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Chapter 4: Life insurance strategies for families and individuals: Term, whole, and universal life explained

4.1. Introduction to Life Insurance

Life insurance is a subject most people learn about in depth only at certain points in their lives. The goal of this book is to prepare you for those times and make the process of deciding what types of policies to buy, what coverage amounts to choose and what premium rates are acceptable much easier than it would be otherwise. Hopefully you will learn enough to make these decisions while you are still healthy and have the lowest premiums possible. Doing so will help make sure your family and dependents have the financial support they need when you are no longer here to take care of them (Mitchell et al., 2023; Ortega et al., 2024; Ali et al., 2025).

Life insurance companies provide coverage on many different lives; hence, they are told that the business of insurance is a transfer of risk to a group of risks. Other than your purchase, this business transaction is different from every other business transaction you make. You buy a car or dress or television and have it in your possession. With insurance, you pay for a promise that a company will make a financial payment upon the death of someone who paid a premium to that company; but no one wants to have to collect on that promise, especially the insured's family. And, unlike your other purchases, you hope not to have your life insured; because if you do, that means someone has died! Buying insurance is unlike any other purchase you make, and it is not surprising that many people have questions about it, even people who have been policyholders for many years (Sanders et al., 2023; Robinson et al., 2024).

4.1.1. Overview of Life Insurance Concepts

Life insurance is a crucial element of family and individual financial planning. In the most general terms, insurance is a technique for preserving assets in the face of unforeseen potential financial hardships. Life insurance specifically protects against the risk of death, although policies often include provisions that cover the risk of accidental permanent disability as well; in this case, the insurance also covers the risk of being alive but unable to earn an income. Key questions you should consider are: How much insurance do you need? What type of insurance? Term, whole, or universal? What should be your policy beneficiary designations? Which are financial considerations in choosing a policy? When should you buy insurance? When should you terminate or modify your policy? How do you repay a family loan? You will consider the answers to these questions in this book.

In its simplest form, life insurance is a contract between a policyholder and an insurance company. The insurer accepts the risk of the policyholder's dying within a specified period of time. In exchange, the insurer also agrees that, should the policyholder die during that time, it will pay a specified amount of money to the named beneficiary. If the policyholder survives or cancels the contract, the insurer retains all premiums paid. However, some types of life insurance have a cash value component and, upon termination, the policyholder will receive a portion of that value as specified in the policy. If you purchase a permanent policy, your policy may accrue cash value as you pay premium bills over the years.

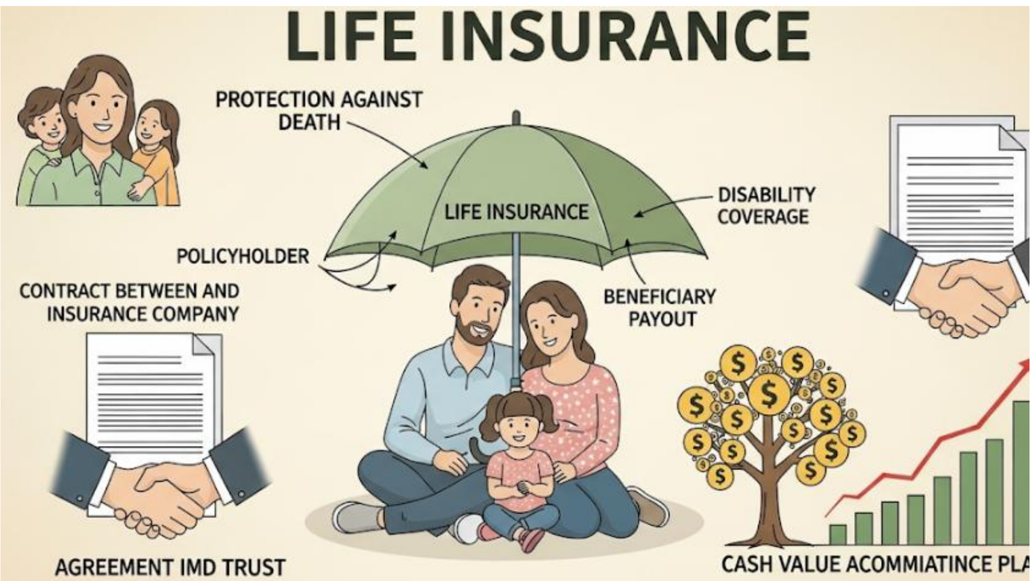

Fig 4 . 1 : Understanding Life Insurance

4.2. Understanding Life Insurance

1. Definition and Purpose

Life insurance is a crucial aspect of personal finance planning, providing financial protection for loved ones in the event of an unexpected death. It works by transferring the risk of financial loss from an individual to an insurance company. By paying a premium, the policyholder's beneficiaries receive a death benefit when the policyholder passes away. There are several reasons why someone may purchase life insurance, such as wanting to replace lost income, cover the cost of raising children, eliminate debt, or provide funds for end-of-life expenses. These reasons, coupled with the need for financial security, have resulted in the widespread use of life insurance.

