Investing With Whole Life Participating Insurance For Affluent Families

By Norm Ayoub, Director, Business Advisory Board — HighView Financial Group November 2011

Overview:

The foundation of any good financial plan ensures that risk is mitigated with respect to potential losses as a result of unforeseen circumstances.

When it comes to life occurrences, no one can predict the timing of death which can create substantial financial loss but be mitigated by the proper application and use of life insurance products recommended by qualified insurance professionals.

At HighView, we work with a number of life and living benefits insurance professionals and coordinate efforts to ensure clients are receiving the appropriate advice by advisors who are experienced and designated with credentials from the life insurance industry such as CLU, CFP, or other recognized certifications.

We do not profess to be experts when it comes to life insurance recommendations. Our role is to be investment counsellors. As such, when life insurance products are being offered as investment or accumulation vehicles, we ensure that clients are aware of questions they should be asking their insurance advisors.

Life Insurance Uses:

We absolutely support the use of life insurance products as part of an overall financial plan for:

- Paying off liabilities such as loans and taxes on death;
- Use in corporate liability situations;
- And other traditional estate planning applications (i.e. Estate Equalizations).

Life insurance professionals are best able to provide the advice and analysis in these circumstances and we defer to their knowledge and experience.

Insurance As An Investment Vehicle:

While the benefits of life insurance are evident when death occurs, life insurance products can also be valuable for asset accumulation for retirement and other purposes such as estate enhancement provided there is sufficient time. The tax sheltered advantages of accumulating capital in life insurance products have been written about extensively, so we will not go into those details.

While the contribution to a life insurance product in the form of premiums is not deductible as with an RRSP, the growth is almost always sheltered while the life product is in place. This advantage enhances the return as measured against other taxable alternatives such as GICs, bonds, and other products attracting either capital gains or interest payments. It is one reason life insurance professionals often recommend the product as part of an overall investment portfolio. It is with respect to the latter use of these products that we wish to comment.

As mentioned, there are advantages to accumulating capital from a tax perspective while a life insurance contract is in place. All other things being equal, this privilege allows a more rapid increase in value because tax is not paid on gains from the investment, and over time, can prove quite advantageous. The nature of the investment portion of these products can be placed either in guarantees or equity but, in either case, no tax is payable until the money is taken from the plan. There are far more details than we can provide in this article and we would encourage clients to seek counsel from a life insurance professional regarding these details before proceeding with the purchase and use of these products as an investment.

However, there are a number of issues that apply specifically to the investment aspects of these products which by necessity raise questions that need to be answered. This aligns with the HighView philosophical approach that before any investment security/vehicle is included in a client portfolio, it should be subjected to rigorous research & due diligence. These, we would like to comment on below.

Insurance & Portfolio Construction:

Recently, there have been illustrations provided by some life insurance advisors to clients that suggest a significant portion of their investment portfolio be deposited in a life insurance product. The product is primarily designed to accumulate cash and, therefore, not strictly used as a protection or risk mitigation product for the risks mentioned above (death).

This type of proposal changes the nature of the recommendation to buy life insurance. It changes the advice provided from one of protection against risk of dying too soon to one that requires analysis of the recommended investment structure and mandate.

In structuring an investment portfolio, there are many factors that are considered and a number of questions requiring answers before proceeding:

- What are funds to be used for?
- When are the funds required?
- What is the risk tolerance of the client?
- What other factors such as taxation, diversification, etc. need to be considered.

We are not going to deal with all of these here in any great length although at Highview Financial we consider all of these before providing investment advice and counsel of course.

The critical approach to investing money is to mitigate as much risk as is possible while seeking reasonable returns. This risk/return equation suggests that the same analysis be used when reviewing life insurance products being recommended as part of an investment plan.

For instance, rarely, if ever, do we recommend exceeding more than 5% -10% of a total portfolio in one investment instrument such as a bond or company stock. This would hold true regardless of the quality of the investment. The reason of course is that we cannot predict the future and even investments which appear risk free can change as a result of economic or other factors. We can all cite numerous recent examples of investments thought to be risk free either failing entirely or being worth much less than anticipated.

