

The Confounding Nature of Policy Maturities

by Peter C. Katt, CFP®, LIC



Peter C. Katt, CFP®, LIC, is a fee-only life insurance adviser and sole proprietor of Katt & Company in Kalamazoo, Michigan. His website is www.peterkatt.com.

Explaining the implications of when and how a permanent life insurance policy matures can seem like Abbott and Costello's "Who's on First" routine for clients. But it is information clients need to understand to make informed decisions regarding their permanent life insurance.

In the first place, a policy matures with the insured's death. Fortunately for my business and insureds, my work is with the living. Proper management of a policy depends on understanding how a policy matures, other than death. But this isn't *one-size-fits all*. How a policy matures depends on the type of policy.

Whole Life

Participating whole life until recently was set up to mature at age 100. Contract premiums and dividends are programmed for the death benefits and cash values becoming equal at 100. For insureds living to 100 the policy matures for its cash values, which will equal the death benefits. Most companies continue the policy beyond 100

until the insured dies, and pay out the cash values as an income-tax-free death benefit, although there isn't certainty as to this outcome and some companies do pay out the cash values at 100, which are subject to income taxes. The genius of participating whole life is that the increase in paid-up additional death benefits along with the guaranteed elements will always end up with cash values equal to death benefits at 100. As you will see below this isn't the case with many other types of policies.

More recent participating whole life policies have extended maturity to 120. Same principles apply as in "to-100 participating whole life," but there is a longer time horizon. That is, cash values and death benefits will be equivalent at 120, not 100. Companies aren't expecting a rash of insureds living to 120, but this extends maturity and slightly reduces the contract premiums.

Universal Life

Many universal life (UL) policies sold in the 1980s and early 1990s have age-95 maturities. However, unlike participating whole life, UL funding

(target premiums) is the responsibility of the policy owner, and without astute management, this funding *always* gets messed up. Because interest crediting rates have fallen across the board from the levels when the policies were purchased, most of these ULs are underfunded, and target premiums need dramatic increases or death benefits need serious reductions. These policies mature for their cash values at 95.

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Here's an example. Tom's \$1 million UL policy has \$300,000 cash value as he turns 95. The policy's value becomes \$300,000 at 95—\$700,000 of death benefit is lost. Some companies will send out a \$300,000 check and that is the end of it. Some will continue the \$300,000 at interest and send out the balance at Tom's death as a death

benefit. The important thing to know is that if Tom counts on a \$1 million death benefit, even if he lives to 95, he needs help in managing target premium adjustments to do this. Unfortunately, managing such policies is like the near-blind leading the blind, and this leads to gut-wrenching decisions.

From a recent case, John is 89 with dementia. He is insured for \$6 million. The current cash values are \$1.4 million. The \$6 million will continue to age 95 with the payment of \$107,000 annual premiums. If John lives to 95, the policy will have no value. Based on a best estimate of John's health, he has approximately a 10 percent chance of making it to 95. What to do? Cash-in the policy now for a sure \$1.4 million or continue paying the \$107,000 premiums with a 90 percent probability of it being worth \$6 million, as long as he dies before age 95? This is not a situation an expert can decide. The expert can describe the options, but the family needs to make this difficult decision. With proper management of the premiums, this situation would not have occurred in the first place.

Second-generation ULs have age-100 maturities with the same principles as age-95 maturities. Third-generation ULs have age-120 maturities. Current mortality patterns mean this has no practical effect, but it does reduce the target premiums because of extending the policy maturity age.

Lifetime Extension Riders

Variable universal life (VUL) policies have the same maturity principles as ULs noted above. Some ULs and VULs have *lifetime extension* riders. With this rider a policy's death benefit continues for the insured's lifetime as long as it is in force at the maturity age. Referring back to Tom with a \$1 million policy that matured for its \$300,000 cash value at age 95, with lifetime extension it would have continued at \$1 million

no matter what the cash value at 95. Therefore, when I manage a policy with lifetime extension I choose target premiums that will generate \$1 of cash value at policy maturity—usually age 100. This can be a huge difference in setting target premiums, especially when done with elderly insureds.

A recent situation has two 75-year-olds as insureds on a survivorship UL. Their bank trustee did not realize that this policy has lifetime extension. Because it wasn't recognized, the bank had set the annual target premiums at \$55,000 so the cash value would equal the death benefit at 100. This amount of premium is completely unnecessary. I reset the target premiums to \$30,000 to generate the minimum cash value, and the policy will continue for a lifetime at the original death benefit, producing approximately \$270,000 in present value savings (\$25,000 difference in target premiums to their joint life expectancy, discounted at 4.5 percent).

Secondary No-Lapse Guarantee Riders

Another version of UL has secondary no-lapse guarantee riders. As long as a specified premium is paid, the policy will remain in force as per the contract regardless of whether there is any cash value, and usually these no-lapse ULs have low-to-zero cash values. Depending on the specified amount of premium, a policy's death benefit can be guaranteed to between ages 100 and 120. Setting the premiums for 120 is not justified. But setting them to, say, 108 is. There may be some flexibility with managing these premiums, but it depends on each policy and is complicated.

A recent case will provide a sense of how policy maturity plays into final decisions. Sam and Mary came to me to purchase estate tax liquidity life insurance of \$5 million. We examined the options, and they decided on UL, whose premiums depend on future

policy crediting rates. I refer to these policies as *market-priced* UL. Sam and Mary qualified for preferred ratings. At ages 57 and 53 their joint life expectancy is 40 years. Perhaps more to the point, there is a 16 percent probability Mary will make it to 100. Therefore, I presented them with a target premium for their policy of \$35,500 to carry the policy (assuming the current crediting rate of 5.55 percent) to Mary's age 108. It is always recommended that policies have ongoing management; that is, this policy will need premium management until it matures (the client should contact me every few years). The dominant factor is the crediting rate. I calculated that the target premiums will range between \$23,000 (at 7.7 percent sustained crediting rate) and \$55,000 (4.0 percent sustained rate). Of course, we won't have a level rate so the target premium will fluctuate.

Also important is knowing the current health of Sam and Mary. Let's say that Sam dies at 80 and seven years later, at age 83, Mary has developed serious health issues and it is nearly conclusive she won't live beyond 90. This then becomes the maximum policy maturity age and premiums are adjusted downward accordingly. In this case the premium could stop entirely because astute policy premium management has generated enough cash value to carry it without further premiums to the adjusted maximum maturity target age of 90. This is a huge savings for the family and provides the most efficient use for life insurance.

As presented by life insurance agents, policies may seem quite simple. But for many types of policies, complexity is a given. Among the complexities is properly managing a policy's maturity. This can be handled with experience, good sense, and patience.