

Executive Summary

Setting the Stage

A law firm referred us into the client's wealth manager. The client had four life insurance policies totaling \$23,500,000. Three of the policies were Hybrid Whole Life policies (mixture of whole life and term) all structured the same; \$6.5M blended with \$4.5M of whole life and \$2M of term. One was a Universal Life policy for \$4M. The wealth management firm had been monitoring the policies to the best of their ability but dividends were decreasing, the illustrations were changing from year to year more significantly, and they did not have enough knowledge about how to interpret the in force illustrations and thus, how to best optimize return.

Scope of the Engagement

Client's goal was to pay \$0 premiums going forward. The assignment was to figure out how to turn \$200,000 of annual premiums into \$0 annual premiums and maximize the amount of life insurance.

Analysis Findings

Hybrid Whole Life can provide some challenges. It is a mixture of whole life and term. The term costs increase each year, so the amount of term has to decrease. The amount of term is decreased by utilizing a portion of the dividend to actually convert a portion of the term annually to paid-up whole life. The excess dividend is reinvested along with the premium to continue to grow the cash value of the policy to support the future costs. The objective is to convert enough the term, so it decreases at the right "speed" based on premium and estimated future dividend payments. The challenge is as dividends decrease if there is too much term in the original mix it will not decrease at the right "speed" and the premium will have to increase or the life insurance will have to decrease.

One of the policies annual statements (John Hancock) said that the policy had \$800,000 of term but in fact, upon further investigation, the term was actually all converted. I also came to discover that the insurance company had designed this policy to never have a dividend paid that was less than the year before! This required finding someone at the insurance company who had the knowledge of past product design - very time consuming and difficult exercise! Both of these discoveries gave me quite a bit to ponder.

The analysis boiled down to the following:

1. Do we keep the term rider premium on the policy and utilize the dividend to offset the premium?
2. Do we eliminate the term rider premium and convert the policy to a reduced paid-up death benefit which zeros out the premium but initially reduces the death benefit?

Scenario #1: The dividend was not quite large enough to offset the entire premium so some of the death benefit had to be surrendered annually to access enough cash value to offset the premium. Eventually the dividend would become large enough to offset the entire premium with any excess reinvested back into the policy.

We illustrated this structure with 3 different dividend scale assumptions, current dividend scale, 50 bps. (1/2%) below current, 100 bps. (1%) below current. Keeping the term rider premium on the policy allowed us to keep the policy death benefit higher than under scenario #2 but also meant that there was a larger drag on the policy because the premium that had to be offset was larger. The other risk was if the insurance company were to change their dividend policy because, in reality, the dividend should have been a lot lower based on the declining interest rate environment over the last 20 yrs.

Scenario #2: Here we would eliminate the term rider premium, therefore lowering the premium and convert the policy to reduce paid-up which means that the death benefit is reduced actuarially based on the amount of cash value. The dividend is adjusted downward because of the very nature of a reduced paid-up insurance and the policy is no longer a premium paying. The dividend, since there is contractually no premium to pay, can now be 100% reinvested back into the policy.

We had to compare these 2 scenarios by finding where the crossover point is in the death benefit growth. Based on our proprietary life expectancy tables the insured could live into her late 90's which was 30+ years from now. The crossover point was 20 yrs. where the death benefit of the reduced paid-up policy (#2) would surpass the death benefit under scenario #1.

The second Hybrid Whole Life policy we analyzed did not have the same dividend structure, had a much higher premium for some reason, and had about \$1mm of term still to be converted. Going through the same kind of analysis we discovered that the crossover point was at about the 26th to 28th year depending on the dividend scale assumption. This policy was better just eliminating the term and having the dividend pay the premium.

The third Hybrid Whole Life policy's premium had not been paid for the last 8 years. The past dividends had been used along with the current annual premium to pay the past 8 yrs. of premiums. The problem here was there were no dividends left to support the policy premium and the term insurance amount was at \$1.8mm. Remember term premiums increase with age so the policy was at a point where the premium of the base whole life policy and the term insurance cost was going to reappear. Our analysis showed that the only option that would work would be to eliminate all the term and convert the policy to a reduced paid-up policy and have the dividend reinvested back into the policy to grow the death benefit.

Universal Life Policy: The fourth policy was Universal Life. Based on the minimum guaranteed crediting rate of 5.5% which was also the current crediting rate my thought was to not pay any future premiums. There was over a \$1mm of cash value and I wanted to see if it would support all the future mortality costs. We discovered that the policy would not run out of cash value until age 98. Normally, universal life policies lapse with no value once the cash value is depleted.



But the actual in force illustration showed the premium reappearing at age 98 and the life insurance in force. I had to call the insurance company with the trustee on the phone to find out why. We came to understand that the insurance company had structured this universal life policy to only require the premium to be paid and the life insurance would stay in force even though there was \$0 cash value!!!

The Bottom Line:

You can see from this analysis is that even though 3 of the policies were structured the same the analysis produced 3 different strategies that fit the particular policy the best in order to optimize return.

We were able to zero out all the premiums and maintain 86% of the original life insurance. By her 85% probability of death (age 97.4) the death benefit was equal to 92% - 97% of the original life insurance depending on future dividend scale assumptions.

Fee:

The Efficient Edge created \$200,000 of savings and maintained a high percentage of the life insurance – goal accomplished for a \$20,000 fee.