

PERMANENT LIFE INSURANCE

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1. INTRODUCTION

Insurance is a financial contract designed to transfer risk from an individual or entity (the insured) to an insurance company (the insurer). Contracts are priced based on the probability of insurable events occurring, allowing insurance companies to cover the risk without jeopardizing their business.

Before issuing a contract, an insurance company will assess the insured to determine their riskiness. This is a process known as underwriting, where the insurance company will set the price of the contract – the premium – based on the history and characteristics of the insured individual. The ability to transfer risk is one of the great innovations of finance¹.

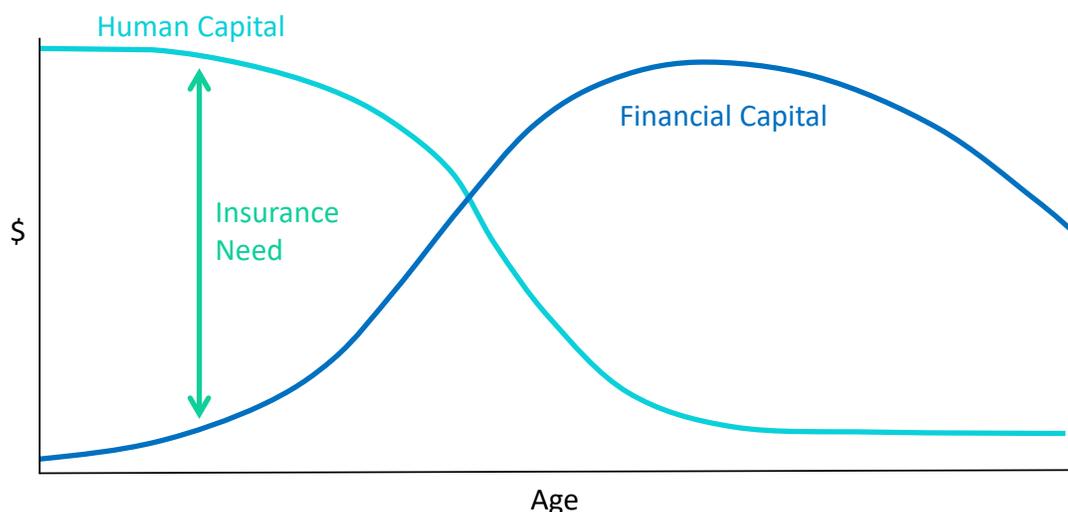
Life insurance is a financial contract that pays out when the life of the insured ends. This paper is designed to give an overview of life insurance as a concept, including an analysis of life insurance as an investment. We observe anecdotally and empirically² that some types of life insurance are sold more as investments than as risk transfer contracts. We call this practice into question through analysis of after-tax returns for traditional investments and life insurance. We suggest that the motivations to sell insurance as an investment are, in many cases, related to conflicts of interest.

2. LIFE INSURANCE BASICS

Life insurance is typically designed to cover low probability but catastrophic losses. Insurance companies facilitate the sharing of risk across many insured people to reduce the financial impact of a catastrophic event affecting only a few of them.

For example, the risk of death is low for a young person, but it could be catastrophic. A young person's most valuable asset is generally their ability to earn income in the future, otherwise known as their human capital. An untimely death could be catastrophic for anyone relying on them financially. This clear financial risk exposure is described as an insurance need, and this need should decrease over time as human capital is converted into financial capital through long-term savings.

Figure 1 - Insurance Needs Through Time



Source: PWL Capital

¹ Goetzmann, William N.. Money Changes Everything: How Finance Made Civilization Possible. Princeton: Princeton University Press, 2017. <https://doi.org/10.1515/9781400888719>
² Mulholland, B., Finke, M. and Huston, S. (2016), Understanding the Shift in Demand for Cash Value Life Insurance. Risk Management and Insurance Review, 19: 7-36. <https://doi.org/10.1111/rmir.12031>

Term insurance is typically a good solution for an insurance need that will decline or disappear over time. Most life insurance needs are temporary. An individual can opt to purchase term life insurance that offers a guaranteed premium for a fixed duration (often 10 or 20 years). In the absence of any desire for additional policy features³, term insurance is generally the most efficient means to transfer the financial risk of an untimely death due to its low premiums.

To illustrate the lower costs of term insurance for a fixed-duration liability, we will compare the premium cost for \$1 million of life insurance coverage on a 35-year-old male in average health between two insurance strategies:

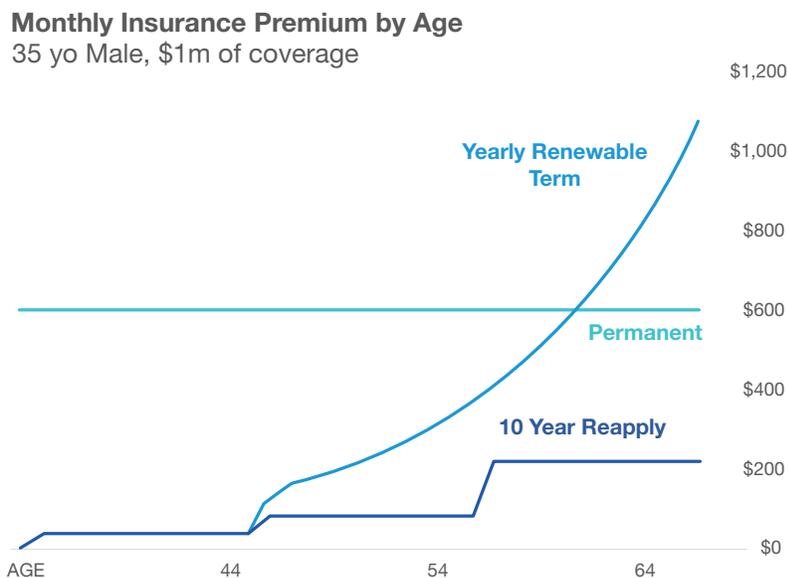
1. 10-year term insurance with a level premium for 10 years (T10), which then converts to yearly renewable term (YRT) with an annually increasing premium.
2. Permanent term insurance with a level premium for the duration of the life of the insured.

