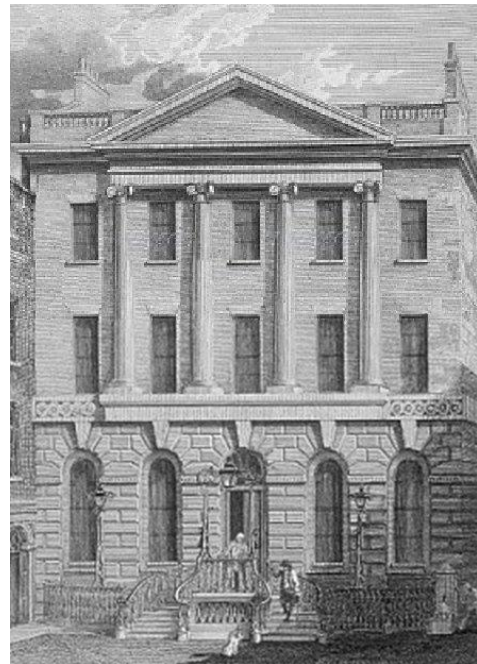


## Durbin Bennett Informational Deep-Dive Series: Private Placement Life Insurance Explained

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The first life insurance policies in history were issued in London by the Amicable Society for a Perpetual Assurance Office in the 1700s. As if the verbose name of the company were an indication of the intimidating and complex nature of the product, nearly three hundred years later the inner workings of life insurance remain a mystery to most.

The purpose of this paper is to (I) explain how life insurance works at a very high level, (II) distinguish between the two main types of life insurance—permanent and term, (III) define and differentiate the two main ways life insurance can be bought—either retail or through *private placement*, and (IV) the role private placement life insurance may have in an investment portfolio. By doing so, we hope to better inform and equip the reader to understand how life insurance, and in particular *private placement* life insurance, may fit into their situation.



Amicable Society for a Perpetual Assurance Office, established in 1706, was the first life insurance company in the world.

[https://commons.wikimedia.org/wiki/File:Amicable\\_Society\\_for\\_a\\_Perpetual\\_Assurance\\_Office,\\_Serjeants%27\\_Inn,\\_Fleet\\_Street,\\_London,\\_1801.jpg](https://commons.wikimedia.org/wiki/File:Amicable_Society_for_a_Perpetual_Assurance_Office,_Serjeants%27_Inn,_Fleet_Street,_London,_1801.jpg)

## I. Life Insurance Basics

There is an old saying that life insurance is never bought, always sold. While this may be an over exaggeration, it is helpful for people to be aware of the true trade-offs involved in purchasing a policy.

At its heart, life insurance is a simple concept: a contract in which you pay an insurance company (premiums) in exchange for some amount of money (death benefit) to be paid to your family if and when you pass away. You receive the most benefit from the insurance contract by passing away significantly before your life expectancy.

The premiums—which are the amount you pay to the insurance company annually for the death benefit—depend on a few different factors that we’ve outlined below. Keep in mind that insurance companies are not charities; any additional risk they take on leads to higher premiums for you. If you remember this fundamental idea, it should help steer you away from any arrangements that appear to be too good to be true.

Factors that affect the amount of premiums you pay:

- **Life Expectancy:** If you are older, or in poorer health, there is a higher probability of you passing away sooner. If you are younger and/or in better health, there is a lower probability. If we keep in mind that the insurance company is not an altruistic entity, then it follows that the older you are and/or the poorer health you are in, the higher the probability the insurance company will have to pay your death benefit sooner, resulting in higher premiums.
- **Death Benefit:** The more death benefit you want to leave for your family, the higher the premiums should be. For two people that are the same age and have the same life expectancy, if person A has a \$1MM death benefit and person B has a \$2MM death benefit, then we would expect person B’s premiums to be approximately double what person A pays.
- **The Length of Coverage:** The longer you are covered for, the higher the premiums should be. Let’s say I have two different life insurance policies that I bought at the same time—one from Insurance Company A that covers me for the next 10 years and the other from Insurance Company B that covers me for the next 20 years. Insurance Company B is covering me for twice

as long. It has a higher probability that it will have to pay a death benefit and so will charge more for the policy.