Life Insurance Company Business Risk:

The Life Insurance Industry is well-regulated in Canada and there are substantial measures in place to ensure that a company meets certain critical hurdles in order for it to continue to operate and market its products. The companies, for the most part (some are regulated provincially, although none of the larger companies are) are regulated by the Office of the Superintendent of Financial Institutions (OSFI), the same body that regulates our banks in Canada.

While this is a major safeguard for the public, there have been failures of life insurance companies in past years, the largest and most recent being Confederation Life in 1994. However, in spite of this not one policy owner has ever lost money in a failure in Canada. This is primarily because of the regulations imposed on insurers by OSFI and because there is a protection fund contributed to by the insurers that provides benefits when there is a failure.

The regulator has implemented a certain capital ratio upon insurers that provides sufficient capital to meet all obligations to policyholders. This capital base is called the Minimum Continuing Capital and Surplus Ratio (MCCSR). OSFI requires this to be at a level no lower than 120% with a target of 150%. This ratio is similar to the Risk Based Capital (RBC) ratio imposed on the banks in Canada to ensure their solvency in the event of a major financial disaster. Most insurers in Canada maintain a ratio well in excess of 200% or double the amount of liability obligation to their policyholders.

In addition to the regulations, there is an insurance fund called Assuris, an organization that protects Canadian policy owners' benefits due to the failure or insolvency of an insurer. However, there are limits on the amount of protection. Details of the benefits available can be found at their website: www.assuris.ca.

As a result of the above, the risk of failure is rather minimal and should a Canadian Insurance company fail, there are safeguards in place to protect the public/their policyholders.

Life Insurance Policy Dividends:

Another area that requires analysis is the indication that returns from the life insurer issuing the product will continue to be constant. In particular, dividends, or returns, being declared by the companies on these products are being illustrated as having superior returns to other investments based on past years' performance. While there is a statement that they are not guaranteed, frequently the returns are being aggressively promoted as having been better than other conservative investments like bonds or GICs. While this may have been true historically much has changed with regard to the elements which go into the declaration of these dividends, or returns.

- **How Are Dividends Treated For Tax Purposes?** First, there should be an understanding that dividends declared on certain types of life insurance products are quite different from those provided by companies we traditionally invest in. They are not treated the same way for tax purposes for instance, they are treated as interest earnings would be, should you withdraw the funds from the plan prior to death.
- **What Are Insurance Policy Dividends?** Further, dividends as declared by the Boards of life insurers are calculated differently in that the elements that go into arriving at the profits of this class of insurance product are somewhat unique. While top line revenues less expenses are what drive traditional profits, this does not directly apply to dividends on life insurance products. Dividends, as they apply to these life products are actually a return of an "overcharge" of the premiums. This overcharge is what is not needed to fund the product and

so by law 98% must be returned to the client in the form of this dividend. (It should be noted that the type of product we are referring to here is what is called a traditional "whole life" participating product, not what is referred to as a Universal life product which is different in structure)

- **What Factors Drive Insurance Policy Dividends?** There are four elements that specifically apply to these life products that enable profit to be made. They are mortality, interest earned, expenses, and an element called "lapse", that is how long a product remains in place. Actuaries (those charged with determining pricing of these products) attempt to predict how each of these elements will perform in future (the future being as much as 20-30 years in advance). The actual result of each of the four elements is compared to the assumption for each in the price and a positive result is what determines whether profits and eventually dividends will be declared on these life insurance products.
- **How Have Insurance Policy Dividends Performed?** As with any prediction, it is impossible to know what will happen, so in the past, actuaries have been very conservative and this has resulted in very good performance of the dividends. The reason is that mortality has improved dramatically; efficiencies have been attained (reduced expenses); interest rates have been reasonable; and historically many people have not kept their policies longer term. These results have provided the life industry the opportunity to declare excellent dividends in past years even in difficult times. The longer term nature of the life insurance products result in timing differences in relation to the general market in terms of interest returns (premiums invested in longer bonds; mortgages; and property investments, where returns can be higher).
- **How Do Dividends Contribute To Total Return?** The dividend performance forms a major part of what the eventual values will be from these products, as with any investment. This must be considered when analyzing whether to place money in the products and of course how much to place.
- **What Is The Outlook For Future Dividends?** History has been kind to life insurers. This is changing however. There is no guarantee that mortality will improve as dramatically as in the past. Interest rates are at historic lows and the longer term nature of the investment being made by life insurers today could prove negative in future years from a performance perspective. Expense management, while it remains a major goal of all large insurers, becomes more difficult to attain as the industry matures (not a lot of opportunity for further mergers of life companies in Canada). Because people are living longer and the use of life products

