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Institutional Life Insurance—A More Suitable Investment Management Container for Affluent Individuals and ILIT Trustees

Charles M. "Mark" Whitelaw and
E. Randolph Whitelaw, AEP (Distinguished)

The Institutional Life Insurance Story

ILI may be an unfamiliar product name to many readers; however, it is a time-tested option that has been the life insurance product of choice for sophisticated large and medium sized corporations (COLI—Corporate-Owned Life Insurance) and banks (BOLI—Bank-Owned Life Insurance) since 1986 to fund, directly or indirectly, cash-oriented supplemental investment and retirement benefits to executives as well as business continuity obligations and liabilities. Further, ILI has evolved as one of the most efficient investment, cash, and risk management structures[1] for business, individual, and sophisticated trust planning. It is unknown to most affluent consumers who mistakenly continue to purchase defined benefit replacement-priced life insurance products through traditional agent distribution channels.

ILI is a defined contribution, retention-priced, IRC §7702 death benefit minimum[2] based investment and risk management product whose distribution is restricted to issuer-approved ILI plan administrators.[3] As such, ILI eliminates the 30-year gap between enhanced product sophistication and the missing but essential product management services.[4] Administrator-based distribution offers active policy administration and risk management (investment and death benefit protection) services. As a result, ILI connects the life insurance planning and risk management dots. Finally, sophisticated consumers with thoughtfully considered long-term investment planning objectives can purchase a sophisticated buy-fund-and-manage investment-driven product designed and supported by the third party administration and risk management provider and the life insurance issuer for long-term policy retention.

The Introduction of Investment Suitable Life Insurance Products

In 1986, IRC §7702 was updated to include the Variable Universal Life policy structure that gives consumers the ability to invest policy cash values in separate accounts (funds specially priced for use in insurance products). As a result, two completely different products were created:

- **Retail-Priced Variable Universal Life (VUL)**—Starting with a retail Universal Life

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The full version of this article, including tables, endnotes, and a sample case, is available at www.financialpro.org/members/sections/FP/2015/institutionallifeinsurance.cfm.

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policy, VUL adds a range of separate investment accounts to enable the policy owner to asset allocate and access historically higher investment returns by comparison to an annually declared traditional UL policy crediting rate. This design increases the expected policy cash accumulation value account and lowers premium contributions.[5]

- **Institutionally Priced Corporate Variable Universal Life (CVUL)**—Combining the IRC §7702 tax structure with minimal death benefit protection and the more favorable longevity experience of highly compensated white-collar executives maximizes the policy cash accumulation account intended to (1) serve as an informal funding source of supplemental nonqualified investment and retirement benefits, and (2) maintain key-person financial protection and/or funding for business continuity purposes.

A small handful of the largest life insurance issuers created a unique product with:

- Separate institutional divisions for the creation, issue, and support of this investment and risk management alternative.
- New distributor requirements focusing on multiple plan and policy administration capabilities, thus allowing the issuer to focus on its product manufacturer role.
- Consumer protection provisions by requiring distributors to separate their retail and institutional product marketing and support.

The Product Suitability Discussion—Why ILI?

Given this introductory background, market segment suitability seems the next logical discussion. As already mentioned, Institutional Life Insurance is the generic term for Corporate Variable Universal Life (CVUL). ILI has been purchased since 1986 by sophisticated large- and medium-sized corporations (COLI) to fund cash obligations to highly compensated employees and by banks (BOLI) for diversifying Tier 1 Capital reserves.[6] The economic driver is ILI mortality risk expenses that have less impact on investment gains than taxes. As a result, the comparative investment analysis is based purely on cash value performance and cost-shifting from today's Federal, State, Capital Gains, and Medicare tax rates to ILI's lower policy costs—with no financial consideration for the added financial protection the ILI policy provides since this is already considered in the ILI mortality risk expense. As a result, ILI typically generates greater policy cash accumulation on the balance sheet and generates supplemental key person death benefit protection (automatically included) at $0 incremental cost.

The greatest differentiation between retail and institutional pricing is what happens after[7] the policy is issued recognizing that we are living longer due to medical science advancements. So, what is the relevance of this differentiation?

