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Life Insurance: New Types of Policies

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"A lifetime of tax-free cash...Tax advantages and investment flexibility." Have you seen ads making these claims for universal or single premium life insurance? Universal life, variable life, single premium life, and variable universal life are new to the life insurance field. Sales of these policies have risen steadily since introduced to consumers.

What are these new forms of insurance? How do they differ from the basic policies? This fact sheet:

- compares the new and basic policies.
- explains how universal, variable and single premium policies work.
- suggests questions to ask when shopping for life insurance.

Life insurance is a major expense for many families. The primary purpose of life insurance is to protect dependents against financial hardship when a family earner dies. In return for the payment of premiums, the insurance company will pay an amount of money (death benefit) to a beneficiary upon death.

Traditional Life Insurance

In the past, consumers could choose from two basic forms of life insurance: term or whole life. All other kinds of policies are variations of these two types. Term insurance provides pure protection against the risk of death for a specified period, often one to five years. Term policies are usually renewable, but premiums rise with each renewal.

Term insurance pays only on the death of the insured person and does not build up any cash value. If the policy has a renewable feature, you may extend the policy for additional time without a medical exam. It is the least costly type of life insurance. Term insurance is useful to people needing a large amount of coverage for a few years.

Whole life insurance, also called straight or ordinary life, combines the pure protection of term with a savings (cash value) plan. The insurance company saves part of the premiums you pay each year. The rest of the premium buys insurance protection. You pay the same premium year after year. The policy continues as long as you pay the premiums. If you cancel your policy, you can receive the cash value in a lump sum. Because of the benefits of whole life insurance, its premiums are higher than those for term insurance.

New Types of Life Insurance

Universal, variable and single premium policies combine term and whole life insurance in one policy. The company invests the portion of the premium above the cost of term insurance. The investment may or may not draw interest to increase cash value. Whole life policies pay a low return (2 to 3 percent) on cash value buildup. Universal, variable, and single premium life policies offer interest earnings that are close to rates offered by mutual funds, bonds, and stocks. These policies also offer flexibility. A policyholder has a choice to have the premiums, death benefits, and investment of interest earnings remain the same or change. As with whole life, earnings are tax-deferred and it is possible to borrow against the cash value.

Pros and Cons of New Types of Policies

Flexibility, tax advantages and high earnings make the new types of life insurance more attractive than basic policies. While the new policies appear to offer a better deal, there are advantages and disadvantages to each feature.

Flexibility. Universal and variable life policies offer flexibility. Death benefits and premiums are changeable as the family changes. For example, extra money is added to the investment fund by increasing the premiums. Or, when money is short, a policyholder can choose to have premiums paid from the fund to maintain the same death benefit.

Each year the company provides an accounting of interest earned. The company sends a statement showing how much of the premium goes to term insurance, commissions, management fees and additions to the investment fund. Variable life insurance allows you to choose the investments made with cash value earnings. The face value of your policy and the cash value may rise or fall as the rate of return on invested funds vary.

Flexibility allows you to change your life insurance to meet changing family needs. However, the flexibility of the policy requires your time. Your agent will contact you frequently to make investment decisions. If you are unfamiliar with the stock market, bonds and money market securities, you should avoid variable life insurance. Flexible premiums may tempt some people to skip payments. This decreases the savings buildup of the policy. Some policies may require a medical exam to raise the death benefit.

The company charges an annual fee for the flexible policy features. A combination of renewable term insurance and regular savings in a money market account can provide the same flexibility at lower cost.

Tax Advantages. The 1987 tax law cut many tax deductions and special treatment for long-term capital gains. Insurance companies have used these tax changes to sell universal and variable policies, especially single premium policies. Money not used to pay for insurance coverage draws tax-deferred interest that reflects current market conditions. However, with lower tax rates, many families have less need to shelter income from taxes.

Those buying single premium policies for a child's education or retirement could do as well with savings bonds, municipal bonds or no-load tax-free mutual funds. These investments may be tax-deferred or tax-free. They offer flexibility at varying risk levels. Money invested in insurance policies is unavailable for long periods. There may be large withdrawal penalties or surrender charges, especially in the first five years of the policy.

High Earnings. Advertised yields on universal and variable life policies often are higher than those offered on similar tax-deferred investments. Advertised rates are gross rates figured before deducting commissions and administrative fees. Some policies pay a low rate on the first $1,000 paid in premiums. However, universal and variable life policies do offer a better return on savings than whole life policies.

An insurance agent may show you a computer printout of high returns for the next 10 or 20 years. As with any offer that appears too good to be true, ask questions and be careful. Computer projections assume interest rates will remain high for the next 10 years. With the potential for high rate of return comes the risk of bad investments. Variable life policies usually have no minimum guaranteed rate of return. It is possible you will lose cash value and the premiums will rise. Also, the amount of the death benefit for variable life policies can vary year to year.

