Creative
wealth maximization strategies*

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## Whole Life Cash Value Loans?[1]


***Question:* Why does it appear the insurance company charges you interest to borrow your cash value?**

This is a "gotcha" question critics of whole life insurance often raise. If the cash values in a whole life insurance policy belong to the owner of the policy, it seems unfair, even unethical, for the insurance company to charge interest to access them. For cynics, these transactions are a conspiracy to defraud the consumer.

Cash value loans aren't a conspiracy. **They just aren't understood very well by most consumers – and even some so-called "financial experts."** When you get how they work, there isn't a "gotcha" moment.

### The Mortgage Analogy

Although the analogy isn't exact, a home with a mortgage and a whole life insurance policy have many things in common.

In a mortgage, the borrower takes ownership of real estate immediately while paying for it over time. When the mortgage is paid off, the individual owns the home "free and clear."

Likewise, a policyowner takes ownership of a specified amount of money (the insurance death benefit) by paying regular premiums. With a whole life policy, eventually it will be "paid up." Meaning no more premiums are due and the policyowner holds the insurance benefit free and clear for the remainder of their whole life.

Just as you build home equity by making monthly mortgage payments, whole life cash values are guaranteed to increase with each annual premium paid. This growth is not linear; to compensate the lender for the risk of advancing the money to buy the home, mortgage payments are weighted toward interest at the beginning, and equity grows slowly. Like a lender, an insurance company has the biggest risk at the beginning of the policy's life; if you make only one monthly premium payment on a $1 million policy and die, your beneficiaries will receive the $1 million death benefit, and the insurance company takes a big loss. Consequently, cash values accumulate slowly at the beginning of a whole life policy.

### The Cost of Converting Equity to Cash

Another similarity between whole life and a mortgage is the way that equity can be accessed. With a home, the owner can tap the equity through refinancing the existing mortgage, establishing a home equity line of credit or selling the home.

If your home is worth $650,000 and you owe $250,000, you have $4000,000 of equity in the property. A bank might typically offer a home equity line of credit equal to 80% of the value of the house ($520,000) minus what you owe ($250,000), which leaves $270,000 available as a line of credit. The lender charges interest on amounts drawn against the line of credit and sets the repayment terms.

If you are tracking the parallels between a mortgage and whole life, a question should pop up:

***"So…If I own the equity in my home, why do I have to pay interest on 'my money,' when I take a home equity loan?"***

## In This Issue…





Hmm…That's a gotcha question. Why *do* you have to pay interest on *your* money? If you want to stay in the home and not sell it you have no choice but to borrow the equity.

While your equity has a dollar value, it isn't money. **The interest charged on a home equity line of credit is the cost of converting your home equity into cash.**

A home equity line of credit not only allows you to convert a material asset to cash, but also allows you to live in it.

The same concepts apply to whole life. The cash value in your policy has a dollar value, but the asset isn't the same as cash — it's part of an insurance benefit. If you want to access the cash while keeping the insurance inforce then you need to either withdraw dividends tax-free up to the policy basis or take a loan against the cash value. There are a few notable differences:

- The repayment schedule is set by you the policyowner, not the bank.
- The insurance company cannot deny access to cash values; a bank can refuse to extend a line of credit.
- You can take your Whole Life policy to a third party such as a bank and use it as collateral to obtain more competitive borrowing rates then what the policy states.

When you see the similarities, it is ironic that many consumers (and "experts") who never think twice about how a home equity line of credit works get lathered up about the same features when they are part of a whole life policy. Especially when the terms, access and repayment of a home equity line of credit are more restrictive than those for loans against the cash value of your whole life. Even more concerning is during the 2008 great recession, banks were reducing or closing Home Equity lines due to real estate values dropping. The cash value in a whole life policy is guaranteed to only increase in value so long as premiums are paid.

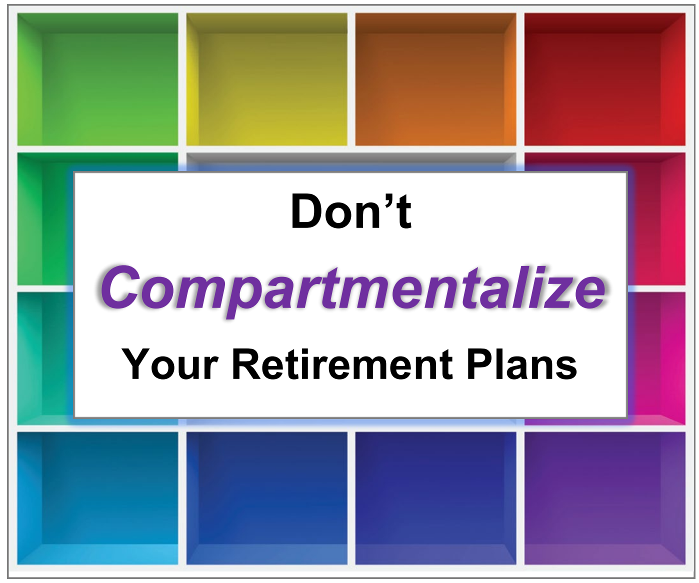
One more thought…to access almost any asset you either have to liquidate that asset and no longer earn interest or growth which is considered a Lost Opportunity Cost (LOC) or you have to pledge it as collateral and borrow against it…such as a margin loan within a brokerage account or use a CD as collateral with a bank.

