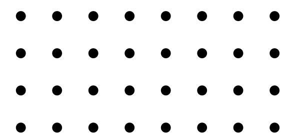
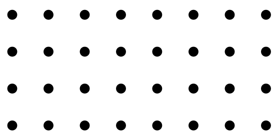


LIFE INSURANCE

A PRIMER

BaldwinClarke



Life Insurance – A Primer

Why Own Life Insurance?

Life insurance can help a family cope with financial hardships that result from the death of a breadwinner: pay off a mortgage, secure a college education, provide income for a surviving spouse and children, etc. Certain types provide living benefits as well: tax free dividends, tax free withdrawals, cash when you need it (be your own banker!) and supplemental retirement income on a tax advantaged basis.

For businesses, life insurance can secure loans, recover the economic loss created by the death of a key employee, secure the benefits provided by executive benefit plans, fund shareholder buyout agreements (including family buyouts), etc.

What Type of Life Insurance is Right for Me?

Life insurance comes in many flavors: Whole Life, Term, Universal Life, Variable Universal Life, and Indexed Universal Life.

Which one is right for you? I'm sure you've guessed the answer: "It depends." On what? Your objectives, tolerance for risk, health and age, and family or business circumstances, to name a few.

Temporary vs. Permanent Life Insurance

Term Insurance:

Term insurance is, by definition, temporary insurance. It provides a death benefit for a fixed number of years, e.g., 10, 20, 30, with a fixed annual premium.

It is ideally suited for temporary needs, such as securing a mortgage. It has no cash accumulation.

Whole Life:

Let's start with the granddaddy of them all: Traditional Whole Life issued by a mutual company. It is tried and true with the most built-in guarantees: fixed premium, tax deferred guaranteed cash value accumulations, and death benefit. The insurer takes on the mortality and interest rate risks. Those guarantees come at the cost of higher premium levels relative to newer product designs. But mutual companies are owned by policy owners and, as such, participate in the company's profits through annual tax-free, but not guaranteed, dividend distributions. Some of the largest mutual companies have histories of uninterrupted dividend payments stretching back for more than a century.

The dividends can be accumulated tax-free in the policy through the purchase of additional paid-up insurance, taken in cash, used to support term insurance riders that can be attached to a policy, or used to reduce premiums, among other options. A popular strategy is to accumulate dividends in the policy until the accumulations and future dividends can be used to pay the entire annual premium, potentially for the rest of the insured's life. Because of these dividends, Whole Life policies often have lower long-term costs than many of the newer designs.

Arguably, Whole Life is still the best—if you can afford the premiums.

They provide guaranteed premiums and death benefit; guaranteed annual cash value increases, and participating dividends to grow wealth and compliment investment portfolios. While premiums are fixed, a Whole Life policy's cash values and dividends provide opportunities for some flexibility.

Universal Life (UL):

A distinguishing feature of Universal Life ("UL") is flexible premiums. Policy owners can increase or decrease the amount of premium they pay at any time. Various forms of Universal Life ("UL") have evolved. Mutual (owned by policy owners) and Stock companies (owned by investors and traded on a stock exchange) both offer universal life products.

A basic UL policy is often illustrated with lower premiums per dollar of death benefit than whole life. There is no guarantee that premiums won't increase, or that the death benefit will remain in force for the illustrated period, say lifetime, at the initial illustrated premium. In short, the policy owner assumes the mortality and interest rate risk.

The objective may be permanent coverage for life with very low premiums relative to whole life, but as noted that objective may not be realized.

The death benefit in UL policies is provided by means of annual one year term insurance, the cost of which increases every year. The annual insurance cost and the company's expense charges are deducted from the annual premium. The excess is allocated to an accumulation account to which the company credits interest at a rate that is determined annually. (Most policies have a minimum guaranteed rate, often 2%). In this design, the accumulation account is funded by the general account assets of the insurer.

The combined annual insurance cost and expenses charges ultimately exceed the annual premium. The shortfall is paid by withdrawals from the accumulation account. If the accumulation account is reduced to zero, the policy will lapse, or an impossibly high premium increase will be required to maintain the policy. This could happen if the insurance company increases the insurance cost beyond what was illustrated, say to the maximum permitted, and/or credits less than the illustrated interest crediting rate or if the policy owner fails to pay the planned premium every year. Many UL policies reach this lapse window when the insureds are in their 70's.

The lapse risk can be reduced by increasing the planned annual premium in the illustration. In an "Accumulation UL" illustration, the premium can be increased, so that the illustrated accumulation account would potentially have significant value, say at retirement. Accumulation accounts grow on a tax deferred basis as do Whole Life cash values.

Query: Would Whole Life then be the better option for this accumulation objective if the premiums are the same?

The UL variations mostly have to do with the nature of the accumulation account. The persistently low interest rates of the last several years have resulted in very low, non-compelling (think non-competitive) illustrations, as the earnings on insurer general account assets were too low to offer reasonable interest crediting rates and maintain profitability for company sustainability. Other than the changes to the accumulation account mechanisms discussed below, the basic UL operating chassis remains the same.

Variable UL substitutes a basket of mutual funds for the company's general account. The performance of the mutual funds not only impacts the value of the accumulation account, but the death benefit as well. The problems here are obvious. Financial market risk replaces interest rate risk. Negative performance can cause the policy to implode.

The most prevalent UL product today is **Indexed UL**. It is also the most complex. Again, the same chassis but a different method of creating a return for the accumulation account. The insurer will provide the account with a return linked to a stock market index, say the S&P 500. Dividends are excluded from the return calculation. The return is subject to a participation rate, meaning that you will participate in only a percentage of the index return. For example, 80%. Your return is also subject to a cap. For example, if the cap is 7% and the index returns 10%, your return will be limited to 7%. Generally, the participation and cap rates can be adjusted by the company annually. In exchange for these limitations, you will not participate in any index losses, and may even have a floor return of 2%, for example. The company relies on options trading success to provide the return.

Some insurers offer Guaranteed Death Benefit UL, which requires a fixed annual premium to be paid on time every year until death. Think of it as lifetime term insurance.

Concluding Thoughts

All insurance companies operate in the same economic environment and face the same mortality exposure, assuming similar underwriting practices.

Mutual companies are owned by policy owners who participate in the company's earnings through dividends and enjoy guaranteed cash values.

Stock Companies, owned by stockholders, must provide returns to stockholders ahead of policy holders, hence the lack of guarantees and the equity market approaches to accumulation.

It is our view that life insurance is about security and guarantees, not about assuming the mortality and investment risks that rightfully belong to an insurance company.

A life insurance policy can be a costly way to participate in limited indexes or mutual funds for individuals who otherwise have access to mutual funds or index investing through their investment advisors or 401(k) plans.

Accumulation Universal Life and **Whole Life** are the better choices.

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