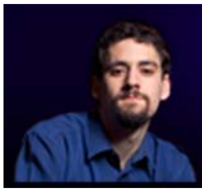

The Kitces Report
Advancing knowledge in financial planning... February 2011

The Policy Review: Ensuring Clients Don't Outlive Their Life Insurance (Part 1)

It is a basic principle of life insurance that in order to receive a death benefit, the policy must actually be a valid, in-force contract at the time of death. Yet despite this absolutely crucial aspect of life insurance - that if you want the death benefit, the policy must be "alive" at least as long as you are - the overwhelming focus of life insurance planning occurs at the time it is bought/sold, not in the years (or often decades) that follow.

In this month's newsletter, we begin a two part series looking at life insurance policies, and how to evaluate their health and anticipated longevity, when they are already present in the form of an existing, in-force contract. Different types of policies have very different contractual provisions that dictate whether and how long a policy stays in force, and what can or cannot be done to extend the anticipated lifetime of a policy. Consequently, for this month's newsletter, we begin by analyzing term and whole life insurance coverage; next month, we will continue with a look at universal and variable universal policies, and the various forms of guarantees they sometimes include.

In the end, you will hopefully have a better understanding of the questions to ask, issues to watch out for, and options that may be available when evaluating various types of in-force life insurance coverage for a client, to ensure that the policy is at least as healthy as the client, so that the client does not unintentionally outlive their insurance protection!

About the Author

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Introduction

Life insurance is a fundamental pillar of risk management in financial planning; it provides the financial means to deal with the financial impact that a death can have on a family (or business, or charity). In existence in some form for several millenia (there are records of basic forms of life insurance to managing burial costs dating back to Roman times), and in "modern" form for centuries (dating back to insurance for traders and merchants at Lloyd's Coffee House {predecessor to Lloyd's of London} in 17th century England), life insurance currently is available in a variety of different policy types, each of which has its own uses, nuances, and challenges.

Nonetheless, most policies can be broken down into a similar cost structure for evaluating the financial aspects of the policy. Although the pieces are more transparent for some policy types than others, ultimately virtually all product types are some combination of: 1) cost of insurance charges; 2) fixed administration/overhead expenses; 3) cash-value-based "wrap" fees (at least for most permanent policy types); and 4) premium loads (charges on incoming premiums to the policy). All of these costs in turn are supported by incoming premiums to the premium, and (for permanent policies) interest/earnings credited to the cash value or the assets underlying the cash value.

Although a rigorous financial plan will likely evaluate any current life insurance protection needs, and recommend and implement new life insurance coverage as required, the ongoing review process for existing life insurance policies often receives far less attention. In this month's newsletter, we begin by looking at insurance reviews for the more "straightforward" types of coverage - term insurance and whole life - and continue next month with some of the more challenging and complex forms of permanent life insurance, such as universal life or especially variable universal life, where problems not addressed early on can be incredibly expense to "fix" later.

Term Insurance Policies

Background

Term insurance is certainly the most straightforward form of life insurance available. The proposition is simple: each year you pay the cost of life insurance, and in exchange you receive one year of insurance coverage. As long as you continue to pay, you continue to receive coverage. Ultimately, annual payments may be broken down into a greater frequency, such as monthly, quarterly, or semi-annually, but the underlying premium is always based on an annual calculation of the cost of insurance. (Editor's Note: It is worth noting, though, that for term insurance policies {and whole life}, it is typically less expensive to pay premiums annually than more frequently. Insurance companies do adjust their pricing for the time value of money, but the payment modality adjustments may be very unappealing at current interest rates. For instance, some companies might convert a $1,000/year premium into a monthly cost of $87.50/month, which actually adds up to $1,050/year and accounting for the monthly payment timing, would require your cash to be invested at 10.8% to break even!)

Several decades ago, the most common term policies were some form of "Annual Renewable Term" coverage, which simply meant that each year, the policyowner could choose to pay the (new) premium, to renew the existing term policy. Premiums would typically rise each year as the insured got older, adjusting to the insurability costs at the insured's newly attained age (often resulting in very high premiums in the later years at advanced ages).

As more recent decades, many forms of Annual Renewable Term (or ART) became "guaranteed" renewable for a specific number of years or certain time period (e.g., 10, 20, or 30 years, or to a maximum age such as 65, 80, or 95), which meant that as long as the policyowner paid the stated premium, the company must renew the coverage (without requiring new underwriting to substantiate that the individual is still insurable). After the specified term of guaranteed renewability, the policy might potentially still be extended, but the insurer could require fresh underwriting and new proof of insurability at that time. Consequently, if there had been an adverse but non-fatal change in health, the insurer might refuse to renew the coverage after the end of the guaranteed renewable time period, or alternative the coverage might be renewed but at a (potentially significantly) higher renewal cost in recognition of current health status.

