

# MANAGING THE CASH VALUES OF PERMANENT LIFE INSURANCE

By Peter Katt

To get the maximum policy value of insurance that is purchased to remain in force until the insured dies, the cash value should be periodically monitored, with careful adjustments made as the need arises.

The need for life insurance can be divided into two categories: *If-I-die* and *When-I-die*.

*If-I-die* life insurance refers to having protection for a specified period of time. An example of *If-I-die* life insurance is insuring the family income earners so that there are sufficient resources to raise children in the event that one or both parents pass away. Once the children are raised, the need for this coverage ceases.

Because *If-I-die* life insurance is needed for a relatively short time frame, term insurance or low cash value permanent life insurance works just fine.

*When-I-die* life insurance is intended to remain in force until the insured dies. Examples of *When-I-die* life insurance are:

- The insured receives a pension that stops upon his or her death—life insurance can provide the insured's spouse with the equivalent of the missing payments in the event the spouse survives the pensioner—and
- As an estate-planning asset.

*When-I-die* life insurance is permanent insurance that can be whole, universal, or variable life. This column discusses the management of permanent life insurance's cash values.

## CASH VALUE'S IMPORTANCE

Individuals with permanent life insurance, or those intending to buy it, often comment that they are not interested in the policy's cash values because they only bought the policy for the death benefits. This misstates the importance of a permanent policy's cash values. When a healthy insured buys permanent life insurance, there is a possibility they may live to policy maturity, which is commonly set at age 95 or 100. For example, the probabilities that healthy 50-, 60-, or 70-year-old non-smoking males will live to age 100 are 3%, 3.5%, and 4.5%, respectively. For second-to-die insurance, the probabilities that at least one healthy spouse of a couple where both are age 50, 60, or 70 will live to age 100 are 14%, 15%, and 18.5% respectively. Therefore, at the time of purchase, it must be assumed that healthy insureds may live to policy maturity, so a prudent policy design uses this as its foundation.

Permanent insurance *endows* for its cash values at maturity. The policy should be designed so that its cash values are equal to the death benefits at maturity. Therefore, a permanent policy's premiums must be sufficient to maintain the goal of endowment at maturity, at least until it becomes known that an insured's health has deteriorated to such an extent that living to age 100 has become nearly impossible. (More on this issue later).

But what role does a permanent policy's cash values play for an insured who passes away before policy maturity? The fact is, for a level death benefit permanent life insurance policy, the cash value on the day the insured dies (as long as it is before policy maturity) is completely irrelevant. That is, a \$1 million policy with \$100 of cash value will pay the same death benefit as a

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\$1 million policy with \$800,000 of cash value. This fact frequently leads me to facetiously comment that if clients will tell me when they will die, I can design their policy to have one dollar of cash value on that day and save them a good deal of unnecessary premiums.

Knowing such a thing is, of course, impossible. However, some insurance agents do recommend permanent policy designs whose premiums are projected to continue the policy only to life expectancy. By definition, life expectancy is a date when it is expected that about half of a given population will have passed away and about half will still be alive. It's the half that are expected to still be alive that causes prudent advisors to recommend policy designs that will endow at maturity.

A permanent insurance policy set up to endow at maturity should not then be put into a drawer and forgotten. While all life insurance policies should be monitored and managed, this is especially true for permanent life insurance.

Permanent life insurance has four important areas that need to be reviewed (and I recommend that monitoring occur every two years):

- Has the insured's family and financial situation remained relatively constant and are the goals for the permanent insurance policy the same? If significant changes have occurred, this may affect how compatible the policy's design is with these new conditions or circumstances.
- Are the insurance company's financial strength ratings still strong and has the company maintained its policy pricing commitments?
- Are policy adjustments needed to keep benchmark cash values on track to endow the policy at maturity because of changes in the policy's performance due primarily to its investment component?
- Has the insured's health changed

in a significant way?

A significant change in the insured's health may be highly predictive that it is no longer a realistic possibility that they will live to age 100. While obtaining such specific health information may seem morbid, it can save the insured a good deal of money, because they can avoid the payment of potentially unnecessary premiums.

For example, an insured now age 82 with a \$1 million policy purchased at age 60, who has recently been diagnosed with a cancer that has no successful treatments and a life expectancy of no more than five years, could stop paying any further premiums if the policy's cash values have been maintained at prudent levels. If the annual premiums are \$23,000 a year and the insured does die in five years, having the forethought to stop paying premiums would save the insured's heirs some \$115,000. Although the recommendation would be to stop paying premiums, I would still advise prudently investing in a side-fund in case a cure were found and the insured was returned to good health. In that event, past premiums would be paid to get the cash values back to the proper benchmark on their way to possible policy endowment.

#### ENDOWMENT AT MATURITY

When a policy endows at maturity, the policy's cash values are paid to the policyowner. Unlike a policy's death benefits, which are income tax-free, the payout of a policy's cash values because of endowment is a taxable event. For example, the taxable gain for a \$1 million policy purchased at age 60 that endows at age 95 is about \$300,000. The prospect of policies endowing at maturity causing this magnitude of unexpected income tax exposure and increasing longevity, (especially among persons buying large amounts of life insurance at relatively older ages) has motivated many life insurance companies to

add a rider to their permanent policies that provides they will become paid-up for approximately their cash values at maturity. As a paid-up policy, it will continue to earn interest with its death benefits paid out at the insured(s) demise as tax-free death benefits. Unfortunately, it isn't clear that this rider will actually work, because there is no clear guidance in the tax code.

