



The Truth About Life Insurance A 9-minute Lesson

Only two things go into insurance;

- 1) the premium and;
- 2) the interest on the premium.

Only two things come out of insurance;

- 1) the death benefit and;
- 2) the expenses associated with it.

INSURANCE IS A VERY SIMPLE PRODUCT. Yet, many people don't understand how it works and some make it complicated.

Let's keep it simple.

There are only two things that go into insurance; 1) the premium and; 2) the interest on the premium.

And only two things come out of insurance; 1) the death benefit and; 2) the expenses associated with it.

Insurance companies must make a profit. We know that they are not going to sell insurance and lose money.

At some point in time the amount of money that goes into insurance, must equal or exceed the amount of money that comes out of insurance-- otherwise the carriers would go broke and wouldn't be able to pay the death benefit claims or their expenses.

Many have long recognized that insurance carriers are very successful.

We know that there is a sufficient amount of dollars available in a "reserve" such that if every person currently insured were to die today, every single policy would be able to be paid out.

Insurance carriers are very well managed.

So, ask yourself, "How can insurance carriers sell you \$1 million in insurance for pennies on the dollar?" Before you answer that, let me ask you another question. Let's talk about the banks.

Today, banks are offering mortgages at rates of about 4.5% for a 30 fixed mortgage, and 3.5% for a fifteen year fixed mortgage.

Which mortgage do you think is better for the bank? Now think about this carefully.

Most people would say the 30 year mortgage, because the bank is getting more interest.

However, if that's the case, why would they offer an incentive with a lower interest rate in the 15 year mortgage? It doesn't make sense,

Banks use something called the velocity of money multiplier.

does it?

The reason they do is because the 15 year mortgage is better for the banks.

Why is that?

Because banks use something called the velocity of money multiplier ("VMM").

How VMM works: if the bank has \$1 of deposits, the bank is able to make \$10 of loan. And for every \$1 of loan that gets paid back they get to lend out another several dollars.

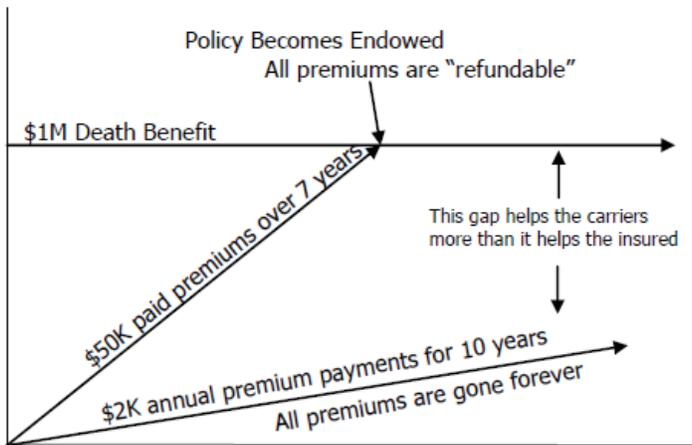
So, the more rapidly the money gets paid back, the more rapidly the banks can loan it back out again and make a profit.

THE VELOCITY OF MONEY MULTIPLIER FOR BANKS TODAY IS SOMEWHERE AROUND 10.

It changes as the regulators change the requirements.

Remember that number and the velocity of money multiplier. So, now that you know that, let's ask the question about insurance carriers.

If the insurance carrier is able to sell you a \$1million life insurance policy for let's say \$1,000 a year, or sell you that very same life insurance policy for let's say \$50,000 a year, depending on your age and health, which one do you think is better for the insurance carrier?



Think carefully. Remember when we talked about the things that go into life insurance and the things that come out?

Well, let's look at that on a graph. Let's assume the death benefit is generally going to be fixed at \$1Million.

The premium paid for the life insurance policy, plus interest over time, will go from the bottom left of the graph to the top right of the graph until it matches and meets up with the death benefit and expense line.

AT THAT POINT IN TIME, THE LIFE INSURANCE IS SAID TO ENDOW. However, you can reach that with that \$50,000 a year premium for

Casinos know that some people win, but most people will lose and they will make 4%. Their job is to keep you, the gambler, at the table as long as possible so that your winnings turn into losses. However, they also know that of the thousands of people that come in who spend thousands of dollars, their take will be 4%.

