HOME ECONOMICS GUIDE

Published by the University of Missouri-Columbia
Extension Division
College of Home Economics

OCT 15 1982

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The "New" Life Insurance Policies

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Life insurance exists in two basic forms. The first is **TERM.** This is a form of pure protection. Choosing a term policy is synonymous with making an insurance company just that—solely an insurer against the risk of financial loss in case of death. The other basic form of life insurance is **WHOLE LIFE.** It combines savings with protection. When purchasing whole life, the insured decides to make the insurance company both a savings bank and insurer against the risk of death.

The main purpose of life insurance is to insure against financial losses that occur at the death of an individual. The life insurance industry has employed marketing strategies that have presented life insurance policies as meeting other financial management needs. One is as a savings instrument. However, when considering life insurance to help save, you must consider the costs. Costs include additional money paid for life insurance commissions and profits, as well as that paperwork to keep the policy in existence and need evaluation. Another factor to consider is the higher rates of interest that could be made by putting money into other savings instruments. But, the most important cost may be less protection for the premium dollar.

At age 35, a person can purchase a $10,000 5-year renewable term policy for about $65 a year. Yet a $10,000 whole life policy for the same person would cost about $190 yearly. Therefore, if a family needs a larger amount of life insurance coverage, it would be possible to purchase about $30,000 of pure protection for $190 a year. On the other hand, if a family only needs $10,000 of life insurance and had $190 available to meet the need, the pure protection term could be purchased for $65 and the remaining $125 could be deposited in an interest-bearing account. Buying less protection at a higher cost or missing out on a chance to invest excess premium money in some other medium makes the opportunity cost high.

Another marketing strategy for insurance companies is to present savings-type life insurance as a tax shelter. The fact is that there are some tax benefits. First, the insured doesn't pay taxes on the interest that accrues to the policy while it is in force. If, after the policy matures, the insured terminates the policy and takes the cash value, taxes are paid only on the amount which exceeds the sum of the premiums paid for the policy. In most cases, that which exceeds the premiums is very little; unless the policy has been in force a long time, there will be no taxable interest. Why? Because a large portion of the premiums pay for the protection feature and for company expenses and profits. Thus, the interest that accrued to the policy will exceed the sum of the premiums paid only after a substantial cash value has been built up over many years.

Also, in terms of tax advantages, if the insured dies, the interest earned will be passed on to beneficiaries or heirs with neither the policy owner nor the recipient having to pay income tax on the interest. The policy value becomes part of the insured policyholder's estate, and estates have to be very large before estate taxes are paid on them. So, chances are there would be no taxes on the money left to the survivors.

However, the bottom line is, "Could a person receive less expensive tax shelter benefits elsewhere?" The answer is yes. Currently, these are found in a number of tax deferred high interest savings instruments.

Universal Life; The Answer?

Currently, a new form of life insurance is being

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marketed. This form of life insurance is known as **UNIVERSAL LIFE.** Other names are adapta life, irreplaceable life, the economist, lifetime life, the solution, flexlife, the challenger, ultimate life, and T-plan. Varied reactions to this form of life insurance has surfaced during its brief existence. Some say it is the life insurance of the future, that it is what consumers really need. Others say, "Be cautious, it is not all that it's cracked up to be."

A basic question should be, "Does it come closer to meeting the need for protection against risk of financial loss in case of death than traditional whole life policies, or than term insurance plus a savings and investment plan?"

What is Universal Life?

Because it has only recently been introduced in the marketplace, many people are not acquainted with the basics of universal life. It is essentially a combination of a flexible premium annuity with a renewable term rider. It is an effort to package term insurance with the popular tax-sheltered annuities. The annuity in universal life is like a variable annuity instead of a fixed annuity. The rate of return is generally determined by a money-market rate and changes periodically.

Flexibility is one of the key characteristics of universal life. Flexibility exists in both premiums and death benefits. The premiums are specified at the beginning of the policy. However, the policy-holder has a great deal of premium flexibility during the policy lifetime. The premium may be reduced to any level. This is possible because the cash amount in the annuity fund can be used to pay all or part of the premium for one or more years, so long as there is enough cash value to cover the necessary premium payment. This, of course, reduces the amount of money in the annuity fund.

The death benefit or face value of the policy is set at the beginning of the policy. But, the policyholder can change the death benefit upward or downward. If it is shifted upward, the policyholder may be subject to evidence of insurability requirements. Also, the premium will increase unless the policyholder wants to reduce the amount of each premium payment that goes into the annuity fund. If the policyholder wants to reduce the death benefit, the minimum may be established by the provisions designated at the outset of the policy.

