# Lost Opportunity:

## Failing to Use Your Life Insurance Capacity

Jay C. Judas
Life Insurance Strategies Group

Terry Navarro
JNJ & Associates, LTD

Each year on June 5th, Bostonians take notice of National Doughnut Day and rush to their nearest Dunkin' to claim their free classic doughnut. This 'right' to a free Boston Cream or Old Fashioned is held as an intangible asset the entire year until the right is realized and the doughnut is claimed. The tasty treat is then a tangible asset…for about five minutes until consumed!

If you live in Boston, you wouldn't dream of passing up your annual Dunkin' giveaway—your chance to take advantage of an intangible promise and to turn that intangible into an asset; albeit, edible. In the life insurance industry, we regularly see prospective clients miss out on their doughnuts when they fail to utilize the capacity for coverage insurance companies and reinsurers have placed on their lives. Realized, this capacity turns into permanent life insurance which can be used to care for a family, pay taxes, defend/transfer/grow wealth and protect business interests.

Capacity is the maximum amount of risk, or pure death benefit, life insurers and reinsurers are willing to place on a person based upon the underwriting functions carried out. Most life insurance companies will retain an amount of risk internally before going out into the reinsurance marketplace to obtain more. When offering capacity, a life insurer will not only consider financial and medical findings but also look to how much life insurance is already in place on the individual, as this amount contributes to the total capacity available

How much capacity is available for someone? Assuming good health and strong financials, today's ceiling for risk is approximately $150 million. If one was to sit around a table and listen to professional life insurance producers talk/brag about their experience, they may very likely have stories of selling policies with death benefits of $200 million or more. Are they correct?

Quite possibly. Before the consolidation of both life insurance companies and life insurance reinsurers and the application of high-tech record-keeping, a client could likely find very high levels of death benefit. This capacity was cobbled together by going carrier to carrier and obtaining the carriers' retained amount of death benefit, upwards to $30 million, and then securing facultative capacity from several reinsurers.

Why HNW Allocate to Life Insurance in Order to Monetize Their Life Insurance Capacity:

- Diversification Tool – Non/low correlation to other assets.
- Stabilizes the investment portfolio – creates a backstop and mitigates sequencing of return risk.
- Increase in yield over bonds/fixed income investments of similar quality.
- Allows clients to stay invested in illiquid assets.
- Creates an asset to offset their projected estate tax liability.
- Mitigates family wealth dilution.

Today, there are far fewer life insurers and even fewer reinsurers in the marketplace. In the application process, it is virtually impossible for any of these companies to offer capacity without any of the others knowing about it—whether by industry tracking or by the requirement an applicant spill the beans on the total capacity being sought and what life insurance coverage is already in-force. As a result, per person capacity is lower and more in line for what is viewed as an acceptable risk by underwriters at carriers and reinsurers.

At both Life Insurance Strategies Group and JNJ & Associates, we see HNW clients failing to recognize the value of the capacity they are leaving on the table...and not only for themselves but also for spouses and other generations. For a family, this means there is an ability to obtain potentially hundreds of millions of dollars to meet current and future financial needs. Family wealth is subject to dilution as a family grows over each generation. By insuring each generation, the risk of diluting family wealth can be mitigated.

Cynthia, 60, is married with two adult children and two grandchildren. She manages and owns around 40% of a private investment firm and has properly accumulated most of her wealth inside of a trust, keeping the bulk of her assets outside of an estate. Cynthia's non-trust assets consist mostly of personal real estate and a qualified plan balance, totaling $12 million dollars. The value of the assets inside of her trust are $120 million and much of it is highly appreciated interest in her investment firm as well as some similarly appreciated private equity investments.

It would appear Cynthia's life insurance need is limited since most of her net worth is already out of her estate. This would generally be true if Cynthia died today, but it is likely she will live for another thirty years and this presents an opportunity for Cynthia to make use of the insurance capacity on her life.

Cynthia estimates that her trustee will need to sell off investments in the trust to loan cash to her and her husband for them to live on for at least the next quarter of a century. They estimate needing $50 million and this would result in a tax bill for the trust at punishing trust tax rates. Cynthia would like to offset those taxes and, in effect, make the trust whole for the beneficiaries. A life insurance policy inside of the trust would be perfect.

Based upon a review of the trust's financials and the insurance need to pay taxes as well as the medical health of Cynthia and her husband, an offer of $25 million for a second-to-die life insurance policy with an increasing face amount is offered. As liquidity in the trust is limited, the trustee leverages assets to finance a single premium on a cash value life insurance policy from a highly rated life insurer. The insurer's retained risk maximum on a second-to-die policy is $50 million so this policy is well within the insurer's retention and a reinsurer is not involved in the transaction.