These three factors make up the true cost of insurance. Said another way, if you were to start a non-profit life insurance company and had enough people buy insurance from you, the premiums you charged them based on (1) their life expectancy, (2) size of death benefit, and (3) length of coverage would roughly equal the death benefits you had to pay out on an annual basis. However, life insurance is very much a for-profit enterprise. There are quite a few other fees that you don't see in a policy which compensate the insurance agents (the people that sell you your policy) and insurance companies. The two most prominent of these fees are as follows:

- **Commissions:** This fee is the dark horse of how much you have to pay in premiums. The more your insurance agent is making from the policy they sell you, the more you will pay in premiums. Remember that the insurance company is not doing you any favors for free. If they have to pay your agent more for the same policy, your premiums will go up to reimburse the insurance company for those commissions.
- **Insurance Company Profits:** Above the pure costs of insurance, the insurance company also layers in a profit margin. Sometimes this is in the form of an "M&E—mortality and expense—charge". Other times it is impossible to tease out.

In its most basic equation, the premiums you pay equal the true costs of insurance plus commissions to your insurance agent and insurance company profit margin.

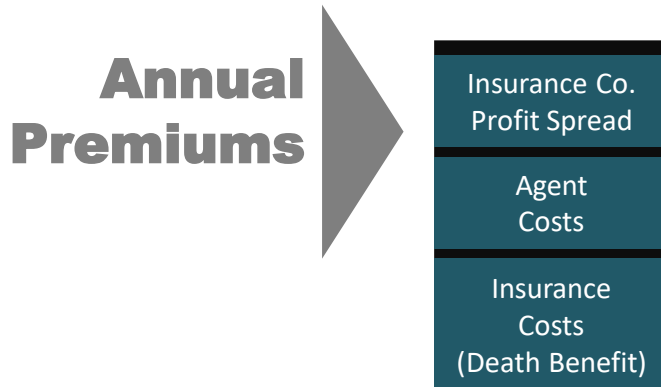
### Key Points

$$\left\{ \text{Premiums} = \text{Cost of Insurance} + \text{Agent Commissions} + \text{Insurance Company Profit Margin} \right\}$$

In our experience, it is helpful to understand who is making money off the insurance policy and in what amounts. Life insurance is a very powerful tool given the right circumstances, but it is not the cure-all that some make it out to be. At the end of the next section, we'll review some key questions to ask any life insurance agent if and when you begin shopping for a policy.

## II. Permanent vs. Term Life Insurance

As mentioned in the previous section, the length of time you are covered in a life insurance policy is a big determinate of the overall cost of insurance. The insurance industry breaks down the length of coverage into two main categories: **Term** and **Permanent**<sup>1</sup>. In term life insurance, you are paying premiums over a set amount of time (usually at least 10 years). Should you pass away in that time period, your beneficiaries get a set death benefit. If you survive past the set amount of time, you get nothing. For example, let's say you are a 40 year old in good health and buy a 10 year term life insurance policy. You will pay a set premium each year for the next 10 years. That amount of money is made up of the costs discussed in the last section: insurance costs, insurance company profit spread, and sales agent costs. If



you are in good health, the likelihood you pass away before 50 should be relatively low. Therefore, the true costs of insuring your life should be low.

The day you turn 50, all the premiums you paid essentially disappear.

To continue to be covered with a death benefit, you will need to extend the

term—which is like buying a new policy. Except this time, you will be 50 instead of 40. The likelihood of you passing between 50 and 60 is higher, so the insurance costs should be higher. Between 60 and 70, it rises faster still. At a certain point, the cost of insurance becomes prohibitive because the chances you pass away (let's say after your life expectancy) become so hard for the insurance company to predict.

What is the alternative if you want to be covered for a longer period of time—let's say your entire life? In that case, there is an option for *permanent* life insurance instead of term.

The main difference between permanent and term life insurance is that you are *overfunding* the true insurance costs in your early years to help pay for the more expensive insurance as you age. All the additional complexities related to permanent life insurance stem from this one concept.

