance.

While all these points are true, they are more than a bit misleading. Here are a couple of important points that agents tend to leave out when promoting the benefits of a permanent insurance policy.

The value of a tax-deferred investment plan
A tax-deferred investment plan does have numerous advantages. But if you already have a 401K, 403B, or other qualified retirement plan you are already obtaining the benefits of a tax-deferred investment plan. Why would you need another one?

Competitive Interest Rates
The rates illustrated on a life insurance policy are often competitive with current market rates. However, what agents neglect to mention is that these are ***illustrated*** rates not your actual ***rate of return*** on your investment. In other words, yes your "cash value" account will accrue the 4% or so that's illustrated on your policy—but only **AFTER** the insurance carrier deducts its "expenses." These expenses can be anywhere from 20% to over 50% of your premium. Imagine if you are considering purchasing a permanent insurance policy with $1,000,000 in face amount and your financial advisor came to you and said:

"Give me a $1000, I'll deduct $200 for "operating expenses" and then credit you 4% on the remaining $800 balance, leaving you with $832 at the end of the year."

Would you consider that a good deal? The answer is no. In reality, it will take you a good 15-20 years of keeping your money in that life insurance cash value account getting interest accumulation just to earn that 4% your agent said you'd be making. And what if you want to take all that money you've earned out earlier than that? Well, then you're in store for another big shocker of life insurance(See "**Surrender Charges**" section below)

Surrender Charges
Now let's say over five years you've put $2,500 a year (total of $12,500) into your permanent life insurance product and have about $10,000 in your cash value account after all the expenses have been deducted. Now you're ready to buy a home and want to put that money towards the deposit on your new home or want to put this money and the $2,500 a year you pay in premiums into a college savings account for your children instead. You might be surprised to learn that you might not get all(if any) of that $10,000 back. Insurance carriers often charge hefty charges upon policyholders who cancel or "surrender" their policy within the first 15 years. You might be forced to keep the policy in force for at least another 10 years just to get a reasonable return on your money. And if you can't afford to pay that $2,500 a year for the next 10 years, then you might have to just lapse the policy—which means you would have spent thousands of dollars investing in the tax-deferred cash value accumulation portion of the life insurance product and received nothing in return for it. This is not as unlikely as you might think. According to the most recent lapse study by the Society of Actuaries, a little more than 25% of all policyholders who purchase Universal Life policies lapse the policy before the end of the fifth policy year[1].

Are these policyholders getting the best deal for their money? Absolutely not. These policyholders would have been much better off buying a 5 year term product and investing their money elsewhere in a more liquid investment vehicle. The only people gaining from this transaction are the insurance company, who would essentially get to keep whatever remains in your cash value account without paying out a death benefit and the agent who sold you a product that wasn't right for you and collected a nice commission at your expense(See "**Agent Commissions**" section below). What's worse is that the

---

[1] 2004–05 U.S. Individual Life Persistency Update, A Joint Study Published by LIMRA and the Society of Actuaries. http://www.soa.org/research/experience-study/ind-life/persistency/2004-2005-ind-life-persistency.aspx

insurance carriers know this. In fact, some policies even depend on a certain number of policyholders lapsing their policies—and getting a horrible deal—in order for the particular insurance product to be profitable. This type of practice is referred to in the industry as "lapse-supported" pricing.

Agent Commissions

One of the reasons insurance carriers charge such high surrender charges to begin with—in addition to any profitability gains they may get from lapsing policies—is that the insurance carrier often has high upfront expenses associated from issuing a policy. Therefore, they need to make up for this somehow. One of the ways they do this is by charging the policyholder a surrender charge, otherwise known in the industry as a "back-end" fee.

What are the high "front-end" expenses they encounter? Well, one is the cost of having a medical underwriter review your medical records and determine how sick/healthy you are so that the carrier can charge you the correct premium for your risk class. But by far the biggest upfront expense is the agent's commission for selling the policy.

An agent generally gets anywhere from 50% to 100% of the first year premium as a commission up to a certain target premium for making the sale. For any additional premium that is paid in excess of that target premium he gets a much smaller commission(generally around 1 % to 2%). So when he goes to make a sale, which product do you think he's going to suggest is best for you—the term product where he will only receive a few hundred dollars as commission or the much more expensive permanent insurance product where he could make a few thousand?

Furthermore, for these permanent policy products how much premium do you think he is going to suggest/illustrate that you should pay—the target premium or something much less that will give you the same amount of death benefit protection?

Because of these reasons, the agent isn't always the most unbiased source of information about what the best life insurance policy might be for you. To add salt to your wounds, if you end up lapsing your policy early—and lose all the money you invested into your cash value account because of the high surrender charge—the agent generally still gets to keep his hefty commission if you lapse your policy after the first year is over.