$5 MILLION SINGLE PREMIUM (MEC): SURVIVORSHIP WL

| | Survivorship: Preferred Nonsmoker | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Issue Age** | 45 | | 50 | | 55 | | 60 | | 65 | | 70 | |
| **Death Benefit** | $18,349,841 | | $15,503,393 | | $13,119,224 | | $11,145,272 | | $9,514,199 | | $8,197,478 | |
| **Age** | Internal Rates of Return on Death Benefit | | | | | | | | | | | |
| **65** | 9.02% | 20 yrs | 10.05% | 15 yrs | 12.21% | 10 yrs | 19.45% | 5 yrs | | | | |
| **70** | 7.68% | 25 yrs | 8.11% | 20 yrs | 8.81% | 15 yrs | 10.50% | 10 yrs | 15.83% | 5 yrs | | |
| **75** | 6.80% | 30 yrs | 6.96% | 25 yrs | 7.20% | 20 yrs | 7.74% | 15 yrs | 8.86% | 10 yrs | 12.63% | 5 yrs |
| **80** | 6.20% | 35 yrs | 6.23% | 30 yrs | 6.27% | 25 yrs | 6.44% | 20 yrs | 6.74% | 15 yrs | 7.45% | 10 yrs |
| **85** | 5.76% | 40 yrs | 5.72% | 35 yrs | 5.67% | 30 yrs | 5.68% | 25 yrs | 5.71% | 20 yrs | 5.85% | 15 yrs |
| **90** | 5.43% | 45 yrs | 5.36% | 40 yrs | 5.26% | 35 yrs | 5.20% | 30 yrs | 5.12% | 25 yrs | 5.07% | 20 yrs |
| **95** | 5.18% | 50 yrs | 5.09% | 45 yrs | 4.97% | 40 yrs | 4.88% | 35 yrs | 4.76% | 30 yrs | 4.63% | 25 yrs |
| **100** | 4.98% | 55 yrs | 4.88% | 50 yrs | 4.75% | 45 yrs | 4.64% | 40 yrs | 4.50% | 35 yrs | 4.35% | 30 yrs |

**At the respective ages above, this chart summarizes the detailed illustrations for a married couple purchasing survivorship whole life (WL). Each policy was funded with a single premium of $5 million (creating a MEC). For each policy, the death benefit was based on the carrier's current dividend scale. For each illustration, it was assumed the initial base face amount was $50,000 with the remaining premium used to purchase paid up additions. The dividend options were set to purchase paid-up whole life insurance. The internal rates of return on death benefit are the rates at which the total premiums paid in that year must be compounded each and every year to generate the death benefit. For the calculations above, these rates reflect after-tax.**

**Because accessing cash surrender value from a MEC policy is a taxable event, the internal rates of return on cash value were not provided. The client and their advisors were only interested in purchasing the maximum death benefit.**