**A sideways thought:** Both home equity and cash values can be great resources for financial emergencies or opportunities. But recent tax changes have eliminated the interest deduction for home equity lines of credit. Given the flexibility and favorable terms for cash value loans, if you had extra savings to allocate, would you make extra principal payments to increase your home equity, or extra premium payments (in the form of paid-up additions[2]) to boost your cash values? Let's discuss!❖

Gotcha thinking, right? Consult with your life insurance professional about ways to optimize your cash values.

1 Policy Benefits are reduced by any outstanding loans and loan interest. Dividends, if any, are affected by policy loans and loan interest, If the policy lapses, or is surrendered, any loans considered gain in the policy may be subject to ordinary income taxes. If the policy is a Modified Endowment Contract (MEC), loans are treated like withdrawals, but as gain first, subject to ordinary income taxes. If the policy owner is under 59½, any taxable distribution from the policy may also be subject to a 10% federal tax penalty.

2 Paid-up Additions (PUA) are purchases of additional insurance (death benefit) that have a cash value. These purchases are made with dividends and/or a rider that allows the policyholder to pay an additional premium over and above the base premium. This creates the growth of death benefit and cash values in a participating whole life policy. Adding large amounts of paid-up additions may create a Modified Endowment Contract (MEC).




What aspect of your personal finances is most deficient, and needs to improve? For many middle-class or upper-middle-class households, the answer is "saving for retirement." Despite incomes that place them in the top quartile of all Americans, many struggle to fund a retirement.

In a November 2015 *Quartz* article titled "America is Full of High-Earning Poor People," Allison Schrager used data from the Federal Reserve to prove her point:

> (U)pper-middle-class individuals aged 40 to 55 with household incomes ranging from $50,000 to $100,000…had fewer assets than ever (assets exclude a house, car, or business, but include retirement funds). (E)ven a high earner who worked for many years typically had only $70,000 in financial assets.

### The Simple Prescription That Doesn't Work

Seeing this deficiency, the response of many financial professionals and policymakers is simple: Tell Americans that retirement saving has to be a priority. This means:

*"Sock away as much money as possible for retirement!"*
*"Maximize your retirement plan contributions!"*

There. Problem solved.

Except it isn't. Because that's what the "experts" have been saying for years, and if anything, retirement savings for the average upper-middle class household (adjusted for inflation and the fact that very few workers have employer-sponsored pensions) are lower today than they were twenty years ago.

If you're not saving enough, the reasons probably run deeper than you simply haven't made it a priority. And the solution is probably not going to come from compartmentalizing your retirement issues to the exclusion of everything else.

### You Can't Separate Retirement from the Rest of Your Finances

Compartmentalization is a way to deal with conflicting issues that compete for our attention and resources. A classic example of compartmentalizing is a business owner who makes a conscious decision to not bring work home at the end of the day so that they can completely engage with their family. At the same time, they do not allow family issues to intrude during their workday; the two spheres never intersect.

Short-term, compartmentalizing may be effective in managing two divergent obligations, like work and family. Long-term, it can leave one aspect of life disconnected from the others.

For those experts who see a fully-funded retirement as the ultimate objective of personal finance, it's easy to recommend a compartmentalized approach. Whatever else is going on in your financial life (debt, a new house, college for kids) should not affect your retirement saving.

There is a rationale for this approach. The tax advantages and distribution penalties associated with qualified retirement plans are intended to compartmentalize this money; it's for retirement. But most Americans, even those with high incomes, can't compartmentalize retirement, simply because they don't have enough money to adequately fund every compartment.

## Fix Your Issues, Fund Your Retirement

A five-year study by Financial Wellness, a California think tank, tracked the financial progress of 2,400 employees whose employers offered ongoing coaching services for all aspects of their financial lives – things like cash flow, building an emergency fund, debt management, as well as retirement saving. A key finding:

**Workers who received advice on all money matters impacting their lives did a better job saving specifically for retirement.**

And the improvement was significant: "Among employees who have had access to ongoing coaching for all aspects of their financial lives, the average retirement-plan contribution rate climbed to 9.4% of pay in 2018, up from 6.3% in 2013."

Greg Ward, the director of Financial Wellness, offers this explanation: "Those with the most financial stress have issues at a foundational level, and are the ones who have more trouble saving." If you address these other financial issues, like paying off student loan debts or saving for a house, a byproduct can be more retirement saving.

This suggests that instead of compartmentalizing retirement, an *integrated* approach might be more successful.

## For General Assistance, Consider Asking Your Specialists

For a bunch of middle-class and upper-middle-class families, a 50 percent increase in retirement-plan saving would make a substantial difference in their long-term financial well-being. So where can you get ongoing coaching for all aspects of your financial life? A good place to start might be the financial professionals who may already provide some compartmentalized services.

Many consumers see their financial professionals as specialists. As in: "That's my insurance guy, she handles my investments, this firm does my taxes, and I have two attorneys – one for business, the other for personal."

It might surprise you, but the financial professionals you value for their specialized expertise may also be good resources for evaluating and integrating your personal finances. Because in order to give you the appropriate insurance and investment products, tax preparation, and legal advice, these financial professionals must know how their niches in the financial service industry intersect with each other. This includes a general knowledge of basic financial philosophies and the pros and cons of common management strategies in personal finance. In fact, many of these financial professionals may have software or other planning tools to help you develop a big-picture approach to your finances.

You need a team of financial professionals to provide specific products and services. But don't compartmentalize them or their work; many operate from a holistic perspective. You might benefit from picking their brains about better ways to increase cash flow, pay for big-ticket items, reduce debt, or set your budget priorities. ❖

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