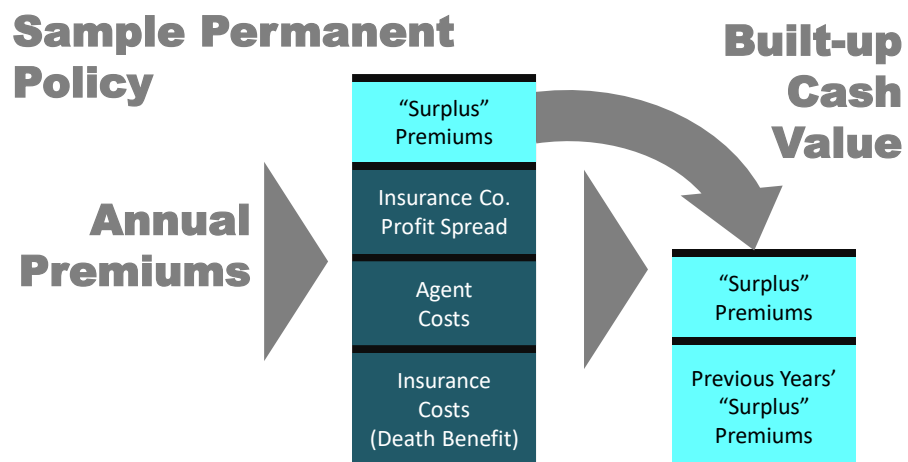
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<sup>1</sup> There is a permanent term option but this is not widely adopted.

The cost or premiums have to be substantially higher for an insurance company to make a profit off of you even though they are certain to pay out a death benefit at some point in the future. For term policies, the instances they pay out a death benefit to, say, someone who is 45-years old are rare relative to how many 45-year old individuals they have insured. In that case, the insurance premiums from the many healthy 45-year old individuals offset the few that pass away prematurely. The insurance company can still make a profit and stay in business.

With a permanent life insurance policy, the insurance company has to make a profit even though it is theoretically assured it will have to pay out a death benefit in an amount much higher than any one year of premiums. They do this through charging higher premiums than are needed in the early years. This surplus is then invested and grows over time. That surplus—also called the policy’s **cash value** or **cash surrender value**—then pays for the higher costs of insurance in the latter years.

This surplus is the source of much confusion when life insurance is sold. As you build up more surplus in your insurance policy, you create an asset that you can access while alive. For instance, if



you have been paying into a permanent policy for more than 10 years, chances are there is a “cash surrender” value: the amount that you could get from the insurance company if you “sold” your policy back to them. That cash surrender value is usually far below the total amount of premiums you’ve paid in, but it still has value. However, the longer you have a surplus and the better the investments it is in, the greater your chances of having an asset worth more than the collective premiums you’ve paid. You can think of this as similar to a Roth 401(k) or IRA account: after-tax dollars are put into an account and grow tax free over time. The more time that passes, the more you save in taxes.

Also similar to a retirement account, life insurance cash value grows tax free and is creditor protected in many states, including Texas. The more surplus in a policy and the better the investments, the faster your asset grows.

Unlike a 401(k) account, though, the cash value can be accessed *almost* tax free. Every dollar of premium you pay can theoretically be withdrawn as a return of your basis. If you put \$1MM into a policy over ten years and the cash value is worth \$1.5MM, then you can hypothetically pull out \$1MM without triggering a taxable event. The remaining \$500k cannot be withdrawn without triggering a taxable distribution that would be taxed at your ordinary income rate. However, you *can* take a loan out on a portion of the \$500k that would not trigger a taxable event. The loan would then be held on the insurance company's books and would be repaid out of the death benefit once you passed away. This is a powerful tool, provided that the interest rate on your loan is low (which is much lower for private placement life insurance compared to retail accounts as will be discussed in the next section).

The problem with most permanent policies is that there exists so much fee-drag in those early years that the surplus is small relative to amount of money you put into a policy. Consequently, these are also the most important years since the cost of insurance is the lowest; theoretically if you have more surplus in the early years, the value will compound faster and higher. (Think about contributing more to a 401(k) in your 20's than in your 50's.)