As guaranteed renewable term policies became more popular, insurance companies also began to offer a version that provided for a level premium over the guarantee period (rather than a premium that rose each year based on the insured's age that year), creating today's commonly used guaranteed level term policies. The principle of the underlying coverage is still the same - term insurance that is guaranteed renewable for a set number of years - but the premiums are adjusted to be slightly higher in the early years and slightly lower in the later years (to level out what otherwise would be a series of rising costs with age). After the end of the guaranteed renewable and level premium years, the policy may either lapse (i.e., no longer be available for renewal), or simply revert to a standard annual renewable term policy with rising premiums (and potentially with the insurance company's option to require proof of insurability again).

With any of these term policy structures, though, the basic framework of the policy remains simple: pay for 1 year of coverage, and receive insurance coverage for that year. If premium payments cease, so too does the coverage. In the interests of protecting consumers from companies that might try to aggressively cancel policies in later years (when they're more likely to produce claims) due to slight "mistakes" in the timeliness of payments, though, state laws today commonly require insurance companies to offer a 30-day grace period. Thus, if a policy lapses through non-payment of premiums, it can be reinstated within 30 days without any additional underwriting; the laws also provide notification requirements to ensure the policyowner has an opportunity to utilize the reinstatement rules, if desired.

Questions To Ask About Ongoing Term Policies

Although the basic framework of a term policy is relatively simple - pay the premium each year to receive coverage for that year - in practice there are still a number of issues that should be evaluated when reviewing an existing term policy.

The first step in reviewing term policy coverage is to understand why the coverage was purchased in the first place: "What is the purpose of this life insurance coverage?" Is the purpose still relevant in the client's current situation?

Beyond that, the next step is to understand the details of the term insurance policy, addressing the following questions:
- Who is the policyowner?
- Who is the insured?
- Who is the beneficiary?
- What is the premium?
- What is the face amount?
- What was the underwriting classification (preferred, standard, etc.)?
- When was the policy issued (and how old was the insured at that time)?

The answers to all of these questions should be easily obtained by looking at the "Policy Declarations" page, typically just 2-3 pages into the standard life insurance contract.

Beyond this initial stage of questions, though, it's important to understand how the premiums may change over time, exploring the following issues:
- Is the premium fixed (for a specified period), or does it rise/change each year?
- Is there a time period associated with the policy? Is it the duration of the guaranteed renewable period, how long premiums remain level, or both?

Given how common it is to find term policies today that are designed to last for some number of years (e.g., "10-year term" or "30-year term"), it is also important to understand what happens to the policies beyond the time period:
- Does the coverage automatically lapse, or can it still be continued, just at a new premium schedule based on the insured's age at that time (and what are those premiums scheduled to be)?
- Can the insurance company require the insured to provide new evidence of insurability (i.e., go through the underwriting process again) if coverage is continued past the guarantee period?
- Does the policy offer an option to convert the coverage to a permanent life insurance policy without evidence of insurability?
- Does this conversion option last the entire duration of the policy, or is it for a limited time period (in many cases, conversion is only available up to some maximum age or for a limited number of years that is shorter than the total guaranteed level premium time horizon)?
- What types of policies can be converted into? What policy expenses may be involved if a conversion occurs? Is the conversion policy a no-load policy, or will a new load be charged for converting an existing policy?

It is also notable that for insurance policies with any material time horizon, the planner should find out the financial rating of the insurance company, to ensure that it is likely the company will still be paying death benefits at the point in the future when they might be needed!

Next Steps For Term Insurance

In practice, the term insurance questions detailed above will fall into two categories: assessing the policy's current status, and determining how the policy can be managed in the future if/when/as it nears the "end" of its term.

With respect to assessing the policy's current status, the primary question - beyond whether the amount of coverage is appropriate, which can be assessed via the financial planning process - is whether the policy is appropriately priced. Policies that were issued relatively recently might potentially be replaced with a current policy with lower pricing, as external forces on life insurance pricing can occasionally push rates downwards even though the insured is a few years older. From a practical perspective, this is unlikely to be the case after the first five years or so, though, at least for what was originally a level term policy. On the other hand, policies that were originally issued as annual renewable term may still have cost savings available to replace with a newer level term policy. However, it's also possible that an extensive due diligence process on pricing was not done in the first place, and consequently the best-priced coverage available now, at current ages, may still be a lower cost than the original coverage purchased in the past at a less-than-optimal pricing point, even if many years have passed. And of course, if there has been a significant adverse change in the financial status of the insurance company that issued the policy, it may be appealing to look at replacing the coverage, regardless of immediate pricing changes.

