

# Beyond Liquidity: A Framework for Assessing the Life Insurance Needs of the Ultra High Net Worth

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At some point in life, nearly everyone will have a critical need for life insurance. In many cases, this need is readily apparent. Consider, for example, the family wage-earner who purchases term life insurance to replace the income that would be lost in the event of his or her premature death. In situations such as this, the need for life insurance is clear and it is relatively easy to assess both the type and amount of life insurance needed.

As individual financial situations change, however, the need for life insurance may diminish or completely disappear. As the need for life insurance changes, decision making about insurance needs becomes more confusing. Compounding the confusion are life insurance professionals whose own objectives can lead to compromised advice. A lack of understanding about the need for and type of life insurance often results in the purchase of too much or the wrong kind of life insurance. Some individuals may be skeptical of the way life insurance is sold; as a result, they may not purchase life insurance even though a legitimate need exists.

We do not sell life insurance. It is our goal to help our clients develop a clear, unbiased understanding of how life insurance does or does not fit into their wealth management plan.

## A Common Myth

For years, the life insurance industry has helped to generate significant confusion through a variety of marketing initiatives. Over the last decade, the industry has positioned the purchase of life insurance as a simple method of estate planning. On the surface, their sales pitch sounds reasonable: To ensure heirs receive an inheritance equal to the insured's net worth, simply purchase life insurance in a trust (designed to be outside of the taxable estate) with a death benefit equal to the anticipated estate tax liability. The death benefit "replaces" the dollars lost to estate tax, allowing heirs to receive an amount roughly equal to 100% of the insured's current net worth.

The insurance industry does not discuss, however, that, except in the case of premature death, other investments could just as

easily have been positioned outside of the client's taxable estate with the goal of "replacing" dollars lost to estate tax. This plan also fails to address the cost of funding the life insurance policy over the client's lifetime.

Reflexively buying life insurance to "fund" estate tax liability is *not* estate planning. True estate planning should involve efforts to *reduce*, not just fund, the projected estate tax liability. While it is true that life insurance can increase the percentage of the estate available to heirs, the purchase of life insurance as the industry sells it does little to decrease the actual estate tax liability paid.

## The Perfect Fit

At the most basic level, life insurance is a risk management tool that is used primarily to address three concerns: survivor income needs, estate tax liquidity needs, and estate equalization needs.

The most common use of life insurance is to address **survivor income needs**. The proper life insurance policy can provide financial security for survivors in the event of the income producer's premature death. For individuals building wealth, this need is often temporary; as the wealth grows, the income producer becomes "self-insured" and is able to provide for survivors with no outside support. Another common survivor income need arises in second marriages when there are heirs from the first marriage. Oftentimes, the estate plan intentionally directs the bulk of the wealth to surviving heirs, not to the second spouse. Life insurance can be used to provide financial security for the surviving second spouse without impacting the heirs' inheritance.

For those with liquidity constraints, life insurance may be crucial to meeting **estate tax liabilities**. For example, when the bulk of the gross estate is composed of real estate, closely-held business interests, or assets that the family wishes to retain, life insurance eliminates the need for a "fire sale" to create liquidity to pay the estate tax. The assets can then be transitioned or disposed of in a manner that is of the greatest financial benefit for the survivors.

Life insurance is also beneficial for **estate equalization**. Most families strive to treat their children equally in estate planning. However, equalization can be a challenge. Consider, for example, a closely-held family business in which one child is intimately involved and other children are not. If the family business accounts for the majority of the family's wealth, it can be difficult to treat all children equally if the parents feel it is appropriate to leave the family business to the more involved child. Life insurance allows the parents to direct the life insurance death benefits to the less involved children to equalize the inheritance of the children.

