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# M Intelligence

Enhancing understanding of sophisticated planning strategies and their applications.

## Participating Whole Life Basics— Dividends and Dividend Interest Rates

This M Intelligence piece will explore the product mechanics and design considerations of Whole Life (WL) insurance. There are two general categories of WL: Participating WL (PWL) and Non-Participating WL (NPWL). Both are forms of permanent life insurance; where PWL differs from the latter, however, is in its ability to participate in the financial gains (and losses) of the insurance carrier through annual distributions. The PWL policyowner is eligible to receive an equitable portion of the issuing carrier's earnings, known as the divisible surplus, in the form of a dividend. Put another way, a policyowner will receive a proportionate return in the form of a dividend payment, so far as the carrier's actual investment earnings, expenses, and mortality experience are better than the sum of the policy's guaranteed assumptions and corporate obligations.

This entitlement to dividends does not exist in NPWL.

A PWL policy is a contract between the policyowner and the insurance company with lifetime coverage. If the policyowner pays the required base premium, the death benefit will be guaranteed for life. Additionally, the PWL policy will endow at a predetermined age (usually 100 or 121). Endowment is when the cash value becomes equal to the death benefit. Three key assumptions are made to arrive at the guaranteed values of a PWL policy: (1) a conservative interest rate that is typically 4% or less, (2) a conservative mortality

assumption that is typically the prevailing mortality table used for calculating carrier reserves, and (3) conservative expenses.

Premiums paid on WL are deposited into the insurance company's general account. The company will use these funds in a variety of ways, including apportions to reserves, funding operations, personnel, and other business expenses. The general account portfolios of all insurance carriers primarily consist of investment-grade fixed income instruments, such as bonds and mortgages.<sup>1</sup>

As stated previously, insurance carriers selling PWL typically price the product conservatively. This approach to pricing increases the likelihood that the policies, as a group, will generate profits. Following each year's operations, the insurance carrier's Board of Directors decides how much of these surplus funds will be passed back to PWL policies in the form of dividends.

Actuaries then divide the surplus equitably among the participating policies, a practice commonly known as the Contribution Principle, which holds that the divisible surplus should be allocated to policies in equal proportion to the policy's contribution to the overall surplus.

<sup>1</sup> Source: Best Statement File (2014), A.M. Best.

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### What is a Dividend?

A dividend payment is considered a return of excess premium, which is not guaranteed. The policyowner can elect to receive dividends in cash, or direct them to be applied back to the policy in several different ways. Near the end of each calendar year, insurance carriers declare their dividend interest rates (DIR) on PWL policies for the upcoming year. The DIR is stated as a percentage; however, it is important to remember that a DIR is not an earnings rate applied to policy account values.

Once declared, the policyowner can elect how dividend funds will be used. The most common options include using the dividend to reduce scheduled premiums or to purchase Paid-Up Additions (PUAs). PUAs have their own separate cash values and death benefits. This is why the non-guaranteed illustration of a PWL policy will show either a decreasing premium amount (dividend used to reduce premium) or an increasing death benefit (dividend used to purchase PUAs). Other options include using the dividend to repay an existing loan or having the dividend paid in cash, both of which will reduce the policyowner's tax basis in the life insurance contract.<sup>2</sup> A policyowner retains the right to change the dividend option year to year. The default option for dividends on most PWL policies is PUAs.

### How is the Dividend Calculated?

Actual dividends reflect the experience of the company and depend on the company's annual results in three key areas:

1. **Investment Earnings:** The earnings the insurance carrier receives on its assets may be more or less favorable than projected. If earnings are more favorable, then dividends may be higher and vice-versa.

2. **Mortality:** If the insurance carrier experiences favorable mortality experience with less-than-expected death claims, dividends may be positively impacted and vice-versa.
3. **Expenses:** If the carrier's actual business expenses are more favorable than expected, costs allocated per policy may decrease accordingly, leading to positive effects on dividends.

### Sample Dividend Calculation

This approach may vary by insurance carrier and product.

