

HOW MUTUAL LIFE INSURANCE COMPANIES TREAT COLLATERALIZED VALUES – AND WHY IT REALLY DOESN'T MATTER.

The method of treating loans that are collateralized by cash value comes in two forms.

1. Direct Recognition: a different earnings rate is applied to collateralized cash value.

2. Non-Direct Recognition: the collateralized cash value is treated the same as non-collateralized cash value.

In actuality, neither makes a large difference over time, yet there is a lot of mis-information in the public and among insurance agents about the impact of these two methods.

Some companies use a **non-direct recognition approach** while others use a **direct recognition approach**, and still others allow the policy owner to decide which method to use when they start the policy.

HOW WHOLE LIFE POLICY LOANS WORK ACROSS ALL INSURANCE COMPANIES

1. Premiums paid by policyholders are placed in the company's general investment account.
2. Depending on the general account's investment yield, the policy contract value can be credited with non-guaranteed interest in the form of dividends to help grow the policy cash values. This non-guaranteed dividend comes from a combination of the general account's investment yield plus the impact of the insurance company's mortality experience and expenses.
3. When policyholders take out loans, (against the cash value) the loans are taken from the company's general account, which reduces the general account balance.
4. The company charges interest on the policy loans, at a fixed interest rate or a variable interest rate. Some companies offer a choice between these two options. The loan interest charged is designed to replace the lost earnings from the general account.
5. Each company credits earnings on collateralized values by taking one of two approaches: direct recognition or non-direct recognition. In most cases, a fixed loan rate uses **Direct Recognition**, and a variable loan uses **Non-Direct Recognition**.

HOW LOAN TREATMENT IMPACTS THE DIVIDEND INTEREST RATE (DIR)

DIRECT RECOGNITION

- Collateralized values and non-loan values are credited differently.
- Collateralized values are isolated
Collateralized values are isolated and receive a different earnings rate.
- Dividend awards on un-collateralized values are not impacted due to outstanding loans.

NON-DIRECT RECOGNITION

- Collateralized values and non-collateralized values are credited the same.
- Both collateralized and non-collateralized values receive dividend adjustments.
- Changes to the loan rate could impact the dividend award for all policy owners — those with and without outstanding loans.

HOW DO POLICY LOANS IMPACT THE DIR?

NON-DIRECT

Loan Charge Rates	and/or	Carrier Loan Utilization	DIR Impact
Low Interest Rate Environment Result: Loan interest rate typically lower than the DIR.	➔	When Policy Loans Are Taken Result: General account balance is reduced and the funds removed earn less interest than the general account portfolio.	Lower DIR for ALL Policy Owners
High Interest Rate Environment Result: Loan interest rate is typically close to or the same as the DIR.	➔	When Policy Loans Are Taken Result: General account balance is reduced and the funds removed earn more interest than the general account portfolio.	Higher DIR for ALL Policy Owners

DIRECT

Loan Charge Rates	and/or	Carrier Loan Utilization	DIR Impact
Low Interest Rate Environment Result: Loan rate is typically fixed and unaffected.	➔	When Policy Loans Are Taken Result: Funds are removed from the general account and there is a separate accounting for the collateralized funds.	No impact on other policy owners. Only the earnings on the collateralized funds are affected either slightly negatively or slightly positively.
High Interest Rate Environment Result: Loan rate is typically fixed and unaffected.	➔	When Policy Loans Are Taken Result: Funds are removed from the general account and there is a separate accounting for the collateralized funds.	No impact on other policy owners. Only the earnings on the collateralized funds are affected either slightly negatively or slightly positively.

WHY A COMPANY'S APPROACH MAY NOT MATTER, AND IF YOU FEEL UNSURE, CONSIDER GETTING BOTH.

BOTTOM LINE

Regardless of what type of loan recognition is used, when loans are taken, the collateralized amount no longer benefits the insurance carrier's portfolio yield and relies on the loan interest rate to replace the portfolio yield.

With **Non-Direct Recognition**, if the loan interest rate does not match the portfolio yield, the DIR will be impacted for every policy owner. Loans from any policy owner will impact the DIR for every policy owner either slightly positively or slightly negatively. This is because once the dollars leave the general account, they earn a different rate that is tied to the loan interest rate (which could be higher or lower than the DIR.)

With **Direct Recognition**, only the person with the loan will be impacted by the loan, and only for the amount of the loan. This impact can have a slight positive or a slight negative impact on the collateralized cash value.