- **Retail Life Insurance** is designed for minimum premiums and maximum death benefits resulting in maximum issuer risk exposure. Said differently, the issuer makes its money from the risk costs—Cost-of-Insurance (COI)—on the net amount at risk (total death benefits less cash value). As a result, the financial benefits of living longer are typically retained by the issuer. If a consumer wants to access lower current rates and participate in the benefit of lower COIs, he/she must apply for a new policy and re-prove insurability. This is also called the replacement-based pricing model.
- **Institutional Life Insurance** is designed for minimal and reduced death benefit protection (total death benefit less cash accumulation value) based on defined premium contri-

bution objectives that reduce and minimize issuer risk exposure over time. Said differently, ILI is issued with the expectation that the death benefit protection element will be managed to $0 by age 95, along with the policy COIs. The issuer makes its long-term money from the M&E fee—an assets-under-management fee for managing the portfolio of available separate accounts. The financial benefits of living longer and reduced risk rates are typically passed through to the policy by the issuer to increase cash accumulation values, enhance policy retention, and increase the issuer's M&E revenue. Issuers can offer this experience based risk pricing because ILI is limited[8] to insuring mid-to-upper income white-collar individuals, a more wellness oriented risk class. This is also called the retention-based pricing model.

A simple product suitability way of thinking about this difference is:

- **Retail—**Issuer and consumer financial objectives are opposed.
- **Institutional—**Issuer and consumer financial objectives are aligned.

Whether a more detailed or simplified explanation, retail life insurance is structurally unsuitable for use as an investment alternative.

2002—Repurposing ILI for Individual Ownership.

ILI was initially created to serve as an alternative to taxable fund investing for corporate America. By 2002, medical science had lowered ILI mortality risk rates to the point where the discounted assets under management (AUM) cost of ILI separate accounts plus the ILI mortality risk cost (COIs) resulted in a comparable or lower total cost-of-investing as compared to a 401(k) or Roth IRA, meaning ILI offered:

- Comparable or greater net accessible cash as taxable or tax-qualified fund investing.
- Supplemental financial protection (terminal illness and death) automatically included as part of ILI mortality risk expense cost structure.

In 2002, a second specialized ILI distributor door was opened for issuer-approved ILI administrators specializing in individually owned or trust-owned ILI. It is available to health-conscious individuals and, by analogy, takes the BOLI investment value proposition across the hall from the chief financial officer to the chief fiduciary officer for affluent families.

2015—ILI and PPLI as Investment and Risk Management Alternatives.

Advancements in life expectancy, often referred to as longevity gains, have shifted the focus of cash value life insurance products from pure protection to cash value utility during retirement. ILI utilizes registered funds and the issuer-approved specialty distributor channel now represents approximately 65 million of potential insureds[9] that meet ILI underwriting requirements. PPLI is the Private Placement version of ILI that offers registered and unregistered funds to highly affluent individuals.

It is important to understand the five different ways ILI/PPLI differ from retail Variable Universal Life (VUL):

1. **Segmented Risk Pool.** By limiting access to healthy upper income white-collar employment roles, the Cost of Insurance (COI) is typically 20% to 30% lower than the same health class in a retail cash value product risk pool spanning all health risks and employment roles.
2. **Expanded Fund Offering.** ILI is designed to meet the planning needs of a chief financial officer and experienced investor as opposed to the general public. Some CVUL policies offer a broader fund portfolio than retail VUL policies so as to enhance their use as a nonqualified or tax-qualified plan complement.
3. **Surrender Refunds.** No surrender charges

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but rather surrender refunds are available for four to ten years. ILI's objective is to generate a 100% or greater year one cash surrender value to premium ratio so that the owner's balance sheet or personal financial statement or a trust's financial statement is neutral, as a minimum, to ILI diversification.

