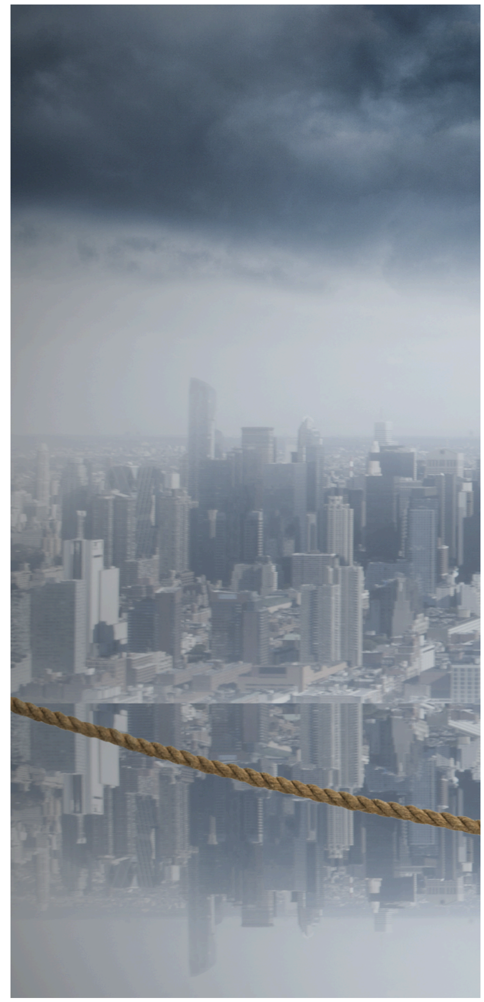
Using the Wealth Gradient in Mortality for Better Policy Performance

By Steven S. Zeiger



In Brief

The wealthy expend a great deal of effort to reduce the costs associated with their investment portfolios, yet often pay less attention to potential cost savings within their life insurance policies. The author examines the ways in which high-net-worth individuals can leverage their economic status to reduce their life insurance costs and keep more of their wealth to enjoy in their later years or pass down to future generations.

In the financial services arena, it is not uncommon for high-net-worth (HNW) individuals and families to negotiate pennies when dollars are flying out the window. Life insurance is no exception, and engaging life insurance advisors with the ability to effectively negotiate life insurance costs can have a positive and meaningful impact on policy performance.

The Wealth Gradient in Mortality

"It's clear that those who have less wealth will have fewer years to live than those with more wealth," says James Smith, senior economist at the RAND Corporation research group (Kimberly Palmer, "Do People Live Longer?" *U.S. News & World Report*, Feb. 14, 2012, http://bit.ly/2arzPBN). The connection is so widely accepted that researchers have named it the "wealth gradient in mortality" (WGM). Conversely, those who have more wealth will have more years to enjoy their wealth. Research has shown that wealthy people have better access to healthcare, and this access promotes longevity.

Enjoying wealth includes fancy restaurants, exotic cars, exclusive clubs, private jets, custom tailors, luxurious travel, and expensive jewelry. These industries cater to wealthy clients who are willing to pay extra for a product or service they consider to be superior or unique. Hedge funds and private equity firms also provide exclusive access to wealthy people, but for a price only few can afford. But for anyone who invests in mutual funds or purchases life insurance, the less expensive option is often the better choice.

Understanding Life Insurance Costs

The cost of life insurance is not just the premium. Rather, it is the amount subtracted from the premium and cash value for policy expenses, premium loads, cost of insurance charges, and subaccount fees. The same holds true for retirement contributions or any other investment; the cost is not the $150,000 annual contribution or investment, but the $1,000 annual fee [66 basis points (BP), for example] charged to manage the underlying investments.

