What Went Wrong With My Dividend Paying Whole Life Policy?
How term blended whole life works… or not.

It turns out that recreating letters of explanation to policy owners and trustees to use in an educational format is welcome. I suppose it makes sense that if one policy owner has the question, others might as well.

Following is a portion of an email I received earlier this week:

My question is to confirm that we indeed have lost the $500,000 rider on the policy. If so, then can you provide a brief explanation as to why? Is it because we didn't pay enough premiums in? He became too old? Etc. I only ask this for my own information in case I ever need to explain it.

The policy in question was a $2 million participating, dividend paying, whole life contract. It was initially a $1.5 million base whole life policy with a $500,000 term rider. There have been innumerable instances where I've had to explain the same thing to a policy owner when things weren't working out as expected.

Following is my response:

Hi Joe:

Regarding the $500,000 term rider, yes, that's gone. Here's how it works:

The original contract was built with the base policy being actual whole life, and the rider is term insurance. The idea is that the dividends on the base policy buy little bits of paid-up insurance every year. These are generally called paid-up additions, or PUAs. The PUAs reduced the amount of the term.

> Example
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> At the first policy anniversary, the dividend, per the dividend option of this contract, buys a given amount of paid-up death benefit based on the age and class of the insured individual. Let's say the base insurance is now $1,510,000, so the term is reduced to $490,000 and the total coverage is still $2 million. The following year the dividends may buy a little more, so the death benefit might be $1,525,000, with the term rider decreasing to $475,000 for a continuing total of $2 million.

The idea is that the whole life portions of the policy will eventually replace all of the term insurance. When this happens, the PUAs are still projected to grow and result in an increasing death benefit in excess of the $2 million.

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This is important because the whole life insurance, while more expensive in the early years, has long-term guarantees and more consistent pricing. The term insurance is very cheap early but gets very expensive over time. This is not supposed to be an issue because the term insurance isn't supposed to be there down the road to ever get expensive. The problem is, the dividends have gone down on whole life policies for decades, since the mid to late eighties. The lower dividends resulted in lower PUAs, which meant more term was left on the policies than anticipated. This term got very expensive. Can you imagine what term insurance would cost on an 80 or 90 year old guy? The initial term insurance charges at age 50, when the policy was issued, were exceedingly low. Even twenty years later, at age 70, when the term charges are higher, they were only projected to be for a small amount of the initial term insurance because the term was supposed to have been largely replaced by whole life insurance. Soon after, the term insurance was initially projected to be gone entirely.

With the lower dividends, about half of what they were initially, it gets to the point where the entire dividend can't even cover the term insurance, let alone buy any PUAs. The policy then surrenders PUAs to pay for the term insurance. When the PUAs are gone, the term premium has to come out of pocket, and it's ludicrously expensive. Not only is the term insurance lost, much of the cash value of the PUA part of the policy is also lost to pay for the rising cost of the term insurance. Much of this could've been salvaged if it had been understood years earlier. And it was foreseeable.

It's helpful to visualize a whole life policy as two or three different policies. One part is the base whole life policy, one part is the PUA policy and one part is the term policy. The base policy and the PUA policy each have their own cash value and death benefit. You may have noticed earlier that I referred to the whole life portions, with an 's', part of the policy. This is why. The cash value, as you understand it, is really the sum of the cash values of the two whole life parts of the contract. Some ledgers differentiate this and some don't very well.

Early in the life of the policies, the base policy earned dividends in excess of the term policy, and the extra went into the PUA policy. Later in life, the term premiums got more expensive than the dividend credited, so the cash value of the PUA policy was tapped to pay them until it was driven into the ground. With no PUAs to pay term premiums, the term portion lapsed.

Here's another way to think about it. Let's assume you have a job with a guaranteed base income along with projected bonuses. We'll say your base income is $100,000, and with bonuses, it's $150,000. Furthermore, let's assume your living expenses are $125,000. You know living expenses won't be covered by your base salary, but you'll likely get your bonuses, so you're confident in your planning. The $25,000 left over goes into a savings account so you can stop working some day. Your financial advisor's modeling shows you can retire at 65 if all the projections pan out, but that's not a guarantee.

Your guaranteed base salary is the guaranteed base whole life, projected bonuses are the projected dividends and the savings account is the PUA cash value.

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In the early years things go according to plan and you live your life and build a savings balance. Later, the company runs into some problems and the bonuses get reduced. You can still cover your living expenses but savings takes a back seat. Some years later, your company starts taking a beating in the market and it lowers bonuses even more. Now they're at a point where your income is less than your living expenses, so you tap your savings account to make ends meet. This can only go on so long before the savings are exhausted and you'll have to change your lifestyle.

Voila! You're not making enough to support your lifestyle, so something's gotta give. Your life insurance isn't making enough to support itself, so something's gotta give. It's very simple.

Maybe the upside potential did pan out and the retirement account did get funded, but inflation was meaningfully greater than expected. The plan might still falter. You will likely have to earn more now or expect less later.

What too few policy owners realize is that much of the projected increase in cash value, and all of the projected increase in the death benefit, and sometimes the projected limited number of payments into the policy, are all projections, not guarantees. They may or may not come to pass.

None of this happens overnight. It progresses over a number of years and can be determined well before its a significant problem if someone's paying attention. It's kind of like a cancer that is quietly growing until a point that it becomes a problem, but by then, it may be too late.

The personal finance example may seem far-fetched, but what if all of your income was auto deposited into an account that your expenses came out of? What if you never opened your statements, or they were too convoluted to understand? Or you simply didn't pay attention because you were initially told everything was very conservative and it would all work out? Doesn't seem so crazy, does it? This is how life insurance works.

Some years ago I had a client with a whole life policy from the same insurance carrier. The initial annual premium was $150,000 for $40 million of survivor whole life. By the time I got involved and ordered an in-force ledger, the projected premium was soon to be millions of dollars a year. Yes, millions a year. $25 million of the policy was initially term insurance. This was supposed to go away, and it partially did for a while. By the time I arrived, the PUAs had been depleted, and the term portion of the death benefit was again $25 million. It turns out that annually increasing term insurance for $25 million costs a lot.

It's a kick in the gut to lose $25 million of insurance in the trust you were counting on for estate tax liquidity. But one more time, it doesn't have to be this way. It may be a black box to you, but it's not to someone who knows what they're doing and is willing to evaluate things objectively and tell you the truth. You probably don't know much about the engine under the hood of your new car, but you still buy one, and you have someone you trust who understands it help you out. Whether something has gone wrong or you just need the occasional oil change (few of us even do that ourselves nowadays) you do what needs to be done.

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