4. **Experience-Driven Ongoing COI Charges.** ILI employs a maximum premium, minimum life insurance death benefit protection design in order to minimize expenses and maximize cash accumulation. While this design minimizes death benefit, the increased cash accumulation results in greater death benefits at average life expectancy and beyond compared to retail life insurance and its high initial death benefit objective. Issuer long-term profits are based upon the M&E fee, not COI charges, since ILI protection is managed to legislative minimum death benefit protection resulting in $0 death benefit protection and mortality risk charges by age 95, while IRC §7702 tax advantages continue to age 121. Because ILI's insured risk pool has the highest probability of living, although not guaranteed, ILI issuers typically pass through reducing COI's resulting from medical advancements extending life expectancy in order to maximize policy retention of this investment and risk management alternative.
5. **Reduced Agent Compensation.** ILI's 100%+ initial cash surrender value is partially funded through (1) reduced agent compensation rates, (2) compensation payments spread over the first four or five policy years, and (3) four-year commission recapture if the policy is surrendered. The result is typically 45% to 55% less agent compensation through ten and twenty policy years as compared to retail VUL managed in a similar manner. Also, it should be noted that the cumulative ILI compensation (premium commissions plus AUM's fees) to life expectancy is 65% to 75% less than a 0.50% asset-under-management advisor fee on a comparable taxable brokerage account.

Defined Contribution Minimums

Most ILI policies have a $100,000 minimum initial death benefit. The minimum defined premium is either the (1) single premium MEC (Modified Endowment Contract) or (2) 7-Pay non-MEC testing premium level based on the insured's age and sex.

To recap the story, individual access to ILI is limited to:

- Employer-sponsored executive-owned benefits—Employer-paid Bonus 162 plans.
- Third-party ILI administrator sponsored direct access programs—Individual or Trustee funded or cofunded Employee/Employer plans. The individual is not simply buying a policy, but is joining an ILI management strategy. Hence, Individuals/Trustees have direct access to ILI through the issuer-approved administrator.

A Fresh Product Suitability Look Has Evolved for ILI Qualifying Individuals/Trustees

ILI is a more efficient fund investment management structure for individuals, for the reasons explained, and its accompanying death benefit protection reduces the amount of retail life insurance a consumer may need to purchase. From a planning perspective, when the estimated death benefit protection requirement exceeds the amount provided by the ILI policy, it is often more efficient to layer the ILI policy with either a convertible term insurance policy from the ILI issuer (issuers permit term conversions to ILI if distributor is ILI approved) if

the insured is under age 65 (term insurance has lower short-term costs than ILI COI's) or an Equity Indexed Universal Life[10] policy as an asset allocation diversification strategy.

Why Should an ILI-Based Approach Be Considered?

If a retail-priced policy was purchased over the past 35 years, the probability it would underperform its originally illustrated pricing is high for reasons also already explained. By comparison, the probability an institutionally priced policy will outperform its originally illustrated pricing is high. ILI reverse engineers the shortfalls of retail-priced products and limitations of the traditional distribution channel. Hence, for qualifying consumers, ILI should be considered as the core life insurance planning product and supplemented, as needed, with retail-priced products recognizing and efficiently managing their performance limitations.

Observations from the Chief Fiduciary Officer Perspective

- Taxes—Within 10 years, the cumulative cost of taxes in a taxable brokerage account exceeds all three life insurance alternatives.
- CVUL (ILI)—100%+ year 1 cash surrender value minimizes potential impact if planning objectives change. Institutional illustrations typically are conservative in their long-term COIs for their finance audience. It is not uncommon for retail VUL products to illustrate higher long-term values under identical assumptions.
- VUL—The front-loaded COIs and surrender charges typically result in significantly lower cash surrender values in the initial 10-20 years. This is sometimes referred to by agents as the client's skin in the game to access lower illustrated long-term COIs. However, this thinking poses a credibility question: Will the long-term COIs of the general insured population really be less than a separate risk pool of upper income white-collar roles?
- EIUL—The front-loaded COIs are typically higher in indexed products as an additional issuer hedge against the indexed methodology. This analysis also demonstrates the impact of not participating in the total return of the S&P 500. This adverse impact is more significantly demonstrated utilizing a Monte-Carlo simulation on the S&P 500 standard deviation and applying indexed methodologies.
- Procedural Prudence—The trust diversification considerations using CVUL are consistent with the balance sheet considerations of COLI and BOLI decision-makers.

Management Support

Institutional products are offered as a component of an employer-sponsored benefit plan or an administrator-coordinated ILI investment plan strategy. Unlike retail products that can be illustrated in a myriad of ways to fund a myriad of consumer needs, ILI products are illustrated and managed based on a single funding objective—minimal death benefit protection and maximum cash accumulation. The inclusion of an administrator provides for plan management continuity. Further, if the administrator ceases operation, the fallback is the issuer's institutional division that supports the same policy management objective.