According to Veralytic, a provider of patented life insurance pricing and performance research, the average $10 million face amount policy issued to a 53-year-old male in preferred-plus health will have the following characteristics:

- Weighted-average annual cost of insurance: $154,027
- Weighted-average annual fixed expense: $9,438
- Weighted-average annual premium load: 7.5% of premium

In comparison, a low-cost $10 million face amount life policy issued to a 53-year-old male in preferred-plus health will have the following characteristics:

- Weighted-average annual cost of insurance $91,174
- Weighted-average annual fixed expense: $9,127
- Weighted-average annual premium load: 5.45% of premium

Cost of insurance (COI) charges are deductions for payments of claims and vary based on age, policy age, premiums, and earnings. A weighted average COI is calculated by averaging the present value of each COI charge using the net rate of return. This methodology is complaint with Financial Industry Regulatory Authority (FINRA) regulations. Policy expenses include mortality and expense charges and other account value–based charges, while premium loads include state and federal taxes, charges for policy issue and distribution, and the insurer's operating expenses.

While both policies have the same $10 million death benefit, and both will accrue cash value, the second policy has lower internal charges, lower premiums, and potentially higher cash values. Lower costs allow more cash value to grow and, ultimately, for the policyholder to pay less in premiums. Tracking these expenses is important for both management and negotiation.

Investment Costs versus Life Insurance Costs

As seen above, the average benchmark $10 million life insurance policy issued to a 53-year-old in preferred-plus health has a weighted average annual cost of approximately $170,000. In contrast, a $10 million investment with 50% invested in funds charging a 20 BP management fee and 50% in funds charging an 80 BP fee would have a current annual expense of only $50,000.

According to Tillinghast Towers Perrin (Richard Harris and Russ Alan Prince, "The Problem with Trusts Owning Life Insurance," *Trusts & Estates*, May 2003, http://bit.ly/2apkQnM), Casco (William M. Arnold and Jeffrey C. Harper, "Trust-Owned Life Insurance Poses Hidden Risks," *American Banker*, Feb. 3, 1998, http://bit.ly/2aZ8eSu), and research from Veralytic, there can be as much as a 40% deviation between best available rates and average rates, and another 40% gap between average pricing and poorly priced products. That means that together, there can be an 80% difference in total costs. With such a large spread, it seems counterintuitive to leave so much to chance when acquiring life insurance.

Furthermore, Morningstar, the nation's leading provider of investment pricing and performance research, has stated that "low fees are likely to be the best predictor of a mutual fund's future success" (Jane J. Kim, "Low Fees Outshine Fund Star System," *Wall Street Journal*, Aug. 9, 2010, http://on.wsj.com/2aZKnng). Morningstar elaborated that "using low fees as a guide would give investors better results than even Morningstar's own star-rating system" (Russel Kinnel, "How Expense Ratios and Star Ratings Predict Success," Aug. 9, 2010, http://bit.ly/2aKjhTs).

Based on the above, a prudent individual and his advisors would focus on reducing the cost of insurance charges ($154,027) before negotiating the investment fees ($50,000). HNW individuals, however, are often more likely to focus on reducing the management fees on their investments, missing the opportunity to lower life insurance charges. The principle is the same: the higher the internal costs of the policy, the less money left for the death benefit and cash value.

Negotiating Investment Costs

Peter Fleming, a prominent advisor to ultra-HNW families with Nease, Lagana, Eden & Culley in Atlanta, recently highlighted the focus on investment fees relative to the lack of focus on life insurance fees ("Scoring Points," *Private Wealth*, Jan. 27, 2015, http://bit.ly/2aPkHKP). In the wealth management world, costs (as measured in BPs) mean everything and are mentioned frequently in the negotiation and performance reporting stages. A hedge fund may charge 100 to 200 BPs plus a performance fee; a fund of funds typically charges 50 to Wealth management firms may charge 50 to 75 BPs for managing a $10 million portfolio. HNW individuals and families (and their advisors) routinely negotiate—and pay close attention to—these fees. It is not uncommon for an asset manager to be fired (or not hired) over 5 to 10 BPs of performance fees or administrative costs.

Internal costs are no exception. Advisors have opportunities to achieve meaningful cost reductions inside life insurance policies, including permanent forms of life insurance such as universal, indexed universal, variable, and private placement. Astute life insurance advisors, Fleming recounts, began collecting claims data and lapse experience data to prove and justify lower pricing for HNW individuals. Several decades' worth of data have uncovered key characteristics of the affluent insurance market:

■ The mortality of the affluent market is 21% less than that of the general insured public, primarily because of access to the best healthcare (Society of Actuaries Individual Life Experience Report 2013).

