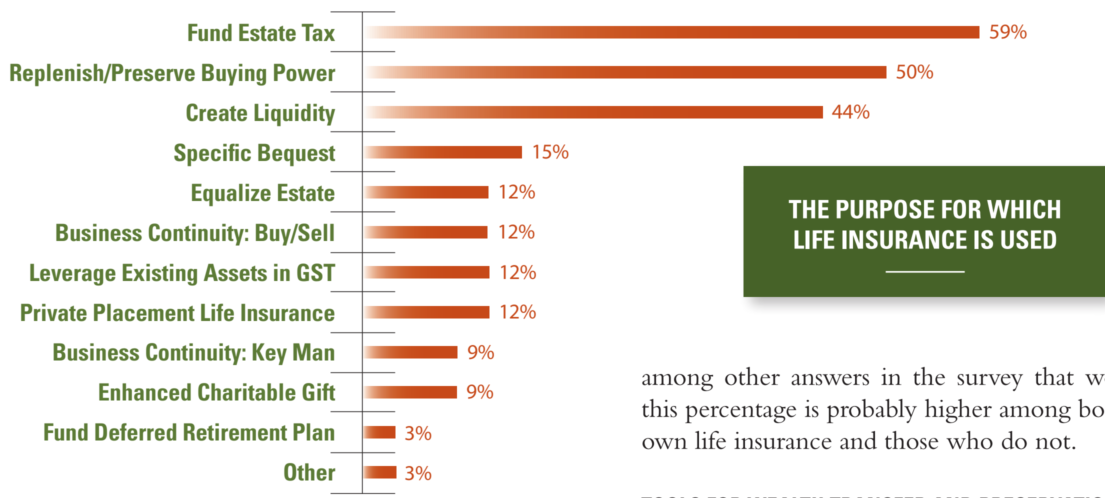
INDUSTRY VIEW

By Michael J. Brink and Thomas R. Love

Untapped Potential

Most affluent families own life insurance, but many fail to leverage its full investment capacity.



THE CONSENSUS AMONG EXPERTS is that a family must have at least $150 million in net worth to maintain an individual family office, and the Family Office Exchange's average client holds more than $300 million in liquid assets. So obviously, these families are not candidates for something as mundane as life insurance, right? Not according to our recent survey, which reveals this and other myths regarding the use of life insurance within family offices. The survey was designed in conjunction with Atlanta-based Nease, Lagana, Eden & Culley, a life insurance advisory firm.

WHO USES LIFE INSURANCE AND WHO DOESN'T?

Nearly nine in 10 respondents personally own life insurance, in trust or through their company, and 59 percent anticipate adding additional coverage. The majority (56 percent) own five or fewer policies, indicating a potential concentration of risk in an insurance carrier and/or the underlying design characteristics of the policies. This, along with other issues, suggests that life insurance is not subjected to the same due diligence and scrutiny as other financial assets.

Of the 13 percent of family offices that do not own life insurance, all admit they use other techniques: Two-thirds say they are self-insured, but half report that it costs too much. While only 20 percent of the respondents admit they do not understand life insurance, we see inconsistencies among other answers in the survey that would indicate this percentage is probably higher among both those who own life insurance and those who do not.

TOOLS FOR WEALTH TRANSFER AND PRESERVATION

Life insurance is largely used by family offices to fund estate taxes (59 percent); replenish or preserve buying power (50 percent); and create liquidity (44 percent). No other option in the survey, including estate equalization, business continuity or enhancing charitable gifts, exceeded 15 percent.

Family offices have begun to recognize and react to the effects of the dilution of wealth across multiple generations. Without intervention, the buying power per individual of each generation diminishes significantly, primarily due to two factors: estate taxes and the growth of the family outpacing the growth of the assets.

Assuming living expenses and philanthropy offset investment growth, if a couple worth $100 million has four children, and they each have three children, individual wealth shrinks to $25 million each for the children and then to $8 million for each grandchild. Estate-tax burdens further diminish the amount of wealth transferred. Today family offices are turning to life insurance to both fund estate taxes and replace at least a portion of the wealth lost to the unavoidable dilution that comes with multiple heirs.