The insurance company will price the premiums for a 10-year contract much more favourably than a permanent contract; the probability of paying a claim in a 10-year window is relatively small, whereas the death benefit is guaranteed to be paid from an eventual claim on a permanent contract.

At the end of a term, 10 years in our example, it is common for the T10 policy to convert to YRT without the need for the insured to reapply. With YRT coverage, the cost of insurance increases each year as the probability of the insured's death increases and the insurance company's information about the insured's health gets increasingly outdated. Eventually, the YRT premiums will surpass those of the permanent policy. If the insured is in good health at the end of a 10-year term, they may choose not to accept the escalating YRT premiums and instead reapply for a new T10 policy. Reapplying provides the insurance company with up-to-date health information on the insured, allowing them to assess risk more accurately and ultimately lower the cost to the insured person.

Figure 1 illustrates the crossover point in premiums between the T10 policy that has converted to YRT after year 10 and the permanent policy with level lifetime premiums:

Figure 2 - Term vs. Permanent Insurance



Source: Compulife

³ Policy features may include side investment accounts, investment features, refund options, or any other add-on that is common with permanent insurance. These options are discussed later.

To generalize the relationship, term insurance that is matched to the duration of the insurance need will typically be far more cost effective than permanent insurance. However, the costs of term coverage can eventually exceed that of permanent coverage if the insurance need extends beyond the initial term at a time when the insured is in poor health. Permanent life insurance offers insurance protection for the life of the insured so long as the policy remains in force, regardless of any future ailments or diagnoses. The point at which permanent insurance coverage ends will be explicit in an insurance contract. This can be a predefined age, such as 80 or 85, or for the lifetime of the insured, regardless of age. In contrast, it is possible for a policyholder to outlive a term insurance policy – where coverage ends at age 85 for example – even if the intent was to continue to pay premiums indefinitely.

Unlike term insurance, which covers the low probability but catastrophic event of an early death over a predefined period, the probability that permanent insurance will pay out is 100%. While permanent insurance may not be ideal for protecting against financial loss related to a premature death, it can be useful in providing immediate liquidity upon death when the liquidity need is permanent. In some cases, additional features are added to permanent insurance policies. These features are designed to make the policies more valuable during life and typically result in increased premiums. The primary feature included as a living benefit of permanent insurance is a cash value, or value in the insurance policy which can be accessed during the insured’s lifetime by various means.

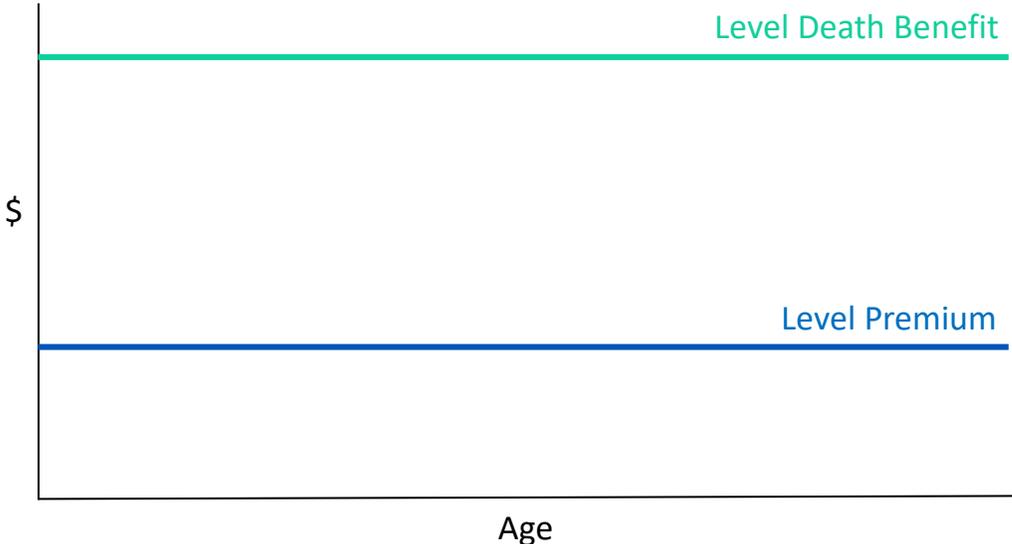
3. TYPES OF PERMANENT INSURANCE

There are various types of permanent insurance available, and each is characterized by unique attributes. Even within each type there are multiple features and options.

TERM-TO-100 INSURANCE

Term-to-100, or T100 insurance, has level premiums and a level death benefit so long as the policy remains in force. Premiums are generally no longer required after age 100 while the policy remains in force for the remainder of the insured’s life. This type of insurance does not have any cash or collateral value. It is not considered an asset and it has no underlying investment component. In the event the policy is cancelled, there is no residual value.

