Life Insurance in Estate Planning

15 OCT 2022

Allen Lim, IBF Fellow
Founder
Advisers' Harbour

Life Insurance in Estate Planning

Every estate planning conversation has 2 dimensions. The financial planning dimension, and the legal dimension. Life insurance is a prominent tool in the financial planning dimension. An estate plan without life insurance is akin to travelling from Singapore to Kuala Lumpur on foot without motor vehicle, an almost unattainable goal.

Life insurance is a creation from 3 important bodies of knowledge, which are (i) the law of contract; (ii) the actuarial science, and (iii) the statute (i.e. Insurance Act 1966).

i. **The Law of Contract –** A life insurance policy is a legally binding contract between the insurer and the policy owner. The insurer is legally obligated to pay an agreed sum assured to a party when a well-defined risk event happens, for example death, terminal illness, and sometimes, total and permanent disability. In order for this to happen, the policy owner has to fully declare his or her health and financial information to the insurer and keep up the premium payment under the terms and condition of the policy.

   The impact of this has significant importance to estate planning because the life insurance policy essentially creates a guaranteed capital at the life insured's death. From the investment risk perspective, this creation of a guaranteed capital at death essentially diversifies away all forms of investment risks at that moment where the capital is needed. And this is absolutely crucial for the three estate planning objectives of (i) Planned Giving; (ii) Debt Cancellation & Estate Settlement Funds; and (iii) Family Endowment Fund. Let me further explained the importance of each objective.

   a. **Planned Giving –** A guaranteed capital at death is required to fulfill a financial promised to a beneficiary, who can be an extended family member, elderly parents, grandchildren or an entity that support certain a cause that is close to the client's heart. To an uninformed mind, one might trivialize such a deliberate act as frivolous. But when you think deeper, this is actually the highest form of financial and estate planning objective where one uses the tools, financial or otherwise, to discharge one's duty or express one's love as a husband, father, and son (or a mother, daughter and wife if the client is a lady); or leaving behind something that matter to a cause which define a person.

   b. **Debt Cancellation and Estate Settlement Funds –** When a bank approves a loan to a person to acquire an asset, property or otherwise, it is usually based on a calculated assumption of the future earning capacity of the debtor. And the bank will secure its own interest under the "event of default" and "right of set-off" clauses in the loan agreement. This means if the borrower dies, the bank has the contractual right to demand immediate payment of the outstanding loan principal from the borrower's estate or surviving co-borrowers. Failing which, the bank has the contractual right to consolidate the borrower's other assets with the same bank and set-off the outstanding debts. If this action is not sufficient to pay off the debts, the bank has the right to force sell the assets and sue the borrower's estate and surviving co-borrowers for the remaining debt amount. The consequence of this risk might push the borrower's estate and surviving co-

borrower into insolvency. Therefore, it is nonnegotiable that one must leave behind a guaranteed capital to the surviving family members to pay-off debts.

Next, estate settlement funds. An estate needs to be settled before it can be distributed to the targeted beneficiaries whether one dies with or without a valid will. This means there will be cost incurred. Hence, it is important to have a guaranteed capital of a reasonable amount (depending on the complexity of the estate) to be given to the estate settlement entity, who could be the family members, or a professional firm, taking on as an administrator or executor of the deceased, to do the work.

c. **Family Endowment Fund –** A guaranteed capital is required to establish a family endowment fund for the surviving family members. For example, an inflation adjusted annuity income for the widow until her life expectancy. Or a financial capital to provide a sense of financial security, or prevent a drastic drop in living condition, for the surviving family members over a long period of time.

One can discern a common thread that weave through these three estate planning objectives, which is the availability of a guaranteed capital at the death of a person. A life insurance policy is the only financial tool that is able to do this via the law of contract between the insurer and the policy owner.

ii. **The Actuarial Science –** In order for the life insurance contract to be sustainable, it is underpinned by serious application of risk pooling mathematical and statistical methods. In order words, the premium is calculated based on actuarial consideration of a large number of people of an acceptable health status, gender and age. It is this collective payment of premium by large group of people that forms the insurance funds, of which claim is being financed. The effect of this technique is that a person is, therefore, able to create a capital at death with a fraction of cost. For example, a $1M sum assured (capital) at death cost $20K premium (cost) for a whole life policy for a 45-year-old man.

iii. **The Statute –** The guaranteed creation of capital at death (by the law of contract) at a fraction of a cost (by actuarial science) make life insurance contract an attractive tool that could give rise to negative usage, i.e. insure a third party indiscriminately and profit from his or her death. Hence, the statute (Insurance Act 1966) has very strict laws to ensure only parties with the right insurable interest can enter into a valid life insurance contract. In other words, it is a privilege to own a life insurance policy, which is based on the following broad insurance interest categories (Section 146 of Insurance Act 1966):

a. You and yourself
b. You and your spouse
c. You and your children (who is below age 18)
d. You and your dependant
e. Trustee and the settlor of a trust

f. Trustee and the beneficiary of a trust

The statute also provides conditions that allow the insurer to pay-out the death claim without grant of probate or letter of administration (Section 132, 133 and 150 of Insurance Act 1966). Hence, the effect of these laws is that liquidity of serious capital at death can be guaranteed via a life insurance contract.

The statute also spells out conditions (Section 132(4) of Insurance Act 1966) that allow the life insurance proceeds to be ringfenced from the deceased's creditors for the benefit of the deceased's spouse or children. This means, if the life insurance policy is properly purchased and structured, the life insurance contract can create guarantee capital, at a fraction of a cost, with guaranteed liquidity and guaranteed protection from the deceased policy owner's creditor! No other financial tool can achieve this outcome at one go!

Conclusion

This article presents the facts of the unique roles of life insurance policy (or contract) in estate planning. Its formation is totally difference with any other financial tools, in fact it is unique in its own right only because of the availability of law of contract, actuarial science, and the statute. Let me end by giving a perspective on the risk of death. This is the only risk that will definitely happen to all of us. Hence, with this definite risk, if one were to die with a life insurance policy, that guarantee capital is perhaps the most tangible capital that one can rely on to pass on to the surviving family members to express one's love to them. And love should not be subjected to risk, death or otherwise.

Allen is a financial and estate planning practitioner since 1998. He also founded Advisers' Harbour, which is a set-up to help raise the professional self-esteem of financial advisers in Singapore. He has numerous designations, amongst them are Chartered Life Underwriter (CLU) and IBF Fellow.