Insurance carriers know exactly how many people will die at a given age, using the Law of Large Numbers.

say only 10 years, or you can make a \$2,000 premium payment for 60 years, and then the line is almost flat from lower left to lower right.

In many cases of “term” life insurance, some only pay the \$2000 for a term of 10 years. Then the premiums paid are “wasted.” If the term has the opportunity to convert to whole, you would have to put a very large sum of money into the policy to bring it up the line that will eventually reach “endowment.”

In order to get up to that upper line you’ll have to put in a whole bunch of cash to maintain the policy.

INSURANCE CARRIERS BASE THEIR PRODUCT ON THE LAW OF LARGE NUMBERS. An entire city was built on the law of large numbers. It’s called Las Vegas. Here’s how it works simplified.

Regardless of how much you spend, or how much money you bring with you to Las Vegas, the house knows they’re going to make 4%.

They know that some people win, but most people will lose and over time they will make 4%.

Their job is to keep you at the table as long as possible so that your winnings turn into losses.

However, they also know that of the thousands of people who spend thousands of dollars, their take will be 4%.

Insurance carriers also know this. Using the law of large numbers, they know that in a cohort of 10 million people, exactly how many people will die at a given age. They don’t know who, but they know how many.

So, let’s break this down into smaller numbers.

Let’s just say there are 100 people in a cohort, and everybody wants \$1,000 worth of life insurance. Let’s also say that we know in the first year, one person is going to die of the 100 people.

IN THE SECOND YEAR, two people will die of the 100 people.

IN THE THIRD YEAR, three people will die, and so forth until you get down to the tenth year, at which point, 10 additional people will die, and so on.

SO, IN THE FIRST YEAR, if one person will die and we don’t know who, but everybody’s willing to buy \$1,000 worth of life insurance, how much will those 100 people have to pay in order for the insurance company to have enough money to cover that \$1,000 worth of life

That difference between what insurance companies write in claims and what they collect in premiums is called the reserve.

insurance for the death benefit of the one person who will die?

Well, that's pretty simple. You take the \$1,000, divide it by the 100 people and that equals \$10.

Everyone pays \$10. Therefore, \$10 paid by 100 people equals \$1,000 available for the death benefit for that one person who dies.

Look at what happens in the second year, when we know that two people will die. The insurance carriers are going to have to pay out death benefits totally \$2,000.

How much premium will carriers have to charge those people in the second year? Well, many of you might say \$20, but that would not be the case, because one person died in the first year, leaving only 99 people to pay premiums. \$2000 divided by 99 people equals \$20.21.

Carriers would have to charge 99 people a premium of \$20.21 each. We will round future amounts to the next dollar. So the second year would be rounded to \$21.

IN THE SECOND YEAR, 99 people paying \$21 would put into the insurance a total of \$2,000. Therefore, two people die and the carriers pay out the \$2,000.

SAME THING IN THE THIRD YEAR; 97 people are left, because three people have died. We know that three new people will die. We'll have to write \$3,000 worth of death benefit claims. We might have to charge everybody \$32.

IN THE FOURTH YEAR, four people will die, but that leaves 94 people left to pay premiums. We might have to charge everybody \$44, and so on and so on, until we get down to year 10, in which case we know that 10 people will die, maybe 55 or so people have already died. That only leaves 45 people to pay premiums equal to the death benefits.

We know we're going to have to spend \$10,000 in year 10 to cover the \$1,000 of each claim for for 10 deaths.

Now, when you sell that life insurance to the 100 people you're not telling them that the premium is going to go up every single year. On the contrary, you're telling them that they can pay a level premium every year for 10 years.

What will that level premium have to be? Well, it might have to be something on the order of say \$85 a year.