## $5 MILLION PREMIUM (NON-MEC): SURVIVORSHIP IUL

| | Survivorship: Preferred Nonsmoker | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Issue Age** | 45 | | 50 | | 55 | | 60 | | 65 | | 70 | |
| **Death Benefit** | $15,958,242 | | $12,975,670 | | $10,953,043 | | $9,300,349 | | $7,924,056 | | $6,783,758 | |
| **Age** | Internal Rates of Return on Death Benefit | | | | | | | | | | | |
| **65** | 8.86% | 20 yrs | 11.30% | 15 yrs | 16.69% | 10 yrs | 45.99% | 5 yrs | | | | |
| **70** | 6.81% | 25 yrs | 7.92% | 20 yrs | 9.70% | 15 yrs | 13.79% | 10 yrs | 38.39% | 5 yrs | | |
| **75** | 6.55% | 30 yrs | 6.23% | 25 yrs | 6.80% | 20 yrs | 8.02% | 15 yrs | 10.84% | 10 yrs | 33.37% | 5 yrs |
| **80** | 6.63% | 35 yrs | 6.38% | 30 yrs | 6.01% | 25 yrs | 5.63% | 20 yrs | 6.31% | 15 yrs | 8.87% | 10 yrs |
| **85** | 6.73% | 40 yrs | 6.54% | 35 yrs | 6.27% | 30 yrs | 5.73% | 25 yrs | 4.89% | 20 yrs | 5.16% | 15 yrs |
| **90** | 6.79% | 45 yrs | 6.63% | 40 yrs | 6.41% | 35 yrs | 6.00% | 30 yrs | 5.40% | 25 yrs | 3.63% | 20 yrs |
| **95** | 6.75% | 50 yrs | 6.60% | 45 yrs | 6.41% | 40 yrs | 6.06% | 35 yrs | 5.58% | 30 yrs | 3.86% | 25 yrs |
| **100** | 6.81% | 55 yrs | 6.68% | 50 yrs | 6.52% | 45 yrs | 6.24% | 40 yrs | 5.86% | 35 yrs | 4.50% | 30 yrs |
| **Age** | Internal Rates of Return on Cash Surrender Value | | | | | | | | | | | |
| **65** | 5.68% | 20 yrs | 5.01% | 15 yrs | 3.60% | 10 yrs | -2.54% | 5 yrs | | | | |
| **70** | 6.02% | 25 yrs | 5.53% | 20 yrs | 4.77% | 15 yrs | 2.97% | 10 yrs | -3.97% | 5 yrs | | |
| **75** | 6.28% | 30 yrs | 5.90% | 25 yrs | 5.34% | 20 yrs | 4.28% | 15 yrs | 2.26% | 10 yrs | -6.08% | 5 yrs |
| **80** | 6.47% | 35 yrs | 6.19% | 30 yrs | 5.78% | 25 yrs | 4.97% | 20 yrs | 3.73% | 15 yrs | 0.72% | 10 yrs |
| **85** | 6.59% | 40 yrs | 6.38% | 35 yrs | 6.07% | 30 yrs | 5.50% | 25 yrs | 4.59% | 20 yrs | 2.14% | 15 yrs |
| **90** | 6.66% | 45 yrs | 6.49% | 40 yrs | 6.25% | 35 yrs | 5.81% | 30 yrs | 5.17% | 25 yrs | 2.91% | 20 yrs |
| **95** | 6.72% | 50 yrs | 6.58% | 45 yrs | 6.38% | 40 yrs | 6.02% | 35 yrs | 5.54% | 30 yrs | 3.81% | 25 yrs |
| **100** | 6.81% | 55 yrs | 6.68% | 50 yrs | 6.52% | 45 yrs | 6.23% | 40 yrs | 5.86% | 35 yrs | 4.50% | 30 yrs |

**At the respective ages above, this chart summarizes the detailed illustrations for a married couple purchasing survivorship indexed universal life (IUL). The total aggregate premium was $5 million paid into the policy over 7 years (non-MEC). For each policy, the assumed average crediting rate was the AG49 maximum rate based on the current cap, floor and participation rates. For each illustration, the chart solved for the maximum increasing death benefit without creating a MEC. Once the full $5 million of premium was paid, the policy death benefit was levelized. The internal rates of return on death benefit and cash surrender value are the rates at which the total premiums paid in that year must be compounded each and every year to generate the death benefit or cash surrender value. For the calculations above, these rates reflect after-tax.**

The 'increasing face amount option' will push the death benefit up over time to stay in proportion to the taxes paid by the trust as well as the investment growth lost through that taxation. When Cynthia and her husband die, the policy's proceeds will replace the funds lost to taxation inside of the trust. It will be as if the trustee never had to sell investments to make the loans to Cynthia. Additionally, amounts loaned from the trust to Cynthia will be recovered from her estate outside of the trust.

In this respect, the life insurance policy inside the trust became another class of asset—in fact, the trustee may look at the policy as two kinds of assets. First, the policy's cash value is like a conservative bond portfolio with low, but dependable and stable growth. Secondly, the policy is also an option, exercised at the death of the insureds, for a larger sum of money than the value of the premium paid and any associated growth on that amount. Both asset classes are backed by the rating of the insurance company which are typically strong. By purchasing life insurance, the trustee was able to diversify and stabilize the investment portfolio, while providing liquidity when needed most (at death).

Cynthia was able to take advantage of her intangible life insurance capacity asset so her children and grandchildren could escape the tax burden and impact of her lifetime use of trust funds.  Like Cynthia, many HNW individuals have addressed their life insurance strategies for a point in time and not for financial liabilities which develop through future living. Fortunately, one's life insurance capacity is standing by to deal with those liabilities!

Life Insurance Strategies Group

Experienced & Independent Advice

# About the Authors

Jay C. Judas, JD M.Sc. is the CEO of Life Insurance Strategies Group, an independent and experienced life insurance advisory firm.  Life Insurance Strategies Group does not sell product but offers unbiased, pragmatic advice on life insurance products, strategies and distribution to carriers, producers, advisors and life insurance clients.

jay@lifeinsurancestrategiesgroup.com

Terry Navarro, CPA is the Co-Founder of JNJ & Associates, Ltd, an independent life insurance brokerage firm.  JNJ & Associates, Ltd designs, implements and monitors life insurance portfolios to assist clients in successfully preserving their private capital through multiple generations and enhancing their business and philanthropic endeavors.  The alternative is to allow wealth to become exposed to income and estate taxes.

terry@jnjassociatesltd.com