10 Ways to Make Sure Your Life Insurance Fails

By Peter Steger, CLU, ChFC, REBC

Life insurance has the dubious honor of being considered a simple "one-and-done" type of product. Just pay your premium and when you die, your beneficiaries will receive a check, right? How hard can this be? Unfortunately, the simplicity of life insurance is grandly overstated and upon closer review it is clear that life insurance is simply…well, Not Simple. The purpose of this article is to remind you of ten common actions that can lead to premature death – of your life insurance policy, that is.

Number 10: Assume that the premium you pay each year gives you the right to the death benefit.

Many people I have consulted with believe that since they are paying their premium that they were told to pay when they originally purchased their policy the policy is guaranteed to pay out the death benefit.

This is a mistaken belief. Over the last 25 years much of the life insurance sold is what I will term, "performance-based life insurance". Performance based life insurance is very dependent upon the assumptions that were used in the illustration that was shown to the client. The assumptions in the illustration are assumed never to change for the life of the policy. Performance-based life insurance includes Universal Life (UL), Variable Universal Life (VUL), Hybrid Policies, a combination of term insurance and some form of permanent insurance (UL, VUL, Whole life, Index UL) and Indexed Universal Life (IUL). All of these policies have many moving parts and the success of the policies rely on assumptions made about interest rates, dividend crediting rates, life expectancy, lapse rates, profitability targets of the insurance company, economic environment, market returns, and non-guaranteed cost of insurance and other expenses in the policies.

The assumptions within an insurance policy will be impacted by various factors within the insurance company and from the outside economic environment. These changes will have an impact on the long term viability of your life insurance. Not keeping up with these changes can leave policy holders in for a shock.

Number 9: I have not paid premiums on my policy for a few years, it is paying for itself!!

Don't be fooled! All policies rely on assumptions that need to play out exactly as illustrated when you first bought the policy but in reality this does not happen. Life insurance lives in a dynamic market place where assumptions that were built into the policy are subject to economic and market realities. Policies that are paying for themselves are relying on the dividends or interest crediting rates to continue to support the cost of the insurance. But where have dividends and crediting rates headed over the last 25 years? They have headed "south" and this will impact the ability of the life insurance to continue to pay for itself. Once again, leaving your policy unmanaged or tended to is a strategy of "hope" and "hope" in generally not a very good strategy for you or this asset to rely on.

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Number 8: Assume that if your cash value is growing your life insurance must be fine.

Just because your cash value is increasing, as you may observe on your annual statement, it does not mean your life insurance does not need attention. Performance-based life insurance requires certain funding - based on returns, crediting rates and several other factors. As interest rates have decreased over the last 20+ years this assumption of increasing cash values can lull people to sleep. Most people do not understand that the cost of supporting the life insurance within these policies increase over time. Therefore, if the cash value does not increase fast enough then the funding of the future costs of insurance will fall short and your life insurance will lapse. This may not occur until later in life but by then it may be too late to do anything about it.

Number 7: Rely solely on illustrations to show you how your policy will perform years from now.

Illustrations produced by insurance companies do not tell the whole story. They fail miserably to demonstrate how market forces will impact the success of your life insurance over the long term. Illustrations are built on a set of assumptions that can be easily manipulated within the illustration technology and cannot replicate the environment in which the life insurance exists. Illustrations assume a static market environment and assume linear returns or crediting rates into the future. The market environment is, as we all know, very dynamic and is subject to change every day. This impacts your life insurance over its 20-50 year existence, more than most understand.

Number 6: Borrow money from your life insurance and don't worry about the impact.

People who have borrowed or withdrawn money from their policy do not understand the impact it has on the long term performance and viability. The policy will most likely die before they do, even if they continue to pay premiums. Loans are also a "boon" to the insurance company; they charge you above market rates and they WILL be paid the interest and principle upon surrender or death. Insurance companies like policy loans on their books because they will receive interest, principal, and can adjust dividend or interest crediting rates in their favor. On a positive note the cash values in life insurance are liquid and readily available.