Figure 3 - T100 Level Premium and Level Death Benefit



Source: PWL Capital

T100 is “pure” permanent insurance in the sense that a fixed, level premium is paid until age 100 in return for a fixed, level amount of insurance coverage until death. T100 policies are useful to benchmark the total cost of policy premiums for more feature-rich policies. Any excess cost above that of a T100 premium is the approximate cost of the additional policy features.

UNIVERSAL LIFE INSURANCE

Universal Life (UL) insurance is a T100 policy with an embedded investment account. Policyholders can opt to pay only the required minimum premium or overfund the policy up to an annual maximum. The minimum premium covers the cost of insurance, administration fees, and taxes, all of which maintain the insurance coverage. Any additional premium payments above the minimum are invested at the discretion of the policyholder in a side account within the contract.

A UL policy may be overfunded for several years in order to reach a point of self-sustenance, where the policy holds a pool of growing assets with sufficient investment income to cover the minimum premium payments for the remainder of the insured’s life. This is otherwise known as premium offset. After achieving premium offset, policyholders may choose to continue making premium payments to increase the policy’s total death benefit.

UL INVESTMENTS

Policyholders control the asset allocation of the investment account. While options are fairly limited, they will include guaranteed interest investments similar to High Interest Savings Accounts (HISAs) and Guaranteed Investment Certificates (GICs), as well as variable investments linked to stock and bond funds. All realized capital gains, interest income and distributions are tax-sheltered within the policy up to actuarial tax limits. This tax-sheltered nature creates an appeal to overfunding and investing within a UL policy as an alternative to making minimum premium payments with external assets.

The fees on a UL policy’s variable investment options are typically well above 2%. Notably, a global equity portfolio of externally invested assets taxed at the highest marginal tax rate in Ontario in 2022 will see an approximate pre- and post-tax difference in returns of 2%⁴. This means the high fee of a UL investment is likely to be greater than the expected taxes payable in an external taxable investment account. Further to this point, low realized returns will lower taxes owing on a taxable investment, but high fees in the UL policy will remain the same regardless of investment performance.

UL INSURANCE

The insurance portion of a UL policy can be structured much like a T100 policy, with level premium payments and a level death benefit. The difference in premium between a T100 and a minimum-funded UL policy are minimal. In our original example, the annual premium on a level UL policy for a 35-year-old male in average health is \$7,443 versus an equivalent T100 at \$7,200.

The insurance can also be structured more like the YRT policy shown earlier, where the insurance cost is low while the insured is young and increases annually with age. For our 35-year-old male in average health, the minimum YRT funding requirement for a \$1 million UL policy starts at \$1,268 per year. This annually increasing cost of insurance peaks at \$100,980 in the 51st year of the policy, at the insured’s age 85. The low premium today allows for flexibility with premium payments and if warranted, the policyholder can overfund the policy with the equivalent cashflows required on a level premium policy. However, the increasing future premium liabilities of a YRT policy introduce significant risk to a product originally designed to reduce risk.

⁴ 2% is based on the pre-tax expected return of 7.09% in PWL Capital’s 2022 Factor Tilted Mid-Year Financial Planning Assumptions and the after-tax returns presented in Table 1.

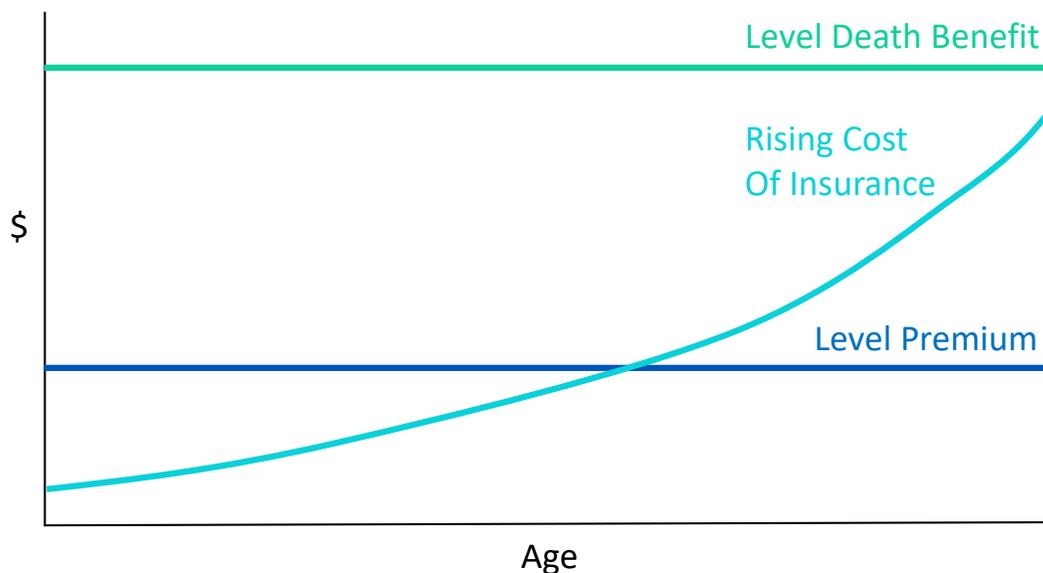
UL RISK

The risk associated with a UL policy aiming for premium offset is the same risk seen in many pension plans: managing a fixed and potentially increasing liability – the cost of insurance – with a pool of invested assets that have either low volatility and low expected returns, or high volatility and high expected returns.