Individual needs and preferences, as well as affordability, typically determine the amount and type of protection purchased. While many focus on life insurance as a way to protect others, a small portion of policies pay benefits to the insured upon retirement or at a specified time. These are called cash value policies. However, when estate planning, determining how much financial resources would be needed to take care of family, business, or estate expenses becomes a larger task. For many, life insurance represents the most affordable way of creating an immediate cash resource.

2. Types of Life Insurance

The two major classifications of life insurance policies are term insurance and cash value insurance. Term insurance provides death benefit protection for a specified period of time, or term. Cash value insurance provides death benefit protection for the policyholder's whole life, assuming the premiums are paid. Some cash value policies also operate in a similar manner as term insurance and are called modified premium policies. Term insurance is generally less expensive than cash value insurance, and there are several reasons for this. The premium generally does not increase with age, while the premiums of a cash value policy are generally designed to remain level or increase as the policyholder ages. Term policies generally offer a larger death benefit for a lower premium. A term policy is affordable for a larger amount of insurance, allowing policyowners to maintain adequate family protection.

4.2.1. Definition and Purpose

Life, as we know it, is filled with uncertainty and unpredictability. Year after year, you spend the majority of your working life in pursuit of security and a financial foundation that will carry you throughout your lifetime. But, have you ever stopped to question what would happen if something unexpected were to happen to you? The thought is scary, I know. But if the worst were to happen, would your family and loved ones be taken care of? After all, no one wants to leave behind a mountain of financial debt for family and loved ones to dig themselves out of. There are several strategies that can help you plan for the best possible outcome for your estate upon your passing. Life insurance is one of them.

At its most basic definition, life insurance is an agreement with an insurance company that in exchange for a regular premium payment, the insurer will pay an agreed-upon amount to the policyholder's beneficiaries upon death. Sounds simple enough, right? Before you get too comfortable, however, there are many pieces of this puzzle that will determine what type of life insurance is best for you and why it is crucial to your financial strategy. Life insurance, at its most basic is designed to provide protection to your estate after your passing and to lessen the financial burden of your family's loss. But, let's take a more in-depth look at life insurance and the intricacies involved in making it a critical piece of your estate planning strategy.

As a financial tool, the fundamental objective of life insurance is to ensure that the financial needs made necessary by your death are met. Life insurance can provide cash to meet short-term obligations or shortfalls, such as funeral expenses, immediate stress of surviving family members, dependent expenses, telephones, debts, and mortgages, and so on. Similarly, the proceeds from a life insurance policy can meet long-term financial needs due to death such as loss of family income, family dependency on income and education for children.

4.2.2. Types of Life Insurance

Several different types of life insurance exist, and choosing the right one depends on the needs of the family. Life insurance can be divided into two main categories: permanent and temporary. Permanent insurance includes whole life and universal life. Temporary or term insurance is just that - it provides insurance over a specific number of years or until a specific age. To decide which type of insurance is best, individuals should look at their life cycle needs, which change throughout life. Young couples starting families or beginning careers typically only need a small amount of life insurance - at least for the first few years. As income increases and families become financially responsible for others, needs increase. As kids leave home and retirement approaches, needs taper off.

Term life insurance will normally be the least expensive option, often by a large margin. Premiums are set and increase only at the end of a level premium period. However, premiums have to be paid for the entire term to keep the coverage. Higher amounts of coverage can be purchased for a relatively small premium. Such insurance is ideal for increasing coverage for kids and spouses until retirement - at which time the need (but not necessarily the income) decreases. Most major long-term liabilities will ideally be finished by the time the family is empty-nested and/or retirement age.

