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Whole Life Insurance

Now, we will turn our attention to cash value policies. We will review the main features of cash value insurance and basic types of policies available to consumers.

The first thing to remember is that cash value insurance combines life insurance coverage with a cash accumulation feature.

A. Introducing Whole Life Insurance

Prior to 1975, almost all cash value life insurance policies issued by companies in the U.S. had the investment portion of premiums invested in the general portfolio of the company. The long-term general account portfolio of life insurance companies is comprised primarily of bonds and mortgages. The fixed interest rate bonds and mortgages within the insurance company's general account investment portfolio earn the prevailing interest rate at the time they are purchased. Until 1975, whole life insurance policies whose investment element was in the general account of the insurance company were the dominant investment type of policy available in the U.S. The policy may have been called a family policy, life paid-up at 65 policy, endowment policy, 10- or 20-pay life policy, or even a single-pay life policy.

Whole life insurance provides a death benefit and an accumulating cash value. By definition, it has a fixed premium and a level death benefit to age 100. The premiums do not increase with age, which averages the cost of the policy over a person's life. The cash value increases with time until it equals the death benefit at age 100. Whole life also is known as ordinary (or permanent) life insurance. This type of policy never has to be renewed or converted.

The most common variations of whole life are modified premium and graded premium. These policies are used when whole life protection is desired but cannot be afforded. Modified premium policies typically have a lower fixed premium for the first 3- or 5-year period, at which point premiums increase. Graded premium policies are similar, except the premium increases each year for the first 5 years and then becomes fixed after that. Modified and graded premium policies work well for individuals who expect to experience an increase in their income in the near future. Another common version of whole life is limited-pay.

A whole life policy requires the lowest premium out of all cash value policies because premiums are payable over the entire life of the insured up to and including age 100. At that age, the cash value is exactly equal to the face amount of the policy, and that amount is paid to the policyowner. In other words, the policy endows. Whole life insurance also always involves a savings feature called a cash surrender value.

B. Whole Life Insurance, Premiums, and Cash Values

When an individual purchases a traditional whole life policy, a fixed premium is paid for life or as long as the policy is kept in force. In exchange for this premium, the insurance company promises to pay a set benefit upon the death of the policyowner at any age under 100. On the other hand, the insurance company agrees to pay the insured the face amount of the policy if the policyowner reaches age 100 or pay the beneficiary the face amount if the insured dies prior to reaching age 100. So, the policy remains in force until the policyowner either dies or reaches age 100, as long as scheduled premiums are paid.

Generally, the premiums for this type of policy remain the same throughout the life of the insured. During the early years of the policy, premiums are considerably higher than those of term insurance policies. The younger the insured is at the time of policy issue, the greater this disparity in premiums is.

Each whole life insurance policy premium may be paid throughout the insured's entire life or for a portion of his or her life (e.g., 10, 20, or 30 years). The premiums are substantially higher for whole life insurance than for term insurance. The reason for this is that the policy has investment features and the premiums are being averaged over a longer period of time.

In a **single premium whole life policy,** premiums are paid in one lump sum when the policy is taken out. In a straight life policy, the insured pays premiums for life. Limited life policies, like 10-pay or 20-pay life, are available in which premiums are paid over a specified period of time. Each of these variants of whole life insurance will be discussed in detail later.

Whole life policies build cash values. Basic cash values are guaranteed, and the growth in cash values is tax-deferred under current federal income tax law. Participating whole life policies are also eligible for dividends. While cash values are guaranteed by the company, dividends are not guaranteed because they depend on the actual results of the company's operations.

Whole life insurance is well-suited to needs that do not diminish over time, such as paying estate settlement costs and taxes. Cash value accumulates on a tax-deferred basis and at a rate based upon numerous factors, including the investment experience of the insurance company.

C. Features and Benefits of Whole Life Insurance

Whole life insurance contains various features and benefits. Some of these features are guaranteed mortality charges, with the premium and death benefit guaranteed as well. Depending on whether the policy is purchased from a mutual company or a stock company, a policyowner may be eligible to receive an annual refund of part of the premium paid in the form of a dividend, which is determined each year by the company.

Guaranteed death benefits. Whole life insurance, like all forms of life insurance, provides immediate cash in the form of a death benefit. These death benefits are guaranteed, so the family can depend on them to pay debts and other obligations or to settle an estate. The guaranteed death benefits will help to replace the lost income after the death of the policyowner, and they can also help transfer a business.

Premium plans. Whole life insurance offers many different premium payment options. The continuous, level premium plan requires the insured to pay a constant amount until death or age 100. Because level premium life insurance involves premium payments in later years, presumably after employment has ended, other plans are available to limit the number of payments or to accept payments only until a specified age is reached. A whole life policy has a fixed premium, minimum guaranteed interest rate, and maximum guaranteed cost of insurance. The insurance company may pay a dividend or excess interest each year. These payments are based on the difference between actual and guaranteed experience in mortality, investments, and expenses. Dividends are not guaranteed but are generally expected to be paid at a rate higher than the guarantees.

The difference in premium payments between level premium and whole life paid up at 65 is relatively small at younger ages. In many cases, it is worth this small difference to remove the obligation to make payments after employment ends. The other side of the issue is that death ends the premium payment obligation, and it is unlikely to pay premiums until age 100. Whole life paid up at 65 involves more savings than continuous premium whole life, and all the arguments for and against saving with whole life apply to this decision as well.