Pension plans rely on the skill and knowledge of actuaries and investment professionals, along with the economies of scale that come with their substantial size. The average UL policyholder does not have those same attributes. A UL policyholder is required to select and manage the investments themselves from a limited pool of either low-yield or high-fee options. If the policyholder uses low-yield products, it is likely the policy will never become large enough to keep itself funded. If they use products with a higher expected return, this comes with higher volatility. This higher volatility results in sequence of return risk; although the mean return of the portfolio may be sufficient, periods of negative returns coupled with withdrawals from the portfolio to fund the cost of insurance result in a shortfall.

For a policy with a level cost of insurance, coverage can be maintained with additional external contributions, and shortfalls can be more easily predicted when comparing fixed-yield investments to the known cost of insurance.

Figure 4 - UL Level vs. Rising Cost of Insurance



Source: PWL Capital

For policies with a rising cost of insurance, the risk is much higher. Oftentimes the insured will choose a low initial cost of insurance and try to capitalize on higher expected returns by overfunding the policy and investing in equities. This is problematic in later years when the cost of insurance is exponentially higher and the rate of return in the policy does not live up to expectations, or in the event of a large market drawdown. Regardless of market conditions, the insurance premiums must be paid to keep a policy in force. This can result in an insurance policy 'eating itself from the inside' during periods of high insurance cost and poor market returns. A policyholder may overfund the policy based on the expectation of premium offset and be left with nothing once the side investment account has been depleted. At this point, the cost of insurance may even be too high to fund from external assets or income sources.

NON-PARTICIPATING WHOLE LIFE INSURANCE

Guaranteed, Non-Participating, or Life-Pay Whole Life (WL) insurance is a T100 policy with an added Cash Surrender Value (CSV). The CSV is equity within the insurance policy that grows in value over time as contributions are made. Premiums for WL insurance are higher than those for T100 to reflect the potential cash value that policyholders might receive if they were to cancel a WL policy. This feature is absent in T100 policies.

At the time of writing, a \$1 million WL policy premium for a 40-year-old female is priced at \$8,240 per year while a T100 policy from the same insurer is \$7,270 per year⁵. The difference in premiums is material.

Figure 5 - Whole Life vs. T100 Premiums



Source: Compulife

The CSV is valuable if a policy is cancelled, or if a policy is intended to be used for borrowing (more on this later). If there is no need for a CSV feature, the higher premiums of a WL policy are not worthwhile and a minimum-funded UL or T100 policy would be more appropriate.

WL insurance can be structured as a limited-pay policy, where premiums are paid by the policyholder for a fixed number of years, typically 10 or 20, after which point the policy is guaranteed to be paid up for life. At the end of the policyholder's limited-pay term, the risk of funding the cost of insurance in perpetuity shifts from the policyholder to the insurance company. Limited-pay policy premiums are much higher than a standard life-pay WL. They are similar in scale to the amounts required of an overfunded UL policy, but without the discretion or freedom to reduce premium payments from a UL's maximum from year to year. Still, these premiums are paid for fewer years than a life-pay policy and importantly, once the policy is paid up, the onus is on the insurance company to cover the cost of insurance regardless of subpar investment returns that may be experienced over the life of the insured.

PARTICIPATING WHOLE LIFE INSURANCE

Participating Whole Life (PAR) insurance shares many of the same features as non-participating WL insurance, with the addition that policyholders can partake in the performance of a collective group of policies. This collective group is known as the block of participating policies. Effectively, policyholders of participating WL pay a higher premium than the equivalent non-participating WL in order to partake in the performance of the insurance company's profits, as it relates to all of the PAR policies issued and outstanding.

⁵ Insurance premiums for this analysis are from one major Canadian insurance company at approximately the mid-point on pricing relative to competitors, with quotes pulled from term4sale.ca on September 9th, 2022. The quotes are based on a 40-year-old female non-smoker with a health rating of "Excellent".

An insurer will price their products based on assumptions about the future, where the premium is set to reflect expectations of various factors including mortality, expenses, policy lapses and cancellations, policy loans, death benefit claims, and taxes. Premiums received in excess of claims and expenses are invested in a participating fund, and the insurer then sets additional expectations for the performance of these investments. If the actual experience of the block of PAR policies is better than expected, “dividends” are paid to policyholders in that participating block. Said differently, if the investment performance of the participating account is better than expected, there is a positive impact on participating policyholders.

This is important: many insurance companies will showcase the asset allocation and historical performance of the participating investment fund, but these details are irrelevant to the performance of PAR policies. What matters to participating policyholders is how well the insurance company predicts the performance of the participating fund when they price the premiums for PAR policies. If taxes and expenses are higher than expected, or if death claims and policy lapses are higher than expected, dividends are negatively affected; policy lapses leave the insurance company with less time to absorb high underwriting costs, sales costs, and commissions.

To represent the expected performance of future policy dividends, marketing materials of permanent policies often illustrate the “current dividend scale” as a percentage. This scale cannot be used to compare insurance providers. The policyholder experience is entirely controlled by the spread between the real outcome and the actuarial assumptions used. The assumptions are kept confidential by insurance companies while the real outcome cannot be reliably predicted with any degree of certainty.

PARTICIPATING DIVIDENDS

The PAR dividends paid to policyholders are opaque, one of the contributing issues being that an insurer will typically smooth policy dividends over time. In an exceptionally good year for example, some of the excess profit may be kept on reserve as a buffer for the following year. Ultimately, the insurer has complete discretion over the policy dividends distributed in any given year, and these will not necessarily reflect the profits or losses accrued in that year. In addition to the opacity of the total amount that may be distributed as dividends, the insurer also has discretion over how these dividends will be distributed among policyholders. Different classes of policyholders may receive different treatment in proportion to the amount that each class is considered to have contributed to the participating account earnings. Importantly, policy dividends are often compared to investment returns or GIC rates, but this is inaccurate. A portion of the policy dividend must be considered a return of the higher premiums than otherwise would have been paid to own a non-participating WL policy. Dividends received are a partial refund of premiums for not making a claim, and this is different than an investment return.

