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Winged Keel Group Insights

Time to Revisit Your Old Whole Life Insurance Policy?

Winged Keel Group Insights is a publication designed to create education and awareness around life insurance topics and solutions that may address certain needs of your clients and their multidisciplinary goals.

By Aaron Abrahams and Kenneth Masters

It's simple, right? Unlike Term life insurance, which provides coverage for a set term of years, Whole Life insurance covers, yes, your whole life. But Whole Life insurance is a lot more complex and often misunderstood by both clients and their advisors.

Why Whole Life

Many of us acquire these contracts because we love someone and want lifetime protection when we pass away. This is not available with Term insurance. Others have acquired these policies as another way to save money in a tax-advantaged way beyond traditional retirement plans. However, over time our lives change, kids grow up, career trajectories ebb and flow, and sometimes the reasons we entered into this "permanent" contract change.

Before we discuss your options, let's quickly review the policy mechanics to better understand how Whole Life works and the causes of performance variability. Let us state that we do not think Whole Life policies are inherently "good" or "bad", but they are misunderstood which can lead to bad experiences and negative perceptions.

(Disclaimer: For Whole Life aficionados, we took some liberties in the description below to get to the main points. Our editors told us to keep it brief.)

Premiums

In a Whole Life policy, the premium is due every year and the policyowner can pay the premium by one of three methods:

1. Writing a check to the insurance company to pay the premium
2. Using non-guaranteed policy values to pay the premium
3. Using internal policy loans

The premium payment then is split into two parts:

1. To fees such as commissions, administrative fees, and underlying costs of insurance
2. To a "savings account" where it grows tax exempt

The savings component is invested in the General Account of the life insurer – a highly regulated pool of investments mostly consisting of fixed income instruments.

Unlike other types of insurance, Whole Life is a bundled product and each premium payment cannot be clearly bifurcated between policy charges and surplus investment. However, the net effect can clearly be seen.

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Policy Dividends

The insurance company in a Whole Life policy passes on favorable investment performance, mortality experience, and expense management to the policyholder via a policy dividend.

Policy dividends are different than the more commonly known stock dividend and can be used to:

1. Pay or reduce the annual contractual premium
2. Purchase additional insurance
3. Pay for policy riders
4. Accumulate inside the policy
5. Be received directly as cash and taxed as ordinary income

Investment performance of the general account is the primary driver of the dividend, and since the general account includes mostly fixed income instruments, the interest rate environment plays a major role. Generally, the higher the interest rate environment, the better the investment returns, and the higher the policy dividend. The opposite is true in reverse, and lower policy dividends may mean additional cash outlay by the policyowner. It is important to note that short-term movements in interest rates have minimal effect on the dividend. It is sustained interest rate trends that drive the dividend, given the size of the general account, the receipt of new premiums on a daily basis, the duration of their bond portfolio, and the hold to maturity approach that insurance companies take with respect to their fixed income investments.

Performance

With interest rates having steadily trended down since the late 1980's and having now hit the lowest they have been since the 1950's, Whole Life dividend rates have been steadily dropping for the last three decades, and most Whole Life policies are underperforming relative to original expectations because of lower policy dividends. It would take a sustained period of significant inflation to reverse this trend. You may not even realize your policy is underperforming, as your annual premium invoices and policy statements are often hard to follow.

Policyholders sometimes mistake the dividend crediting rate for the rate of return on their policy—a common misconception of Whole Life performance. Insurance companies employ complex and varying methodologies to calculate the actual dividend derived from the crediting rate. The absolute number of the dividend crediting rate is somewhat meaningless as the dividend applied may be far less. Simply put, a 6% dividend crediting rate does not equate to a 6% return on your cash value.

Many policyowners who believed that their policies were "all set" are now receiving premium notices. This is because lower dividends can no longer support the annual contractual premium as they may have been able to do in previous years.

Or worse yet, in lieu of paying premiums in cash or by policy values, automatic premium loans may have been accruing on the policy, creating additional downward policy performance pressure and potential tax implications. The contractual policy loan rates can exceed 8% even in today's interest rate environment. Insurance companies that use Direct Recognition will ding your already reduced dividend because of the outstanding policy loan.

So now is the time to sit down with a good insurance broker and review your Whole Life policy. With the right information, a policyholder can make an informed decision to retain, rehabilitate, or terminate a Whole Life policy.

Choose Your Own Adventure

To understand your insurance policy, your advisor will need a few pieces of data from the insurance carrier, which can include:

- The cost basis in the policy (essentially how much premium has been paid to date into the policy)
- The current cash value and cash surrender value
- The current policy loan amount if any
- The current dividend options
- Forward looking illustrations that show how the policy performs at different dividend rate assumptions and utilizing different policy options

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Don't worry, you do not need to go get this information yourself. Usually there is a form or a letter the policyowner will sign to authorize the insurance carrier to send out this information to your advisor.

When a policy's cash value is above its cost basis, surrendering the policy will incur a taxable event. However, if the policy is not meeting the objectives of the family, or is underperforming, it may be worth considering depending on the family's overall planning needs (especially if the gain – and therefore tax friction – is minimal).

You might also consider donating an underperforming or unneeded Whole Life insurance policy to charity. The charity can keep the policy and wait for the insurance benefit to pay out some day or surrender the policy, get the cash value, and because the charity is tax exempt pay no taxable gain. If your policy has a loan on it, a transfer will likely incur some income tax liability.

If your family still has a permanent need for insurance, or if you have a health impairment that may reduce your life expectancy, it makes more sense to keep a Whole Life policy. If a decision is made to continue the policy, the advisor can share illustrations highlighting the premium required to be funded out-of-pocket under different dividend crediting rate assumptions.

When evaluating the policy make sure to look at all options including:

1. Removing any unnecessary riders, including term insurance riders, which can reduce the coverage and premiums
2. Surrendering paid-up additions to repay existing policy loan balances
3. Electing to place the policy in reduced paid-up status eliminating the contractual premium

You can also exchange the policy cash value into a newer generation of permanent life insurance policies, and take advantage of Section 1035 of the Internal Revenue Code that allows accumulated gains to transfer between insurance contracts income tax-free, such as a Guaranteed Universal Life (GUL) policy, Variable Universal Life (VUL), or a Private Placement Life Insurance (PPLI) policy. If the insured is still healthy, newer generations of permanent life insurance may be less expensive, more transparent, and offer better investment options than an older Whole Life policy. Some new policies also offer long-term care or chronic illness riders providing lifetime benefits.

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