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Variable Life Insurance

Variable life insurance is a form of cash value life insurance that uses separate accounts for cash value accumulation. The term “separate account” simply means that the account(s) where the cash value is invested are separate from the insurance company general account. The value of the death benefits may fluctuate depending on the performance of the separate accounts where the cash values are invested.

NOTE: The separate accounts are often called **subaccounts**.

Although most variable life insurance policies guarantee that the death benefit will not fall below a specified minimum, a minimum cash value is seldom guaranteed. While variable life is a form of whole life insurance, because of investment risks, it is classified as a security **contract** and is regulated under federal securities laws.

Variable life offers the potential for a greater return on cash values than other forms of cash value insurance. While there is a potential for a greater return, it is important to keep in mind that if one wants the benefits of higher investment returns, one must also be willing to assume the risks of loss. Bigger investment profits in the subaccounts can lead to an increased death benefit and an accelerated build-up in cash value. However, investments can also end up losing money (sometimes in a big way), and that can lead to lower cash values and reduced insurance coverage, although it can never fall below the minimum death benefit stated in the policy.

A variable life **insurance policy** offers a fixed premium and a minimum death benefit.

A. Definition of Variable Life Insurance

Variable life insurance is cash-value life insurance with values reflecting the performance of a variety of funds (subaccounts) that the **policyowner** has selected. It differs from traditional cash value life insurance where the insurance company invests the cash value in investments with relatively predictable performance over long periods.

With variable life insurance, one chooses how the cash value is invested among a variety of funds, such as growth, value, index, balanced, overseas, money market funds, and often a fixed account. There is no limit on the potential growth of cash value. This means that over time, both the cash value and the **death benefit** have the opportunity to outperform other forms of life insurance. Unlike traditional life insurance, variable life insurance has inherent risks associated with it, including **exposure** of the death benefit and cash value to market volatility.

Variable life insurance is patterned after the variable annuity, which had been available for a number of years before variable life insurance was introduced, and was designed

as a solution to the decline in purchasing power of the dollar due to inflation.

Although several models were proposed for a variable life policy, the plan that eventually emerged is patterned after the **ratio plan**, under which the premium is fixed but the **face amount** of the policy varies, subject to a minimum that is the original amount of insurance. The cash value of the policy is not guaranteed and fluctuates with the performance of the portfolio in which the premiums have been invested.

It varies by insurer and policy, but most often the policyowner decides how to invest the cash value portion of the account.

Although the NAIC approved model legislation providing for the sale of variable life policies in 1969 and recommended this legislation to the states, there remained the problem of the equity-based nature of the **contract** and the qualification requirements of the Securities and Exchange Commission (SEC). In 1972, seeking to avoid the difficulties encountered in connection with variable annuities, the insurance industry petitioned the SEC for exemption on variable life. The SEC ruled that variable life would be treated as a security, which meant that such contracts only could be sold by agents registered as broker/dealers with the Financial Industry Regulatory Authority (FINRA).

B. Features and Benefits of Variable Life Insurance

Variable life policies carry many of the features of universal life, with the added distinction that death benefits and premiums are more directly linked to the performance of investments, and policyowners have a say in how their funds are invested. Here are some of its distinct features.

An individual can select a level death benefit or choose a death benefit that increases as the cash value grows. Guarantees are based on the claims-paying ability of the insurance company and do not extend to the variable subaccounts, which may fluctuate with market or other economic **conditions**.

1. Enhanced Policy Loan

The enhanced policy loan feature lets one borrow from his or her cash value (at zero net interest cost) when specific cash values are achieved or when the policy has been in force for a specific length of time.

2. Regular Policy Loan

The regular policy loan allows one to borrow from a cash value at 2.5% net interest cost. Some variable life insurance policies offer up to 30 different subaccounts in which the **policyowner** can allocate their cash values. The policyowner does have access to their cash value accumulations. An individual can withdraw accumulations or arrange tax-free loans against the policy. Loans and withdrawals reduce the cash value of the policy and the **death benefit**.

3. Adjustable Premiums

An individual needs to decide how much premium to pay and when to pay it based on the performance of his or her subaccounts and changing needs.

4. Tax Advantage Liquidity

While policyowners do have access to their cash values through loans, and these loans or not considered taxable income, loans and withdrawals will reduce the amount of the policy's cash values and **death benefit**, and withdrawals may be taxable.

5. Variable Savings Feature

The savings portion is not tied to a fixed-income investment. The cash buildup is dependent on the performance of the subaccounts, which can contain stocks or bonds, typically through mutual funds.

6. Death Benefit Choices

The **policyowner** can select Option A for a level **death benefit** or Option B for a death benefit that increases if the cash value grows.

