

Bill Boersma - Blog

Life Insurance for Charity & Nonprofits

The non profit community is a market with which I work on life insurance strategy development as well as provide policy audit and policy management services. What I see is interesting. The institutions that you would think may have numerous policies have almost none and others that you would guess not to have many policies have scores or a few hundred. My observation is that it is largely due to the past directors and whether or not they had friends or donors in the life insurance industry.

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Regardless of how many policies are owned for endowment purposes, they are seldom managed, let alone managed well.
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With inevitable turnover in staff, distanced relationships with donors and the poor performance of unmanaged policies over time, many non-profit directors are quite disillusioned with life insurance, don't know what to do with what they have and certainly don't look forward to taking on more.

The concept of utilizing life insurance as part of an diversified endowment building practice is quite sound and I will discuss the economic dynamics of this in Part II. However, as with any good idea, implementation and management is critical for long term success. I will share two stories to illustrate the importance of this.

A couple of years ago I was contacted by a college to review a policy on the life of a major donor which had been in force for a couple of decades. This is an exceedingly wealthy individual who is surrounded by the best council money can buy. However, as you will see, that really doesn't mean a lot to this part of his planning. Over the years this individual

had paid seven figures in premium into the policy with the intent of creating an endowment for the school. When I was brought in I immediately set off on performing a policy audit to determine the health and longevity of the policy relative to the health and longevity of the donor.

The short story is that the policy was performing so poorly due to continuous declines in the interest rate market and a lack of policy management, that my report to the foundation director was that the policy would not last until Christmas, let alone the life of the insured. In fact, the policy was performing so poorly that the insurance company was unable to run ledgers showing what it would take to keep the policy in force because the amount of money the policy needed to survive on a year to year basis would violate insurance and tax guidelines limiting how much money could be put into a policy. It was unsalvageable. Furthermore, it was so bad that even the life settlement market had no interest in it. The policy lapsed and was literally thrown in the garbage soon thereafter.

To add insult to injury, five years earlier the policy had \$500,000 of cash value and a respected agent told the foundation director that the policy was "fine". Unfortunately, this was never the case. Nothing had transpired in the past five years to make this happen. Five years earlier I could have shown, give or take a few months, when the policy would collapse. Instead, without a thorough audit and valid information, the policy burned through the \$500,000 of cash value as well as the \$50,000 in annual premiums being paid. In other words, \$750,000 in cash value and cash flow was wasted which could have otherwise been directed into an alternate investment from which the foundation would realize a benefit.

Upon further review of the portfolio, our analysis showed that all but one of the

remaining policies owned by the foundation would likely fail before the insured's/donor's life expectancies, if substantive changes were not made.

The next example is about another college which hired us to evaluate their entire book of business which consists of the better part of a hundred policies. This portfolio is a mix of whole life, universal life and variable life policies. The result of our audit process is that, though almost every single policy is underperforming expectations, some of the policies are fine, some are just hanging on and some are disasters and have no hope of ever paying a death benefit.

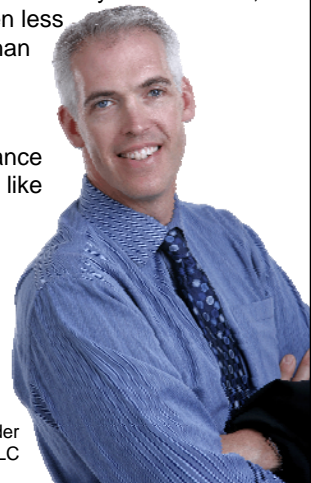
Without getting into the gory details, by the end of the analysis my expectation is that the portfolio of policies will be significantly smaller but it will be a portfolio of properly funded, quality policies with a known expected internal rate of return all wrapped up with an ongoing management philosophy and system.

Every life insurance portfolio of any charity or foundation I have ever reviewed represents another chapter of the same story. Though there is nothing about these charity owned policies that makes them fundamentally any better or worse than other policies, they are performing poorly because they tend to have, in my experience, even less active management than other policies.

So the mantra continues... life insurance needs to be managed like any other financial transaction.

Continue...

