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Life Insurance Cash Value: A Practical Discussion

by Peter Katt

As readers of my AAII articles know, I believe the best way to understand the maddeningly complicated life insurance asset is to present various anecdotes on specific issues.

In this spirit, several recent client encounters about aspects of life insurance cash value has prompted me to discuss cash values—not in a historical and comprehensive sense, but with narratives to provide a better practical understanding of cash values for owners of life insurance policies.

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About the author

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It's My Money and I Want It Now

A client I will call Stan came to me furious because he was being charged interest on cash value loans from his participating whole life policies. Recently, his agent told him that without either premium or loan interest payments his policies would terminate. Stan was furious because of his insistence that no loan interest be charged, since it was his money and he viewed the cash balance like a bank account.

This isn't the way life insurance cash value works. Life insurance as an asset is not dissimilar to, say, apartment units. If you want cash from the apartment asset (or your life insurance), you take a mortgage (loan) and pay interest. This reduces the net value of the apartment (the life insurance death benefits) by the amount of the mortgage (loan). Alternatively, you could sell some units (withdraw cash value) to receive cash. You would not create a mortgage (loan), but you would reduce the net of your asset (you would own less). This is why a life insurance policy's cash value is not, nor should it be viewed as, a bank account.

Unattended Cash Value Loans Can Crater a Policy

Stan's loans accumulated due to a combination of factors. His agent left the business. When Stan moved, the insurance company lost track of the correct address to send him premium notices. As a result, Stan didn't receive them. Stan also didn't pay premiums because he thought the premiums were covered within the policy. The premiums were covered by loans. Due to missed premium notices and the loans, the policy eventually reached a tipping point of being in danger of lapsing with phantom income within a year.

Stan, mistakenly believing that the cash values were his to do with as he pleased, then spent hours in discussions and written communications with the insurance company trying to pin blame on them for this situation. He threatened legal action. He churned up a lot of frustration. Even if Stan successfully proved that the company mismanaged this situation, the cost in money and time would have produced a huge net loss to him. The amount at stake was really quite small.

Cash value life insurance with a large loan can cause a policy to lapse

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without value, but with taxable income. This is because the cash value loan value (known in the tax world as boot) is the gross value of the policy when it lapses. (In this example, the gross value is the loan.) The insurance company's calculation of the cost basis is subtracted from the gross value and the difference is the reportable taxable income. Note that when a policy lapses with no value but with taxable income, there are no funds from the policy to pay the taxes. This is known as phantom income.

I determined that Stan had three choices to rescue the situation, but only one that was in his best interest. Fortunately, Stan has a relatively high net worth with cash resources. Repaying the loan of approximately $46,000 immediately raises the policy's cash value by about an equal amount. It also raises the death benefits from approximately $28,000 to $81,000. Taking into account the payments and the death benefit payout at Stan's life expectancy, the calculated yield is 3.14% of tax-free income based on the current dividend.

In the current low fixed-income yield environment, this is a decent return. More to the point, it is the only way for him to have a positive outcome with this policy. All the other options produce negative financial outcomes, including repaying the loan and then terminating the policy for its surrender value. (Doing so would produce significant taxes.) Because of his negative feelings generated for this insurance company during his long battle, Stan only reluctantly repaid the loan. Astonishingly, during the long ordeal the insurance company spent most of its time defending its practices. To the extent the company suggested repaying the loan as the only real solution, Stan didn't accept the suggestion because of his total mistrust.

Letters
Member questions and comments on recent AAII Journal articles.

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Account Value Is Not the Same as Cash Value

Almost all universal life policies have significant surrender charges that are listed in the contract. They also show up as the difference between the account value and cash value in statements and illustrations. Many clients and advisers don't understand the difference.

Let's say a $1 million universal life (UL) policy has a $100,000 account value and a $50,000 cash value. The surrender charge is $50,000. The client could borrow or withdraw against the $50,000 cash value, but not the account value. If the client were to withdraw most of the cash value, the policy could continue for quite some time because the monthly insurance charges are usually deducted from the account value that would be approximately $50,000.

Let's say that the client wants to reduce the policy from $1 million to $500,000. This would cause half of the $50,000 surrender charge to be incurred, or $25,000. After the reduction to $500,000, the account value would be $75,000 while the cash value would remain at $50,000. (The difference between the account value and the cash value is the surrender charge, the penalty paid for reducing the policy.) Since the surrender charges go down each year, this is a real loss in policy value.