4.3. Term Life Insurance

1. Overview of Term Life Insurance

As a life insurance product, term life is simple. You buy a level amount of insurance for a guaranteed premium for a specified period of time. For example, a 20-year $500,000 level term life policy guarantees that your beneficiaries will receive the $500,000 death benefit if you die within 20 years of the date the insurance goes into effect. Your premium will remain the same for the entire 20-year term and must be paid in full to ensure that the policy is in force. If you outlive the 20-year term, the policy no longer has any value unless you purchased a convertibility or renewal option. If the policy has these features, you may be able to convert or renew the policy at your current age without being required to provide proof of good health. However, the renewals will likely be extremely expensive since they must be based on your current age.

Level term policies are typically issued with terms of 5, 10, 15, 20, and 30 years. The premiums increase with each age increment that is entered on the insurance application. Special terms from one to 89 years may also be available, but they are rates for your current age and may be very expensive. However, level premium term policies are a good, cost-effective way to guarantee a sufficiently large death benefit for a certain period of time, particularly during what are generally called the risk years. These risk years generally correspond to the years your dependents are mainly dependent on you for financial support. Term life is the best choice for covering the risk during these years.

2. Advantages of Term Life Insurance

The primary reason people buy term life is its low cost. Term life is usually the lowest cost type of permanent insurance until after age 75. This is because there are no savings or cash value components to build, as is the case for permanent or whole life policies. There are therefore little or no sales commissions for agents. The only objective of term life is to provide a death benefit. During the risk years, when death benefits need to be large and you don’t need coverage after your ACV no longer needs protection, term life is an excellent idea.

3. Disadvantages of Term Life Insurance

Term life insurance has disadvantages as well. There is no cash value, meaning it cannot accumulate money to be used during life. If no claim is made prior to expiration of the policy term, the policy is worthless. Also, if you need to extend your protection after the policy expires, the premium could be extremely high. Converting from term to whole or universal life is one way to avoid this risk. In addition, for same-age applicants, premiums for term life increase every year after the renewal years. For the term life policyholder for the period beginning after expiration of the level guaranteed period and the whole life policyholder, premiums for the whole life policy are likely to be much lower unless the policyholder expects to need the whole life coverage for a relatively short time period.

4. Ideal Candidates for Term Life

Term life is the best choice for covering the risk during these years. The ideal candidates for this type of insurance are all people who could not afford to buy a permanent life insurance policy. As a result of their low cost, term life policies are also appropriate for wealthy persons with enough assets to self-insure their deaths, who wish to obtain large amounts of life insurance for a limited time at the cheapest possible price.

4.3.1. Overview of Term Life Insurance

Term life insurance is designed to cover a specific period in the life of an individual or family; therefore, many people call it temporary life insurance. Premiums are paid during the life of the policy, and if the insured dies during that specified term, then the death benefit is payable. If the insured lives longer than the length of the term, the policy expires, and nothing is payable. The majority of life insurance policies are designed to last for a long duration, most often for the whole life of the insured; however, for many people, that is an excessive amount of time to be paying insurance premiums. In some cases, individuals may prefer to have affordable premiums for a specified amount of time and little or no cash value build up and thereby choose a term life plan. Also, term life insurance is often used by businesses to cover a key employee or buy-sell agreement due to the fact that businesses will not continue to exist forever, so the term nature of the policy may make financial sense.

The term life industry has adapted by presenting a variety of products to individuals, families, and businesses, with both short-term and long-term solutions being offered. The two major types of term insurance available today are level term and decreasing term. With level term, the premiums and death benefit remain constant throughout the length of the term. This is the same concept as level premium whole-life insurance. When someone speaks of a level term plan, he or she is usually speaking of a long-term level term plan with a term of 10 years or longer. Some companies offer plans with terms lasting 30 years; however, they are not as prevalent as the 10-20 year products.

4.3.2. Advantages of Term Life Insurance

Many financial planners suggest that most people need life insurance only during their working years when their families, businesses, or estates are building up values, debts, or income needs that would adversely be affected by the insured person's premature death. Consequently, term insurance fits the need for protection during these years. For those in this category, term insurance is the most efficient way to keep needed protection in place at the lowest cost. Also, it generally costs only about five to twenty-five percent of the same amount of whole life insurance protection. Many employers now provide their employees with some group term insurance on a voluntary basis at much lower rates than are available from insurance companies for the same benefits. Another advantage of term coverage is that it is very easy to understand. In its simplest expression a term insurance policy states, "If you die during the next twenty years, we will pay your beneficiary $100,000." The question of premiums, benefits, and length of time are clearly stated. Also, it is the only form of insurance that pays a benefit when the insured dies during the term of the policy. Claim payment can usually be done faster than permanent insurance due to terms of application. There also are no investment return issues or loose policy provisions.