ILI requires proactive policyowner support services and interactive communication consistent with both investment management and life insurance best practices—contribution capacity monitoring, monthly fund performance reporting, asset allocation monitoring and rebalancing, protection reduction monitoring, etc. Put another way, with retail life insurance, the retail agent's job typically ends with sale of the policy, whereas with ILI, the administrator's job is just starting.

Additionally, ILI administrators typically provide, at no additional fee to the policyowner, investment level analytics, reporting, allocation

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opportunities, and asset diversification support. The administrator is compensated by the advisor or issuer to provide this added level of services to support this investment management alternative.

Multigenerational Wealth Preservation

ILI's history has been to fund multilife executive benefit plans that may include different generations of management, thus allowing the funding gains at the death of the older generation to enhance the contributions and tax-deferred policy cash accumulation of the surviving insureds. ILI is structured so that the cash value accumulation is comparable regardless of the number of insureds.

Today, some ILI Issuers have extended ILI access to individually owned and funded plans, thus allowing affluent family members as a group, or the trustee of such affluent family members, to take advantage of the same multi-life, multigenerational funding strategy.

A More Suitable Grandfathering Strategy

Since product evolution has promoted the cash accumulation advantages of life insurance, at some point Washington may renew its efforts to eliminate life insurance's tax-deferral feature and start taxing the inside build-up gains on an annual basis.

Historically Washington:

- Does not provide consumers advanced notice—the effective date is based on the day the legislation was introduced, not approved.
- Grandfathers policies that were in-force or in underwriting as of the effective date.

While grandfathering would benefit all cash value life insurance owners, ILI's retention-based pricing model should benefit ILI owners more.

Agent Replacement Activities—Best Practices or Predatory

Retail life insurance uses a replacement-based pricing model. As a result, it is difficult to determine when agent conduct is consistent with a best practices standard that reflects the client's best interests or a predatory practices standard that reflects commission-motivated unwarranted replacement.[11]

By comparison, Institutional Life Insurance uses a retention-based pricing model. As a result, an agent replacement recommendation should initially be viewed as predatory conduct, especially if the ILI policy was issued prior to 1/1/2009 when new life insurance policies transitioned to the 2001 CSO from the 1980 CSO. Because of the required guideline premium testing required by IRC §7702, 2001 CSO policies require 10%-15% higher death benefits than 1980 CSO based policies and, in turn, higher COIs. Older ILI policies are better priced to serve in the investment management alternative role because they can be managed to lower costs.

This comparison also explains why retail and institutional distribution is managed separately by issuers. Conduct viewed as best practices in the retail marketplace can be viewed as a red flag and predatory in the institutional marketplace.

Why Should ILI Be Considered by Estate Planning Attorneys and Tax Advisors for Their Clients?

Pros

- ILI mortality risk rates have less impact on investment gains than trust or individual tax rates. For example, assuming an 8% market total return, ILI's total policy costs reduce lifelong investment gains 5% to 12% (less if you factor death benefit gains) depending upon the individual's age and sex compared to the 15% to 54.4% range of combined Federal, State, and Medicare taxes.
- Minimal or no depletion in current net

accessible cash—ILI's 100%+ cash surrender value minimizes downside risk if planning needs change.

- Supplemental death benefit protection at $0 added investment cost—all ILI financial comparatives do not include a cost factor for additional death benefit protection whereas such protection is a component of traditional buy term and invest the rest comparisons.
- Flexibility to include adult family members to establish multigenerational funding strategy—Some issuers permit the qualifying ILI individual to utilize up to 50% of his/her desired contribution capacity on related nonworking family members. Other issuers restrict ILI access to only ILI qualifying employees and require employer verification of employment.
- Issuers that permit adult family members typically also permit the use of a family member as a surrogate insured[12] if grantor is uninsurable or highly rated.