	Deaths Per Year	People Left	Death Benefit	Premiums	Avg. Prem. X people left
1	100	\$ 1,000	\$10	\$ 8,400	
2	98	\$ 2,000	\$20	\$ 8,232	
3	95	\$ 3,000	\$32	\$ 7,980	
4	91	\$ 4,000	\$44	\$ 7,644	
5	86	\$ 5,000	\$58	\$ 7,224	
6	80	\$ 6,000	\$75	\$ 6,720	
7	73	\$ 7,000	\$96	\$ 6,132	
8	65	\$ 8,000	\$123	\$ 5,460	
9	56	\$ 9,000	\$161	\$ 4,704	
10	46	\$ 10,000	\$217	\$ 3,864	
Totals					
55		\$ 55,000		\$ 66,360	
Average Premium (\$84)					
100 per year per person		\$ 66,360			
55 Death Benefits		\$ (55,000)			
Reserve/Profit		\$ 11,360			

Now, think about that. You have to pay \$85 a year. You write \$85 a year premium for 10 years. You've written \$850. The sum of all the people paying a premium year one through year 10 is 835. 835 payments then of \$85 equals \$71,000.

Yet the insurance carriers only had to pay death benefit claims for the 55 people who died over the 10 years, or \$55,000 in claims.

The difference \$16,000 of what they pay in claims and what they collect in premiums is called the "reserve."

And there is something else the insurance carriers know based on the law of large numbers. They know exactly how many people will drop out and quit paying their premiums and they know about what point in time those people will discontinue paying their premiums.

Consider that they may know by the fifth year, five people will drop out and won't make future payments.

By the tenth year, another 5 people or so may have dropped out and not pay premiums, so they're really not collecting \$71,000 maybe they're only collecting \$66,000.

Still, they only had to pay approximately \$55,000 in death benefit claims. That leaves them a \$11,000 reserve.

Ask yourself this question. Would you rather the insurance company owned that \$11,000 reserve, or would you rather own a piece of that \$11,000 reserve?

Nobody has ever answered that question incorrectly. Of course, you would rather own that reserve.

HOW DO YOU GET TO DO THAT?

Well, there is a way to do that: That's to develop something approaching a "maximally efficient contract." To own the reserve, the premium of the 100 people who want \$1000 death benefit would have to be well above \$100 per year.

Let's go back to the example of a 50 year old who wants \$1 Million in life insurance. You could buy permanent or term insurance.

You could pay for permanent \$1 Million life insurance benefit with a \$50,000 premium for only seven years; versus paying the \$2,000 for 10 years for term insurance, that only results in a \$20,000 loss for you. Even if you die, you would never see any benefit with term insurance.

With the permanent insurance, after 7 years you would have paid \$350,000 in premium. Your cash value would be \$375,000. Your

If you write a large premium between four and 11 years, depending on your age and your health and how it's constructed, every dollar that you put into the premium, you should be able to take back out within four to 11 years.

\$1million death benefit is permanent. It can never be taken.

It will always pay your beneficiary upon your death. And you now own the reserve, to do as you wish with it. You could access that \$375,000 at any time, for any reason, in 72 hours, and TAX-FREE.

It is rare to find a maximally efficient contract. This is because it is rare for a life insurance purchaser to have the cash flow to fund such a contract. And it is easier to buy and sell a high death benefit for a low premium amount.

And most people do not understand how the reserve could work to the benefit of the policy owner. Many participating, mutual whole life insurance companies pay over 4-6% in “dividends”.

The internal rate of return can exceed 4.5% to 5.2%, tax-free, in 2015.

In fact, for every illustration that we have seen in over 80 different policies that have come to us from somewhere else, 100% of them were inefficiently constructed.

This means that the premiums and the death benefits lines were never going to meet. The clients were always on the lower line.

ARE THE INCENTIVES IN THE INDUSTRY MISALIGNED AGAINST THE CLIENT?

The carriers are in the inventory turnover business of selling more, and the agents’ commissions don’t change very much between a maximally efficient premium structure and an inefficient one.

Because the insurance commission is typically based on the cost of the death benefit. Commissions on the cash value are very small. Remember, the cash value is the amount that goes toward you owning the “reserve”.

Are the carriers and the agents are incentivized to lower the price?

Because they know:

1. You are going to drop out or not die, and
2. They get to keep the reserve?

However, if you write that large premium between four and 11 years, depending on your age and your health, and how it’s constructed, every dollar that you put into the premium, you should be able to take back out within four to 11 years. If you want.

But, why would want to? When you can get tax-free growth on your premium? You get triple compounding:

Benefits of the 7702

- tax deferred growth,
- tax free distributions
- competitive rate of return
- high contributions with virtually no limits
- collateralization opportunities
- safe harbor
- no loss provisions
- guaranteeing access to your money,
- unstructured payments
- liquidity
- full access
- control.