Lack of future Insurability

While the agent is right and there's a chance that you could become ill at the end of the term period and no longer insurable, the question he should be asking is "Will you need life insurance at that point in time?"

Assume you're a married 35 year old male with two small kids under 5 years old. You desire to get insurance to protect your wife and kids in the event of a tragic accident whereby your family would lose your annual income every year. But in 30 years your kids will be around 35 years old themselves. Will they still need the loss of your income due to death to protect them? And if you already have a retirement plan setup, then your wife will already have access to your retirement plan proceeds for life as an automatic beneficiary.

Who are permanent insurance policies suited for?
It appears then that the negatives of permanent insurance policies far outweigh the benefits of them.

However, if you are a wealthy individual or corporation or a young adult with long-term life insurance needs and low mortality expenses, a permanent policy may prove beneficial for you because of a life insurance policy's tax advantages.[2]

Wealthy Individuals and corporations
Currently when someone dies, the value of their estate above the exemption limit is taxed at a certain rate before their heirs can get access to it. Currently that exemption limit is $5.12 million and the estate tax rate is 35%. For example, someone with an estate valued at $15.12 million would currently pay taxes of $3.5 million(35% multiplied by the $10 million over the exemption limit) before the remaining $11.5 million could be given to the deceased's heirs. This is a lot of money to pay in taxes for income that has already been taxed once (when the person originally earned it). Now let's assume that this individual decided to take his $15 million and spend it all on a life insurance policy with $15 million in death benefits that will be paid to his heirs once he dies. One of the existing tax benefits of life insurance is that the beneficiary of the policy receives the death benefit tax free. So in this example, the insured's beneficiary will receive the full $15 million tax-free. This is a savings of the $3.5 million that the beneficiary would never have had access to if not for the tax benefits of life insurance.

Wealthy corporations can also obtain great tax benefits through utilization of "keyman" life insurance policies. Keyman life insurance policies can help fund corporate liability for highly compensated employees that are key to the business. The basic premise is that the company pays the premiums on a permanent life insurance plan for a key executive with the company being the beneficiary if the insured were to die and they incur losses as a result of losing a "key man" in their business.

Remember, the example above where the individual policyholder had $200 of expenses deducted, and earned 4% interest on the balance leaving him with a balance of $832 at the end of the year when he started off paying $1000? This is a horrible investment for the average policyholder because the high expenses prevent the policyholder from taking full advantage of the tax-deferred growth advantage of the permanent policy. However, wealthy entities can take full advantage of the permanent policies by paying significantly more in premiums. For example, if you pay $10,000 in premiums a year for the same policy that $200 expense is not nearly as significant. Earning 4% on the balance after the expense fee would leave the entity with $10,192 at the end of the year. By maximally funding these policies, these entities can receive worthwhile tax and accounting benefits over time that allows them to gain returns on these policies that are significantly greater than treasury yields. The average policyholder can not afford to do this.

Young Adults with long-term insurance needs
Young adults with long term insurance needs have both low mortality expenses and a long duration to take advantage of the tax-deferred accumulation. For these individuals it might actually end up being economically cheaper for them to purchase a permanent policy than a term policy. For instance, instead of paying $1,000 a year for the $1,000,000 30-year term policy, a 35 year old married father of two

---

[2] The following Wall Street Journal article describes in more detail the dramatic shift in demographics that has taken place in the last twenty five years of the core purchaser of life insurance from middle class households to more affluent households and corporations.
(http://online.wsj.com/article/SB10001424052748703435104575421411449555240.html)

looking for protection might have to pay an average of $1,500 a year resulting in $15,000 in extra premiums over the thirty year period. However, at the end of the 30 year period the insured who purchased the permanent policy would have accumulated $30,000 in cash value whereas the term policyholder would not have accumulated anything. If this amount is significantly greater than what the policyholder could have earned by investing the difference in the premium costs between the two policies in 30 year treasury bonds which offer the same risks, then he is better off purchasing the permanent insurance policy.

Conclusion

Clearly permanent life insurance products are complicated financial products that can be very confusing to the average policyholder who is not familiar with all the jargon and technical specifics on how the products work—and the real benefits and costs of the policy. Before purchasing any type of life insurance policy the future policyholder should ask himself/the selling agent the following questions:

1. What are all the reasons behind my interest in applying for life insurance?
2. How much life insurance death benefit protection do I need?
3. How long do I need it for?
4. What are all the fees, surrender charges, and commissions associated with purchase of the policy?
5. How does this policy best meet my needs?

Without having all these questions answered by a knowledgeable and responsible party prior to purchasing a policy, the potential policyholder might be setting himself up for a large amount of both future frustration and monetary losses.

Rajiv Rebello is a Principal of Colva Insurance Services, which provides tailored insurance services to current and future owners of life insurance policies. He is a Fellow of the Society of Actuaries(FSA) and a Member of the American Academy of Actuaries(MAAA).