Replacement coverage may also be appealing for cost savings if there has been a change in health status that would merit an improvement in the underwriting classification. This may be the case if the insured no longer smokes (but did in the past), or has experienced weight loss and/or had an improvement in a previously persistent medical condition. Underwriting classification can also improve if the policy was originally written when the insured had recently experienced some adverse event (e.g., recovering from a benign cancer incident) where there has been no recurrence (e.g., cancer now in remission for 10+ years). Notably, though, if there has been a positive change in health, replacement is not necessarily the only option. In many cases, the original insurance company may be willing to re-consider the underwriting status on the policy (and change the premiums accordingly) if there has been a positive change in health since the original underwriting; this is especially common if the insured originally was a smoker but has stopped smoking for several years.

Term replacement is also a strong option to consider if there has been a change in the original time horizon needed for coverage. For instance, if a 45 year old client is 5 years into a 20-year term policy that has limited extension or conversion options, and believes now that he will need coverage until age 65, not age 60, it may be more effective to replace with a new 20-year term policy that will last until age 65. The alternative - to keep the current coverage, and pay whatever rates apply, if possible, from age 61 to 65 - may in the end be far more expensive than absorbing a slight premium increase now to purchase 20-year coverage as a current 45-year-old. In point of fact, this is often the challenge with term insurance - in essence, it requires you to estimate, correctly, up front, the time horizon for which coverage will be needed and where the client will be financially and health-wise down the road, given an uncertain future. The more clearly those time horizons and needs can be identified, the better the fit for term insurance.

Most issues with term insurance, though, will relate to what happens - or can happen - to the policy at the end of its original time horizon. Depending on the coverage, the term insurance may outright lapse at the end of the time period, but more commonly it will still be renewable - the question is just at what rates, and whether the insurance company can require fresh underwriting to continue the coverage. For those who are near the end of the original term, the decision about whether to maintain the policy will likely be based primarily on the client's health status at that time. If there has been a significant decline in health, and mortality may be close, then the greatest urgency will be to maintain the coverage if at all feasible, and the focus will be whether the coverage can be renewed without evidence of insurability and/or if it can be converted to permanent insurance (so that it can be maintained beyond the original term).

On a prospective basis, it's important to know what decisions will or will not be available at the "end" of the term of a term insurance policy, so at least a plan can be in place if there is a change in circumstances. Will it even be possible to extend the term insurance policy further, if desired, in an annual renewable term format? Will conversion always be an option? In other words, what flexibility does the policy have to allow an extension past the original time horizon, if needed? Not all clients will necessarily worry about being able to extend the term coverage past its original time window - after all, the decision was made to buy term for a limited time horizon in the first place - but it's important to understand the options available.

When term insurance coverage is no longer needed, the process is simple: the client just stops paying the premium and allows it to lapse, now or at some point in the future. Notably, in some cases where the policy is convertible and the insured is "older" (i.e., at least age 60, often a minimum of age 65-70) and has had an adverse change in health but still doesn't want to maintain the coverage, selling the policy to a life settlements company may be an alternative exit strategy.

In the end, most term insurance will simply be bought for a limited time horizon, have premiums paid over the years, and be terminated before or at the end of the time horizon. Coverage will be replaced if cheaper options come along (or re-applied for a change in underwriting status), and face amounts may be increased (with new coverage) or decreased (with replacement or by adjusting existing coverage) if needs change. If the coverage is no longer needed, it may simply be allowed to lapse, or possibly sold to a life settlements company. Nonetheless, for the limited number of clients where the goals may change near the end of the time horizon due to a change in health or circumstances, it's important to be aware of the choices that will be available and, if desired, to ensure that there will be sufficient flexibility to make adjustments when the time comes.

Whole Life

Background

In principle, the concept of Whole Life insurance is similar to term insurance - you pay the premium every year, and in exchange you receive life insurance protection for that year - with one notable difference:

whole life coverage is generally intended to last for your whole life, however long that may be.

In order to accommodate this, whole life coverage is typically structured using a level premium that is intended to remain constant for the entire duration of the policy. Due to the fact that in reality, actual life insurance costs (in terms of the raw cost to provide one year of coverage) rise over time as age and the probability of dying increases, this has the practical effect of generating more premiums than are needed strictly to pay death benefits in the early years, while in the later years the accumulated excess premiums (plus growth) will help to manage significant insurance costs at advanced ages. Premiums are required to be paid each year, in a similar manner to term insurance, to maintain the coverage in place for each year; if premiums are not paid, the coverage will lapse (unless another source of premium payments is available, such as dividends or loans, as discussed later).
However, especially relative to term insurance, the significant amount of up-front premiums required to make a level premium policy "work" for life creates new complications, especially addressing the question: what happen to all those excess premiums if the policyowner doesn't keep the coverage?

In the earlier years of life insurance, less scrupulous companies viewed this as an incentive and an opportunity to 'encourage' policyowners to lapse their policies, intentionally or otherwise. A policyowner might pay premiums for many years and decades, yet have the company lapse the coverage 30+ years later due to one premium payment not arriving in a perfectly timely manner. Not only might coverage itself be lost in such circumstances, but the effective "front loading" of the policy that had occurred would accrue significant wealth to the company and indirect financial loss to the policyowner (who, after the fact, would have paid far more than was necessary for coverage in the early years, yet not have received coverage in the later years after all).

