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Repair or Replace: A Case Study

by Glenn S. Daily

Recent articles in *Partners* have discussed the important role of fee-only advisers in reviewing existing life insurance policies.* By eliminating the obvious conflict of interest created by commission-based compensation, fee-only advisers are well positioned to perform this service. Here's a real-life example to highlight the difference between salespeople and advisers.

My 45-year-old client had two universal life policies, issued by two large mutual companies with top financial strength ratings. The table on the next page shows some of the important features of the two policies.

Company B's agent claimed that Policy A was too expensive and recommended dropping it and getting more coverage from Company B. Company A's agent was not effective in defending his policy. A third agent recommended dropping both policies and getting coverage from Company C. My client didn't know what to think, and he wanted an independent review. Are these policies providing good value? If not, can they be repaired?

Policy A's current interest rate is excellent, but its performance is hurt by high cost-of-insurance rates. The company's chief actuary confirmed in correspondence that the COI rates are unlikely to be reduced in the near future. Because the policy was issued in 1984, it benefits from the more generous corridor percentages of IRC Section 101(f), rather than Section 7702. For example, at age 50 the death benefit must be at least 130 percent of the cash value under 101(f), compared with 185 percent under 7702.

This suggests a way to salvage the policy. By reducing the face amount to the $100,000 minimum and dumping in a $40,000 lump sum, my client can have an attractive single premium whole life policy, with a design that is no longer available. If the policy is held for many years, the 5.5% premium load is tolerable. Why not dump in more than $40,000? Because there will eventually be a force-out when the cumulative guideline premium exceeds the total premiums paid, and a higher dump-in doesn't provide enough time to amortize the premium load.

It took several rounds of correspondence with the company's chief actuary to arrive at this solution, but my client decided that the policy was indeed worth keeping.

Policy B is more problematic. It appears to be lapse supported. In the early years, the company is using a high premium load, high surrender charge, high insurance charges, and below-average interest rate to finance the interest bonus and low insurance charges in the later years. The policy has a $5,560 minimum premium for three more years, and a face amount reduction triggers a partial surrender charge. The company has produced a product design that leaves no attractive course of action.

Selected Features			
Feature	**Existing Policy A**	**Existing Policy B**	**Ameritas Low-Load VUL**
Issue date	10-19-84	9-28-93	
Face amount	$850,000 Option A	$1,000,000 Option B	
Cash value	$21,200	$-0-	
Cost basis	$28,600	$16,000	
Premium load	5.5%	10.0%	3.5%
Administrative fee	None	$10.00/month	$4.50/month
COI: Age 46	$2.97	$2.58	$1.64
48	3.40	2.83	2.41
50	3.90	2.95	3.06
55	5.15	3.76	3.63
60	7.70	4.90	5.81
70	23.25	12.45	18.52
80	64.00	37.07	50.68
Interest rate	7.05%	6.20%+ 10-year bonus	6.60%
Surrender charge:			
Amount	None	$15,500	None
Years remaining		18	

One possibility is to do a tax-free exchange to an annuity, in order to make use of the cost basis to shelter future earnings from income tax. However, dropping the policy would probably be a mistake at this time, because the performance is boosted by the declining surrender charge. The yearly after-tax rates of return for the next ten years are likely to be at least six percent. It’s doubtful that switching to an annuity or a new low-load life insurance policy will provide better value.

My client decided to leave this policy alone for now and take another look at it in a few years. He also decided not to buy replacement coverage for the reduced Policy A. He has learned a painful lesson about buying full-commission policies, however, and his future purchases will be low-load.

[*] See “Older Policies: Repair or Replace?” by Pete Leniart (February 1996) and “Life Insurance Policies Need Checkups, Too” by Paul S. Kelley (May 1996).

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