■ The affluent market lapses their policies 60% less frequently than the general insured public because they purchase life insurance for a specific need and have the resources to pay the premiums (*Moody's Statistical Handbook 2012*).

■ The average policy size of the affluent market is seven times greater than that of the general insured public ("A.M. Best Announces the Availability of 2013 Annual Financial Data through BestLink," Feb. 23, 2014, http://bit.ly/2aiAdga).

With better mortality, insurer costs are lower. With lower lapse rates, insurers have more time to recoup initial expenses. Higher face amounts create economies of scale that lower costs for insurers. Based on these characteristics, advisors believed that policyholders should share in these benefits, specifically through products priced to reflect these advantages.

Negotiations for Existing Policyholders

The profitability of life insurance carriers is heavily influenced by the mortality of the insurance pool. If the pool of insured policyholders lives longer than projected, then the carrier takes in more premiums over a longer period of time and delays the projected payment of death benefits. In addition, the carriers also subtract monthly mortality and expense charges from the cash value portion of the policies for longer periods of time. Overall, better mortality results in more profit for the carriers.

When this occurs in the retail market, the carriers keep these excess profits, and they may create a new version of the product. This new version will have better pricing because it reflects the newer mortality experience of that particular carrier's block of business. Policyholders of the new version get the benefit of the more profitable experience generated by policyholders of the previous version. While this is an accepted practice, it raises the question: Why can't carriers reward the current policyholders who created the value?

To take advantage of the better pricing, holders of the original policy must surrender their policy, go through underwriting again, and buy the new version of the product with a new surrender charge. Insurance advisors and insurers focusing on the HNW marketplace saw an issue with this result and presented a compelling case that a portion of the profits in excess of original projections should be returned to existing policyholders. This return of profits manifests as reduction of costs to the existing policyholder and is, in essence, a monetization of the WGM.

Impact of Lower Costs

The impact of lower charges can be significantly positive for a policyholder. In his article, Fleming considers a 65-year-old male who obtained a policy priced for the HNW buyer in June 1997. The $2 million face amount policy was designed to have a non-guaranteed 8% net rate of return with a premium outlay of $85,985 for 10 years. During the ensuing years, the client's life insurance advisors were able to negotiate with the insurer, and the policy experienced three cost-of-insurance charge reductions and three reductions in asset-based charges. As a result, the premium was lowered to $74,065 for 10 years—a 14% reduction.

While past experience is no guarantee of future performance, the principles are solidly in place. The HNW risk pool has experienced 51 cost decreases and no increases to date. From the pricing of the product at the outset to reflect the longer lifespan of the HNW marketplace to the in-force management of an existing policy when an even more favorable experience emerges, an advisor can establish a level of advocacy that delivers real value to clients.

When evaluating product options, a cost management lens can be a good way to evaluate the individual's life insurance portfolio. Affluent individuals can take advantage of their socioeconomic demographics to join a risk pool with an opportunity to participate in future mortality gains and expense reductions. As seen above, the impact of fewer BPs in charges can have an important influence on policies' performance. This is critical when considering the various factors HNW families evaluate when purchasing life insurance. Given the opportunity, affluent families want to take full advantage of the WGM to lower their costs.

Choosing an Advisor or Insurer

Insurance companies can produce detailed expense pages (DEP) for their in-force policies. The DEP looks like the original "as sold" illustration, except it contains updated current annualized charges for policy expenses, premium loads, COI charges, and cash value–based wrap fees. An advisor or insurer who has past experience with cost reductions will be happy to show multiple examples of original "as sold" illustrations along with current DEPs showing lower costs compared to the original illustration.

Several leading insurers offer lower cost life insurance policies that reflect the needs and better claims experience of the HNW marketplace. This cohort of HNW individuals has superior longevity proven by years of experiential data that has resulted in superior policy pricing.

Wealthy families have a constellation of advisors: attorneys, CPAs, wealth managers, trustees, and risk managers. Just as these professionals bring insight and value, the inclusion of a life insurance advisor skilled in negotiating life insurance costs can deliver profound expertise and benefits. ❑

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