4.3.3. Disadvantages of Term Life Insurance

Term life insurance is a great tool for people who need help getting started protecting their families. As time goes on, they will need coverage for longer and longer time periods. That's when term life insurance presents its challenges. There are three disadvantages of term life insurance that people should understand.

First, coverage ends. If you purchase a 20-year level term (meaning the premium does not change for the first 20 years), after 20 years you have the option of keeping the policy, but the premiums will increase dramatically, and if you have any health conditions, there is a chance that you may not be able to continue the coverage. The benefit is that you had insurance for the 20 years that the price didn't increase, which was often much lower than if you had invested in permanent life insurance. Possibly more importantly, by then you may have enough assets to be self-insured, and you may not need the coverage anymore.

Second, the premiums increase each year after the original stated term. That means once the original term expires, every subsequent year is counted as a new year for you, and every year after your policy expires, your premiums will increase and may become prohibitive. Just like choosing a term for coverage, if you choose a longer term on your policy, the longer term you choose, the larger your premiums will be. It may also be possible to convert your term policy into another type of policy while you're still healthy enough to qualify, but if you do that, it's going to be much more expensive because you're getting that same amount of coverage for a longer time. Because of the usual increase in premium costs, you run the risk of dropping your policy, leaving yourself with no life insurance when the financial world, or even just your own world, blows up.

Third, it has no cash value. Your premiums pay for only the insurance and not a cash accumulation or investment column. With a permanent policy, the accumulated cash value can help with funds during a life crisis, like starting a business, paying for college or retirement funds. With a term policy, you have to wait until the insurance pays out for it to have any benefits.

4.3.4. Ideal Candidates for Term Life

Designing your financial life can often require you to make challenging decisions and achieve a careful balance. On the subject of protecting your loved ones from unexpected financial loss this general principle holds true. Ask yourself about how much and what kind of protection you want for your family or dependents and for how long? For some people, the expense of term life insurance might be a smaller consideration than a belief that insurance is good practice or a desire to make absolutely certain that one's children will get a college education, regardless of what happens. For others, term may be better suited for the expense of day-to-day living or to meet funeral expenses. Or, during childless single years, the term expense may be less than the cost of altering a will each time their assets change.

The reality is that, for many families, the best possible solution for the protection of their income may require that inexpensive term life insurance be addressed now or combined with whole or universal policies for later. Identifying the ideal candidates for a term life policy is relatively easy. They need to be young, preferably in good health, and typically just beginning a family. In addition, they probably have very little disposable income and are in the process of purchasing their first home. It is rare and fortunate for a family member to pass away with no children. Generally, families with small children depend on two incomes. If something were to happen to one of them and they could not keep their jobs, it could leave the spouse or family on the other income with mortgages to pay, school tuition, or college funds, as well as day-to-day living expenses.

4.4. Whole Life Insurance

1. Overview of Whole Life Insurance Whole life insurance promises to provide coverage for the life of the insured, or at least until age 100. A fixed premium is paid either annually or monthly. The insurer’s mortality costs are much higher in the early years, so

the premium will initially build a cash value. Eventually this cash value will equal the death benefit at age 100, but the cash value is sometimes “picked up” by the insured even earlier. In these cases, the insurer keeps the cash value and the family finds another means of fulfilling the death benefit. As in the case of the grandchildren’s policy, the latter usually means retiring an outstanding mortgage and perhaps making a deposit toward the children’s college education.

Whole life insurance becomes less valuable as an accumulation vehicle when compared to other investments. It should be understood, however, that the cash value grows at a guaranteed minimum rate of return. In other respects, the policy performance relates to actual investment results, and an effective interest rate is reported in the annual statement. Improvement of interest rates has led many companies to issue a greater supply of policies that they label “interest-sensitive” whole life. It is also possible to tie company dividend policies to actual interest performance, although this can reduce performance in other years.

2. Benefits of Whole Life Insurance Whole life is a guaranteed death benefit. Compared to term insurance, whole life offers tax-favored savings, loans, and withdrawals. Fixed premiums make the plan easy to budget for, and since premiums are paid with after-tax dollars, the tax implications of these payments are quite simple. And of course, as the policyholder approaches age 100, the guarantees become even more clear-cut — the policy never lapses and the death benefit is payable upon death or the potential cash value is returned. Moreover, if the policyholder ceases making premium payments during the insured’s lifetime, the death benefit remains in force, although it will be reduced according to the insurer’s policy.