Universal, Variable, and Single Premium Life: Questions to Ask

Universal life combines term insurance with an investment fund or retirement annuity. The company deposits your premiums in a special fund. From this fund, the company deducts its fees and costs of term life insurance protection. After deductions, the annuity fund earns tax-deferred interest at a market rate. The annuity promises to provide monthly retirement income for as long as you live.

Death benefits and premiums for universal life can remain the same or vary. There is usually a guaranteed minimum rate of return on savings. The rate is often higher than the minimum and varies with market conditions. The company decides where to invest your funds. The interest earned can 1) increase the face value of the policy, 2) increase the savings portion or 3) help to pay premiums. You can borrow against the savings part of the policy. Questions to ask when comparing universal policies:

- What are the expenses ("loads") associated with the policy? How are the fees charged? These costs vary. There may be lump-sum deductions in the first few years of the policy and a yearly fee. Some "low or no-load" policies have large surrender charges.

- How much are the surrender charges, if any?

- Are there any medical requirements for increasing the policy death benefit?

- How is the rate of return figured? Is the rate of return guaranteed? You can request a projected buildup of cash value for 10 years based on a projected interest rate. However, the guaranteed rate is very modest, normally in the 4 percent range. Compare savings buildups minus surrender charges, not just projected savings accumulations.

- Does the death benefit include the policy's cash value? Some policies pay the face value of the policy plus cash value. Other policies pay only the face value.

Variable life is similar to universal life, but allows the policyholder to choose where to invest savings. You can invest in stocks, bonds or money market funds. These investments vary in risk. You can change your investment mix several times a year. Premiums remain the same or change. Both the death benefit and cash value can rise and fall in relation to the performance of funds. Questions to ask include:

- How much do I know about investing in stocks, bonds and money market securities? Am I willing to spend the time to make wise investment decisions? How much risk can I take with my savings?

- Am I willing to take the risk that my life insurance protection will fall if market returns fall? If not, would I be better off with a different type of policy? If I am willing to risk my protection, do I really need the life insurance? Could I do as well with tax-free municipal bonds or no-load mutual funds?

- As with universal life, what are the management costs and surrender charges?

- Is the life insurance company financially sound? This is very important for variable life policies. If the company sells mostly this type of policy and the market falls, many policy withdrawals could strain company reserves. Consider only companies with an A+ or A rating.

Single premium life insurance can be a whole or variable life policy. You pay a single premium of $5,000 or more. With single premium whole life insurance, the policyholder receives some insurance protection and a big tax-deferred investment. There is a guaranteed minimum interest rate.

With single premium variable life insurance, the death benefit can increase or decrease depending on investments. You choose how to divide the premium among stocks, bonds and money-market funds. There is no guarantee on rate of return. On both whole and variable policies, you can borrow your interest earnings free of charge. There is usually a 2 to 4 percent fee to borrow from your original premium. Ask the following questions.

- Is there a guaranteed interest rate? Will earnings on the single premium be enough to pay the cost of insurance, even if market rates should fall?

- Is the company financially strong? If market rates fall, will the company have enough funds to withstand policy withdrawals?

- What are the charges for commissions and management fees? Commissions can total 4 to 7 percent of the single premium.

- Is the policy I am buying going to yield the advertised rate? Some companies advertise a low cost/high yield policy. However, they sell a different policy with higher fees that reduce the advertised yield.

- Do I need this insurance? Would I be better off buying a term policy and investing in another tax-deferred investment?

- Am I willing to hold the policy for at least 10 years to increase the return on investments? It takes this long to recover commissions, fees and avoid surrender charges.

- Will a change in tax laws affect my ability to borrow from the policy for college costs or retirement?

Which Type of Policy is Best?

How do you decide which type of policy is best for you? The answer differs for each family depending on the amount of insurance needed and the money available for premium payments. Remember, the basic aim of insurance is to protect your dependents from financial hardship.

Universal and variable life policies do offer a better return than whole life policies. However, they still buy less protection per premium dollar than term insurance. Choosing the right type of policy can mean the difference between leaving your family secure or in financial difficulty upon your death. Table 1 shows a comparison of five life insurance policies.

Most families do not have enough insurance. Young families with children can afford the protection they need by buying large amounts of term insurance. Older families who need less insurance protection can build investments by buying a

Table 1: Comparison of Life Insurance Policies

Type of Policy	Premium	Cash Value	Death Benefit	Company Fees
Term	Low with increase at renewal	None	Stays the same	Low; hidden in premium
Whole Life	High and fixed	Fixed rate of growth	Stays the same	Unknown; hidden in premium
Universal Life	High; policyholder can raise or lower	Varies depending on interest	Policyholder can raise or lower	High
Variable Whole Life	High and fixed	Varies with investment return	Can grow if investments do well	High
Single Premium	Very high; paid only once	Varies with investment return	Low; grows as cash value builds	High

universal, variable, or single premium policy. These policies can provide a good return if held for long periods. Families who lack the desire and time needed to manage investments may benefit from the "forced savings" of regular insurance payments.

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