PAR insurance is often sold as a “Cadillac” policy with attractive investment attributes based on the investments held in the participating account. However, the fact is that PAR insurance is an investment with returns proportional to the difference between the insurer’s assumptions when they price their permanent policies and the actual experience of the participating block over time.

Although insurance sales illustrations will use the “current dividend scale” to represent the policy’s expected performance, the actual or realized dividend scale for most participating accounts has fallen consistently over the last decade. Insurance companies are not at fault – predicting future returns is hard. Until very recently, interest rates had marched steadily downward for more than 40 years. Many participating accounts are heavily invested in fixed income, and this makes sense given the nature of the insurance liabilities that the participating account is required to fund. However, in a low interest rate environment this will also deliver low yields. As previously mentioned, insurance companies smooth participating policy dividends in low return years, but this smoothing is not sustainable forever when rates remain low.

A Canada Life policy illustrated in 2010 at the then-current scale of 7.36% may have left policyholders who purchased on the basis of “current dividend scale” disappointed by the average dividend scale interest rate of 6.23% since then, or the average of 5.75% for the five years ending 2021. This highlights the risk of participating dividends: they are not guaranteed. Insurance companies are upfront about this fact. In addition to uncertainty about the dividend scale interest rate, it is important to remember that policyholders within the participating block will receive different treatment based on their cohort’s contribution to the experience of the block. The effects of low interest rates on insurance companies are studied in [Berends et al. \(2013\)](#) who detail the reality that insurance companies are not always able to perfectly hedge their insurance contract liabilities with financial assets. The empirical findings in their study suggest that large life insurance companies are hurt when bond yields fall. Similarly, [Fan et al. \(2020\)](#) detail the challenges for life insurance companies in the recent macroeconomic and interest rate environment. It is generally sensible to illustrate participating policies at current dividend scale minus at least 1%, and preferably (in the author’s opinion) minus 2% when considering how participating policies will behave in the future.

DIVIDEND OPTIONS

Participating policy dividends can be taken as cash, used to purchase more insurance in the form of paid up permanent additions and/or term insurance, or used to pay for future insurance premiums by way of premium offset. When taken as cash, dividends may be left on deposit in an account with the insurance company. The interest earned on dividends left on deposit earn taxable interest income. Cash dividends will also reduce the policy’s adjusted cost basis (ACB), and if total accumulated dividends exceed the ACB they are taxable to the policyholder. Alternatively, when dividends are used for paid up additions, these translate to fully paid increases in the policy’s permanent death benefit with incremental cash values earning incremental policy dividends. Like traditional investments, there is a compounding benefit to using dividends for paid up additions. PAR policies will often allow for deposits beyond regular premiums to purchase these paid up additions. These are separate from the premiums required to fund the policy, and they offer the flexibility to increase the death benefit, the CSV, and the basis for future policy dividends. These additional deposits may also be used to get a policy into a premium offset position sooner than would be possible with regular premiums.

Dividends, CSV and paid up additions accumulate over time. They do not have downside risk in that they will not drop in bad markets, and this has important behavioural implications. Oftentimes conservative investors are averse to any downside risk in their investments. Since an insurance policy will only ever go up, albeit sometimes slowly, this can have an appeal. It is important to highlight that required premium payments from external sources and opportunity costs are both real, although not obvious, downsides. Depending on the investor, permanent insurance can be an attractive workaround for psychological biases, but investor education may be more appropriate. More on this later.

POLICY PRICING

PAR policies are expensive per dollar of insurance coverage, but this additional cost may be viewed as an investment in the potential for the policy to grow. At the time of writing, holding premiums constant, a UL policy from a major Canadian insurer with no investment or cash value delivers around double the guaranteed death benefit of an otherwise comparable PAR whole life policy from the same insurer. In other words, the death benefit under a UL structure costs half as much as participating WL. With additional consideration for the current dividend scale assumption in the illustration software, this participating WL policy is predicted to have a total death benefit of approximately 27% higher at age 90 than the UL policy due to accumulated paid up additions. However, at the current dividend scale minus 1%, the total death benefit on the participating WL would approximately match the guaranteed benefit of the UL policy at age 90.

In a scenario where the dividend scale ends up being above the current dividend scale, or below the current scale minus 1%, the PAR policy could look substantially better or worse. This example illustrates the fact that participating policyholders are dramatically overpaying for the guaranteed death benefit in the hopes that policy dividends provide an additional return on their investment.

4. AFTER-TAX RETURNS OF PERMANENT INSURANCE (ON DEATH)

Permanent insurance is often sold as a tax planning tool. In Canada, most policies have a tax-exempt structure where the internal growth of policy cash values is not subject to taxation at the policyholder's level. When it is considered that PAR policies have the potential to earn policy dividends, permanent insurance looks increasingly like an investment. This appears to be attractive to high net worth investors who have maximized their personal tax-advantaged investment accounts. For owners of a Canadian Controlled Private Corporation (CCPC) the pitch seems even more compelling. The death benefit in excess of the adjusted cost basis is credited to the Capital Dividend Account (CDA) which can be distributed to shareholders tax-free, and policy growth is not included in Adjusted Aggregate Investment Income for calculating passive income.