In response to these challenges, regulators and lawmakers intervened with several different consumer protections, including the mandatory 30-day grace period (with notification requirements) for policyowners to reinstate an otherwise (perhaps unintentionally) lapsed insurance policy, and the implementation of various forms of non-forfeiture values. A non-forfeiture value, simply put, was intended to be a value associated with the policy that you could not forfeit - in other words, it was what you would automatically keep, even if the policy otherwise lapsed. Early forms of non-forfeiture protection included a reduced paid-up policy (if the policy lapsed, the face amount of the coverage would simply be reduced to whatever level would allow it to be self-sufficient without any future premiums) or extended term insurance (if the policy lapsed, the face amount would continue for a limited additional period of time automatically as temporary term coverage). However, in today's world, the most common form of the non-forfeiture value that all whole life policyowners can keep, even if the policy lapses, is the cash value.

Indeed, while the cash value is a standard feature of today's whole life policy, historically it was not always present. In the early years, whole life policies did not maintain a cash value, and operated in practice more similar to toady's term insurance policies, where the policyowner paid the premium (every year for life) and coverage continued as long as premiums were paid. If premiums stopped, so did the coverage, and the entire transactional arrangement ended there. It was only subsequent consumer protection legislation that produced the cash value as a form of non-forfeiture value for individuals who let their policy lapse after many years but still wanted something to walk away and show for it (which was reasonable, given the front-loading nature of premium payments for such policies). And since everything about the whole life policy was structured up front - i.e., the premiums and the amount of coverage - the cash value available in any particular year became a guaranteed feature of the policy.

Of course, once whole life policies had a guaranteed cash value associated with the policy, it didn't take long before insurance companies began to offer policyowners the opportunity for policy loans. Technically speaking, a policy loan is actually a personal loan

Out and About

- Michael will be speaking about "The Impact of Market Valuation on Safe Withdrawal Rates" at FPA St. Louis on March 3rd

- Michael will be presenting "Tax Update: 2 More Years" for the Montgomery County Bar Association Trusts & Estates section on March 7th

- Michael will also be speaking about "Revisiting Modern Portfolio Theory" at the FPA Minnesota meeting on March 15th

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from the insurance company to the policyowner, for which the cash value of the life insurance policy is pledged as collateral. Accordingly, when a loan is taken, the insurance policy continues to remain in force, and the cash value continues to grow as required premium payments are made; at the same time, the personal loan with the insurance company can be maintained, and accrues its own interest. As long as the cash value of the life insurance (i.e., the collateral) exceeds the value of the loan, the insurance company's risk is secured and the company allows the loan to remain outstanding. If the loan gets too close to the value of the collateral, the insurance company calls in the loan by forcing the loan to be paid back (or at least, interest paid to stop its value from accruing higher) or by requiring the insurance policy collateral to be surrendered/liquidated in satisfaction of the loan.

Historically, most insurance companies that issued whole life were *mutual* insurance companies, which means the company is owned by its policyowners; accordingly, such companies would issue "participating" insurance policies, which meant the policy would participate in the success and profits of the insurance company by issuing dividends to the policyowners. Dividends represent a combination of a return of the policyowner's original premiums, as a refund for "excess" costs that turned out to be unnecessary due to the financial success of the company, and a crediting of "excess" interest from the actual performance of the insurance company's assets underlying the cash value above and beyond what was originally guaranteed. Typically, although by no means required, dividends would tend to rise over time as the insurance company became more profitable, and especially if/when/as mortality turned out to be more favorable than the insurance company's original estimates. On the other hand, whole life policies from stock insurance companies (rather than mutual insurance companies), distribute a profits dividend to their shareholders, not their policyowners; consequently, such policies generally are not participating ("non-par" policies), and do not pay policy dividends. (Notably, there are some non-par policies issued by mutual insurance companies as well, but most mutual companies issue participating policies, and by definition any policy that receives a dividend must be a participating policy.)

Most mutual companies with participating policies give an array of options on how dividends can be used, from being paid out directly to the policyowner (or being held on-hand in an interest-bearing account), to being used to reduce future premiums (by re-directing the dividend received back to the policy as a new premium payment), to paying down loan interest and/or principal (if there is a loan), or being used to buy paid-up additions. Paid-Up Additions (also known as "PUAs") are purchases of a small amount of single premium life insurance coverage that is fully paid up. For instance, a $1,000 dividend might be used to buy $1,500 of single-premium paid-up additions, such that the total insurance coverage increases to $200,000 (original face amount) + $1,500 (paid-up additions) = $201,500 of new coverage. Since the additional $1,500 of coverage is paid-up, the total ongoing premiums would not increase, since they are only due on the "base" $200,000 of coverage which hasn't changed from the original policy. In turn, the PUAs would have their own cash value associated with that portion of the coverage, and can generally be liquidated separately from the rest of the insurance policy, and without any surrender charges.