Finally, many life insurance professionals encourage clients to view life insurance as an **investment**. Because the return on a life insurance policy is greatest in the event of premature death, life insurance can be viewed as a mortality hedge that will provide a windfall in the event of an unexpected demise. Some argue that, from an investment portfolio perspective, life insurance should be viewed as an entirely separate asset class whose performance is tied primarily to the insured's mortality rather than to the financial markets. Even in the event of a normal life expectancy, some policy illustrations show respectable internal rates of return on death benefit and /or cash value to cumulative premiums paid. Because the illustrated internal rates of return may resemble bond-like returns, many insurance professionals urge clients to view this "investment" as a portion of their overall fixed income asset allocation.

## Beyond the 'Perfect Fit'

We have found that many ultra-high net worth (UHNW) individuals have determined that the common needs for life insurance do not apply to them. This is especially true for individuals who have a relatively liquid and well-diversified portfolio. They will likely be able to meet potential estate tax liquidity requirements without life insurance. Depending on the level of spending, these individuals often have more than enough wealth to provide for survivors in the event of premature death. If they are not interested in owning life insurance as an investment or already have exposure to this "asset class" through existing life insurance, is there a need for life insurance?

*In assessing the need for life insurance once you move beyond the perfect fits, the analysis should turn to whether life insurance is needed to manage the risk that the client's wealth will decline below the minimum amount the client wished to leave to children, heirs or charity at death.*

This decline in wealth could occur for any number of reasons, including overspending, investment underperformance or untimely death. To determine if life insurance is appropriate, the client must first determine whether their wealth transfer goals are at risk and then evaluate how much and what type of life insurance coverage can help mitigate this risk.

To that end, GenSpring has developed a proprietary framework to help clients analyze their life insurance needs in an unbiased, agenda-free manner. This analysis is framed around one very important question that clients must answer: What is the minimum level of wealth, in today's dollars, that he or she wants to pass to children, heirs or charity at death? This critical question is often very difficult to resolve and will likely require a great deal of time and reflection.

Once the client has determined the amount to be passed on, the next step is to analyze the impact of several variables on the client's ability to achieve this wealth transfer objective. To complete this analysis, the GenSpring financial model takes into account five key variables:

**1. Spending patterns** - *To what extent does the client feel that the current level of spending will remain constant, decrease or constantly increase?*

**2. Investment philosophy** - *Is the client's overall investment philosophy conservative, moderate or aggressive?*

**3. Investment performance** - *What are the potential outcomes if the investment performance exceeds expectations, meets expectations or falls below expectations?*

**4. Opportunities for new wealth creation** - *Does the client have any portion of his or her wealth designated for new opportunities? If so, what are the odds that these opportunities will result in new wealth that is available to meet wealth transfer objectives?*

**5. Estate taxes** - *Estate taxes are often the largest impediment to meeting wealth transfer objectives. To what extent has prior estate planning reduced the liability?*

This exercise provides a “gap analysis” that identifies and tracks, on a year-by-year basis, any gaps that exist between the wealth transfer goals and the wealth available to meet these goals. A gap may indicate a need for life insurance, or may prompt clients to revisit their spending, investment and wealth transfer objectives. As those changes are incorporated in the model and different results emerge, life insurance needs may increase or decrease. The two examples below show how this gap analysis can provide a framework for determining life insurance needs beyond the basic levels.