Compounding on your premium.
Compounding on the rate of return.
Compounding on the tax you saved.

What a great “bond surrogate” to add to your portfolio.

IT ALSO AMOUNTS TO A GUARANTEED RETURN OF PREMIUM ON LIFE INSURANCE.

Very few people know about this, very few people will tell you about this, and the reason is because it’s harder for carriers or agents to sell it.

Now, why would I want to put in \$50,000 besides getting my premium out?

WELL, THAT’S ONE MAJOR THING, BUT HOW ABOUT THIS?

There is something in the tax code.

You have all heard about 401k, which is a tax-deferred vehicle. Let’s never call it tax-deferred any longer, let’s call it tax-postponed.

You take a payroll deduction to put money into an account. The government tells you when you can put it in, how much you can put in, and what you can put it in. And then the government tells you, you don’t have to pay tax on it now. In addition, it is a tax calculation postponement.

The government tells you when you have to take it out, how much you have to take out, and oh, by the way, when we figure out how much we need, we’ll let you know what the tax rate is.

That is a 401k or 403b and so forth, a government “qualified retirement plan” vehicle.

Everyone knows about the taxable vehicle.

That’s where you put money into a taxable account, and if you have taxable gains, it might be tax deferred as well, but at some point in time you’re going to have to pay tax on that.

But, how many of you know of a 7702 plan?

IT’S IN THE TAX CODE. IT IS 7702.

A 401k is in the tax code under Section 401; 412 is in Section 412; 437 is in Section 437; and 7702 is in Section 7702 of the tax code.

Sometimes it's better to pay tax on the seed rather than on the harvest. Many of you would agree with that—you understand that intuitively. Code 7702 provides for the private life insurance to be tax advantaged. Your “excess” premium grows tax-free. And by taking out your original premium, on which you already paid tax, that comes out completely tax-free. And any gain comes out tax-free as well by using policy loans. You borrow against the cash value. To avoid any issues, we construct the loans to leave just enough to maintain the policy in force.

The benefits are:

- you can put in almost any amount
- high contributions permitted
- it grows tax deferred
- you can access your money tax-free, at any time, for any reason
- has guaranteed loan provisions
- “collateral capacity” opportunity
- you have easy and quick access to your capital
- asset protected in many states
- competitive rate of return
- unstructured loan payments, meaning you may never have to pay back the loan
- guaranteed completion plan, which means that if you die your beneficiaries will get money that you put in

That death benefit can be free, because you can have a maximally efficient contract that will pay you 3%, 4%, or even 5% or 5.25%, tax free in many cases.

And if you're in the upper tax brackets, you can do the arithmetic and figure out it's almost the equivalent of making 7%, 8% or sometimes even 9% rate of return, taxable.

So, how much would you like to put in your 7702?

For many of us—as much as necessary, in order to have our premium's guaranteed return rather than have it going to the carriers.

USE A MAXIMALLY EFFICIENT CONTRACT.

And make great decisions.

ABOUT THE AUTHOR



MITCH LEVIN, MD, CWPP, CAPP, *THE FINANCIAL PHYSICIAN™* developed his interest in financial matters while working in the Harvard Graduate School, where he was instrumental in setting up, what may be the first and completely student-financed long-term endowment campaign through insurance and derivative products.

In the early 2000s, Dr. Levin retired from active practice of eye surgery to devote himself to philanthropic endeavors and to his family.

Ultimately, this led him to begin a new career in the field of wealth management and he became *“The Financial Physician™* and President of Summit Asset Protection Group, LLC.

Summit is a Florida registered insurance agency providing a wide array of insurance products and services to individuals, families, organizations, and institutions.

Dr. Levin is a two-time national best-selling author, trusted advisor and accomplished public speaker.

His published works include a multitude of professional articles and papers, as well as the books *Power Principles for Success; Goal!, The Financial Physician’s Ultimate Survival Guide for the Professional Athlete; Shift Happens; Smart Choices for Serious Money; and Cover Your Assets: How to Build, Protect and Maintain Your Own Financial Fortress.*

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