Questions To Ask About Ongoing Whole Life Policies

The basic framework of a whole life policy isn't that much more complex than a term policy - pay the premium each year to receive coverage for that year - it's just that the whole life policy is expected to continue those payments "for life" and not just for a limited term. However, in practice there are far more issues and concerns that arise for permanent coverage such as whole life.

As with term insurance, though, the first step in reviewing whole life coverage is to understand why the coverage was purchased in the first place: "What is the purpose of this life insurance coverage?" Was the intention to receive lifetime life insurance protection? Was the need potentially shorter term than that? Were there accumulation goals being satisfied by the policy as well? Do those goals still exist in there current form? Have any of the circumstances and needs changed?

Beyond that, the next step is to understand the details of the whole life insurance policy, addressing the following questions:
- Who is the policyowner?
- Who is the insured?
- Who is the beneficiary?
- What is the premium?
- What is the face amount?
- What was the underwriting classification (preferred, standard, etc.)?
- When was the policy issued (and how old was the insured at that time)?

As with term insurance, the answers to all of these questions should be easily obtained by looking at the "Policy Declarations" page, typically just 2-3 pages into the standard whole life insurance contract.

Once getting through this initial stage of questions, planners must delve deeper when evaluating whole life policies, because of the additional complexities that arise due to the presence of a cash value, potentially a dividend, and the possibility that there may be policy loans involved. Accordingly, some additional questions to ask include:
- What is the current cash value?
- What are the costs (although cost of insurance charges, fixed administrative expenses, premium loads, etc., are typically not shown separately with a whole life policy, total cost information may be available upon request)?
- Is the policy participating? If so, what is the dividend?
- If there are dividends, how are they currently being used?
- Is there a loan? If so, what is the balance, and what is the loan interest rate?
- What is the purpose of the loan? What it is being used for/towards (and does the client realize that!)?

Blended Whole Life + Term Policies
In many situations, whole life policies are structured as a blend of whole life and term coverage. The term coverage is priced as One-Year Term (OYT), and the cost is based on the insured's attained age each year, while the underlying whole life coverage has its own (typically fixed) price. For instance, rather than purchasing a $500,000 whole life policy, the client might own a single blended policy with $200,000 of whole life coverage and $300,000 of OYT to provide the $500,000 total death benefit.

The initial purpose of using such a policy structure is to help manage the cost. Especially in the early years, the cost of a $500,000 policy that includes only $200,000 of base whole life coverage and $300,000 of one-year term will be far less expensive than paying for a full $500,000 of whole life protection.

Of course, because the cost of one-year term insurance will rise every year as the insured ages, blended policies are not viable in that form for the long run; eventually, the OYT costs become unmanageable. However, most blended whole life and term policies are issued as participating policies, and the goal is to use the dividends over time to help manage the ongoing cost.

Most commonly, this is done by using the annual dividends to purchase paid-up additions - small amounts of increased coverage that are fully paid up at the time they are acquired with the dividend. Over time, the (hopefully) rising dividend stream will purchase increasing amounts of permanent coverage, reducing the need for the one-year term insurance to supplement it. For example, after 10 years, the policy might include $200,000 of base whole life coverage, plus $30,000 of paid-up additions, so the remaining term coverage is only $270,000 of death benefit. If the dividends increase fast enough - and the required one-year term face amount decreases accordingly - overall premiums remain relatively level, as the OYT cost of insurance coverage becomes more expensive per $1,000 of death benefit, but the amount of OYT death benefit decreases to keep the total cost in line. After several decades, ideally there have been enough paid-up additions to completely offset any need for term insurance, effectively converting a blended whole life plus term policy into a fully permanent policy by the later years.

However, there are risks with this strategy. If projected dividends do not rise as quickly as first anticipated, the client could discover down the road that the amount of permanent coverage increases through paid-up additions are not enough to offset the rising costs of the one-year term insurance, causing total premiums to rise, potentially quite significantly. In some cases, policies are pushed to the absolute minimum level of whole life coverage with the maximum amount of term to make the policy appear viable, with the risk that virtually any underperformance in the projected dividends results in a policy where the premiums begin to rise over time as the amount of term insurance turns out to be higher than anticipated. In addition, blended policies can also quickly be "derailed" from their original projections if the dividends are ever used for anything besides the paid-up additions they were intended to purchase. If dividends are paid out to cash, or are used to reduce premiums instead, over time the OYT costs will rise, and without an increasing level of paid-up additions to reduce the OYT face amount needed, premiums begin to rise, eventually becoming problematic.