What is the primary source of fee-drag in the early years of a policy? Sales agent commissions.

Have you ever wondered why your life insurance agent wants to you to buy a larger permanent policy? As a rule of thumb, a sales agent can make the equivalent of one full year of premiums (or more) in commissions when selling larger, permanent policies over shorter, term ones. Since the insurance company is not going to take a loss on those commissions, you ultimately are the one that pays them. This is the reason that a cash surrender value is lower than the amount you've spent on a policy in the first few years. If not for the sales agent's commissions, your policy may be worth more than you invested in cash surrender value at the end of the first or second year, which in turn means that there would be a lot more surplus premiums that would be invested.

## Key Points

### Term

- Pay premiums for set amount of time (10, 20 years)
- No Cash Surrender Value
- Less expensive premiums in early years

### Permanent

- Pay premiums over the course of your life.
- Access to Cash Surrender Value
- Overfunding premiums in early years to cover cost of insurance in later years

Understand which is most appropriate for your situation by using the questions below.



## Questions to ask an insurance agent when shopping for a policy:

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- Can you tell me all the ways you are compensated?
- What about this policy makes it particularly well-suited for my situation? Are there less expensive policies that would accomplish the same overall goals?
- How flexible is this policy if I don't need it in 10 or 20 years? What would you recommend I do if I didn't need the policy any more?
- I want to get a good understanding of how your commissions are structured. Can you walk me through that so I understand it?
  - Over what period of time would you be paid for selling me this policy and how exactly would those commissions be calculated?
  - How much more do you get paid for selling me a larger death benefit or permanent policy? Is it linear (e.g., twice the payout for twice the death benefit) or a larger increase?
- What are the total estimated charges in the policy over the first five years? Please list a dollar value.
- What annual return would I have to make in a taxable investment account to match the return you are modeling out over the next 10 and 20 years?
  - Please list for both the projection and minimum guaranteed value.
- Has the insurance company ever raised their cost of insurance? If so, am I at risk of having that happen in my policy?
- What is the "charge" if I were to borrow a loan from my policy?

### III. Retail vs. Private Placement Life Insurance

We've established that permanent life insurance surplus cash value has some great benefits. To maximize those benefits, it is important to minimize all non-essential costs.

Retail life insurance is predicated on being essential protection for the average person. If you have a young family and something were to happen to you, your family would most likely need a replacement for your income for some amount of time. Enter **Retail** life insurance. There is a place for it and a place for the sales agent. For most people, they need to be introduced to life insurance products, and the sales agent as a distribution channel is there for the introduction, education, selection, and monitoring.

But what if you are a high or ultra-high net worth individual? In that case, your family would most likely be protected if you were to pass prematurely without life insurance. There may be some outside debts or estate issues that would warrant a retail life insurance policy, but for the most part the introduction to life insurance products is not needed because you are essentially self-funding your death benefit.

In many cases, the largest fee/expense of a life insurance policy in the early years is the sales agent's commissions. If you are accessing life insurance for the pure insurance/death benefit component, then you are less focused on the buildup of cash value in the policy. You mostly care that the policy continues up until the point your beneficiaries get paid a death benefit. However, what if you are more interested in life insurance for the benefits conferred to the cash value? In that case, you would want to minimize all non-essential costs in order to maximize the amount of surplus that goes into your cash value.