In both cases, these tax benefits lower the bar for the return that a permanent policy is required to deliver to match the after-tax return of an investment held by a high-income taxable individual or a corporation. Cashflows of an insurance policy are dictated by when a policyholder buys the policy and when the insured passes away. The financial return is affected by the duration of the life of the insured. It is useful to estimate the after-tax expected return of traditional asset classes over common periods for an apples-to-apples comparison to WL insurance purchased by a 40-year-old⁶. Insurance premiums for males are generally higher than for females, all else equal. This drives down the return for males.

Stock and bond after-tax returns have a weaker relationship to time horizon, but there is a slight positive relationship due to the deferral of tax on unrealized capital gains. For this exercise we use the highest tax rates for individuals in Ontario in 2023 to calculate after-tax post liquidation returns.

At shorter horizons insurance will always look better (few premium payments have been made for a large death benefit) while at longer horizons it will look worse. It is important to remember that betting on an early death is somewhat like purchasing a lottery ticket that you do not wish to win. The expected return of this bet is low or negative; receiving a positive payoff requires the “unlucky luck” of an early death. It is also important to note that if there is a desire for this lottery-like payoff, rather than combining the cash surrender value feature of whole life with the permanent insurance feature, an investor may purchase a lower-cost term product and invest the premium difference in stocks or bonds. Due to having lower premiums, the financial return on the term policy will be higher at death than on a whole life policy.

Table 1 - Estimated After-tax Returns for Stocks, Bonds, and Insurance at Death Based on a Healthy 40-Year-Old

Time to Death	Stocks	Bonds	WL (F)	WL (M)	T100 (F)	T100 (M)
40-Years	5.09%	2.14%	4.83%	4.18%	5.32%	4.66%
50-Years	5.14%	2.14%	3.14%	2.61%	3.55%	3.00%
60-Years	5.18%	2.15%	2.12%	1.66%	2.46%	2.00%

Source: Compulife, PWL Capital

⁶ Insurance premiums for this analysis are from one major Canadian insurance company at approximately the mid-point on pricing relative to competitors, with quotes pulled from term4sale.ca on September 9th, 2022. The quotes are based on a 40-year-old non-smoker with a health rating of “Excellent” purchasing a guaranteed whole life policy with premiums payable for life. Stock and bond expected returns and return characteristics are based on PWL Capital’s 2022 Mid-Year Factor-Tilted Financial Planning Assumptions. Taxes are calculated based on the highest personal tax rates in Ontario in 2022.

As a death benefit at the 40- and 50-year horizon, guaranteed whole life insurance looks great next to taxable fixed income, and not so great next to equities. At the 60-year horizon insurance is on par with or below post-tax bond returns. These figures are based on average returns. It is possible for either stocks or bonds to have a poor return experience over an investment lifetime, while permanent insurance is a contractual liability of the insurance company; it is more certain to deliver on its return at a given horizon, but the horizon is still an important variable. The fact that permanent insurance is on par with bond returns even at long horizons may suggest that permanent insurance should be used as a fixed income investment for taxable investors.

While a behavioural argument may support this scenario, the safety of permanent insurance as an investment is debatable due to the relative illiquidity of cash values in whole life insurance and the non-existence of cash values in T100. Permanent insurance is in a unique position as an asset with low volatility and low expected returns, like a bond, while being primarily suitable for capital that will not be used during life due to its illiquidity.

Bonds and permanent insurance can be employed to minimize the overall volatility of an investor's assets. However, since bonds are liquid, they can be conveniently used for rebalancing, maintaining the asset allocation, and keeping the overall risk level within targets over time. If 100% of the fixed income allocation in a portfolio was replaced with insurance and the equity portion of the portfolio grew faster than the insurance, as projected, this would lead to increasing risk and volatility as the investor aged. This is contrary to the desire of many investors. In many cases the investor would not be able to rebalance by selling equities and buying insurance, since additional insurance would require additional underwriting and the purchase of a new policy. Conversely, the opposite is true as well. When equities drop, an investor would not easily be able to temporarily give up some of the insurance coverage to rebalance.

5. THE “NEED” FOR PERMANENT INSURANCE

A common example of a “need” for permanent insurance is a family cottage or other illiquid asset like a business that is intended to stay in the family. If the long-time owners of the asset pass away (say, Mom and Dad), there will likely be a capital gains tax liability. In many places in Canada, capital gains on a cottage held for 40 or 50 years could be substantial. If Mom and Dad do not have other liquid assets to cover the tax bill, their children may be forced to sell the cottage rather than keeping it in the family as intended. Permanent insurance can be used to cover this tax liability, but it may not be the best tool. Permanent insurance is expensive. A T100 life insurance policy with a \$250,000 death benefit for a 40-year-old healthy male costs about \$2,500 per year. If Mom and Dad had simply instead invested their \$2,500 annual premiums into low-cost index funds, the resulting investment could likely cover the cottage's expected tax liability and more. For an investment with contributions identical to the insurance premiums at \$2,500 per year until age 90, the required net of tax return to match the death benefit is only 2.6%. To be fair to the case for permanent insurance, Mom and Dad may not want only a good chance at covering the tax liability; if they want to guarantee a specific amount payable tax-free at death, permanent insurance is uniquely positioned to deliver that from the joint perspective of certainty and tax efficiency. Additionally, life insurance death benefits assigned to named beneficiaries bypass probate, result in near-immediate liquidity, and are much more difficult to contest than assets left in a will.