In the end, blended whole life and term policies can be a viable longer-term life insurance strategy that provides for "more affordable" permanent coverage in the early years than buying a full value whole life policy up front. But unlike the traditional whole life policy, its long term viability is NOT guaranteed, and instead is reliant on dividends to rise as projected (but not guaranteed), and for those dividends to be used as originally planned.

- Will there be a charge for surrendering the policy or allowing it to lapse?

In addition to the above questions, it's also important to clarify if there are any other notable features about the structure of the policy and its premiums. So further questions to ask include:
- Is the policy purely whole life coverage, or is there a portion that is term?
- Are the premiums scheduled to be level, or are they rising? (In some cases premiums were scheduled to rise, even with whole life {non-term} coverage, to make the policy more affordable in the early years; in other situations, it may be due to blended term insurance with rising cost as the insured ages.)
- Is the policy scheduled to be paid up at some point, where the premiums cease (sometimes scheduled at a specified age such as "paid-up at 65")?

And of course, as with any insurance coverage, it is important to check on the financial ratings of the insurance company itself, to ensure that it will still be supporting the coverage whenever it might be needed in the distant future!

Next Steps For Whole Life Insurance

Of course, as mentioned earlier, the starting point for any evaluation of life insurance - whole life or otherwise - is to look at the need and purpose of the life insurance. And if the need has changed, it may be time to look at cancelling or transitioning out of the coverage (e.g., via surrender, or perhaps a 1035 exchange to a deferred annuity if there is an insurance gain that the client doesn't wish to currently recognize).

However, often the primary issue for whole life insurance is simply evaluating the coverage that is currently in place, and determining what should be done with it, *especially* if there is a loan involved. Loans often represent some of the stickiest situations in managing existing whole life policies, because compounding loan interest can eventually cause a policy to lapse if/when/as the accumulating loan balance approaches the collateral cash value of the policy. And in point of fact, this can be a risk even with an initially modest loan, as the interest rate on policy loans will be higher than the guaranteed return on cash value, which means over time the growth of the loan balance will compound at a faster pace than the annual increase in cash value collateral of the policy itself.

If there is a loan involved with a whole life policy, the first step should be to request an in-force ledger from the insurance company, to see how the policy is projected to perform in the coming years and decades, given the loan. If the policy is participating - and there is a dividend involved in the projection - it's important to bear in mind that the results of the projection are not guaranteed. In fact, because there is no requirement that the insurance company reflect in the in-force ledger an interest assumption for the dividend that is related to the actual performance of invested assets underlying the cash value (it is, after all, a non-guaranteed "projection"), the planner should ensure that the non-guaranteed interest rate assumptions tied to the dividend are reasonable and appropriate for the presumably conservative insurance company portfolio that underlies the policy assets. If policy dividends are projected to grow at an unrealistic rate, then the policy with a loan may appear to be healthier than it actually is.

Although there is still some uncertainty in an in-force ledger because of the non-guaranteed aspects of dividends, this still allows the client to begin to understand if/when the policy is destined to lapse if the loan interest is accumulating; it also allows the client to see how the death benefit will decline over time (since the death benefit is reduced by the amount of the outstanding loan balance). If the planner is concerned that the viability of the projection may be highly reliant on the policy dividends, it may be desirable to requst directly from the insurance company a second projection with a reduced dividend crediting rate, to understand whether or to what extent the policy is relying on growing dividends to be sustained. If the loan is very modest relative to the size of the policy, the in-force ledger may show that the policy will sustain as is, regardless of dividends, albeit with a slowly declining death benefit. In other situations, the loan balance may be high enough that with compounding interest, the policy will lapse in a limited number of years, again regardless of dividends. However, in practice, dividends can have a material impact over an extended number of years and decades, and consequently considering the impact of policy dividends - especially at varying crediting rates - can be crucial to understanding the viability of the policy with a loan. On the other hand, if the policy is not participating and there are no dividends involved, the policy projection with a loan is at least very straightforward; all components of the projection will be based on the guarantees of the whole life policy, and the only variable that alters the outcome is whether or to what extent the policyowner does or does not put additional monies towards the loan interest and/or principal.

