Insurance as a solution for all (selling koyok!)?

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One of the "fun part" of doing financial planning is that I get to see how people manage their money. It is a privilege of seeing people's common ways of managing money and as well as unusual ways of how people spent their money. For individuals themselves, they will never know what are the "common ways" and the "unusual ways" because they will never disclose their full financial details to their friends or relatives. Even if they do, their "sample size" is limited. One of the "unusual ways" how some people manage their money is to buy endless number of insurance products.

For some, insurance products have been used as a solution for all sort of financial needs. It is like a common medicine prescribed to cure headache, sinus, cancer, gastric, cardiovascular diseases, etc. Some insurance advisers would actually prescribe insurance products as a solution for all financial problems. It is like selling "koyok" to cure all ailments. It is common to see insurance products being used for:

Savings (by using anticipated or non-anticipated endowments)

Children's education (by using endowments)

Investments (by using ILPs)

Estate planning (by using third-party whole life marketed as "three generations")

Protection (using ILPs again)

So it appears to me that all financial matters can be solved by insurance. However, in my opinion using insurance products to solve all problems is a very bad way of financial planning. In fact, it creates a new set of problems namely cash flow and a poor balance sheet.

1. When there is a lost of earnings, there will not be enough cash flow to pay for these regular premiums. Some regular premiums will end up becoming APL (automatic premium loan) while others have to be converted to paid-up. This will cause significant financial lost and lost of benefits – at a time when there is already a lost of earnings. In this world right now, who can be assured of continuous employment? Nobody can be assured of it. Therefore, committing a large amount of cash flow to pay for regular premium insurance is a BAD way of financial planning.

2. Buying too many insurance policies will be reflected poorly on a person's net asset or balance sheet. Since many insurance policies will have its benefit maximized upon maturity, the surrender value before maturity is low due to the surrender penalty. If we would to put the surrender value as the fair value of these policies into one's net worth, the policies will almost always be in the red. The implication is that one's networth remains to be low for extended period of time.

3. One's networth can remain low even if all policies mature if these policies give poor return. Historically, insurers love cutting annual bonuses for par plans. There was a period of time in which the entire terminal bonuses were eliminated. In other words, the matured policies gave poor returns. Moving forward, I felt that par-products will provide poor value for money on a long-term basis.

4. By committing a large amount of money into regular premiums, it implies that there will be less cash flow available for other needs. When I ask my clients their short term goals, common short term goals cited are: to expand one's family (to have a third child for example), to upgrade to a larger property, setup a business, sign up for a course to upgrade one's academic qualification, etc. Unfortunately, they cannot do all these if their cash flow is already locked into long-term

contracts such as regular premiums.

Many people are attracted to the illustrated returns of the insurance policies showed to them at the point of sale. But what they don't see are countless number of statements and letters sent to policyholders informing them of cut in bonuses for existing policies. When I do financial planning, I'll ask my clients to give me all statements and documents. I'll always see a sea of correspondence from their insurers telling them that bonuses have been cut again and the projected value at maturity or age 65 is reduced by 30% or 40% due to poor stock market return blah blah blah. There is only one insurer that has never cut bonuses. However, currently they no longer have any attractive endowment to offer. So my advice is to stay away from endowment altogether moving forward.

When a person enters into a long-term contract such as an endowment, ILPs etc, they need to demand for a higher return to compensate for the lack of liquidity and for sacrificing the cash flow. For example, if the illustration says that if the insurer earns 5.25%, it is considered a lousy product if it says that at maturity the policyholder will get 4%. The policyholder must demand a liquidity premium of about additional 1%. Hence, a policy is considered attractive if the ROI is 5% (for a 5.25% projection). I don't know of any such products in the market that can do this.

For ILPs, a higher liquidity premium must be demanded. For 9% illustration, if the product says it will give 7%, this is considered a lousy product. It should give exactly 9% after adding the liquidity premium. Why? Because an ILP guarantees nothing. So if we compared it with a plain vanilla ETF (which guarantees nothing too) with expense ratio of just 0.75%, a 9% market return will yield 8.25% in actual yield after cost. However, for ILP due to the early surrender penalty, the policyholder must demand 1% extra for liquidity premium which is 9.25% per annum. But since it is not possible to earn better than the insurer's 9% return before cost, the policyholder ought to enjoy 9% return exactly. For course this reasoning appears to be unreasonable since it implies the insurer will earn nothing. That is why for this reason – AVOID ILP at all cost. It is better to just invest in an index fund and earn 8.25% (for a 9% market return) and be assured of liquidity and no commitment of cash flow.

The lesson? Avoid the "koyok" seller and stick with simplicity. Simplicity could end up be the best solution to achieve your financial independence.