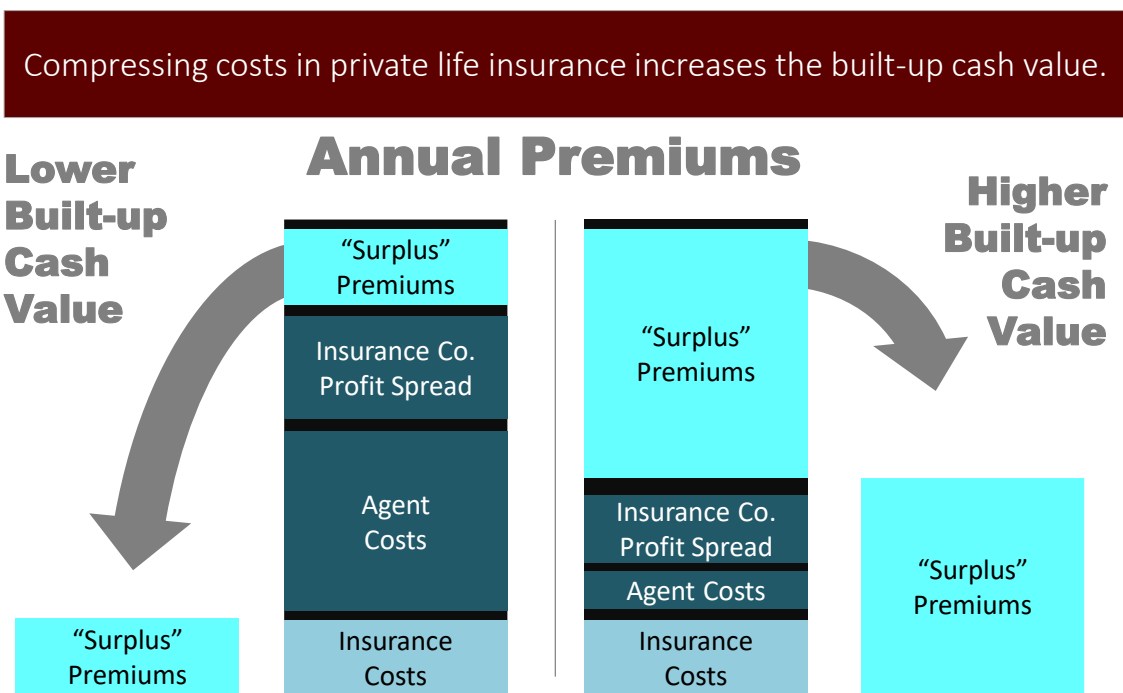
#### **Surplus cash value:**

- **can be invested as a personal asset**
- **grows tax-free**
- **is creditor protected**
- **can be accessed almost tax-free**

Private placement life insurance is a direct contract with an insurance carrier that cuts out as many non-essential costs as possible. Instead of buying a suit off the rack, private placement life insurance is like going to the tailor and getting the bespoke treatment. By doing so, it is possible to largely exclude sales agent commissions.

Additionally, if we are accessing life insurance for the surplus cash value benefits, we want to get as much surplus pushed into the policy as quickly as possible as well as invest in the least tax-efficient, highest growth investments available.

Whereas a retail permanent life insurance policy may have a 20+ year time horizon over which premiums are paid in, a private placement policy inverts this and compacts premium payments into as little as one, two, or three years. This is important for two reasons: (1) the true cost of insurance is the lowest in the early years, and (2) the longer an investment has to compound, the higher its eventual amount—also known as the compounding effect of wealth.