The account value offset by the surrender charge is really a way for the insurance company to hide the sales commissions. If the commissions are lower, the surrender charges are lower and the surrender cash value is higher. This can be done on some universal life policies (not all) by demanding that blending be used to replace base death benefits with term insurance. This blending alters nothing in the policy's pricing, except to reduce the commissions and surrender charges and increase the cash value.

Can I Have My Cake and Eat It Too?

A client reviewing his annual universal life statement showing $2.5 million cash value for his $10 million policy had a question: Does the cash value add to the death benefit? He then had an epiphany that the answer for his policy is no. So why not take out most of the cash value?

There are two reasons why this shouldn't be done. First, borrowing or withdrawing cash values will reduce the death benefit by the same amount, so nothing is gained. Secondly, the cash value is the foundation of a permanent current assumption universal life policy (as opposed to guaranteed universal life). The target premiums are set up to level the annual cost of the policy with the buildup of cash value used to support the increasing cost of insurance charges as insureds get older, with the account value reducing the amount of actual life insurance.

The overall management of a level death benefit universal life policy needs to take into account an insured's potential for a change in health so the target funding age is accurate. For a healthy insured, we need to fund the policy as if he will live to age 100 or beyond—lifetime funding. Depending on the type of policy, this may mean generating a cash value equal to the death benefit at 100. In others, we only need $1 to continue lifetime funding beyond age 100. But if an insured incurs significant health issues, we may decide to fund the policy to an earlier age, if the probability of living to the earlier age is low because of health issues. The goal is to have $1 of cash value when the insured dies.

This, of course, is a theory and not reality, but we can save significant premiums by assessing mortality prospects and minimizing the cash value buildup when mortality probabilities are more in favor of dying around, say, age 85 than age 100. The secret to effective universal life cash value management is not to build it up in the first place, because as I've explained, you can't get it out without reducing the death benefits.

Guaranteed universal life (ULG) has low to zero cash values. Unlike other permanent policies that terminate if there is no cash value, guaranteed universal life depends on a specified premium being paid as contracted for the coverage to remain in force, regardless of zero cash values.

→ Peter Katt CFP, LIC, is sole proprietor of Katt & Co., a fee-only life insurance advising firm located in Kalamazoo, Michigan (269/372-3497); www.peterkatt.com.

Discussion

J Deike from California posted 23 days ago:

Understanding life insurance is akin to explaining to an alligator that if he would climb a tree he could avoid drowning. What kind of tree you ask? Well, of course that depends. I give credit to the alligator for not caring in the first place. Besides, he's more interested in finding his next meal and avoiding the shoe company entrepreneur.

The above doesn't make sense you say? Kind of like insurance; my point exactly.

Subramania Jegathesan from Oklahoma posted 23 days ago:

Any life insurance is good ,only if you die. If you are disciplined , put the money in the market .at the end you will have more money and you are in control.life insurance is the worst form of investment. As I said it is good only if you die

Daniel Wickenhauser from Illinois posted 23 days ago:

Term life Insurance makes sense to cover a risk for a specific amount of time. Whole life insurance is just a bad investment, unless you will do nothing if not paying into your whole life policy. Sort of a forced savings, but not unlike overpaying the IRS so you can get money back...

G Gordon from Tennessee posted 23 days ago:

This discussion assumes the death benefit remains desirable. If I take the cash value out and cancel the policy, I have to pay income taxes on the cash value earned above the total of the premiums paid. With a 65 Life policy, over 30 years the cash value has increased at ~8% annualized, PRE-TAX. Not a bad investment.

Jerry Durham from Tennessee posted 23 days ago:

For at least 90-95% of the population, term insurance makes the most sense. I feel that the cash value in permanent life insurance is basically what you have overpaid for. In the words of A.L. Williams----"Buy term and invest the difference". Another problem with permanent insurance is that is it very difficult to figure out just what return you are making on your policy. Of course, that return is at the discretion of the insurance company, meaning that you have no control whatsoever.

Marvin Warren from Montana posted 20 days ago:

If I were given a dollar for every person who planned to "buy term and invest the difference" and didn't do it, and had to give back a dollar for everyone who planned to "buy term and invest the difference" and actually did it, I would be quite wealthy.

The AAII crowd is probably different, but the vast majority of families could really use a few hundred thou when somebody dies, and they are unlikely to be concerned about what the return on investment was.

Life insurance has it's place.