has changed, “lapse” rates are not resulting as predicted (companies get to keep all gains from products once they are not in place or retired early, which impacts profits positively).

This environment identifies the real concern that future predictions or illustrations, as with all investments, need to be analyzed carefully and with caution.

Accessing Insurance Investments: Still another area for due diligence by the client and their professional advisors surrounds the eventual need to access the money from the life product. The proposals we have seen frequently involve the use of leveraging (i.e.: borrowing money from financial institutions) in order to remove the money from the product without attracting the taxes that would be payable when retiring the life insurance policy. The advantage is evident in that while accumulating in a tax sheltered vehicle, you may also avoid taxes by using borrowed funds to live on in retirement. The insurance product is used as collateral on the loans with the eventual death benefit proceeds, which are tax free, paying off the debt to the lender.

Borrowing Against Your Life Insurance Policy: Banks are cited as the lender in most cases of course. While the provision is certainly available, and some banks are presently providing the loans, there are considerations to be aware of. Again, because this is such an important benefit being illustrated in these proposals it is an important factor to be reviewed and taken into consideration before proceeding.

The banks are NOT obligated to provide the loans and many will not accept life insurance products as collateral on these types of loans, even if there are cash values that are guaranteed in the contract. Further, many proposals illustrate a factor of interest capitalization where interest is simply added to the loan being taken. In our experience, most banks will not allow this because the loan could be identified as non performing if at least interest is not being paid. This can result in the bank being taken to task by OSFI, the regulator, and penalized in some fashion. There are means by which this can be done but once again we suggest caution in simply accepting this as a given.

Do these cautionary stipulations suggest that clients should not consider placing a portion of their portfolio into a life insurance product? On the contrary, this is <u>not</u> what we are proposing.

In fact, as mentioned, we support the use of the life insurance products as an integral part of a total financial plan. They provide a valuable vehicle that can be part of an asset class that in turn forms part of the investment mandate in a portfolio structure.

Our Advice For Insurance As An Investment[1] :

What we do advise is the following:

1. **Insurance As A Security**: An investment in an insurance vehicle should ideally be viewed as a 'security'. The classification of either a fixed income or equity security would depend upon the underlying nature of the investments within a given insurance contract.
2. **Portfolio Allocation:** That the percentage placed in these products should be viewed as an investment security and as such be reasonable (5% to a maximum of 10% of a client's total investable assets with the former being our recommendation).
3. **Future Performance Illustrations:** That full disclosure with regard to potential performance of future returns is provided using a three illustration approach. The three illustrations should incorporate an expected, best and worst case performance illustration.
4. **Financial Leverage**: That such indication of a leveraged solution is automatically available for removing cash values from the products on a tax free basis need be properly explained and that the advisor or client actually has a bank ready to cooperate. This is a critical part of the advantage of such a proposal and need be confirmed and available. Most life professionals will be in a position to provide this introduction and will have it already arranged.
5. **Fee & Cost Transparency:** While we have not mentioned it in this article, we at Highview provide complete transparency when it comes to the expense ratios charged to the client for our services. The client does get a breakdown of what they are paying for each of the services being provided.

   Life insurance products do have a different form of compensation for the professional advice being provided. This form of payment impacts early performance of the life insurance product and needs to be understood by the client. In our work with life insurance professionals, they do explain to the client these differences and the longer term nature of the products they are recommending. They have found that this transparency avoids the potential disappointment should the client find that they have to terminate the relationship.

1 This advice only applies to insurance being used as an investment vehicle and does not include advice related to insurance being used for other purposes.