- **Option A: Level Guaranteed Death Benefit** — The level death benefit guarantees the policyowner that the policy will not **lapse** for any reason, regardless of investment performance, as long as one pays his or her minimum premium stated in the **contract**. The death benefit is equal to the **face amount** of coverage purchased less outstanding policy loans only. As cash values grow, they reduce the net amount of death benefit risk to the insurer and thereby reduce the mortality expense charges deducted from the subaccount. Increases in cash value do not increase the death benefit above the original amount of coverage purchased.
- **Option B: Variable Death Benefit** — The variable death benefit guarantees the policyowner that the policy will not lapse for any reason, regardless of investment performance, as long as one pays his or her minimum premium stated in the contract. The death benefit is equal to the face amount purchased less any policy loans, plus the accumulated cash value. As cash values grow, they do not reduce the net amount of death benefit risk the insurer is exposed to and thereby do not reduce the mortality expense charges deducted from the subaccounts.

A variable life insurance death benefit, like other life insurance types, passes income tax free to the beneficiary.

7. Waiver of Monthly Deduction Benefit

The waiver of monthly deduction benefit waives monthly deductions for the cost of insurance and policy fees if the **policyowner** is disabled. This affords the same protection to the policyowner that a waiver of premium does for other policies.

Variable life policies have the potential for greater and quicker cash value accumulations than other standard life insurance policies, but they require more attention and participation on the part of the owner to manage the allocation of cash values among the subaccount choices.

The policyowner of a variable life product is assuming the entire investment risk.

C. Variable Life Insurance Riders

1. Accelerated Benefit Rider

The accelerated benefit **rider** provides early access to the **death benefit** if the insured becomes terminally ill.

2. Primary Insured Rider

A primary insured **rider** provides policyowners with additional term insurance on the primary insured with guaranteed convertibility.

3. Additional Insured Rider

The additional insured **rider** provides additional term insurance for up to five family members. It permits coverage of nonfamily members for business reasons.

4. Children's Term Rider

The **children's term rider** allows children of the insured (natural, adopted or stepchildren) to be added to coverage for a limited period of time for a specified amount. This coverage is also term insurance and usually expires when the minor reaches a certain age (18 or 21). Most riders provide the minor with the option of converting to a permanent policy without evidence of **insurability**.

D. Expense Factors of Variable Life Insurance Products

Expense factors have to do with various variable policy features. Some variable policies do not contain all of these expense factors, but all variable policies contain some of them. All expenses will be disclosed in the policy prospectus.

1. Issue Expense

Sales commissions and other front end costs to issue a variable policy, which may run between \$2.50 and \$10 per \$1,000 of **face amount**, are deducted from the policy. Some policies take this expense directly from the first year's premium. Other companies total these costs and express them as a "contingent deferred sales charge," which is only charged against the policy of the policy owner surrenders the policy before a certain number of years.

2. Sales Load

The variable insurance salesman earns whole life commissions, generally 50%–60% of the premium in the first year, plus another 60%–70% over the next 9 years. This does not include field management commissions, overrides, and various "allowances" based on the agent's sales volume. The maximum sales load allowed by law is 9% of the premium over 20 years.

So if an individual pays \$1,000 in premiums, the maximum permitted sales charge over 20 years is 9% of \$20,000, or \$1,800. The salesman and managers will not wait 20 years for their commissions. To pay them, the company reaches into its surplus account, hoping that the policy will stay in force long enough to repay the "loan" to finance sales. If the company is a mutual company (or is owned by one), the surplus account is the policyowners' money that was not paid as dividends but retained by the company on the excuse that this surplus would "improve policyowner security."

3. Mortality Charge

Mortality charges are the "premiums" withdrawn from the policy's investment account to pay for term insurance inside the policy. The maximum mortality charges guaranteed by the policy are very conservative.

4. Surrender Penalties

It is not a matter of whether a variable **insurance policy** is subject to surrender charges. The important determination is how much those surrender charges are and how they are assessed. The amounts and procedures vary widely between companies and policies, but will be detailed in the prospectus.

5. Policy Fee

It is customary and almost uniform in the industry to determine the total premium by multiplying a basic rate by the number of thousands and then adding a fixed policy fee that is generally about \$50. Theoretically, the policy fee is to cover the administrative cost to the insurance company for the policy. The effect is to provide a lower rate per thousand for customers who can afford larger policies. Because the policy fee is part of the premium, the **policyowner** pays it every year.

6. Risk Charges

Some variable policies guarantee to pay the original **death benefit**, even if the policy's investment account has dwindled to zero. For this generous feature, the company charges a separate premium called the **risk charge**, which can run between 1% and 3% of every premium the **policyowner** pays.

7. Mortality and Expense Risk Charges

Mortality risk is not to be confused with either the "risk charge" or the "mortality charge." The mortality risk assumes that insureds may live for a shorter period of time than estimated. Therefore, a greater amount of **death benefit** than expected will be payable compared to the amount of premiums received. The expense risk assumes that expenses incurred in issuing and administering the policies will be greater than estimated. The insurance company will then realize a gain from this charge to the extent that it is not needed to provide for benefits and expenses. This charge for some insurance companies is 0.5% per year against the policyowner's investment account. The charge is deducted daily.

8. Dividend Reduction

Not every variable policy pays dividends. In fact, participating variable policies are something of a rarity. However, the prospectus for one insurance company states that "a deduction for dividends to be paid or credited" will be made from premiums and that "this deduction will vary, but is expected to average 8–13% of the basic annual premium."

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