3. Limitations of Whole Life Insurance Although these guaranteed features are attractive, there are costs associated with them. The investment return on whole life has historically underperformed stocks and real estate, which have provided superior growth. Even other investments, including various tax-favored retirement plans, have often provided better long-range growth. The cash value of whole life policies is not a liquid, available-for-withdrawal asset. Withdrawals before death are in excess of basis, or capital, and are thus subject to income tax. If a policy is surrendered for its cash value, any excess over what has been paid in will be taxable. Moreover, once cash value is taken out, it will reduce any death benefit, which also would be subject to income taxes if it exceeds basis.

Whole life insurance also takes thought and planning exactly due to its limitations. Last, terms and conditions of advisedly structured whole life policies can differ greatly among different companies, requiring further close study. Therefore, it is valuable for whole life, along with other policy types, to be included on an objective basis in a selection of general estate planning recommendations.

4.4.1. Overview of Whole Life Insurance

A whole life insurance policy is designed to provide lifetime protection and is the most basic form of life insurance. With it, the insurance company guarantees the payment of a specified death benefit as long as premiums are paid. Whole life insurance also accumulates cash value that the policyholder may borrow against. A statement of cash value is typically provided to the policyholder annually and discloses the cash value of the policy. As long as the policy is in force, the insurer is obligated to maintain the cash value at a stated minimum amount. The policy's cash value accrues on a tax-deferred basis; however, tax may be due if the policy is surrendered, or if the borrower dies with an outstanding loan against the cash value.

In contrast to term life insurance, which offers coverage for a specified period, whole life insurance provides lifetime coverage with fixed premiums, a portion of which pays for the expense of insuring the policyholder, and a portion of which is invested according to the insurer’s specifications. The returns on investment are generally modest and not guaranteed; however, insurers do specify a minimum cash value. The policy is also eligible for a share of the insurer’s surplus, which is distributed as dividends. An insurer typically pays out policy dividends when the company has met or exceeded its guaranteed obligations. If an insurer fails to meet its dividends, the policyholders’ risks are amortized. Insured persons are projected to die within a certain time period. In the years in which too many insured die, the company is required to lower its non-par dividend for its entire constituency. Likewise, in the years in which too few insured die, surplus from those in other risk classes can subsidize the actuary’s dividend plan.

4.4.2. Benefits of Whole Life Insurance

A contract with guarantees is offered in the buy-term-and-invest-the-difference model. It is almost never followed. You can do it yourself and save the commissions. It is also possible that you can’t afford whole life, and you are buying term. If you have a few thousand dollars per year to invest, considering whole life may be complimentary. Or you just think the difference is worth it. Or the money is going away in investment expenses anyway for mutual funds, and instead you would just pay an initial cost of insurance and the death benefit would also be a nice windfall for your family. Your assets may grow fairly well in the whole life cash value when you die and beneficiaries at the same time lack assets. Or you think that whole life is better for your estate plan and family than investing the money for a while or lazily paying for an investment account. Or you think whole life is a good alternative to both risky and relatively safe investing. Or you just want the guarantee that you can rely on it, and you think comparing stocks or bonds is irrelevant.

The guarantee makes these policies much easier to justify at certain stages of life. These other policies are designed to be unreasonably expensive within the first few years; you hope to get the policy on a premiums-paying basis within a few years. Whole life companies are valuing the policy as if you will pay premiums until you die. Both the insurance part and the investment are built into the plan and you can't have it unless you cash the entire policy in. The death benefit is reduced. With the guaranteed plan, premium payments, the tradeoff is the company's guarantee. There is no investment need; you hope to do away with the investment need for someone else to take care of, or to invest; or both; or that you and your family want that person to be you until you die.

4.4.3. Limitations of Whole Life Insurance

Whole Life Insurance's limited investment upside creates some downsides in addition to its high cost. The key element is its internal returns on cash dividends. The cash is basically invested in the issuing insurance company's portfolio of bonds, so the investment returns are guaranteed not to exceed what could be earned on such bonds, but with liquidity constraints. Even if the insurance company invests far better than its competitors in taxable bond funds, which are likely to do at least as well, whole life policyholders cannot access any of those returns until their policies are dissolved; in the meantime, they are taxed on the insurance company's investment income as it is earned.