#### Investment Earnings Component

Assume the declared dividend rate is 6.0%, with a guaranteed rate of 4.0%, and a reserve of \$100,000.

$$\text{Interest Return} = (6.0\% - 4.0\%) \times \$100,000 = \$2,000$$

#### Mortality Component

Assume the actual mortality experience rate is \$1.00 per thousand of insurance, the guaranteed mortality rate is \$2.00, and the face amount is \$1 million.

$$\text{Mortality Return} = (\$2.00 - \$1.00) \times (\$1,000,000 - \$100,000) / 1,000 = \$900$$

#### Expense Component

Assume the carrier experiences higher-than-projected business expenses during the period.

The Expense Component is negative \$500.

#### Putting It Together

The dividend at the end of the policy year is:

$$\text{Dividend} = \text{Interest} + \text{Mortality} - \text{Expense} = \$2,000 + \$900 + (-\$500) = \$2,400$$

The above calculations are theoretically straightforward, but in practice, the inputs are purposely not disclosed to the policyowner by the

<sup>2</sup> Rev. Rul. 2003-95, 2003-2 CB 358, 08/15/2003, IRC Sec(s). 7702.



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insurance carrier. The primary PWL issuers do not release the calculations used to arrive at the dividend amount. These insurance carriers enjoy some of the highest financial strength ratings in the life insurance industry. It is important to note that ratings agencies often grant high financial strength ratings to insurance carriers whose policy liabilities are predominately comprised of PWL policies because the carrier is largely insulated from financial risk through the ability to pass adverse financial consequences to the policyowner via the dividend mechanism. The bundled nature of PWL policy mechanics makes it difficult for a policyholder to understand, evaluate, and audit actual performance.

### The Black Box

PWL policies have a bundled or black box architecture, due to the lack of disclosure of policy charges and dividend formulas. Therefore, policyowners are not able to reconcile dividends and policy account values. Many insurance carriers issuing PWL advertise long histories of dividend payments; historically, interest earnings have been higher than guaranteed rates and mortality and expense charges have been lower than the guarantees. There is no guarantee that these conditions will continue and, consequently, DIR performance may be less than illustrated at policy issue.

The underlying drivers supporting PWL dividends are shared by all life insurance companies (including companies that issue universal life contracts) and consist of mortality, expenses, and investment income. The composition of this experience is affected by the individual incidence of each separate component (e.g., favorable mortality experience can serve as a counterbalance in a period of declining investment income). Differences between DIR methodologies make it difficult to compare DIRs across products. Therefore, it is important to note that the actual dividend paid

reflects all experience factors (mortality, expenses, and investment income) and not simply the current DIR.

### Whole Life vs. Universal Life

PWL pricing starts with guaranteed values (premium, cash values, and death benefit) based on conservative assumptions and offers a non-guaranteed dividend to pass on carrier experience (good or bad) that exceeds the guarantees. Universal Life (UL) contracts are based on the same assumptions, but start on the opposite end of the spectrum with performance based on non-guaranteed current carrier experience (i.e., current assumptions), and include guaranteed assumptions where charges cannot exceed the guaranteed maximum charges and the crediting rate cannot be lower than the guaranteed minimum crediting rate. The crediting rate for a UL policy is the actual rate applied to the policy values.

For UL, the risk transfer for each element is specified and transparent to the policyholder; for PWL, risk transfer for each element is accomplished through the dividend mechanism. Both UL and PWL products provide actual performance that is based on the insurance company's current experience.

