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what you need to know before you sell your life insurance policy

Research Brief #4

Do cash values matter?

The cash value is what you get if you tell the life insurance company that you want to cancel the policy. Here's why cash values should matter to life insurance buyers, even if they expect to keep their policies until they die:

- You may change your mind. Needs change. New policies come along. Based on life insurance companies' own statistics, each year more than 5% of policyowners drop their policies — and what they get is the cash value.
- Cash values are your safety net against unforeseen events.
- A high cash value makes it easier to dump a policy if performance or the insurer's financial strength declines. If insurability isn't a problem, you're not faced with the tough choice of accepting a large loss by bailing out or possibly losing even more money by staying in.
- If the company gets into financial trouble and is taken over by regulators, a higher cash value will let you keep the policy going for a longer time without having to pay additional premiums. No one likes to throw good money after bad, and a high cash value gives you more freedom to wait and see.
- Cash values make tax-free exchanges possible. Suppose you own a policy with a cost basis of $50,000. If you have a $10,000 cash value, you can exchange your life insurance policy for a deferred annuity. The $50,00 cost basis will carry over, and you can use it to shelter the next $40,000 of investment earnings from income tax. But if you don't have a cash value, you will have trouble doing a tax-free exchange, and you will forfeit the economic benefit of the cost basis.

- The cash value determines the maximum loan that you can take against the policy for premium payments or any other purpose.
- If you own the policy outside an irrevocable trust, the cash value is an asset that you can put on financial statements to support a bank loan application.
- Cash values are related to commissions. A high first-year cash value indicates that the policy probably pays a low upfront commission.
- Cash values are related to the equitable treatment of terminating and persisting policyowners. If cash values do not bear a reasonable relationship to each policyowner's share of the total assets, one group of policyowners will be subsidizing another, and that can create risks for everyone.

The emergence of a secondary market for life insurance policies gives policyowners another reason to care about cash values: a higher cash value can mean a higher purchase price.

Universal life and variable universal life policies have two sets of values: an account value and a cash value. The account value is calculated in the same way as the balance in an interest-bearing checking account: the insurance company credits premiums and interest, and it deducts various charges for insurance and expenses.

The cash value is the account value minus a surrender charge. Surrender charges typically disappear after 10 to 20 years.

Most policies lapse if the cash value is not sufficient to cover the monthly cost-of-insurance and expense charges. Even if there is a large account value, the policy will lapse if the cash value is depleted by the monthly deductions.

This provision affects the purchase price of a policy because it affects the premiums that a buyer will need to pay to keep the policy in force. If the full account value is not available to cover the monthly deductions, the buyer will have to put more money into the policy sooner.

Here's an example to show the impact.

Suppose you own a universal life policy with an $800,000 level death benefit. The account value is $60,000. The policy has no surrender charge, so the cash value is also $60,000. The policy lapses if the cash value is not sufficient to cover the monthly cost-of-insurance and expense charges.

Here's the value of the policy using four discount rates from 8% to 14%:

Gross purchase price if there is no surrender charge

(before deducting broker's commission and income tax)

Buyer's rate of return			
8%	10%	12%	14%
$309,000	$283,000	$259,000	$239,000

But what if the policy has a $53,000 surrender charge that declines by $1,000 a month over the next 53 months?

Gross purchase price if there is a surrender charge

(before deducting broker's commission and income tax)

Buyer's rate of return			
8%	10%	12%	14%
$305,000	$278,000	$254,000	$232,000

The surrender charge reduces the value of the policy, because the buyer has to pay additional premiums as soon as the cash value is depleted. However, in this example the decrease in the purchase price is much less than the $53,000 difference in cash values.

Cash values can affect what you receive for another reason: some brokers charge a commission that is a percentage of the difference between the gross purchase price and the cash value. A higher cash value means a lower commission. In some cases, the commission savings could be greater than the increase in the gross purchase price.

On the other hand...

In the life settlement market, there are some situations where cash values don't matter.

If the entire account value, rather than just the cash value, can be used to pay cost-of-insurance and other charges in the policy, a surrender charge will not affect the purchase price.

If the purchase price is based on a guaranteed no-lapse provision, rather than on the policy's nonguaranteed values, cash values don't matter.

For nonguaranteed, lapse-supported policies, low cost-of-insurance rates could offset the lack of cash values. When policies are lapse-supported, the insurance company provides artificially low cash values to policyowners who drop out, and it uses the windfall to reduce the cost of coverage for those who remain. If the cost of the policy is guaranteed, the insurance company bears the risk that fewer policyowners will drop out than the company's actuaries expected. In that case, the company may suffer a big loss on that block of policies.

If the cost of the policy is not guaranteed, the insurance company can raise the future cost by increasing the cost-of-insurance rates or decreasing the interest rate. The policyowners bear the risk of having to pay higher premiums, probably without understanding much about how lapse-supported pricing works.

If cash values are low because of a deliberate plan to overcharge terminating policyowners and undercharge persisting policyowners, the policy may appear favorably priced to a potential buyer, who expects to keep the policy in force until the insured dies. Buyers may be willing to pay a higher price for a lapse-supported policy with low cash values, unless they are concerned that the insurance company will increase the cost-of-insurance rates in the future.

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