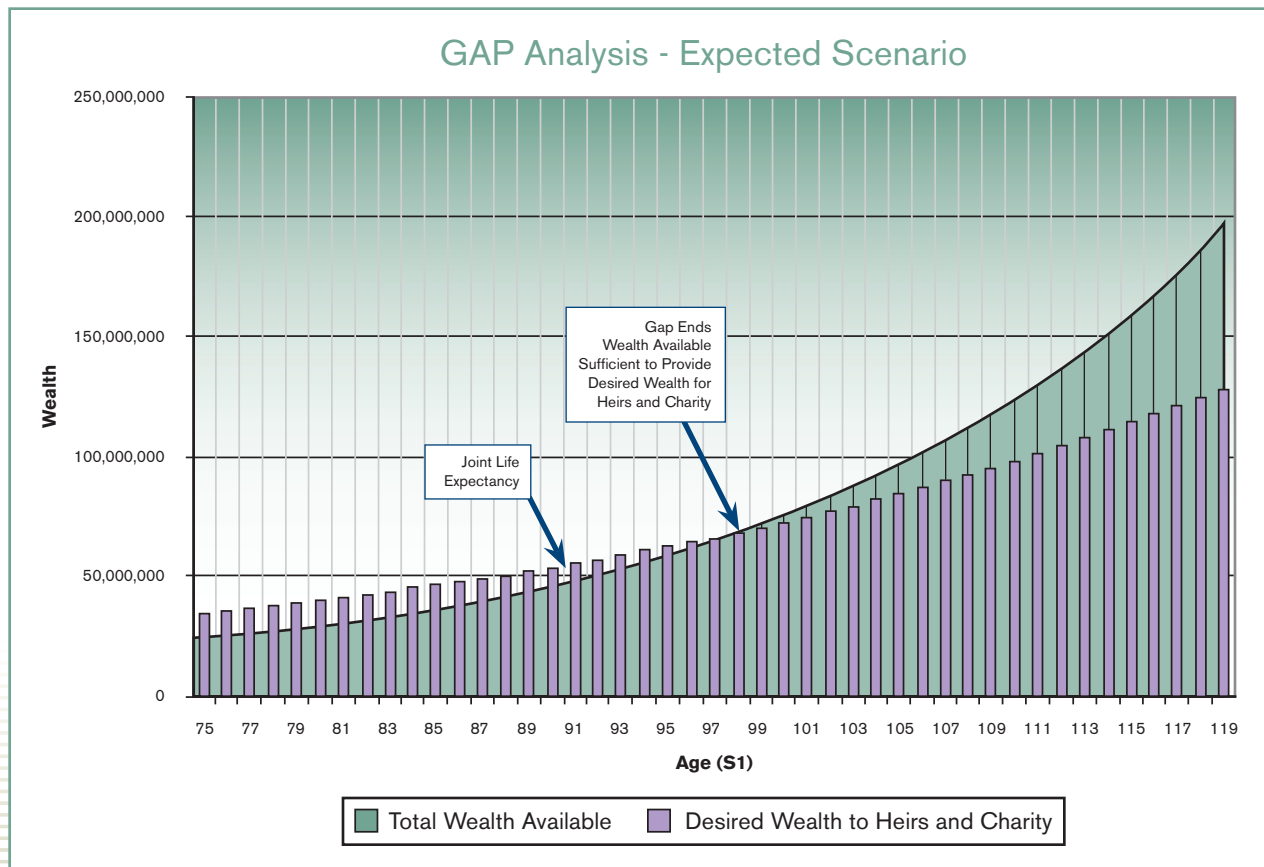
In the first example, we generated the following gap analysis for a married couple, ages 75 and 76, with a net worth of \$40 million. After much reflection, they decided that they wanted to leave a minimum of \$10 million to each of their three children. They also wanted to ensure that a minimum of \$4 million would be available to fund a private family foundation. The additional factors taken into consideration were:

- Personal use assets (art and personal residences), accounting for approximately 10% of the wealth
- \$2 million earmarked for a future business venture with a son-in-law; the business has an estimated 50% chance of success

- Living expenses of \$400,000 per year, expected to remain constant
- Conservative investment philosophy

Based on these assumptions, the analysis identified a significant gap between the amount of wealth the clients desired to leave to their children and charity and the amount of wealth that would be available to meet these goals.

The blue bars represent the desired wealth to children and charity, and the green line represents the wealth available for meeting these goals. At age 75, the gap is around \$10 million, then gradually decreases each year and ends at age 98. At that point, the gap disappears and a surplus of wealth beyond what is needed to meet their goals begins to develop. We considered this gap to be permanent because it continued well beyond their joint actuarial life expectancy. The analysis revealed a genuine risk that they would not be able to achieve their wealth transfer goals, and indicated a possible need for life insurance to help mitigate this risk. The analysis also proved helpful in determining the appropriate death benefit and policy type.

