On the Money: The risks of borrowing from your life insurance policy

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As the recession drags on, consumers may be considering a loan from their life insurance policies as a source of ready cash. But think long and hard before making such a move and learn about the true implications of this kind of loan-related decision. Life insurance policy loans are almost universally misunderstood and mismanaged. Complicating policy loan decisions further is that life insurance agents are generally not trained in providing optimal advice about borrowing against policies.

Few understand the true cost of borrowing against life insurance policies and that this type of loan is often more expensive than other forms of borrowing. Consumers fall into the trap of thinking that borrowing does not have any associated costs because they are "paying interest to themselves." Many think they are somehow getting essentially a "free" loan and perhaps even enhancing their policy at the same time! Few realize that they are not borrowing from themselves, but instead they're borrowing from the insurer with the policy's cash value serving as collateral. Additionally, the interest on the loan is not tax deductible.

The financial advantages of permanent life insurance are maximized when a policy is held until death. Heavy borrowing activity can leave a policy in an underfunded state and cause the policy to lapse before your death and leave loved ones behind without benefits. Because a life insurance policy loan is against the policy's cash value, the death benefit is reduced if the loan isn't repaid. This can leave survivors with fewer benefits than expected. For example, if a policy loan is $100,000 and the stated death benefit is $500,000, the net death benefit is just $400,000 because the loan is paid off at the time of death.

Fee-only life insurance advisors have no vested interest in whether or not consumers borrow from policies because these advisors have no ties to any specific insurance companies or their products. As such, they can be an objective resource to help evaluate both the consequences of life insurance policy loans and possible alternatives.

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