Whole Life's tax-advantaged status will not do much to help if taxation of the income on the underlying bond portfolio is deferred, since that can be accomplished simply by investing directly in municipal bonds. They have now generally come in at lower Federal tax-exempt yields than Fortune 500 corporations have offered over any reasonable historical period. The insurance policy is effectively denying its owner the ability to take advantage of those higher yields as an investment return paid over during the period of low interest. Thus, few people will have sensible liquidity for a policy that is unlikely to remain useful for even 15 years before its cash returns surpass what could have been obtained alternative plus tax deferred and tax-advantaged State if from bond investments a direct investment in them. Whole Life doesn't offer the right product to people in their highest income years while they are surely creating liquidity needs.

4.4.4. Who Should Consider Whole Life

While whole life insurance is among the oldest forms of permanent insurance, it also has a somewhat limited audience. Some advisors will tout whole life as the choice for everyone. Others will argue for term insurance exclusively. The reality is there are those who may benefit from investing in a whole policy, while for others it may not be advisable. While it is a more expensive plan, whole life may be useful if you want to lock in both your coverage premium and the death benefit for the life of the policyholder. For those who may be challenged by any increase in health risk, or who may have a family history of certain illnesses, this certainty can be important. Even if you purchase now, there is no risk of losing your coverage in the future. A whole policy also offers a small cash value benefit to build, and access if the need arises. A whole life policy typically also pays dividends on a regular basis. These can create additional cash value, or be used to reduce your premiums. Budget may be a critical consideration as well. If your insurance budget can accommodate it based on how much protection you want, and for how long, investments in whole or universal life may serve you very well. While both may be quite a bit more expensive than term coverage, they were around before 401k's, and IRAs, and they are probably of very little benefit as a tax shelter. While tax-deferred growth is part of your cash value advantage, it may not be a huge component of the return on your investment. You should have some solid investments outside of insurance. Have an investment advisor who is well acquainted with estate planning tactics to help with this.

4.5. Universal Life Insurance

Universal Life Insurance combines the features of Death Benefit Security and savings growth. Universal life insurance products include both mortality and expense costs. However, universal life allows variable expense deductions for companies' overhead. As companies incur more costs, perhaps due to inflation, the cost of insurance can change. This makes the expense component of universal life unpredictable. Also, the additional interest accrued is not guaranteed, as it is with a whole life policy. The company only guarantees a certain minimum rate of return that could be less than a government bond. As expenses and costs change, accounting for this uncertainty is crucial to purchasing an appropriate amount of universal life policy coverage. Rates of return, costs, and guidelines governing the products can all change.

Universal life insurance is a form of permanent insurance. That is, once the premium is paid, it will remain in force until the death of the insured or a lapse in policy. An insured lives no longer than an actuarially determined amount on the basis of the initial premium schedule. Universal life offers a flexible premium and flexible face amount. Flexible premium means that after the first, you choose the amounts and times you add to the cash account. You are not locked into a fixed premium schedule. Flexible face amount means, at designated times during the year, you may choose to change the amount of coverage, and sometimes the risk, you are paying for. However, as mentioned above, there may be a cost associated with these changes – either increasing or decreasing your coverage. A flexible premium with a guaranteed minimum along with a flexible face amount is the reason why universal life insurance is much more expensive than term.

