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NEWPORT GROUP™

Third Quarter 2017 Issue

Behavioral Finance and Institutional Insurance: Utilizing Modern Financial Theory

The sale of institutional insurance (COLI/BOLI/ICOLI) is traditionally done through solid relationships and the application of economics. Specifically, the economic arguments revolve around the current tax efficiency that can be achieved with the insurance product.[1] The arguments are compelling in that the institution can achieve total returns, net of taxes, which are superior to more traditional financial instruments with similar risk characteristics. However, over the past two decades, many of the basic assumptions of traditional (neo-classical) economics have been questioned by the emergence of a new type of thinking: behavioral economics.

Where traditional economic theory holds that all economic actors are rational and act in their best interest, behavioral economics studies how people actually make decisions. What this type of inquiry has discovered is that people often make decisions that, when viewed through the lens of traditional economics, appear irrational. One of the most robust discoveries is the idea of loss aversion.

For a perfectly rational person, a gain of 10% and a loss of 10% should make them equally happy and sad respectively. However, through multiple experiments, it has been shown that people feel losses more powerfully than an equivalent gain. Because of this, people do not engage in perfectly rational behaviors and they go out of their way to avoid losses. This idea of loss aversion is part of a bigger behavioral theory called Prospect Theory, which has proven to be so powerful that it eventually won a Nobel Prize for Daniel Kahneman.

This is all very interesting, but what does it have to do with the sale of COLI/BOLI/ICOLI? When speaking with a client or a potential client, it is important to consider loss aversion. Even though these decisions are institutional in nature, they are being made by people. These people will very likely display loss aversion, therefore, highlighting how the insurance products avoid losses can be more persuasive than a discussion about potential earnings.

When talking to a bank about a BOLI transaction, one way to apply this theory is mentioning the minimum rate guarantee and that negative returns (losses) are unlikely. Doing this will garner a more powerful response than exclusively focusing on the tax-effective return (gains). When looking at a COLI-funded Deferred Compensation Plan (DCP), discussing how proper asset-liability management can effectively immunize against losses will generate a more positive reaction than only considering the potential gains. These arguments are effective, regardless of the product type. Institutional insurance products are outstanding vehicles to help clients overcome loss aversion.

While the tax efficiency of institutional insurance is a critical component of any COLI/BOLI/ICOLI sale, having an understanding of behavioral economics will make that sale proceed more smoothly. When paired with loyal relationships, the application of lessons learned from behavioral economics can generate sales and clients that are more comfortable with their purchase.

Further Reading:

The Undoing Project: a Friendship That Changed Our Minds; Michael Lewis, 2017

Misbehaving: The Making of Behavioral Economics; Richard Thaler, 2015

Thinking, Fast and Slow; Daniel Kahneman, 2011

[1]Variable life insurance policies have certain inherent risks, including the possible loss of principal. Risks associated with variable life insurance policies include, but are not limited to, liquidity, market volatility, asset default and investor control tax risk. Additionally, variable life insurance policies' fees and expenses include, but are not limited to, mortality costs, stable value charges, policy administration fees and asset management fees. Please refer to your Private Placement Memorandum, Stable Value Agreement and/or Life Insurance Policy for definitions of the terms and/or data included in this report and to better understand the risk and fees associated with these policies.