

What to Do With Those Old Life Insurance Policies Now that the Kids Are Gone

It's a lifelong expense. Is it a lifelong need?

A Case Study

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This case study is based upon a real situation. Hopefully, it may be of some help or interest to readers who have questions about their life insurance, and particularly those with older policies who are wondering what to do with them.

Background Information

The first of my two case studies¹ involved a couple in their seventies, Mr. and Mrs. Freeman. Mr. Freeman had managed the accounting department of a large Chicago area firm. Mrs. Freeman had been a primary school teacher for 10 years, but soon after their first child arrived, she stopped working to be a full-time Mom for their four kids.

Mr. F earned a high salary for most of his career. More importantly, he had a good old fashioned defined benefit pension plan that paid them \$40,000 per year, with inflation adjustments. They were collecting \$20,000 in Social Security benefits. He had been a faithful contributor to his IRA and, later in his career, a 401K. As a result, they had accumulated \$400,000 in the retirement account, on which they were now taking \$20,000 in annual distributions. They had another \$125,000 in bank accounts and CDs.

His life insurance consisted of five whole life policies: one purchased when they were married, with a new policy added each time a child was born. All the policies were issued prior to 1970. The total death benefit was \$200,000. The cash value in the policies was nearly \$100,000. The annual premiums, which were payable for life, totaled \$7,500.

All in all, the Freemans appeared to be in pretty good shape. Their retirement income from all sources was \$80,000, which comfortably covered their living expense needs. But Mr. F was understandably tired of forking over \$7,500 per year in premiums. In two of the policies, he was having the premium borrowed from the cash value and had accumulated \$15,000 in loan balances. They wondered if they really needed life insurance any more. And, if they did, was the return inside these policies competitive?

¹ Names and baseline data have been changed to protect the confidentiality of the clients. The fact pattern and recommendations are the same.

The couple also wondered if they should continue to invest all of their IRA in the money market fund where it had been securely housed since the 2000-2001 stock market upheaval. They wanted a review of their asset allocation.

The Freemans sought out an hourly financial planner, recognizing that if the best answer for them did not involve a replacement policy, it might be unfair to ask an agent to do this analysis for them. The agents who had sold them the policies had all long-since left the business or retired.

From an investment perspective, they were very comfortable with their account at Fidelity and did not want to move their assets to another firm.

After an initial fact-finding session and a cursory review of their financial statements, I suggested a limited financial planning engagement that would address:

1. A secure retirement income for them and then, probably at some point, Mrs. F on her own for a few years.
2. The need for a permanent life insurance death benefit.
3. The appropriateness of this type of insurance (whole life, in this case).
4. The competitiveness of these particular policies.
5. A portfolio review and recommendation

The retirement income plan was the place to start because it provided the context and framework for a logical decision about the need for insurance, as well an appropriate mix of assets for their risk tolerance and time horizon. The Freemans were living within their means, but being very generous with their children, grandchildren, and church, they did spend or give away all of their \$80,000 income.

Together we identified the four major financial goals that were most important to them:

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| 1. After-tax retirement income for life: | \$60,000 |
| 2. New Buicks every 5 years: | \$35,000 |
| 3. One nice trip per year: | \$ 10,000 |
| 4. Annual gifts for grandchildren's college: | \$ 5,000 |

We assumed the Freemans would live beyond their normal life expectancy, well into their 90's, and that Mrs. F would survive Mr. F by five years, as a baseline. However, we also tested a scenario in which Mr. F passed away earlier than expected and Mrs. F lived for another 20 years beyond his passing. This was important because his pension was set up to pay only 50% of the current amount to his surviving spouse.

All of their financial data was entered into financial planning software, which calculated the probability of achieving the four goals over time. Inflation, taxes and expected market returns were all based on historical averages.

The result: If Mr. F survived to his life expectancy and beyond they could achieve all of their goals. The planning software also does statistical analysis to compute the odds of achieving the goals in various configurations of market returns. This result was a little

less comforting. If the Freemans portfolios earned exactly the expected return every year, without variation, they would be OK. But, in the real world, returns are never exactly as expected every year. If there were some really bad years, especially early in the plan, the projection was that they would come up short in the last years of life.

More disturbing was the scenario in which Mr. F passed on within the next three years but Mrs. F survived another 20. In this case, because of the reduction in his pension, she was projected to run short five years ahead of her life expectancy.

We tested scenarios in which they cashed in all five policies and invested the cash value in various mixes of assets. We considered the result if they took money out of investment assets to pay off the policy loan. In addition, we looked at the possibility of cashing in one of the policies to get rid of the policy loan and keeping the rest. Finally, we looked at the impact of adding assets with a bit higher expected risk and return to their IRA.

Using formulas published by financial author Ben Baldwin (*The New Life Insurance Investment Advisor*) and Indiana University professor Joseph Belth (*Life Insurance: a Consumer's Handbook*), we calculated the rates of return within the cash value accounts of the policies.

