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Life Insurance and Policy Loans

A match definitely not made in heaven.

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As a life insurance consultant, I see just about everything imaginable out there. My desk is littered with cases for which I've been called in to pick up the pieces after the wheels fall off. In fact, litigation support and expert witness work is the fastest growing part of my practice. There's a lot of good work, but there are also a tremendous amount of lousy plans. Advisors are regularly bringing me their client's non-performing policies and structures and I like to use these real life cases to educate as many advisors as possible.

I urge the advisor community to address these issues before clients are dissatisfied and angry. Proactive action can prevent problems and save a ton of money. There's a common problem that few are aware of that has an obvious and simple solution.

Large Policy Loans

There are a handful of current files on my desk with large policy loans. The loans on these policies range from $500,000 to $3 million. In some of these contracts, money was actively borrowed out, and in some, the loans are a result of borrowing premiums to fund the policy. In others, the policy owners didn't even know a loan existed. Imagine the shock when they learned this.

Furthermore, even the policy owners aware of the loans didn't know the loan interest rate, how it worked and how the policy was affected. The loan interest rates for the policies range from 6% to 8%, with most of them at the top end. Would you ever move forward with an 8% home mortgage? What would you tell a client if you discovered she had an 8% mortgage?

An Undesirable End Result

One file is for a $2 million policy with an $800,000 loan growing at 8% with no premium or loan interest paid out of pocket. This means that just this year, the loan will grow by the $64,000 of accruing interest plus the $30,000 of annual premium. Ten years from now, the loan will be $2.2 million. This will require a couple $100,000 a year out of pocket to support the loan interest and premium for a net death benefit that's almost nonexistent. If the client doesn't fork over the money every year, the policy will fall off the books soon thereafter with a 7-figure taxable gain. In another contract, the annual interest is currently $180,000 that must be paid to stave off a 7-figure taxable income.

Lapse or cancellation of any of these policies results in an income tax liability on phantom gain. Imagine that: All those years of paying premiums and the policy lapses or implodes, with 100% of the cash value and the death benefit gone and you owe the IRS hundreds of thousands of dollars. That's unconscionable.

The Re-Finance Option

Would you refinance an 8% home mortgage today? Of course you would. Why not refinance the policy loan? Most policy owners don't think about this because life insurance is complicated and a bit of a black box. "Can I even do that?" is the typical response. Yes, but you do have to know what you're doing.

The existence of a loan affects the performance of many life insurance contracts beyond the growing loan and accruing interest. The cash value that's collateralizing the loan is often credited differently than if the loan wasn't there, so don't ignore policies that might have lower loan interest rates. We employ a process to determine the effects a loan has on a policy, the best way to deal with the loan and how to best manage the policy moving forward. There's always a most effective action for a given situation.

Why Is This a Surprise?

It's just confusion, misinformation and a lack of awareness and education.
Many policy owners mistakenly believe that their life insurance policy is a source of inexpensive loans. This is partially due to the fact they've been told their cost is only the small spread between crediting and borrowing rates, but it's not that simple. Regardless of the spread, an 8% loan still grows at 8%.

Even more misunderstood are "wash loans." These are loans in which the borrowing rate and crediting rate are illustrated and assumed to be the same so many policy owners understand it to be a wash with no adverse effects - effectively a free loan. A wash loan still grows at the loan rate regardless of crediting. The point is, the loan can easily grow out of control.

Analysis in the Big Picture

Should a loan be paid off or re-financed? Let's do the math. If it should be, what's best? Provide the data, and we'll do the calcs. This isn't the time to go with your feelings. This is real money and an important issue. The math will tell the story especially when the facts and circumstances of each client are clarified and understood.

For the referenced policies on my desk, we're saving our clients and trustees hundreds of thousands, if not millions, of dollars in loan interest and eliminating catastrophic income tax consequences. The death benefit is salvaged, and the policies move forward more efficiently.

What's a Logical Next Step?

Anyone who has a significant policy loan is eyeing life insurance cash value as a source of funds or considering new coverage that may be financed will benefit from a second opinion and objective analysis.

If you're an insured, trustee, advisor, CPA, attorney or family office advisor who deals with significant life insurance and wealth transfer matters, comprehend the math and measure the risk or have us provide this analysis for you.

No one should move forward with an existing loan or take out a new loan or policy without an independent analysis of options, financial results and risk management.
As far as simple and profitable solutions go, this takes the cake.

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