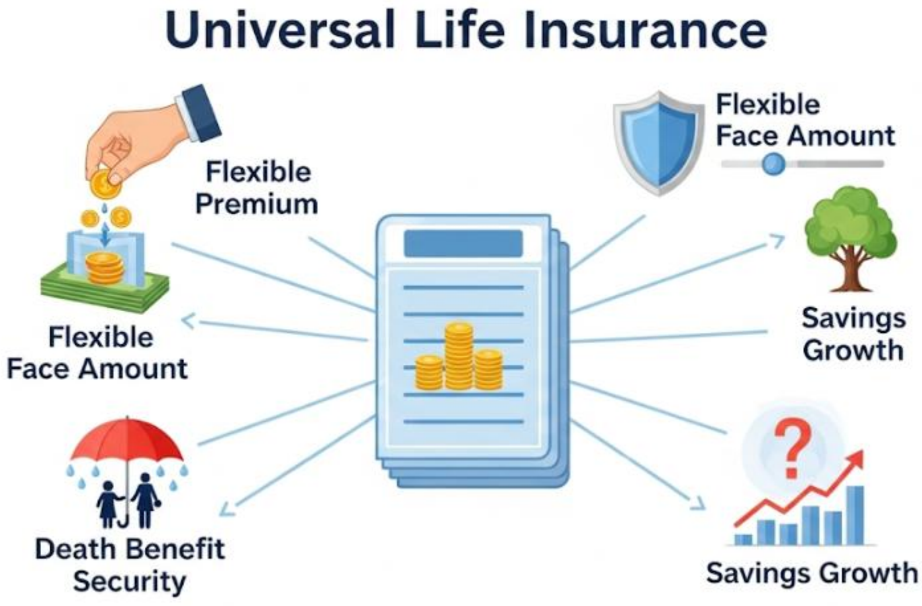

Fig 4 . 2 : Universal Life Insurance

4.5.1. Overview of Universal Life Insurance

Universal life insurance is a flexible premium policy that combines the economics and mechanics of a whole and term policy. Users pay premiums, much like whole life, which are placed into an accumulation account that earns interest. The term part is, for all intents and purposes, the cost of the coverage, which is deducted from the account monthly. As with whole life, friends and family are covered, and upon their death, the company will pay a lump sum, called a benefit, to the insurer's designated beneficiary.

In essence, universal life is an interest-earning checking account with a fee for a term insurance policy every month. After the term portion is deducted monthly, the remaining accumulation account can be kept with the company to earn interest, or the policyholder can take it all back for some other purpose. Universal life is also a regulations-friendly asset-protection vehicle because in most states the cash value and the death benefit are protected from creditors. In general, life insurance equity is protected unless the insured’s intent is to defraud creditors, in which case there is a law exempting a certain amount of equity from seizure.

Premium payments into universal life can be flexible, and policyholders can decide how often the insurance should be paid. Universal life insurance is based on an insurance contract with a general insurance company, so it has a level death benefit and a level insurance cost until the costing reaches each level. If the costs go up due to recession or loss of insurance company profitability, the policyholder may or may not be notified in advance. Consequently, while the economics and mechanics of universal life are similar to a whole life policy, the investment experience is quite different. The interest earned on the accumulation account can change based on the life insurance company's investment experience.

4.5.2. Flexibility of Universal Life

Universal life insurance is designed to be flexible, allowing the owner to pay premiums at any time and in any amount from the minimum premium to the maximum premium under federal regulations. However, the premium shown on the illustration is the premium the owner must pay each year to keep the policy in force until the maturity date, usually the insured's age 100, without any chance of a policy lapse, assuming additional premiums are not required in the first few years. Additional premiums can be added at any time, and a cash value is created from the increase in death benefits plus interest. The insured can also make periodic withdrawals from the cash value. Universal life insurance policies can offer the option of a flexible premium to pay. If a policy is going south, say because of poor performance or because the minimum premium is much lower than what should be paid or because no premiums are being paid, the policy will stay in force until the cash value is completely depleted, but the owner will be notified many times that the policy is about to lapse. At that point, the owner can either allow the policy to lapse and forfeit the guaranteed death benefit, or dump a lot of money into the policy to get it back on track to allow a more reasonable premium. In most illustrations, after year 10, the minimum premium and based-on-illustration base cost for the policy will be about the same, so that the policy can be set to lapse a few years after assurance that a minimum premium will be made.

4.5.3. Costs Associated with Universal Life

Data Choice: What is the cost of the insurance coverage? When you buy a universal life policy, the company first tells you how much you are going to pay for the coverage. In the quotes you receive, the cost of coverage in the various designs is indexed to the current interest rates and current cost-of-insurance rates. These current rates are applied after the premium payments have been applied to the contract. The basic factors are: the insured's attained age and sex, the insured's risk classification, the death benefit level, the fact that values will not be withdrawn, and the insured's travel and living arrangements.

But both those factors, the cost of insurance and the assumed interest rate, are going to change over the years, maybe even change drastically. Changes in medical progress, mortality, longevity, current interest rates, and other economic factors are part of the overall risk pool that affect insurance rates. Changes in markets and other economic considerations may impact insurance overhead. As time goes on, new and cheaper insurance is issued and those empty seats higher in the stadium are being filled. Those new people are facing lower rates and so should the existing customers also. That's equity and insurance is founded on the principle of equity. That's why the cost structure of insurance is so important. When the actuarial methods and other costs are unstable and unpredictable, the excesses in the premiums that come in have to be larger in order to compensate for the excess claims that may result.