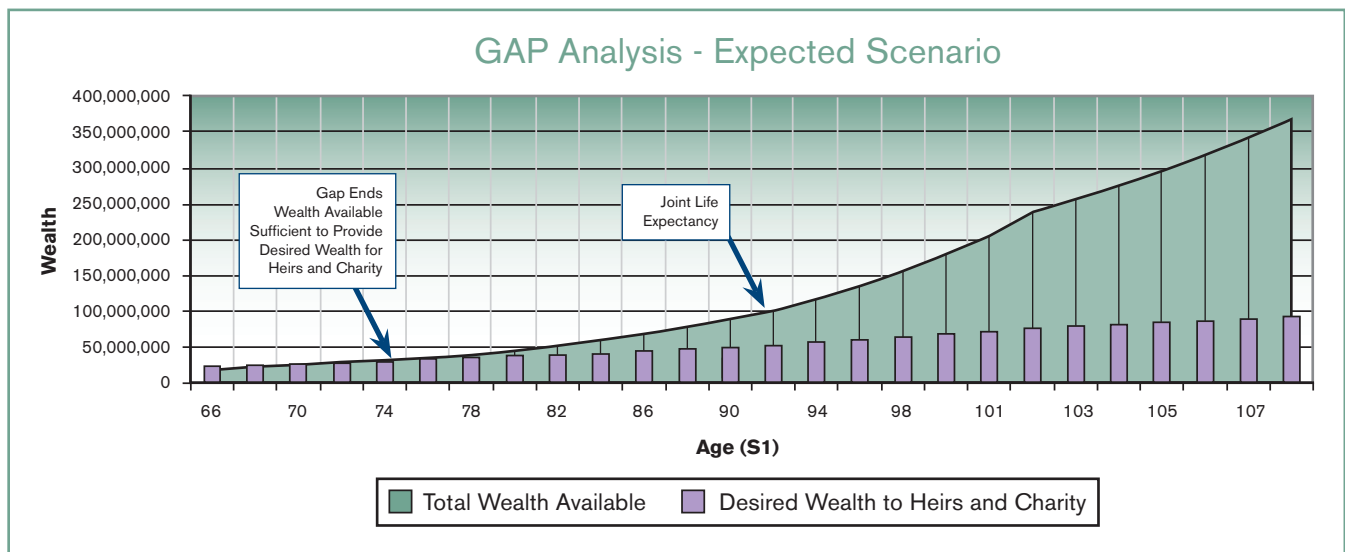


Not all analyses will suggest a need for life insurance. In this second example, we generated the following gap analysis for a married couple, ages 66 and 64, with a \$30 million net worth. After careful reflection, they decided that they wanted each of their two children to receive a minimum of \$10 million upon their deaths. They also hoped to leave \$5 million to various charities. The additional factors taken into consideration were:

- Personal use assets (personal residences) accounting for approximately 15% of wealth
- Living expenses of \$300,000 per year, expected to remain constant
- Moderate investment philosophy

The analysis identified a gap between what the clients desired to leave for children and charity and what they would have available to meet these goals. In this situation, the gap lasted around five years, disappearing when the clients reached ages 74 and 72.

Based upon the results of this analysis, the clients considered purchasing short duration, term life insurance to manage the risk over the gap years. In the end, they decided they were willing to live with the short-term risk rather than purchase life insurance, primarily due to an aversion to paying life insurance premiums and the husband’s reservations about life insurance health examinations. Despite the fact that they did not purchase life insurance, this framework helped them quantify the risk and provided solid guidelines to help make an informed decision.



## Conclusion

For many, life insurance is a powerful risk management tool that can provide an added level of financial security. At the same time, however, the insurance industry oversells life insurance as a key estate planning component that is appropriate for all

individuals, regardless of net worth. For UHNW individuals, the traditional needs for life insurance may not apply, yet these clients may still have a need for life insurance.



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