Raising Cash Under Duress And The Role Of Cash Value Life Insurance: An Educational Example

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ABSTRACT

Consumers face hard choices when they need cash quickly. Hard choices can lead to emotional or economically unsound decisions. Traditional classroom discussions of raising funds to pay for expenses usually focus on generating income, borrowing, or the sale of real and financial assets, if hardship is discussed at all. However, many families have additional "non-traditional" sources of cash. This article examines the use of life insurance surrenders and policy loans as a source of funds for both routine funding needs as well as a source of emergency financing. The article concludes with a review of the economic considerations of life insurance for Insurance and Financial Planning educators and students.

Keywords: Life Insurance; Surrender; Policy Loan; Duress; Stress

INTRODUCTION

The Financial Crisis of 2008 provides an excellent case study for examining household financial management under duress. During that period, a prolonged period of rising unemployment concurrent with diminished income, shrinking asset values and lower levels of liquidity demonstrate that cash flow and balance sheet stress resulted in some families losing their homes, deferring financial goals and/or liquidating assets at fire sale prices to stay current on their bills. Some financial planning experts counsel a certain amount of cash holdings (i.e., six months) or building an emergency fund to bridge the gap between setback and recovery (e.g., Hallman & Rosenbloom, 2009).

When an emergency fund is not in place or it is insufficient, households face the prospect of high cost borrowing and/or assets sales, potentially at distressed prices; for example, cash advances on credit cards provide a common but expensive source of emergency cash (Bajtelsmit, 2006). Whether an emergency fund is missing or underfunded, long-term goals may suffer from bearing the costs of financial distress required to get through a rough patch.

While there are many sources of cash during a time of need, including credit cards, pawn shops, and consumer finance companies, this article focuses on cash value life insurance as a source of funds during a period of economic hardship.

Cash Value Life Insurance

Life insurance is a common tool in household risk management that provides a death benefit to beneficiaries when the insured person passes away unexpectedly. Some kinds of life insurance carry level or flexible premiums and develop, over time, accumulations known as "cash value." Cash value life insurance policies, also known as permanent insurance, include whole life insurance, universal life insurance, variable life insurance, and variable universal life insurance. There are other types of life insurance that do not accumulate cash value (namely term life insurance) and many other types that command a relatively small share of the market.

Policy Surrenders

Over time, surrender values generally grow within cash value life insurance policies. A relatively sound analogy can be drawn with the equity build-up in one's house as one pays off the mortgage. As one makes payments on a mortgage, the equity in a home increases as the loan balance declines. Likewise, a cash value life insurance builds cash value as premiums are paid and the cash value accumulation earns interest (or dividends and capital gains) that compounds over time. This increases the amount available upon policy surrender.

The amounts at stake are large. With over 142 million life insurance policies in force and well over $1 trillion in reserves, life insurance policyholders, as a population, have access to significant amounts if they chose to surrender their cash value policies (American Council of Life Insurers, 2016). While each policy is unique, in 2015, there were $28.8 billion in surrender benefits paid to policyholders. While it is not known why each policyholder surrenders, it is reasonable to assume that at least some of those surrenders are in response to need.

Policy surrenders can be costly. During the early years of a policy, a schedule of decreasing surrender charges is applied over a period for as long as 15 years. Designed to recover the costs of issuing a policy in the early years, the surrender charge is a significant cost to the policyholder who seeks to "cash in" his or her policy in the first several years the policy is in force. In the case of older, seasoned policies (in force for decades), part of the surrender proceeds may be taxable if the proceeds exceed the basis in the policy.

One theory known as the Emergency Fund Hypothesis (EFH) suggests that surrender activity will increase during periods of economic stress, when life insurance policyholders seek cash from their policies in response to financial need of some kind. Other variations on the EFH suggest that a downturn in real income can lead policyholders to make up for the income lost by surrendering their policies. Others might use a policy surrender to send their children to college or to purchase a home.

The historical evidence on life insurance policy surrender activity during difficult times is mixed. Liebenberg, Carson, and Hoyt (2010) and Liebenberg, Carson, and Dumm (2012) find support for the EFH using data on life insurance demand, major household expenses and policy loan data.