Certain creative and aggressive marketers of life insurance have devised various methods for promising permanent policy performance without maintaining adequate policy cash values. Such policies are promised to have guaranteed premiums that are lower than for those companies who don't make such promises.

My analysis of these promises has led me to conclude that they are too good to be true and could cause companies to face insolvency. Indeed, there are about 10 companies from the past decade that had to be restructured because of severe solvency concerns because they got too aggressive with their promises or otherwise became too clever. Life insurance regulators have devised various life insurance policy valuation guidelines in order to stop such reckless promises, but I suspect that some companies will always be able to stay one step ahead of the spirit of the law in order to outpromise far more responsible companies. My advice is to stick with companies whose policies become paid-up (cash values equal death benefits) at maturity.

#### POLICY DESIGN AND TYPE

Different policy designs and types have different effects on policy maturity.

- *Universal Life*—Universal life policies with level death benefits (generally known as Option A) should have benchmark cash values that are on schedule to equal the death benefits at maturity as long as the insured re-

**TABLE 1. A COMPARISON OF PROJECTED POLICY VALUES**

Insured: Male, Aged 60, Standard Non-Smoker  
 Face Amount: \$1 million  
 Death Benefit: Option B (Face Amount + Cash Value)  
 Values: Projected Values Based on 6.0% Interest Crediting

Policy Year	Age	Annual Premium (\$)	Option B Death Benefit Without Adjustment		Option B Death Benefit With Adjustment	
			Cash Value (\$)	Death Benefit (\$)	Cash Value (\$)	Death Benefit (\$)
1	61	44,500	42,771	1,042,771	42,771	1,042,771
2	62	44,500	85,857	1,085,857	85,857	1,085,857
3	63	44,500	129,186	1,129,186	129,186	1,129,186
:	:	:	:	:	:	:
25	85	44,500	1,523,707	2,523,707	1,523,707	2,523,707
26	86	44,500	1,589,578	2,589,578	1,594,336	2,323,707
27	87	44,500	1,654,703	2,654,703	1,671,462	2,323,707
28	88	44,500	1,716,264	2,716,264	1,754,715	2,323,707
29	89	44,500	1,773,262	2,773,262	1,846,006	2,323,707
30	90	44,500	1,825,832	2,825,832	1,948,784	2,323,707
31	91	44,500	1,873,750	2,873,750	2,067,120	2,323,707
32	92	44,500	1,916,035	2,916,035	2,205,986	2,323,707
33	93	44,500	1,952,727	2,952,727	2,372,496	2,323,707
34	94	44,500	1,980,640	2,980,640	2,570,951	2,622,370
35	95	44,500	1,996,717	2,996,717	2,787,511	2,815,386

blended (combination of term and whole life) policies may not be on track to become paid-up at maturity for the total death benefits and should be carefully monitored.

## WEALTH-TRANSFER DESIGNS

As noted in my July 1999 article, there are two basic types of permanent insurance designs. The policy design that needs monitoring and management is the defined-benefit design, where the death benefits are supported with the minimum amount of cash values, keeping in mind the possible need for the policy to become paid-up at maturity if the insured remains in good health.

In contrast, a defined-contribution design has the goal of generating as much cash value as possible, turning the policy into an investment. As such, the kind of monitoring described in this column isn't necessary.

## CONCLUSION

In the movie "The Verdict," Paul Newman's character (a drunken washed-up attorney) says that having money is only important if you are alive tomorrow. The same can be said for defined-benefit type permanent life insurance policy cash values. As long as insureds remain in good health with the prospect that they could live to policy maturity, the management goal is for the policy to become paid-up at maturity.

However, if it becomes nearly conclusive that an insured will not live to policy maturity, premiums can be adjusted, or even stopped altogether.

The key is to periodically monitor permanent policies and use judgment in making adjustments as they become necessary. Doing this will likely give policyowners greater policy value. ♦

mains in good health. Universal life policies with death benefits that equal a specified amount plus the cash value (generally known as Option B) should be adjusted, generally within 10 years of policy maturity, if the insured remains in good health. Table 1 compares an Option B universal life policy in which the insured does live to policy maturity (age 95) without any policy adjustment to the same policy with an adjustment to Option A at age 86. Without an adjustment, the policy's cash values are \$1 million less than the death benefits. With a change from Option B to A at age 86, the policy becomes paid-up at maturity. A decision to change a policy from Option B to A depends on the insured's health. If the insured's health has deteriorated with little prospect he or she will live to policy maturity, the change from Option A to B

should not be made.

- **Variable Life**—The same comments made for universal life apply to variable life as well, with the additional observation that the volatile and unpredictable nature of equity investments makes policy management much more difficult. (See my article "The Do's and Don'ts of Buying Variable Life Insurance Policies," in the July 1999 *AAIL Journal*, available on AAIL's Web site at [www.aail.com](http://www.aail.com).)
- **Participating Whole Life**—Non-blended whole life is supposed to be set up to endow at maturity. Therefore, if you pay the premium every year, a whole life policy will become paid-up at maturity without monitoring. However, a premium payment scheme known as vanishing-premium or premium-offset will require active policy monitoring to properly manage it. Also,