Let me explain:

In a whole life policy if you borrow money from the policy the loan interest rate applied is most likely a variable loan rate that is much higher than prevailing rates in the market, especially today. Additionally, the dividend that is credited to a whole life policy with a loan is much lower than if there was no loan on the policy. A double whammy! The problem has been that many agents have promoted the fact at the time of sale that the cash value is available to you, but they fail to help you understand the impact on the policy if you take such an action.

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In Universal Life (UL) and Variable life (VL), if you have skipped premiums or have borrowed or withdrawn funds then the funding of the future costs of insurance has become impaired. With interest rates declining -- severely impacting UL -- and market volatility severely impacting VL due to poor sub-account performance, these policies are in more danger than ever of lapsing.

Number 5: Make a one-time payment into a policy, never review it again, and assume that you will never pay another premium – because that is what the agent who sold the policy said would happen.

I have had many situations that could have had an outcome that was different but the client waited too long to review their policy. The problem is that the projections and assumptions in the illustration, which are the sole basis of the sale, have not come true. People do not understand how market forces impact the long term viability of their policy. Declining interest rates, market volatility, and the financial crisis all have played and will continue to affect the success of life insurance property. People who made a one-time dump–in to fund their life insurance are under the impression, based on the illustration, that their life insurance property is "paid-up". But many performance based life insurance contracts are built without guarantees of any kind so as the assumptions in the illustrations are impacted by economic factors so is the viability of your contract.

I had a case where an insured, who is now in his mid-80's, made a one-time payment in 1987 of $800,000 for $8,000,000 of death benefit in a universal life policy. One of the main factors affecting this policy, as in all universal life, is that these policies are very dependent on the level of interest rates. In 1987 interest rates were quite a bit higher than in 2009. His health had deteriorated significantly and he had not reviewed the policies since 1987 believing that it was "paid up". When they were finally examined in 2009 the cash value was close to zero and within 18 months there would be no cash value and the insurance coverage will lapse. Without going into too much detail, the cost to keep the policy from lapsing was going to be close to $400,000 per year and that cost would increase each year! Sadly, the decision was to surrender the life insurance.

Number 4: Put your policy in a drawer.

All policies are performance-based, just too different degrees. Interest rates have been declining over the last two decades, the stock market has become more volatile, the economic and financial environment has changed and all of these global market factors will continually have an impact on the success of your life insurance property. If you just put your policy in a drawer you will most like be very disappointed. Life insurance policies are complex financial instruments with many moving parts and they merit on-going management. When was the last time you reviewed your life insurance?

Number 3: Assume that your agent will call you if the policy is having trouble.

Will the agent call? What I have discovered is that agents who you have trusted find it difficult to tell their clients that the life insurance program they sold to them is not performing. I have also come to discover the service model within the industry is broken. Agents are paid for new sales only and renewals on life insurance have decreased by 85%. Most of what I hear is that the agent only calls when he wants to sell me something, once you understand the market dynamics you can understand their motivation.

Number 2: If you have a variable policy, which is very dependent on market performance, and assume that the recent rebound in the stock market means that your policy "is back on track." Or, if you have a Universal Life policy, when interest rates rise my policy will be in "back on track".

The market rebound will not have revived your policy. Remember the assumptions were based on a linear return of let's say 9% at the time of sale. Your cash values that support the ever increasing cost of insurance is even more dramatically impacted because as the market declined the monthly deductions from the cash value to support the life insurance have exasperated the loss. The sequence of returns has to be on a trajectory that is not sustainable for your policy to recover.

Number 1: The number one way to make sure your life insurance fails: Assume that if an agent has not called you about your policy, your life insurance must be in good shape.

I encourage you to think differently. As you have probably discovered from my previous answers, life insurance is a complex financial instrument which merits on-going management and review. If your life insurance is an important part of your financial plan you need to manage this important asset for your family. As in any industry, insurance agents come and go. If your agent leaves the business, don't assume your policy will be serviced by a new agent. Also, it is worth noting that agents get paid very little after the initial sale of a policy. For their sake, it is difficult to justify on-going reviews of policies where there is little or no compensation. This is an unfortunate reality of the new insurance industry, not a reflection on the ethics of today's agents.

In conclusion, treating your life insurance policy like the important and complex piece of property that it is will help ensure that you and your beneficiaries receive the best of what this valuable financial tool can provide.

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