### Conclusion

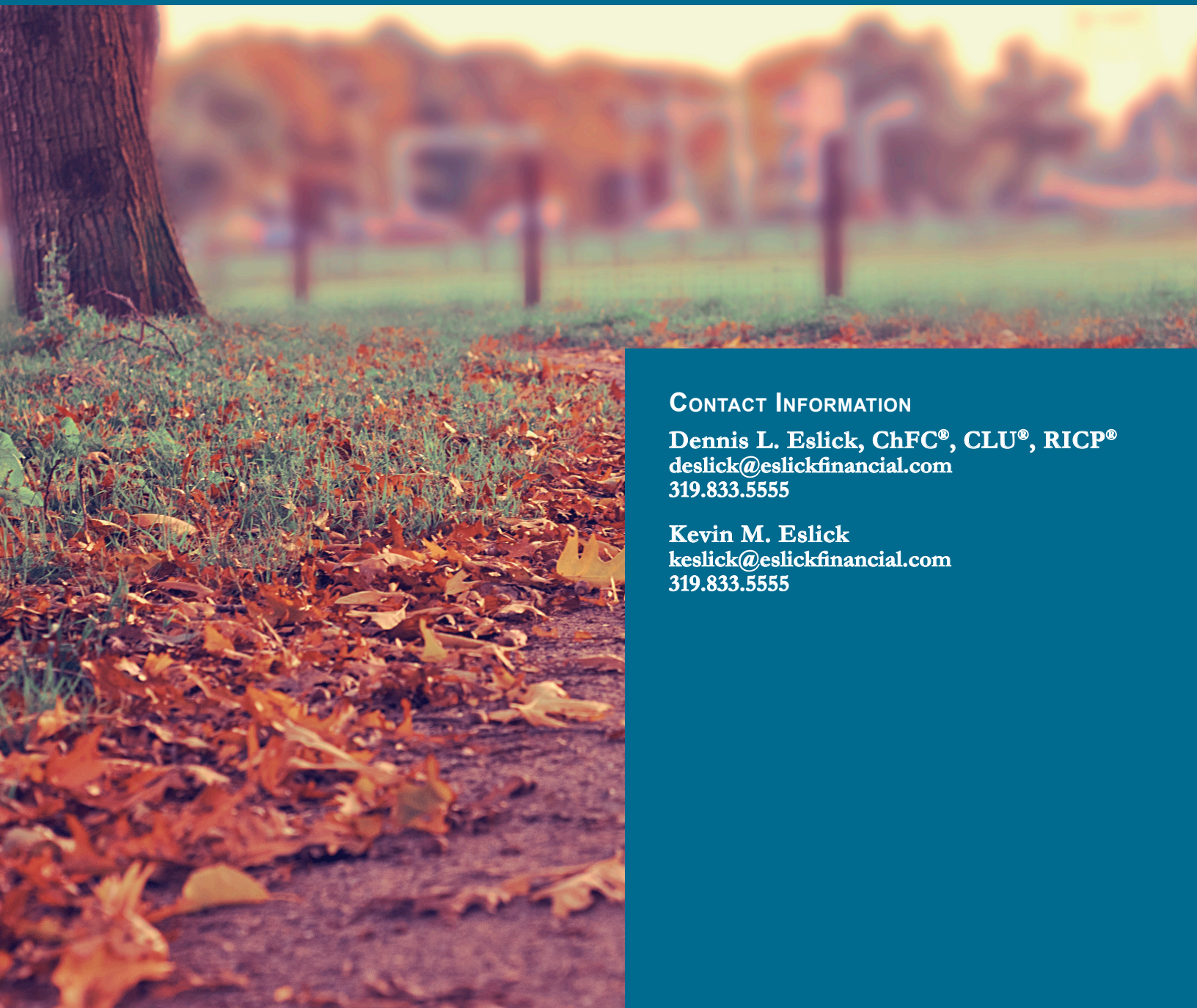
PWL insurance policies present unique challenges when assessing competitiveness for a new policy acquisition, or reviewing the performance of an existing policy due to the non-guaranteed black box dividend mechanism. When evaluating any life insurance policy, it is important to consider the client's needs and objectives to design a policy that reflects their risk preference, ability to respond to future changes in insurance costs resulting from ongoing life insurance carrier experience—especially at a time when many individuals are increasingly seeking financial products that provide transparency and flexibility.





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### CONTACT INFORMATION

**Dennis L. Eslick, ChFC®, CLU®, RICP®**  
deslick@eslickfinancial.com  
319.833.5555

**Kevin M. Eslick**  
keslick@eslickfinancial.com  
319.833.5555

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Eslick Financial Group, Inc.  
999 Home Plaza, Suite 201, Waterloo, IA 50701  
319.833.5555  
www.eslickfinancial.com