D. The Workings of Whole Life Insurance Policies

Whole life insurance tops the list of products that are difficult for consumers to understand. Whole life is a hybrid that combines insurance and a conservative investment. If premium payments start at $2,000 per year, that's what the policyowner will pay as long as premiums are due. If he or she cannot pay the premium in a given year, the policy will lapse, and the policyowner will get the cash value back, minus any surrender charges. If the policy has been in force long enough and has an automatic premium loan provision, it is possible that the cash value of the policy can continue the coverage until the cash values are exhausted.

In addition, this individual is likely to lose the full amount of premiums that he or she has paid if the policy is canceled in the early years. This is because the cost of writing these policies (agent's commission, underwriting fees, and expenses) are front-loaded. The cash value of the policy is likely to remain a fraction of what is paid in premiums for several years.

Many people have common goals for their future: starting a family, buying a home, sending a child off to college, and looking forward to a comfortable, worry-free retirement. Any or all of these events may be in the future, and all require careful planning. It's never too early or too late to start planning, but one first needs to understand the mechanics of the whole life insurance policy.

With whole life insurance, part of the premium goes toward the insurance portion of the policy, a part goes toward administrative and operating expenses, and the balance goes toward the cash value portion of the policy.

About 17% of whole life consumers cancel within the first 2 years, according to the American Council of Life Insurance in Washington, D.C. The biggest problem with whole life insurance is that the policyowner does not know how fast the invested portion will grow because he or she does not know in advance the rate of return that the money is earning, nor how much of the premium is actually credited to cash values. The insurer gives just one guarantee on the investment portion of the policy: the cash value will earn interest at the guaranteed rate at the minimum, probably 3% or 4%. As investments go, that may not seem like much of a return.

Whole life is a higher-premium life insurance than term insurance. The policyowner pays a higher premium up front. So the younger an individual is, the less he or she will pay to maintain the same amount of death benefit throughout a lifetime. Whole life insurance builds cash value inside the policy and has guarantees in writing of what the cash value minimums will be as years go by. The owner has no control over how the savings element is invested.

Under a whole life policy, purchasers agree to pay regular premiums to an insurance company in exchange for a guarantee of a specified benefit payable to his or her beneficiary upon death. Earnings on a whole life policy are set by the insurance company based on the overall return on its investments. Earnings above and beyond those required to cover the death benefit go to the policy's cash reserve, which the policyowner can borrow against, withdraw, use to pay premiums, or allow to accumulate for long-term goals such as retirement. Some products combine the lower premium costs of term insurance with the cash value savings element of traditional whole life, which provides a hybrid type of policy.

This cash value build-up is part of the reason the premiums on a whole life policy generally remain fixed for the duration of the policy, instead of increasing to match the increased risk of death. As the cash value within the policy grows, the risk to the insurance company declines. Although the cash value in a policy belongs to the policyowner, he or she cannot simply withdraw it as needed. In order to withdraw funds, he or she can either surrender the policy for its cash value or take the needed funds as a policy loan.

PERMANENT LIFE FEATURES	TAX TREATMENT
Premiums	Not tax deductible
Cash value exceeding premiums paid	Taxable at surrender
Policy loans	Not income taxable
Policy dividends	Not taxable
Dividend interest	Taxable in the year earned
Lump-sum death benefit	Not income taxable

E. Consumer Application

A car dealer has a substantial investment in his car lot and inventory. This year his business is up over 200% and his accountant tells him that he may have an income tax problem. Moreover, he has not saved much money for retirement, nor has he protected his family from the loss of his income if he should die prematurely. In addition, he might want to access some funds at a future date, in case a business opportunity comes along, or he needs money for his daughter's college education in about 10 years.

For a business owner, the premiums for up to $50,000 worth of group term life insurance may be tax-deductible as a business expense if all employees are covered. Cash values in a whole life policy are usually accessible through loans.

F. Suitability

1. Appropriate Sales

Some planners recommend a combination of cash value and term life insurance to build a complete risk management solution. The term insurance can provide the bulk of the life insurance protection in the earlier years and as premiums rise it can be reduced to save premiums. At the same time the smaller face amount in the cash value policy will provide a level premium which is easier to budget in later years. This strategy requires very detailed planning to make sure that an adequate face amount of coverage is present at all times. If the customer's primary reason for buying life insurance is to provide a death benefit, securing an adequate amount of death benefit coverage should be the primary consideration for the agent.

For most individuals, the amount of coverage needed is greatest in the early years of building a family because debt is generally higher, income is lower, and children are totally dependent. Over time the same individual will see their need for life insurance decrease as their income rises, debt is paid down, and children become independent. The need for life insurance rarely completely goes away, so one should plan to have some level of insurance for their entire life.

Determining the right amount of death benefit is very important. Families must carefully consider their current and future needs for death benefit to determine whether the needed amount of coverage can be addressed with term, cash value life insurance, or a combination.

2. Suitability Checklist

What are your primary objectives in obtaining life insurance coverage?

_____ Asset preservation
_____ Debt protection
_____ Death benefit for heirs (liquidity for taxes)
_____ Funeral expenses
_____ Income replacement (major wage earner)
_____ Business continuity
_____ Charitable gifting
_____ Retirement supplement

Which of the following statements best summarizes your financial objectives?

_____ My goal is to pay a low premium and have death benefit protection for a limited time.
_____ I want death benefit protection and access to cash values for life.
_____ I want to be able to access cash values in the future.
_____ I want death benefit and premium guarantees.
_____ I plan to keep this policy in force for at least 15 years.
_____ I am concerned about inflation and want to take steps to reduce its impact on my future finances.
_____ It is important for me to be able to change the underlying investments in my policy.
_____ It is important for me to be able to increase or decrease the policy death benefit.
_____ It is important for me to have some flexibility in premium payment amounts.
_____ I am comfortable with some risk to principal because it offers the best potential for long-term results.

Chapter Complete

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