Allen Romain from Michigan posted 12 days ago:

term insurance claims are paid out on 2% of the polocies issued. if I could offer you a 98% ROI guaranteed you would take it all day long.Did it ever occur to any of you the life ins companies started the buy term debate.It would certainly behoove them. Furthermore, look at all the wealth tranfer that does not take place due to prohibited premiums in our senior years.

Edmund Waller from Georgia posted 12 days ago:

Life insurance, especially whole life insurance, always gets a bad rap on investment discussion boards. I have had term life and "Comp Life" (a blend of whole life and term life insurance) from NWM for the past 23 years. The Comp Life policies were acquired in pieces, over time, mostly by conversion of portions of the term policies, utilizing the conversion feature. The death benefit of the Comp Life policies are 7% of the total death benefit value of all insurance.

I have calculated the ROI for the Comp Life policies in a number of ways. First, I note that about two years worth of premiums for Comp Life pay the agent/company. Second, after the commissions are paid, the ROI on subsequent premiums is currently 4%, integrated over the past 23 years. This corresponds to a pre-tax ROI of about 5.5%. Not the best investment, but the beta for the cash value with respect to the SP500 is very low so that the cash value of the life insurance leavens out the volatility of my exposure to the stock market. At present, for someone about 14 years form retirement, the cash value of the life insurance represents about 18% of all my "retirement" savings. When I retire, it will still be about 18% of my "retirement" savings. As I spend down 457B and 403B accounts, the cash value of the life insurance policies will continue to increase, giving me a cushion of cash so that I will not outlive my savings if the markets performs worse than predicted over the next 20 years. For me, the cash value of life insurance becomes a buffer against excess volatility and down-side risk in the stock market and a way to transfer wealth to my children/grand children tax free.

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Steve Daniels from Connecticut posted 11 days ago:

I have had a small whole life policy ($90K fixed death benefit)for almost 40 years now. I had been told that the annual dividend would pay the full premium in less than 10 years. That never happened. I still pay about $600 a year over the roughly $1000 dividend.

The cash value of the policy goes up about $2,000 a year and is now slightly over $53k. At a relatively healthy age 72, I am now trying to decide whether to continue the policy or take the cash value and invest it elsewhere. I really don't have a need for the insurance anymore (I just kept it thinking the dividend would pay the premium).

thoughts about whether it pays to keep it or not?

Charles H Wadhams from California posted 11 days ago:

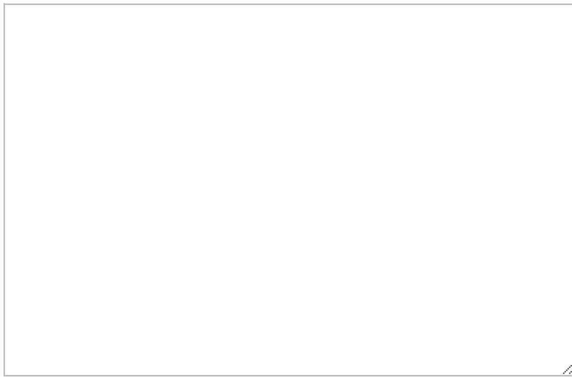
Oh Dear; This discussion proves that Whole life insurance as a part of a total plan is very individual. all of you will argue the value of your securities, the relevance of your issues and the worth of bonds. That's what this organization is all about.
In consulting and selling Life insurance for 45 years, and managing agencies and teaching many individuals the business. I believe that there is a place for that whole life policy in my portfolio. and for the policy on my wife's life. we will always need the liquidity. At 87 and 84 we have done well and live well. the key is discipline! Buy term when you have a high risk, convert some of it as you grow, and invest all along. let the cash value be a bond portion and buy Value and growth securities.
As Peter Lynch taught; buy quality merchandise, in securities and in life insurance.
Charlie Wadhams BS, MSFS,CLU, ChFC.

Steven Sears from Iowa posted 11 days ago:

Back in the 1980s I bought a Universal Life policy that guaranteed 12% return. But with every statement the value was less and less. That was because the undisclosed and obscure fees totaled 15%. They even charged a fee for charging a fee. How do you think they pay for those skyscrapers downtown? None the less I have a Whole Life policy I have paid into since High School and is now worth much more than I have paid in. In our state every estate, no matter how small, is required to go through probate. That is our state government at work looking out for the little people. However Whole Life Insurance bypasses probate and is paid directly to the beneficiary at death.

Name:

State:



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