According to Russell, Fier, Carson, and Dumm (2013), life insurance policy surrender activity tends to increase when per-capita income declines, but they do not find the expected spike in surrenders during times of unemployment. However, earlier studies by Russell (1997) and Hoyt (1994) find that higher unemployment does tend to drive surrenders up.

Since a policy surrender terminates the policy, students will benefit from a discussion of a potentially severe choice: Should householders sacrifice long-term security to get the money now? And at what cost? Without such a debate, a student will not be able to weigh the important life choices at hand.

Policy Loans

Cash value life insurance products allow policyholders to borrow a portion of the cash value without terminating the coverage. Policy loans usually carry a reasonable interest rate (that may vary with market rates) and credit the policy with a significant portion of the interest paid; for example, the policy loan may carry an interest rate of 5%, but the policy cash value is credited with 4%, leaving a net cost of the loan of 1%. In addition, the policy loan does not appear on the policyholder's credit report.

As of the end of 2015, life insurers had lent nearly $135 billion to policyholders. Clearly, the policy loan represents a significant tool for households to borrow at reasonable cost without an impact on household credit scores.

Policy loans leave the coverage in place, but require periodic interest payments or the policy may lapse and the death benefit protection may be terminated. Some policyholders whose financial troubles continue over long periods initially may take out a policy loan, but later surrender the policy to extinguish the burden of loan payments and policy premium payments. This may leave the family vulnerable in future periods.

It is important to note that policy loans generally reduce the death benefit payable to beneficiaries in the event the insured passes away. For example, a $250,000 policy would pay $225,000 to beneficiaries if a $25,000 policy loan were outstanding at the insured's death. Financial Planning students and instructors may use a discussion of the life insurance policy loan in concert with a discussion of life insurance to discuss the slippery slope of access to easy credit that may lead to an eventual loss of household wealth, flexibility, and security.

Instructors in Personal Finance and Financial Planning may find it useful to engage students in a discussion of hypothetical financial scenarios. What follows is a sample classroom exercise. This example illustrates that a family approaching a financial crisis faces several choices, including what to do with its life insurance asset.

Imagine the following scenario:

Financial Profile

- Married Couple (Both 48 Years Old) with Two Children
- One Parent Has Been Laid Off
- Mortgage 30 Days Late
- Savings Depleted; Liquid Assets Have Been Sold
- Household Runs a Small Deficit After Recent Budget Cuts

The Important Question: What should the family do now?

Universal Life Insurance Policy

- $100,000 Death Benefit
- $500 Annual Indicated Premium
- $10,000 Cash Value (Crediting Rate of 4.5%; Policy No Longer Carries Surrender Charge)
- Policy Loan Carries Net Cost of 2% (Loan Rate is 6.5%; Policy is Credited with 4.5%)

Choices:

1) Surrender the Policy: Receive $10,000; Terminate Coverage; End Premiums
2) Policy Loan: Borrow Up to $9,500; Retain Coverage; Premiums and Interest Due
3) Leave Life Insurance Policy Alone: Find the Money Elsewhere

Discussion Questions:

1) Should the couple surrender or borrow money from the policy?
2) Should the couple consider borrowing from friends and family before accessing life insurance cash value?
3) If they choose to borrow from the policy, will the couple be able to continue making the loan payments?
4) If they choose to surrender the policy, will the couple have the discipline to restore needed coverage when stress abates?
5) If they surrender, will the couple be healthy enough to obtain life insurance when their financial situation improves?

CONCLUSION

Planning for a rainy day is key to understanding the goals of a sound financial plan. As part of that plan, life insurance is a common savings and risk management tool for many families. Financial planning students and instructors could use a discussion of cash value life insurance surrenders and policy loans as part of a larger unit on decision-making under financial stress. While cash value life insurance may or may not be the best source of low-cost funds during difficult times, the exercise can help students broaden their understanding of non-traditional sources, creative financing, and how to weigh the tradeoffs of using long-term assets to fund short-term needs.

Educating students about other sources of cash, such as home equity, retirement account borrowing, and unsecured credit, can also help provide the basis of a well-rounded discussion about overcoming a short-term cash crisis, and motivate reasoning behind how, with good planning, a crisis can be avoided before it ever occurs.

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