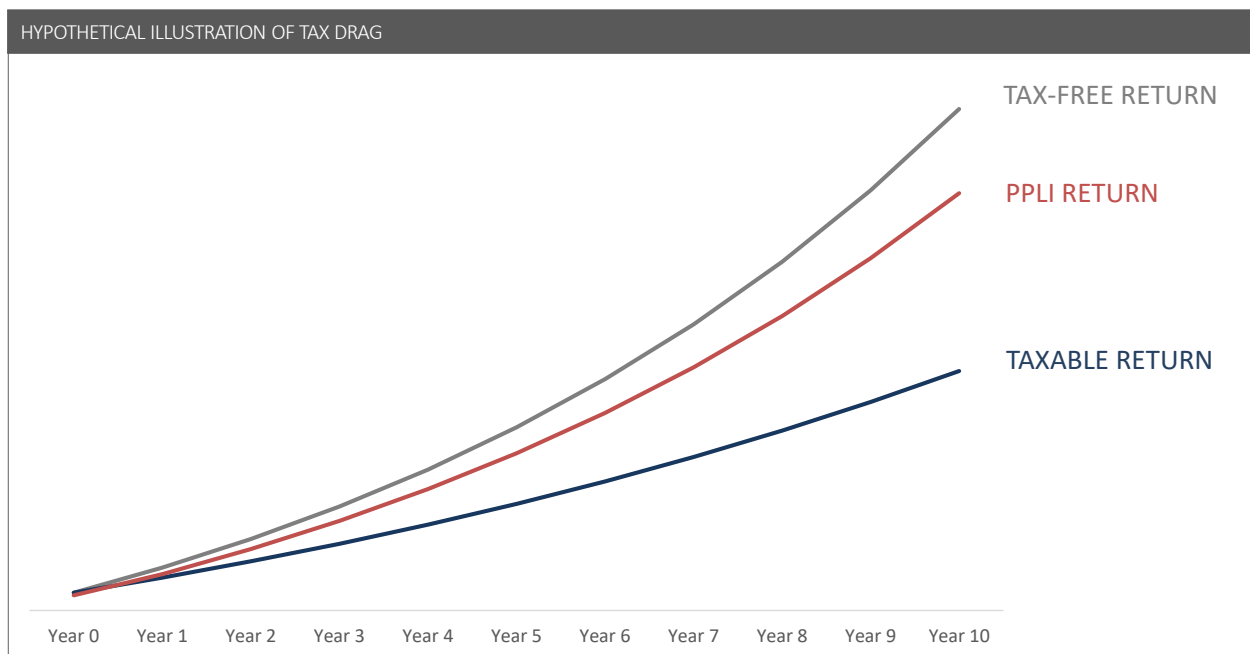


#### Key Points

- Private placement life insurance compresses many fees associated with retail life insurance and allows policy owner to pay a majority of the premiums up front in a much shorter time period.

## IV. The Role of Private Placement Life Insurance in a Portfolio

For select high and ultra-high net worth individuals, **Private Placement Life Insurance (PPLI)** can add structural alpha to their family’s diversified portfolio. We define **structural alpha** as increasing after-tax returns for a portfolio by decreasing the tax-drag for less tax-efficient investments. A PPLI policy can help push returns for less tax-efficient assets closer to their tax-free “ideal” state. The longer the time horizon for an investment, the more the separation that occurs between taxable and tax-free returns because of the compounding effect of tax-drag (see hypothetical illustration below).

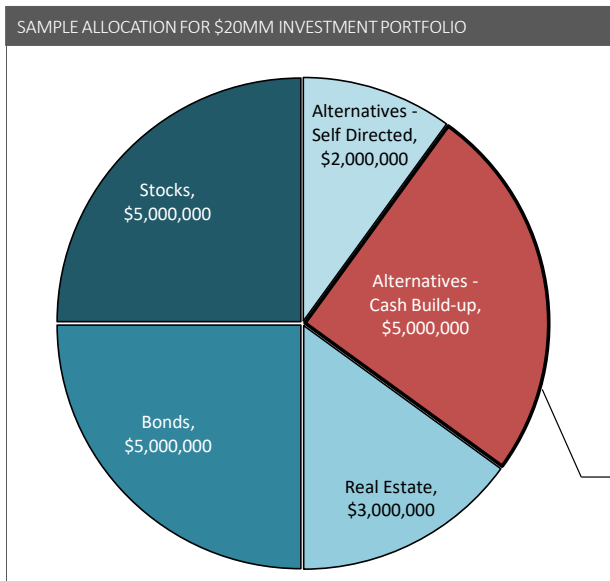


As **qualified purchasers** (individuals with investable assets above \$5MM USD), high and ultra-high net worth individuals have access to many alternative investments that non-qualified purchasers do not. These investments often have high expected returns and reduced liquidity. Often they produce significant current income, which tends to be taxed at the highest income tax bracket. Some examples of alternative asset classes which fit this description—and are found in many HNWI and UHNWI’s portfolios—are listed below:

- Private Lending
- Hedge Funds
- Distressed Debt
- Some Types of Real Estate

If these asset classes have a place in your portfolio, a PPLI policy may be able to add significant structural alpha to your returns. It has been called the Rich Man's Roth IRA in the past because of how tax advantaged PPLI can become if all fees are compressed along the way. Just as with a Roth IRA, the assets that make the most sense to put into a PPLI policy are those with both high expected yield/growth and high expected tax-drag, such as the asset classes mentioned above.

