“Managing your Life Insurance” - What does that mean?

Sometimes people ask me what I mean when I say life insurance needs to be managed over the duration of the contract. Most think that means making sure the premiums are paid but, while obviously important, that’s not really it.

Making sure contributions to a policy are sufficient given a decades long reduction in the interest market is something I talk about incessantly but there is so much more to it. Here is a very simple example:

An advisor I work with brought me the policy on his own life. It turned out to be a traditional whole life contract with a well-known carrier. There was no issue with the company but the policy was deteriorating due to the loan it was carrying. I don’t recall if the loan was a result of actually pulling money out of the contract or if the loan was created by the policy “auto loaning” itself money to pay premiums which weren’t paid out of pocket. It doesn’t really matter. We can even assume the policy owner funded the contract as originally proposed and a sales ledgers might have even shown he could withdraw money with no ill effect.

Why then would his policy be suffering? The policy had an annually decreasing death benefit and would continue to decrease indefinitely. The reason was that the loan and accumulated loan interest were compounding and outpacing any growth of the base policy. Once again, he may have originally been shown that he could terminate premiums or take money out and not have to pay loan interest so why is the contract falling apart?

Back when he put the policy in force, the divided rate was 10% and the loan interest rate was 8%. The arbitrage was positive and though the loan would grow, it could be managed by a growing policy. However, by the time he brought the policy to me the dividend rate was less than 6% and the loan rate was still 8% so the positive arbitrage had disappeared.

The policy needed an infusion of cash to perform reasonably. An evaluation of alternative polices was off the table due to his lack of insurability. Where could we go?

I looked at the dividend options available in the policy and what dividend option was currently in effect. It turns out it was on “Dividends Purchase Paid-Up Additions”. What this means is that any dividends from the policy would go to buying extra insurance while the premium continued to be paid by loans and increase the size of the loan. But why buy insurance crediting less than 6% while increasing the size of an 8% loan? It may have been reasonable to set the policy up like that at the point of inception but, with a significantly reduced dividend rate, it wasn’t anymore.

What we ended up doing, after ordering multiple in-force ledgers under a variety of funding parameters and dividend options, was to change the dividend option. We changed it so that the dividend would be applied to premiums and paying loan interest and even reducing the loan principal if there was any leftover; anything to keep the loan form growing. What we saw was amazing. Rather than a deteriorating policy with a continuously decreasing death benefit and cash value and a growing loan, we turned it around into a healthy policy with a long term growing death benefit and cash value with a shrinking loan.

Make sense? If you had a 5% home mortgage and where sure you could make 10% in the market, you may decide to take extra cash flow and invest it rather than pay down your tax deductible loan. However, if you were in safety of principal investment making a percent or two on your money, you may choose to take extra cash flow and pay down your mortgage more quickly.

This was accomplished without a single dollar of cash flow being utilized for the policy. It was an option there for the taking with no cost and a fantastic upside. It may have even kept the policy from cratering with an income tax consequence on phantom gain. Who knows why the agent never mentioned it.

That's what I mean, in part, about managing a policy.