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So, after writing about the poor state of charity owned life insurance in Part I, why is life insurance regularly utilized in charity planning and what's my take on it? This discussion will focus solely on the economic dynamics of a life insurance policy from a "dollars in, dollars out" internal rate of return perspective on a premium to death benefit basis.

In 2009 I coincidentally had the opportunity to work with three different couples where the husband was age 73 and the wife was age 71. In each instance I was retained for trust owned policy audit work pertaining to the clients' estate planning. However, in each circumstance, the clients were also charitably inclined so I took the opportunity to discuss the role of insurance in charitable planning and related the following numbers. I initially discussed the concept with one of the couples whose estate plan called for donating \$3,000,000 of the estate to a local charity upon death. There was already some concern about sufficient liquidity for paying federal estate taxes and taking \$ 3,000,000 off the top would likely only exacerbate the situation. In such a plan, charity and the IRS would get their pound of flesh with no consideration to liquidity requirements of the business or the children as successor owners.

For a reasonably healthy couple this age, survivor life insurance is priced at roughly \$20,000 per \$1,000,000 for a new policy with guaranteed death benefit and guaranteed premiums paid every year. Also, these couples are all in the top income tax bracket and I'll use a combined federal, state and local rate of 40%. We'll also assume that if a tax exempt entity owns the policy, whether it is the ultimate charity of choice or a family foundation, the full annual premium is tax deductible. At 40% the real annual cash flow is \$12,000; no different than a donation of cash for any other purpose. Let's look at the internal rate of return (IRR) of the full premium and the net cash flow (CF) to death benefit (DB) at a few different intervals:*

The 50th percentile actuarial life expectancy for a 71/73 year old couple is 22 years when this hypothetical transaction would result in a 10.4% IRR on Cash Flow to Death Benefit or 6.4% IRR on Gross Premium to Death Benefit.

Yrs	Ages	CF to DB	Prem to DB
15 yrs	86/88	19.6%	14.0%
20 yrs	91/93	12.3%	8.1%
25 yrs	96/98	8.3%	5.0%
30 yrs	101/ 103	6.0%	3.1%

This is a net guaranteed rate of return which I will argue is a non-duplicable transaction on a risk adjusted basis. So here is the argument; if there is charitable intent, cash flow and the commitment to premiums, why not consider layering in life insurance as a part of a comprehensive charitable plan for the right clients/donors? By incorporating a guaranteed life insurance policy with a quality life insurance carrier, one can conceivably decrease the investment risk of an endowment portfolio without mitigating return or increase the return on a portfolio with out increasing the risk.**

My wife and I created a Family Foundation some years ago and from the money we contribute annually, some flows through to our ongoing interests and some is retained to build an endowment. When I consider the endowment portion of the Foundation, I have to choose investment options. Upon realizing that at life expectancy, premiums put into a \$1,000,000 guaranteed survivor life policy would return roughly 6% on a premium to death benefit basis and over 7% on a cash flow to death benefit basis for a guaranteed transaction, it made sense to allocate a small portion of the annual giving or endowment funds to such a policy. In addition, if my wife and I go down together in the near term, the full \$1,000,000 comes into the Foundation to accomplish our goals though we didn't have time to build it up.

In almost every other financial portfolio the professionals and common sense suggest diversification, so why not in a charitable endowment portfolio? I wouldn't suggest allocating a large percentage of such a fund towards life insurance premiums but committing some of the income off the assets or even some of the endowment fund principle to a properly created and properly managed plan will likely make a meaningful difference.

One thing to keep in mind for those advisors or donors who feel queasy about committing to a potentially decades long premium stream is to evaluate a guaranteed short pay premium scenario or even a guaranteed single pay insurance policy.

In summary, for any given client/donor situation, bringing options to the table for consideration is rarely a bad idea. We look forward to hearing from you whether you concur or want to challenge any part of my comments or to discuss in more depth what we see happening in real life in the market.

*illustrating IRR on after tax cash flow is not intended to argue for repositioning current charitable giving cash flow from investments to insurance premiums but to encourage an increase in charitable giving cash flow. Otherwise, traditional investment IRR on after tax cash flow would have to be calculated as well to have an apples to apples comparison.

** The diversification argument does, however, argue for repositioning some current cash flow from traditional investments to life insurance when leveraging cash flow for endowment giving purposes.



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