Insurance Insights

Policy Loans Exposed

Loans on life insurance policies are very misunderstood. Let's see if we can help you better understand their impact on life insurance policies.

Many consumers have turned to their life insurance policies when they have needed some economic relief. Quite frankly, that is one of the reasons to have bought permanent life insurance and for many it has saved the day. But, on the flip side, if you do not "deal" with the loan you may be surprised by the damage it can cause.

Whole Life

Older whole life policies 1980's and into part of the 1990's had maximum interest that could be charged on loans, typically 5% - 6%. At that time you could invest the money at returns greater than the interest charged. The insurance companies combated the tremendous loan demand by changing the way dividends were calculated, they called it direct recognition. They used to credit the same dividend to similar policies whether they had a loan or not but that changed with direct recognition. With direct recognition the policy would "recognize" the loan and the dividend would be adjusted downward (it does work both ways, when interest rates are extremely low and you have a high fixed rate you may actually have a higher dividend than a person with no loans due to the extreme overpayment of interest).

Consumers felt cheated in that they could not understand why they would even be charged an interest rate on borrowing their own money! The money you borrow comes from the insurance company's general account, therefore if they lend you the money from their general account they do not have that money invested for you and the other policyholders. Loans are actually assets on insurance company's balance sheets. It is a money maker because they charge interest which most people do not pay so it rolls up into the loan balance and they will be repaid upon death or surrender.

Since that time the insurance companies have changed the interest rate from fixed to variable which makes even more money for the insurance company. The interest rate floats annually. Currently what we see are variable loan rates in the 7.5% to 8% range even though we are in the lowest interest rate environment seen in a very long time. You couple that with direct recognition and insurance companies are earning close to 10% on their policy loans. Not a bad deal!

If you have a whole life policy with a mixture of term insurance, called a hybrid whole life, your policy could be in tremendous danger.

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Performance-based Life Insurance Policy Loans (Universal Life, etc…)

If you borrow from one of these types of policies the insurance company sets up a loan account separating the cash value and the amount of the loan. They charge the loan account a reasonable interest rate, say 5.5% and they credit the loan account with 4% interest (this is the basic structure), therefore, the cost of the loan is 1.5% (some policies will allow "wash loans" where the crediting rate on the loan account is the same as what is charged on the loan if you wait to take loans for 15 yrs.). The problem is that the money is not earning any interest. In order for the policy to survive with the planned premium you were originally paying the net amount at risk (NAR), the difference between the cash value and the death benefit or in other words the actual insurance amount, whose cost rises each year, must converge with the death benefit. Loans greatly inhibit this requirement and the policies will most like "die before you do"!

The bottom line; loans wreak havoc on the long term viability of any and all life insurance policies.

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