In addition to flexibility in premium and death benefits, other features make universal life attractive. Extra money may be added to the annuity fund. You do this by increasing the premium but not the death benefit. Cash may be withdrawn from the annuity fund without being treated as a loan. This is made possible in that the policy's face value and cash value (annuity fund) are reduced by the amount withdrawn. Finally, the policyholder receives an annual disclosure statement. Contained within this statement are how much was deposited in the annuity fund, how much interest accrued to the annuity fund each month, how much was withdrawn from the annuity fund to pay for protection, how much was withdrawn for other purposes, and the current value of the annuity fund.

Now, how does flexibility advance this type of life insurance in the direction of meeting the consumer's life insurance needs? Does it provide a larger amount of protection at a lower cost? This is not evident in the flexibility feature. Actually, all the flexibility feature does is give the insured the option to increase or decrease the amount of protection purchased, the amount of savings deposited, and thus the amount of pocket money paid to keep the policy in force.

These needs are probably more efficiently met at a lower cost in other ways. Money market instruments provide flexibility in a savings plan. A person can increase and decrease the amount in them readily and receive a higher rate of interest than can be earned on life insurance savings. If a person wants flexibility in protection, one year renewable term insurance can be purchased. The face value can be changed on an annual basis. A local bank could be commissioned by one of its customers to pay the premium. Thus, the insured would have no responsibility for remembering to pay premiums.

While Universal Life is superior to traditional policies, there are other avenues for obtaining flexibility in a total program of insurance and savings.

Unadvertised Costs

Probably the most attractive part of Universal Life is its high advertised tax-deferred yield. Several companies have boasted of 10.5 percent to 13 pecent returns. But the cautious consumer should ask, 10.5 percent to 13 percent of what? In the first place, that amount is not paid to the entire savings (annuity) fund. In many cases, a small rate, 4 percent to 5 percent, is paid on the

first $1,000 in the annuity fund. It is only the amount above this $1,000 which will earn the advertised high yield. However, even when the high interest rate is paid on the amount over $1,000, the net rate of return is lower than the high advertised rate. This is because as long as the policy is in force, the first $1,000 earns only the low interest rate.

For example, take a 35-year-old man buying insurance at the face value of $200,000. The premium would be approximately $3,000 a year. There are many demands on the premium. The first year there might be a first year expense charge of $400, plus a charge of $1 per $1,000 of the death benefit, for a total charge of $600. A rate of about $2 per $1,000 would be taken for mortality charges. This amount would equal $400. Usually there is an annual expense charge. In this case, assume 8 percent of the premium, or $240.00. Thus, the charges total $1,240, and only $1,760 of premium would be credited to the cash value. Assuming a 4 percent return of the first $1,000 and 11 percent (the advertised rate) on the amount above $1,000, the first year's return would be $123.60. If the first year expense charges are considered part of the protection cost, then one can conclude that the cost is high to buy into Universal Life for protection purposes. If one considers the annual expense charge as being charged against the savings element (as was done in the example above), the first year return would be *minus* 5.82 percent.[1]

According to Joseph Belth, an expert on insurance, it takes at least five years to earn a return as close as 2 percent to 3 percent below that advertised.[2] Such a low net rate of return makes the disclosure features of Universal Life somewhat deceitful.

Tax Questions

Not only do these issues cloud the picture of Universal Life, but there are also tax concerns which have yet to be decided upon by the IRS. A private letter received by Hutton Life from the IRS suggests that the earnings on the annuity fund will receive tax treatment similar to that for any other life insurance policy. Chances are that a formal court ruling will not deviate from the private letter. But the issue is in doubt.

So, What?

Given these facts about Universal Life, what should the concerned consumer do? The first thing is to ask, "What do I get for my money?" Just as with the traditional whole life policies, the consumer pays a large premium to cover the costs of the policy (including commission, savings, protection, and paperwork costs).

Let's return to the basic question. Is this new form of insurance the ideal answer to the consumer's need for protection against the risk of financial loss in the event of death? The obvious answer at this point is no. It does have a number of advantages over traditional whole life policies but in order to get the most for one's money, the maximizing consumer can pay lower premiums for term insurance. And, to meet savings objectives, a variety of no-cost, high return, tax-deferred savings instruments are available on the market.

REFERENCES

[1]Total premiums paid to savings: $2,000
($240 expense charge, $1,760 to savings)

Net earnings: $-116.40
($123.60 interest minus $240 expense charge)

Return on savings: $\dfrac{-\$\ 116.40 \text{ (net earnings)}}{2000.00 \text{ (premiums paid to savings)}}$
= -5.82% (return on savings)

[2]Joseph Belth. *The Insurance Forum,* November 1981.

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