There are several steps that can be taken to try to manage a policy with a loan, especially an "unhealthy" loan that may be setting the policy on a path to lapse in the future. The first option is to simply pay down the loan, so that it is no longer outstanding; if the funds were borrowed from the policy for a temporary reason, this may be an appealing course of action. Alternatively, the client might wish to at least pay the loan interest on the policy, to keep the loan from accruing to the point where it may someday cause the policy to lapse, although in practice many clients find this unappealing because it "feels" like an increase in "premiums" being paid into the policy.
If the policy is participating, many ongoing policy loan issues can be partially or fully managed by redirecting the use of the current dividend. Most often, the default setting for policy dividends is to purchase paid-up additions, which is a very cost-effective way to buy small amounts of additional insurance coverage (paid-up additions generally have many insurance acquisition costs waived, including any commissions otherwise typically associated with the purchase of new coverage amounts). However, in a situation where a loan is present, dividends can also be redirected to pay loan interest (reducing the compounding growth rate of the loan balance) and if the dividend exceeds the loan interest, can also be used to pay loan principal. By this process, the dividend applied systematically again loan interest/principal can at the least slow the growth of an ongoing loan, and may even hold it steady or begin to pay down the loan balance, extending the life of the policy. If dividends have been used in the past to purchase paid-up additions, the policyowner might even consider surrendering some or all of those paid-up additions (which can generally be done without cost or surrender charges) and using the proceeds to further pay down any loan balance (without out-of-pocket costs for the policyowner). However, as discussed earlier, this use of dividends (and surrender of paid-up additions) may be problematic if the coverage is a blended whole life plus term policy, as redirecting dividends away from paid-up additions in the near term may increase the likelihood that the one-year term costs become unmanageable in the long run. Simply put, if the policy is blended, dividends rarely are sufficient to do "double duty" of managing a loan *and* buying enough paid-up additions to reduce the reliance on term over time.

In many cases, policyowners may not even be aware that there is a loan balance accumulating. This occurs most often because the policyowner chooses to stop paying the premium (or forgets/fails to do so), and the premium is instead paid automatically via a loan against the policy. Remember, with a whole life policy, it is a *requirement* that the premium be paid every year, so if the policyowner does not write a check, the premium *must* come from some source, and a policy loan is the source most often used (by default). On the other hand, policyowners with participating policies will likely also find at some point that the dividends may be large enough to fully offset the premiums, and (especially if there is no loan balance) may simply wish to request that dividends be used to reduce premiums (and therefore out-of-pocket costs), rather than purchasing paid-up additions. Even if dividends are not sufficient to fully offset the premiums, some policyowners may still wish to allocate whatever dividends are available to reduce the out-of-pocket premium costs, and when dividends eventually rise to fully cover the premium costs, the out-of-pocket expense will fall to zero. Of course, the exact timing of when this crossover may occur can be uncertain (see dividends and "vanishing premiums" sidebar, next page).

Beyond evaluating the whole life policy to determine if there is a loan that needs to be addressed, and looking to how dividends are being used and whether they should be re-directed towards a loan or simply used to pay the premiums, policies should also be evaluated for cost compared to other permanent coverage options. In practice, if the whole life policy has been in place for many years or decades, the costs to replace with a new policy (i.e., incurring new state premium taxes, Federal DAC {deferred acquisition cost} taxes, sales charges, etc.) can be greater than cost-savings that may be available by acquiring a policy with today's generally-more-favorable mortality tables, even if the client's health has not declined. As such, it is often unlikely that an older policy can simply be replaced with a new policy at the current (and much older) attained age if a number of years have passed.

Notably, the likelihood that an older policy remains competitive is especially true if the original whole life coverage was a participating policy, as any better-than-expected results for the insurance company in terms of either investment returns or favorable mortality results are already being shared with the policyowner via dividends. On the other hand, if the whole life policy was purchased many years ago from a stock insurance company or is otherwise non-participating, it may be worthwhile to price it against new current coverage, even at a higher age (if there has not been an adverse change in health) and with new policy costs, given the fact that the policyowner is not otherwise sharing in any beneficial shifts in mortality or favorable investment experience via a dividend. In addition, when considering replacement, it may be wise to evaluate if overall policy costs are reasonable in the first place; some publicly available tools (such as www.policypricingcalculator.com) can help provide perspective on industry averages for policy costs as a benchmark. Planners who wish to conduct a more in-depth pricing analysis regularly with clients might consider subscribing to a life insurance policy pricing and performance research service, such as www.TheInsuranceAdvisor.com (more information at info@TheInsuranceAdvisor.com). Given that not all policyowners performed a rigorous cost analysis of their prospective policy up front, there is also a real possibility that competitively priced replacement coverage could be appealing to a less-favorably-priced original policy in some cases.

In other situations, it may be appealing to exchange an existing whole life policy to a new universal life policy, either for changes in pricing or if the only desire is a death benefit (but not significant accumulating cash value), to acquire a policy that offers guarantees against lapse but offers less in cash value build-up. As discussed further in next month's newsletter on universal life, many of today's policies offer "secondary guarantees" that allow coverage to remain in place as long as premiums are paid each year - similar to whole life coverage - but may not necessarily build up as much cash value in the

Dividends and "Vanishing Premium" Whole Life

Because whole life policies are priced very conservatively - to ensure that the insurance company can make good on their guarantees - virtually all participating whole life policies begin to generate policy dividends, as future results turn out to be more favorable than the original conservative projections.