Another instance where permanent insurance is common is in covering a known liability with unknown timing, such as when an estate freeze has been implemented. After an estate freeze, the original owner of the shares holds fixed value shares with a locked-in capital gain.

Taxes are due on the death of the shareholder. This known liability, together with the date of obligation tied to the life of the owner, highlights a case where permanent insurance seems to be a perfect fit. Regardless of when the insured shareholder passes away, the funds will be there to cover the expected tax. Premium payments are simply pre-funding that tax liability. If the insured passes away early, the rate of return on this prefunding is fantastic. As we have seen, this rate of return declines the longer the insured lives. In general, those with a long life would likely have been better off investing the funds that went towards premiums to maintain liquidity throughout their lifetime and potentially leave a larger estate.

It would be misguided to use permanent insurance to cover the tax liability on a liquid asset. Sometimes permanent insurance will be put in place to cover the taxes on an RRSP or RRIF at death. In contrast to the fixed assets of a business or a cottage, in most cases an RRSP is a completely liquid asset. Assets within the RRSP can be sold to fund taxes, and there is no need to provide additional liquidity through insurance. Purchasing insurance is replacing one liquid investment with another and should be approached through the lens of comparing any other investments: risk, return, fees, time horizon, etc.

6. The Timing of Insurance Purchases (“Buy It While You’re Young”)

A common argument for purchasing permanent insurance sooner rather than later is that the premiums are lower for younger people. If there is a chance that permanent insurance will fit into a financial plan in the future, maybe it makes sense to purchase it pre-emptively. It is true that, holding life expectancy constant, the rate of return on premiums decreases slightly with age. The following table compares the rate of return on a T100 policy purchased at various ages, with death held constant at age 90⁷.

Table 2 - Financial Return on Policies Purchased at Various Ages

Age of Policy Purchase	T100 (Female)	T100 (Male)
30	3.50%	3.17%
40	3.55%	3.00%
50	3.33%	2.73%
60	3.24%	2.19%

Source: Compulife, PWL Capital

The benefit of buying insurance at age 30 over age 40 is slightly positive for a male and slightly negative for a female. Waiting longer does have a more consistently negative, but still modest, effect. Not shown here is the significant opportunity cost of investing in insurance at age 30 or 40 rather than riskier investments with higher expected returns, like stocks. A younger investor also likely has a much higher pure insurance need. A lower level of permanent coverage should never be put in place at the expense of a higher level of required term coverage. The most important thing is to make sure that the required amount of human capital is required first, even if this comes at the expense of a more expensive permanent policy in the future.

⁷ Insurance premiums for this analysis are from one major Canadian insurance company at approximately the mid-point on pricing relative to competitors, with quotes pulled from term4sale.ca on September 9th, 2022. The quotes are based the respective ages listed in Table 2 for a non-smoker with a health rating of “Excellent” purchasing a \$1,000,000 T100 policy with premiums payable for life.

A much stronger argument for permanent insurance at younger ages is that a future health issue could result in the inability to purchase insurance, or the requirement to pay much higher premiums than a healthy person for the same amount of insurance coverage. If an individual knows that they want to have a permanent life insurance policy, purchasing it when they are young and healthy ensures they will have the coverage for life, regardless of future health events. Many term policies include a conversion option in which term insurance can be exchanged for permanent coverage without any evidence of insurability. The premium at the time of conversion will be higher than if the insured had originally purchased permanent insurance, still this shows that someone who purchases term and would not qualify for a new permanent policy in the future may have other options available to them.

7. Behavioural Arguments for Permanent Insurance

In addition to the tax planning benefits, some evidence⁸ supports the hypothesis that loss averse individuals prefer permanent insurance over term insurance. Prospect theory predicts that boundedly rational consumers may view term insurance as risky because it delivers a guaranteed cost and an unlikely payoff. Investors sensitive to losses theoretically choose what feel like safer options to prepare for uncertain future events by purchasing whole life insurance, which has a savings component and guarantees the payment of a death benefit, or by accumulating safe financial assets like deposits and bonds. Taken together, the view of permanent insurance as a “safe” investment for loss averse individuals, and the tax advantaged growth of policy cash values, there is an interesting argument for permanent insurance as a tax-efficient, low-risk asset. One of the challenges with this argument is that while permanent insurance has stable and growing cash values, it has required premium payments early on when financial capital is often low (e.g. a job loss may result in a forfeit policy). Permanent insurance is not very liquid and there is an opportunity cost to funding premiums which otherwise could have gone to assets with a higher expected return.

8. Insurance as a Living Asset

The most efficient way of accessing a life insurance asset is through the death benefit, but this, of course, requires dying. Accessing cash values in permanent life insurance policies during life may be accomplished through policy loans from the insurance company or collateral loans from third parties. Policy loans from the insurance company tend to have high interest rates, which is likely related to the fact that access to the policy loan is typically a contractual right in the policy. There is no financial underwriting required to take a policy loan which increases the risk to the lender. The policy is held as collateral, but the lender would still prefer the borrower made their premium payments. If the policy loan exceeds the policy's adjusted cost basis, the excess amount is fully taxable as income.

Alternatively, the cash value of a life insurance policy may be used as collateral to borrow from a third-party lending institution. In this case the loan will not be taxed, but access to credit when credit is needed is not guaranteed. The requirement to borrow from or against the policy to access its cash value challenges the claim that permanent insurance is a safe asset in practice, even if it feels safe due to its relatively stable cash surrender value component. The other important reality is that over long periods of time assets typically viewed as risky, like stocks, are much safer than bonds and savings deposits when safety is measured by the probability of losing purchasing power.