Wealthy families are also beginning to view life insurance as an alternative investment strategy, as reflected in the 12 percent that use it to leverage generation-skipping trust assets. For those with a multigenerational view, insurance can be an attractive asset class when measured by comparing the premium to the coverage amount—and when families consider its tax advantages, potential stability, predictability and noncorrelation to other investment alternatives.

PRODUCT TYPES

It appears family offices primarily utilize life insurance for long-term planning strategies, such as funding estate taxes, creating liquidity and preserving purchasing power. However, the prevalence of term life insurance with its limited time horizon and lack of availability for older adults seems to conflict with the long-term nature of these goals. Individuals we surveyed appear to own a majority of term, whole life and no-lapse guarantee policies, which have little or no inherent flexibility to adapt to future changes.

Our respondents use products with transparent pricing and built-in flexibility, such as universal life, variable life and private placement less often. This surprises us, considering the apparent conflict between families' stated goals and the type of coverage they own, as well as the pricing transparency lacking in certain term products.

OWNERSHIP STRUCTURE

Sixty-two percent of family offices use irrevocable life insurance trusts to own insurance, and 21 percent of products are owned by an individual other than the insureds. Both strategies enable families to avoid having to include death benefit proceeds in an estate. However, the survey revealed that 80 percent use either a family member or family office executive as trustee, which raises liability issues.

Typically, people enter a trustee role with limited concern over and little or no strategy for active review, management or benchmarking. They are usually surprised to learn the extent of their liability if they are ever faced with a family upset by underperformance or claims that they could have received millions more in benefits by using a different product design. Nearly half reported personally owning at least a portion of their life insurance, which will result in not only the death benefit being included in their taxable estate, but also those proceeds being taxed upon death.

KEEPING TABS

We are encouraged that 71 percent of family offices report having completed a life insurance policy review in the past 12 months. The areas most commonly examined include ongoing coverage suitability (100 percent); policy performance to date (86 percent); premium adequacy to maintain coverage in the future (83 percent); and reprojection of future performance at current pricing (82 percent).

Ninety-two percent of those doing reviews examine the guaranteed duration of the insurance coverage, yet only 6 percent reported utilizing no-lapse guarantee coverage, a form of universal life that provides guaranteed premiums and death benefits, largely at the expense of reduced or eliminated policy cash-value accumulation. Although 44 percent reported owning at least some whole life, which can provide guaranteed coverage, the survey doesn't reveal how many of them use nonguaranteed dividends to reduce premiums or support nonguaranteed term riders. Thus, a number of respondents may believe they own a guaranteed product, but have lost those guarantees through product design changes they don't fully understand.

One in five respondents does not continue to review the financial strength of a carrier or the impact of mergers in the insurance industry. Would one in five respondents ignore the financial position of firms in a stock portfolio when reviewing investments? Once again, it appears life insurance is treated with less diligence than other assets.

KNOWLEDGE LEVELS AND NEEDS

Several survey questions focused on the degree of comfort and understanding regarding life insurance. Family offices appear to have a firm grasp of the purpose of existing coverage and the impact of lower interest rates on policies. In addition, survey respondents purport to have a good appreciation for various gifting and wealth transfer strategies.

On a scale of 1 to 5, with 1 indicating a low degree of understanding and 5 a high degree of understanding, survey respondents rated their ability to adjust insurance terms to align with changing circumstances at 3.7. This indicates most of our respondents feel they understand the flexibility or rigidness of their coverage. However, this again seems to conflict with the survey findings that show 85 percent own term insurance, 44 percent own whole life and 6 percent own no-lapse guarantee coverage. The least understood insurance purposes include: leveraging existing assets in generation-skipping trusts; using insurance for business continuity/buy-sell situations; and using insurance as an alternative investment strategy. This is consistent with our survey showing only 12 percent of respondents employ life insurance for those strategies.

Family offices clearly value life insurance as a vehicle for achieving many financial goals, especially funding estate taxes, creating liquidity and preserving buying power. It further indicates that family offices understand the need to properly manage an existing life insurance portfolio and have become more active in doing so. But family offices must also reevaluate the way they manage life insurance as an asset less important than others. They should apply the same depth of quantification and due diligence used in determining the appropriateness of other investments. W

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