

# Life Insurance Options for Tough Times

by Peter C. Katt, CFP®, LIC



Peter C. Katt, CFP®, LIC, is a fee-only life insurance advisor and sole proprietor of Katt & Company in Kalamazoo, Michigan. His Web site is [www.peterkatt.com](http://www.peterkatt.com).

**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 possible ways that the management of life insurance can assist in such periods. First, instead of buying higher-cost permanent policies that generate cash values, many clients can stick with much lower-cost term insurance. Second, when cash value policies are acquired make sure they are low expense so clients can have immediate liquidity. Third, to save cash flow, existing permanent policies' premiums might be skipped. And finally, if investors need funds, they may be able to withdraw or borrow from cash values of permanent policies. Case studies follow to explain these.

## Term Insurance

**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 protec-

tion 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 lets them maximize protection within their budget.

**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 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 flexibility of increasing the funding when they have the cash flow to make the policy last their lifetimes.

## Universal Life (UL)

**Tom**, age 62, already bought his permanent estate tax liquidity life insurance. Five years ago his trust bought a \$15 million, no-lapse universal life policy. No-lapse UL policies have guaranteed premiums and death benefits. They are like term for life. No-lapse UL

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

policies are very different from other permanent policies that don't have these aggressive guarantees. I refer to the no-lapse policies as static-priced because the pricing 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 *Journal of Financial Planning* column at [www.peterkatt.com](http://www.peterkatt.com), or on this journal's Web site at [www.FPAjournal.org](http://www.FPAjournal.org) for details about no-lapse policies and their differences.) A drawback to static-

priced UL is low to zero cash values relative 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. 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. Had Tom bought a market-priced UL (low-expense version) with much higher cash values, it would continue for ten years without premiums. Of course, skipping static- and market-priced UL premiums means higher premiums will be needed 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. Instead of just walking away from his static-priced UL policy with no surrender value he might try selling it in the life settlement market, but not before he reads my March 2008 *Journal of Financial Planning* column "The Life Settlement Mosaic" (also at [www.peterkatt.com](http://www.peterkatt.com) or [www.FPAjournal.org](http://www.FPAjournal.org)). This lack of liquidity is a serious drawback to static-priced universal life. Had Tom bought a market-priced UL policy with slightly higher target premiums in the first place, the loan or surrender value would be about \$1 million. He could continue the policy or surrender it for the cash.

### Whole Life

**Greg**, a surgeon, age 59, bought 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 properties with mortgage payments of some \$120,000 a year. The idea was to flip them within two years.

The house prices have tanked. Greg has decided to wait for a market turnaround but he needs liquidity to finance this delay. Unlike a UL policy where premiums can be missed, whole-life premiums need to be paid. But they don't need to be paid by the policyowner. Dividends 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 (sum of his premiums). Greg's 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. Since Greg hopes to sell the properties and repay the funds taken from his whole life policy he will take them as loans.

### Variable Universal Life (VUL)

**George**, age 62, sold his business in 2000 for \$2.5 million. He invested the down payment in a variable universal life policy and also expected to invest half the ten-year payments into the VUL. At 65 the VUL 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. Eight years later the business has failed and the VUL cash value is 60 percent less than illustrated due to the volatility of the stock market. George's retirement is in great jeopardy.

A realistic option for George is to transfer his VUL cash values to an income annuity to take advantage of the much higher cost basis and receive a guaranteed income for life. 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 VUL. Variable universal life is a flawed life insurance concept, espe-

cially in the situation described above.

Some investors and all VUL sellers expect the illustrated 10 percent constant returns to come true. In real life, equity volatility and high VUL expenses almost always reach out to spoil the party. Please avoid VUL in good and bad times. (See my VUL columns at [www.peterkatt.com](http://www.peterkatt.com).)

### Liquidity

Term insurance has no cash value. It has no liquidity component. Whole life, universal life, and variable universal life policies have cash value. But remember that no-lapse UL has low to zero cash values. The lack of cash values is Tom's problem and VUL is such a flawed concept that it should almost always be avoided. Whole life and conventional UL'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.

### 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 survivorship universal life should be used for term insurance when estate tax liquidity is the problem. Static-priced universal life insurance with low to zero cash values shows its significant weakness when liquidity is needed, and might be rejected for that reason alone. Variable universal life is a poor insurance choice during all economic periods. Finally, the amount of early whole life and conventional UL cash values can be improved by buying low-expense versions.