A sample portfolio allocation and how insurance may be incorporated as additive to the overall allocation.



### Common Alternative Characteristics

- **Higher expected growth**
- **Less tax-efficient**
- **Less correlated to public markets (stock & bond)**
- **Often private investments**
- **Often limited to HNWI's**
- **Potential fit for a cash build-up allocation in private life insurance**

A concern we often get is that PPLI sounds good to be true.

PPLI is not without its downsides, and it is important to know those shortcomings on the front-end. While there are certainly several potential considerations when evaluating a PPLI policy, the three main ones are as follows:

- 1) Investor Control
- 2) Upfront Costs
- 3) Premium Commitments

If you have a PPLI policy, you can invest the surplus cash value in the alternative asset classes listed above. However, there is a definite limit to the control that you, as the policy holder, have over the investments in the surplus cash value. You are limited to the funds that are on the private insurance platform. This is again similar to a 401(k) setup. If you are in a 401(k), you are limited to the funds on the

provider's platform. These funds are diversified in, most often, stocks and bonds. If you want to buy only a couple of stocks (or even more extreme, short specific companies) because you have a hunch, you are unable to do so.

In a PPLI policy, the same concept also holds true. You may have access to a private debt fund, but you cannot influence the entities to whom the private debt fund lends. Investor Control prohibits the insured from influencing the selection of assets within a fund, whether directly or indirectly. You may have access to a real estate fund, but you cannot put properties you own into that fund. This would breach the **Investor Control** rule and, at best, take away the tax advantaged status of your policy. At worst, it could get you into hot water with the IRS.

Aside from the Investor Control issue, another consideration for setting up a PPLI policy is time horizon. While costs can be compressed for a private policy by minimizing sales commissions and insurance company profit margin, there are still significant upfront costs in the form of (1) true costs of insurance, and (2) "toll" taxes on insurance premiums. While these costs pale in comparison to overall retail charges, they are still material.

For a Roth IRA, it would not make sense to convert from a traditional IRA and pay the associated taxes just to turnaround and make withdrawals from the account in the next few years. The longer you give a Roth IRA time to compound, the more powerful it becomes. The same holds true for a PPLI policy. We suggest that people allow for a 10+ year time horizon before they evaluate accessing the PPLI cash value. That gives the policy more time to recover from the relatively small upfront charges and start creating meaningful separation from the after-tax returns in a comparable taxable account.

Finally, for any PPLI policy, the commitment is made at the outset for the total amount of premiums and the time period over which they are contributed. For instance, if you agree to a \$5MM policy paid in over 5 years (\$1MM per year) and decide you want to increase to \$12MM, you would have to go through the underwriting process for a new \$7MM policy. The old saying "measure twice, cut once" is particularly applicable to private life insurance.

## Key Points

### Pros of PPLI

- Tax advantaged growth of tax inefficient investments
- Compressed fees
- Access to private investments

### Cons of PPLI

- Lack of investor control
- Significant up-front costs and premium payments
- Understanding individual death benefit needs

## Summary

There is a lot of confusion surrounding life insurance despite the hundreds of thousands of insurance salespeople in the US alone. It comes as no surprise then that Private Placement Life Insurance is a mystery even within the confusing world of life insurance; with much less money to be made from PPLI, insurance agents are disincentivized from researching or promoting it. But as with other under-explored things, there is a wealth of opportunity for those in the right situation. While it is important to take into consideration the investor control, upfront costs, and premium commitments, PPLI can be a very powerful tool for HNWI and UHNWI's.

At Durbin Bennett Private Wealth Management, we are not insurance agents nor are we able to accept any form of commissions. Our firm is in a unique position to shed light on life insurance in general, and PPLI specifically. We hope this paper has been informative and foundational. Please don't hesitate to reach out if you would like to continue the conversation.