Question:

Please help me out with the effect of a loan on my policy. What happens to policy crediting and am I focusing on the cash value or the cash surrender value when looking at COIs (Cost of Insurance).

Answer:

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Questions & Answers
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The effect of loans on life insurance policies is a source of common confusion and frustration. There are potentially multiple effects a policy loan can have but regarding mortality charges we have to focus on the cash value and not the cash surrender value.

The reason is because of how life insurance loans actually work which is different than most people understand based on what agents tell them.

When policy owners take loans they aren't actually "borrowing from themselves" as is common vernacular. The insurance company is issuing the loan just as a bank would but without the financial underwriting because you are “pre-approved”. And why wouldn’t you be? I think any financial institution actually holding assets of yours for greater than the loan amount would be fine issuing an on demand loan.

The cash value of the policy is collateralizing the loan which is why there is a different cash value and surrender cash value. It's no different than a line of credit collateralized by your investments. Your total investments are there but your net available assets are lowered by the amount out on your line of credit.

The reason it matters that your cash value is still in the contract is because the insurance company only charges mortality charges or COIs on the spread between the cash value and the death benefit. If ones death benefit is $1,000,000 and cash value is $200,000 then the COIs are on the $800,000 spread because you are basically self funding $200,000 of the insurance. That's why we like to see a growing cash value in most life insurance policies. As the insured individual gets older the cost per thousand of coverage gets higher but theoretically it is on a smaller and smaller amount. (Though this depends on what kind of policy we’re talking about.)

When a policy owner takes a loan, the cash value is still there but can get credited a different amount. The "amount at risk" doesn't change immediately due to the loan. However, over time the effect of the loan could be meaningful or even devastating. Lets' say for sake of (a very simplistic) example that we have a variable life securities based policy and the policy cash value would have grown at 8% but the cash value collateralizing a $500,000 loan balance is put in a fixed account at 4%. Over 20 years the account value at 4% would have grown to $1,095,000 versus $2,330,000 at 8%. Over 30 years at 8% it would have grown to $5,935,000, a $3,410,000 difference over the $1,621,000 it would have grown to at 4%. Now imagine the difference in mortality charges on $3.4 million for an insured individual at age 85. It could be astronomical; hundreds of thousands of dollars a year.

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The sinister aspect of this is that the cash value that doesn't materialize due to the cash value collateral being reined in results in greater mortality charges which itself reduces the cash value which results in greater mortality charges which reduces the cash value… it's a death spiral of sorts.

On the flip side, if one happened to be doing this prior to a market crash, the collateral moved to the fixed account could actually benefit the policy as the cash value wouldn't have been hammered.

Regarding whole life contracts, some policies change the dividend crediting based on loans and others don't. There is an ongoing "discussion" regarding the benefits and costs of direct recognition and non-direct recognition policy loans and this is something to pay attention to but beyond the scope of this Q&A.

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