Cons

- Not available to all career roles—ILI risk pool is typically limited to white-collar roles earning a minimum of $50,000 to $120,000 (2015—Highly Compensated Employee (HCE) Threshold for 401(k), 403(b), Profit-Sharing Plans, etc.).
- Not available for traditional maximum death benefit protection planning strategies—ILI is a defined contribution product. Its death benefit protection is the minimum MEC (modified endowment contract) or non-MEC regulated minimum based on the insured's age, sex, and premium contribution objectives.
- Not accessible from traditional agent distribution—ILI is priced for multilife plan funding administered by issuer-approved specialty plan and ILI administrators. Like the employer-owned ILI marketplace, some approved individually owned ILI distributors allow joint work if permitted by both broker-dealers, although most larger broker-dealers do not permit their reps to work with another firm's reps.

Retail vs. ILI Structure Differential

While all cash value life insurance policies have four core components (loads, administration, crediting, and cost-of-insurance/COI), it is the COI that garners the most attention and debate. Retail life insurance products present multiple COI exposures not found in ILI.

- Guaranteed Interest Crediting—If the policy guarantees a 3% or 4% crediting rate and government instruments used by the issuing carrier for reserve purposes are only yielding 1% to 2%, the issuer will increase the COI charge on in-force policies to make up the difference.
- Health Trends—As explained in the U.S. Dept.

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EDITOR Mark Jones, MBA, CFP
NorthLanding Financial Partners
90 Linden Oaks
Rochester, NY 14625
585-497-5013
mark@northlandingfp.com

CHAIR Michael Kitces, MSFS, MTAX, CFP, CLU, ChFC, RHU, REBC, CASL
Pinnacle Advisory Group
6345 Woodside Court, Ste. 100
Columbia, MD 21046
410-995-6630
michael@kitces.com

STAFF LIAISON Bill Drennan
Managing Editor, Sections Newsletters
Society of FSP™
610-526-2559
bdrennan@financialpro.org

Copyright © 2015 Society of FSP™
3803 West Chester Pike, Ste. 225
Newtown Square, PA 19073-2334
Tel: 610-526-2500 • Fax: 610-527-4010
E-mail: newsletters@financialpro.org
Web Site: www.financialpro.org

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of Health and Human Services 2010 National Health Interview, there are two distinct health groups in the U.S.—the college-educated group earning $100,000 or more whose general wellness is increasing, and the everyone else group whose general wellness is decreasing. Retail product COIs are being adjusted to reflect the everyone else insured group experience.

- Replacement—Healthy retail life insurance consumers are incented to replace their policy periodically in order to access lower COI costs resulting from medical advancements extending life expectancy, and the more favorable select[13] insurance rates resulting from re-proving evidence of insurability. The Center for Disease Control (CDC) annual report on life expectancy in the U.S. has gone from 1-2 week annual increases twenty years ago to 3-4 months for the past five to ten years. Given replacement-based pricing of retail products, it is logical to assume that the major reason a 10- or 15-year-old policy has not been replaced is because a high percentage of the remaining insureds are experiencing adverse health conditions, thus prompting issuers to raise COIs to offset this expected negative experience.

How Does ILI Reduce These COI exposures?

- Guaranteed Interest Crediting—ILI insureds select ILI to utilize its separate account (fund) management options, not its Guaranteed Interest Crediting division, minimizing or eliminating issuer investment market risk exposures.
- Health Trends—The ILI risk pool is limited to individuals whose career and life achievements demonstrate superior wellness.

Conclusion—A Fresh Look at Current-Day Product Suitability

ILI recognizes the consumer need for multiple distribution channels. Traditional life insurance products that address basic "what if I die" death benefit protection needs remain readily available through traditional retail distribution channels. Alternatively, ILI addresses more sophisticated investment and investment/death benefit "what if I live, or live much longer than expected today" needs that require attentive annual performance monitoring and risk management. Hence, ILI requires an alternative distribution channel with unique plan design and management capabilities.

While ILI is well-known in the COLI and BOLI markets, it is little-known in the affluent family and family office markets, as well as by their key legal, tax, and investment advisors. In addition to its established market uses, ILI is ideally suited to multigenerational wealth preservation, management, restructure, and transfer planning. ●

Charles M. "Mark" Whitelaw is the founder (2002) and President of Valley View Consultants, Inc.

E. Randolph Whitelaw, AEP (Distinghished) is a recognized Trust-Owned Life Insurance (TOLI) placement and restructure expert at Trust Asset Consultants, LLC.

3803 West Chester Pike, Ste. 225
Newtown Square, PA 19073-2334