8 Hwang, In Do, Behavioral Aspects of Household Portfolio Choice: Effects of Loss Aversion on Life Insurance Uptake and Savings. Available at SSRN: <https://ssrn.com/abstract=4069707> or <http://dx.doi.org/10.2139/ssrn.4069707>

In a large sample of developed markets from 1890 through 2019, over 30-year horizons there is a much smaller probability of a loss in real terms for domestic stocks (13%) compared to bonds (27%) and bills (37%)⁹. An alternative perspective is that while stocks may offer a higher probability of maintaining purchasing power in the long run, they may also offer a wider distribution of outcomes. This comes back to the preference to leave a specific after-tax legacy rather than a wide range of possible legacies. Permanent insurance shines as an asset designed to leave a specific tax-efficient legacy at death.

Empirically, it is important to note that many permanent life insurance policies are surrendered before death, meaning that the policyholder receives the after-tax cash value of the policy, rather than death benefit. Cash values are typically below death benefits. Using US data, [Shaughnessy and Tewksbury \(2019\)](#) give policy lapse rates for whole life policies sorted by policy size. For large (>\$500,000) whole life policies, based on annual lapse rates, only 31% of policies remain in force after 30 years.¹⁰

Again using US data, [Gottlieb and Smetters \(2021\)](#) find that 29% of permanent insurance policyholders lapse within just three years of first purchasing the policies, and within 10 years, 57% have lapsed. They find that nearly 88% of universal life insurance policies do not terminate with a death claim.

9. Conflicts of Interest in Insurance Sales

While there may be an argument in specific cases for permanent insurance, an unfortunate aspect of the insurance industry is that policies are sold on a commission basis, and commissions paid to agents are proportional to the premiums required to fund the policy. It is common for insurance agents to earn a commission of 50% to more than 100% of the first year's policy premium. For large policies, the financial incentive for agents to recommend permanent insurance is substantial. Importantly, commissions are typically paid to the agent upfront at the time of sale, and that commission only has to be repaid if the policy is cancelled within a two-year window. The agent has minimal financial incentive to provide long-term service and advice to the policyholder, which is starkly misaligned with the fact that many policies are intended as solutions for which the benefit will not be realized for many decades to come. There is little accountability for an agent who sold an unsuitable permanent policy 10, 20 or 30 years ago.

This commentary does not suggest that life insurance agents will not provide good long-term service, only that the incentive model does not encourage them to. A sample from the Indian insurance market shows that agents recommend products that provide high commissions even if better (for the client) alternatives are available, and that consumers demonstrating lower levels of sophistication are more likely to be offered the wrong product¹¹. In a US sample of annuity insurance, product sales are four times as sensitive to brokers' interests as to investors' interests¹². Similar data on sales incentives predicting product recommendations regardless of product quality are found for mutual funds sold in Canada¹³. This is problematic because permanent insurance pays higher commissions than term insurance, cash value permanent insurance pays even higher commissions, and participating whole life pays higher commissions still. Anecdotally, many high-income professionals (e.g. physicians) are inappropriately targeted and sold permanent insurance, and many of those who purchase it [end up regretting their decision](#).

This is not only to the fault of the agent. The educational and compliance requirements to be an insurance agent are minimal when compared to those of a portfolio manager or CFP professional. Many life insurance agents are only licensed to sell insurance products like permanent insurance and segregated mutual funds.

9. Hwang, In Do, Behavioral Aspects of Household Portfolio Choice: Effects of Loss Aversion on Life Insurance Uptake and Savings. Available at SSRN: <https://ssrn.com/abstract=4069707> or <http://dx.doi.org/10.2139/ssrn.4069707>

10. This long-term figure is a rough approximation. Annual lapse rates are likely to be representative of policy lapse/ surrender, while over longer periods mortality plays an increasing role in the termination of policies.

11. Anagol, S., Cole, S., & Sarkar, S. (2017). Understanding the advice of commissions-motivated agents: Evidence from the Indian life insurance market. *Review of Economics and Statistics*, 99(1), 1–15. https://doi.org/10.1162/REST_a_00625

12. Egan, M., Ge, S., & Tang, J. (2022). Conflicting interests and the effect of fiduciary duty: Evidence from variable annuities. *The Review of Financial Studies*, 35(12), 5334–5386. <https://doi.org/10.1093/rfs/rhac047>

13. Cumming, D. J., Johan, S., & Zhang, Y. (2016). A dissection of mutual fund fees, flows, and performance [SSRN Scholarly Paper]. <https://doi.org/10.2139/ssrn.2678260>

This restriction prevents insurance agents from contrasting permanent insurance with other traditional investment products they are not licensed to recommend or sell, such as low-cost index mutual funds and ETFs. The lack of mandatory education also leads insurance to be a product sale rather than one component of a comprehensive financial plan. Permanent insurance may look like a good investment in a vacuum, but without the ability to compare to other options, investors are unable to make an informed decision.

10. Conclusion

Permanent life insurance is a product with unique tax and risk mitigation attributes. Due to its nature as an insurance product, it pays off handsomely in the event of an untimely death but diminishes in value at longer life expectancies. Pure permanent insurance is available through T100 policies which have no cash surrender value – T100 is pure insurance. Policies with cash values and more exotic features like the ability to participate in the experience of the block of participating whole life policies, or to hold investments inside the policy are available through non-participating whole life, participating whole life, and universal life insurance. These features come at the cost of higher premiums and are associated with non-guaranteed benefits.

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