Conclusions and Recommendations

The Need for a Permanent Life Insurance Death Benefit

Our first conclusion was that Mr. F did indeed need to keep his life insurance in force. Even though he had not had any 'earned' income for ten years, the reduction in his pension benefits meant that there was still an income replacement need for Mrs. F. This is, of course, the first and most important reason for having life insurance.

The other two core reasons for staying insured are to cover final expenses and for tax efficient transfer of wealth (life insurance death benefits are not normally subject to income tax or to estate tax if the policy is not owned by the insured). Although Mr. F's estate was not projected to incur estate tax, the rules in this area are scheduled to change through 2010 and are uncertain beyond that. His other assets could cover funeral and other final expenses, but having the insurance benefits would mean not having to sell other assets, which could stay productively invested for Mrs. F's long-term benefit.

The Appropriateness of This Type of Insurance

The reasons for having the life insurance would last Mr. F's whole life. Therefore, permanent insurance was appropriate. We had his policies analyzed by a service of a large well-respected life insurance company that sells no-commission policies to clients of fee-only advisors. Their conclusion: based on this client's age and health situation (some issues here and there), there was not likely to be a significant benefit in switching

to a newer generation policy. We did suggest to Mr. F. that if he wanted to look into the possibility and were willing to have a physical exam, this could be further investigated.

The Competitiveness of These Particular Policies

By in large, however, the whole life policies appeared to be fundamentally appropriate for the Freemans situation. The rate of return calculation revealed a range from 2% to 6% among the policies.

At the low end was the policy on which Mr. F had borrowed. Although policy loans are factored into the Baldwin formula, it appeared that the insurance company used a less favorable dividend scale for policies that had loans outstanding.

In general, however, the policies were competitive for what they are: guaranteed, fixed dollar investments that accumulate assets on a tax-deferred or tax-free basis. They are also quite liquid because of the loan provisions in the contracts.

When viewed next to comparable investments -- bank accounts from a guarantee perspective and municipal bonds from a tax perspective -- the returns appeared to us to be reasonable. These particular policies had been issued by three of the largest, oldest and most respected insurance companies. All had A+ A.M. Best ratings. Therefore, we felt they could be counted as part of the 'cash' or 'non-taxable short-term bond' component of an asset allocation.

Portfolio Review and Recommendation

Based upon the Freemans answers to our standard risk tolerance questions, the indicated asset mix was 55% equity/stocks, 43% fixed income/bonds, and 2% cash. Mr. F knew that he had tried to 'time the market' before 2001 and had been badly bruised in the downturn. He also seemed to understand that he had been his own worst enemy by then hunkering down in a 100% cash portfolio and missing all of the bull market gains that had come in the five years since. Still, as things had become more unsteady in the markets this year, it seemed unduly aggressive to go full bore into equities again.

We did a separate "liquidity test" which sets out the cash needs of the clients over the next ten years and allocates equity exposure only to the needs that are further away in time, much more to bonds in the intermediate term, and all to cash in the next 12 to 18 month range.

Also factored into our thinking was that their other sources of income -- the pension and Social Security -- were substantial, reliable, and inflation adjusted. Plus, they had significant holdings in safe, cash-like whole life cash values. In short, they were well-anchored.

Owing to the ages of the clients and their needs for cash now and in the next several years, we suggested a modest move back into equities at 20% (12% large cap, 6%

developed international, and 2% small cap). More importantly, we recommended a significant movement of cash into short and intermediate-term bond funds, with a 60% allocation. Although bonds have yielded little more than money market funds in recent years, this is not the historical case. The remaining 20% would be split between cash and CDs or money market funds.

The expected return from the new asset mix was about 1.5% higher. This had the impact of making our projections for the Freemans retirement income much more secure, especially if he did predecease her by a substantial number of years.

We suggested five very low cost, no-load index mutual funds that could be held in their Fidelity accounts without the necessity of moving the money or incurring a commission.

Life Insurance Recommendation

We identified one of the oldest policies as having cash value very nearly equal to its face amount. This meant that cashing it in would not sacrifice much in the way of benefit. And, the premiums Mr. F had paid into this policy were greater than its cash value. So, there was not likely to be an income tax liability for cashing it in.

Accordingly, we recommended that he surrender that policy, using the cash value to pay off the other policy loans.

We also recommended that he write to the companies and instruct them to apply all future dividend payments to the premiums due, rather than to paid-up additional insurance, as had been the case.

We encouraged Mr. and Mrs. F to continue to pay the premiums on the remaining policies, thinking of them as additional tax-favored savings, rather than an onerous extra expense.

Next Steps

Our report included some simple guidelines and a timetable for periodically rebalancing the portfolio. We included a check-in phone call to answer any questions that might come up in making the suggested changes in the scope of this project. We suggested a brief follow-up and review in 6 months.

Longer term, our recommendation was for annual checkups if there were no major life changes or market events. The Freeman's asked for reminders and to be on our e-newsletter circulation list.

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