In the 1980s, many whole life insurance policies were actually sold on the up-front assumption that insurance companies would continue to have the positive results they were experiencing at the time. In a world where whole life insurance cash value had a relatively low guaranteed rate of return - yet actual bonds, even Federal government bonds, paid a far higher interest rate - insurance companies were generating very significant "excess interest" earnings (by having the cash value invested more favorably than the returns guaranteed under the whole life policy itself). In the case of mutual insurance companies, much of the excess interest earnings were credited back to policyowners as a generous, rising dividend.

In light of these early favorable results, many insurance agents began to make the significant dividends a featured selling point of the participating whole life policy under the popular label "vanishing premium" whole life - policies where the dividends were assumed to rise at a fast enough rate that by approximately 10 to 20 years into the policy's lifetime, the dividends would be sufficient to fully offset the policy premiums, such that the out-of-pocket premium costs would "vanish" for the policyowner. As long as interest rates remained at levels that were so much higher than the guaranteed rates of whole life policies, the insurance companies would be able to earn enough excess interest to support the rising dividends at such levels.

Unfortunately, though, in practice many of these dividend scenarios did not turn out as anticipated. As interest rates declined through the 1980s and 1990s, dividends did rise for many whole life insurance policyowners, but nowhere near the rate originally anticipated in the projections. In addition, while mortality results generally turned out more favorable than originally projected, due to medical advanced, it was still not enough to support dividends at the originally projected levels in the face of declining interest rates. As a result, 15 years later, most policyowner premiums still had not "vanished" as expected, and sometimes weren't even close. In other situations, declining rates actually caused dividends not just to slow their growth rate, but to actually drop, and in the extreme a few policyowners actually experienced premiums that "vanished" (with rising dividends in the 1980s and early 1990s), and then "reappeared" a few years later, as lower dividends were no longer sufficient to cover the premiums anymore.

The vanishing premium debacle ultimately cost the insurance industry hundreds of millions of dollars in class action lawsuits in the late 1990s, as so many policyowners ended out with results far less favorable than originally projected and "promised" by agents. Although the whole life policies themselves had performed exactly as anticipated - since all aspects are guaranteed - the non-guaranteed nature of the dividend, and overly optimistic projections thereof, resulted in an overall combination of policy and dividend that did not perform nearly as well as originally expected. In practice, many such policies have finally had their premiums vanish by now - almost 30 years later - and may be desirable to keep at this point. Nonetheless, they still serve as a warning reminder about the risks of excessively relying on non-guaranteed dividends.

meantime, which can still be a desirable outcome if the primary goal of coverage was "just" a death benefit.

Of course, if the needs for the policy have changed and it simply does not serve its original purpose, the client may wish to just let the policy go. Depending on the details of the policy, this may involve either just surrendering the policy and keeping the cash proceeds, 1035 exchanging the policy to an annuity to defer a gain, stopping premiums and allowing the policy to maintain itself on loans (until it lapses in the more distant future), stopping outside premium payments and allowing the dividends to pay some or all of the future premium costs (in essence, maintaining the coverage "for free" at no additional out-of-pocket cost), or reducing the face amount of the coverage to a point where the policy is either paid-up and/or can be maintained from dividends alone. Alternatively, the client might also consider investigating whether it is viable to sell the policy for more than its cash value on the life settlement secondary market, especially for "older" clients who meet the age requirements.

Summary/Conclusion

Life insurance is a risk management pillar of financial planning, yet in reality we have a tendency to focus more on life insurance decisions at the time of initial need and purchase, and not so much in the ongoing years (and decades!) that a policy remains in force.

For some types of coverage - like term insurance - this is not necessarily problematic, as long as the client is aware of what happens at the end of the term, and as long as needs have not shifted and health hasn't changed. The focus simply becomes an ongoing cost comparison of whether pricing is still favorable given policies currently available and the remaining time horizon.

In the general case, whole life coverage can be similarly relatively straightforward, as it is analogous to a term policy with annual required premiums, albeit one that happens to extend for the insured individual's whole life, as long as that may be. However, the common presence of dividends, and the fact that policies often take on loans that can become problematic over time, demands some greater attention. And in the case of reviewing existing whole life policies, sometimes problems have already begun, and corrective action is necessary to get the policy back on track.

In any event, hopefully the questions and information in this newsletter will help to provide a little more structure and guidance in how to evaluate existing life insurance policies, and the action steps that can be taken in response. In next month's newsletter, we will continue the process by looking at some of the more complex challenges that arise with universal and variable universal life policies, and how to evaluate such coverage when the client brings in an existing policy. But the bottom line is that ensuring a client does not unwittingly outlive his/her life insurance (and insurance needs) means not just the right decision about a life insurance up front, but an active review process to ensure the right coverage remains in place throughout and that the policy is at least as healthy as – and lives as long as – its insured.

What did you think?

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Please let us know what you think by emailing us at feedback@kitces.com! Thanks in advance for sharing your thoughts!