Getting back to your universal life policy, testing shows us—testing by our own experience and by experience—that when overhead is high, the policies tend to go into lapse compared to other low-overhead policies. Universal life is a cyclic product, it does best when interest rates are high and it does poorly when the cost structure is such that very little interest over time is being earned. That's why the selection of company and policy has to be active during the years your policy is being used.

4.5.4. Best Candidates for Universal Life

Choosing universal life makes the most sense when your goals align particularly well with the advantages of the policy. This flexibility can be useful when you see life and death changes approaching and want to be ready for them. These changes might include marriage, divorce, or the arrival of children and grandchildren, and you want to be ready to raise kids or need to either increase or reduce your insurance benefit. Other life altering changes could involve starting a business or thinking of retiring soon and needing long term future planning. And in the earlier phases of these life changes and readiness for an increase or decrease in premium payment and policy benefit amount, you will want to leverage the flexible availability of cash value growth over time in order to catch up or increase your cash value in preparation for those future events.

A key thing to note here is that long-term universal life is not the easiest vehicle to navigate. As we mentioned, the universal life policy is complex both in terms of its internal structure and the external financial factors. Therefore, a well-informed agent and ongoing financial education are essential. Universal life policies are rarely set up to be all-in-one tools for all consumers in all life stages and financial circumstances. To maximize the utility of universal life plans, you will need to think carefully about your current and future needs and available income for premium payments, especially as you age. Unlike many other permanent policies, universal life policies please many consumers due to their cash value flexibility. As a result, they have decided to opt for the universal life plan for the long haul.

4.6. Comparative Analysis of Life Insurance Types

After having reviewed the details of term, whole, and universal life insurance, we can now perform a comparative analysis focusing on three important areas: cost, coverage issues, and the flexibility and cash value features.

1. Cost Comparison While term insurance is usually the cheapest way to buy high-level coverage, the premiums increase significantly when one applies for renewal or purchases a new term policy because these same rates are based on your age at that time. If you live long enough, the cost of insurance will eventually reach the level of permanent life coverage. Since the premium payments for whole life are higher in the early stages of the policy, you are essentially prepaying for the cost of insurance in the later years. Your premiums for universal life will typically be less than the whole life premiums, but whole life has other advantages.

2. Coverage Comparison Another major way in which term insurance differs from the two types of permanent insurance is in the length of the coverage period. Term insurance offers pure protection, while whole and universal life provide a combination of protection and savings. Therefore, whole and universal policies will cost more than term insurance of the same face amount. With whole or universal life coverage, there is a cash value growth that can be accumulated through dividends or interest, but permanent life insurance is primarily purchased for its death benefit and not for any savings or investment it would provide. In addition, the savings feature is not primarily an investment account, so the investment return will usually be quite modest compared to what you could earn by investing the money in the marketplace.

3. Flexibility and Cash Value The policy flexibility offered by universal life can also be an advantage or disadvantage, depending on the person. With whole life insurance, you have fixed, permanent premium payments that will remain the same throughout the life of the policy. Universal life allows you to shift the premium payments to other intervals – monthly, quarterly, semiannually, or annually – and also to vary your premium payments as your financial situation allows. However, the flexibility has its price, as you must monitor the performance of your universal life policy.

4.6.1. Cost Comparison

To get a clear understanding of the coverage features of the three types of life insurance policies, it is useful to focus on the costs first. The relatively low cost of term policies that appeals to many is actually a definition of term insurance. Term life insurance covers death, and only death, so the cost is relatively inexpensive. Term premiums are lowest if you plan to die young, and they get progressively higher for older people. The premiums are based on the mortality experience of the group, assuming a constant total mortality pattern over all the years of insurance. The amount of risk at age 80, for example, is comparatively small compared to the risk at age 20, but the premiums are based on the mortality experience of the total group. Over the long term, you are paying for the insurance of those who die young as well as for your own insurance.

Whole life is designed to be a complete package. Similar to term policies, the insurance company is betting you will die at an early age; you are betting you will live to an old age. Over the course of the policy, however, the structure of whole life is designed to prepay the life agents and the insurance company services on your whole life policy while you are still alive. The costs are much higher when you are young and those costs level off or drop in your old age. With a limited-pay whole life policy, the term costs in your old age disappeared a long time ago; the policy then becomes a pure death benefit for your heirs less any loans you may have taken.

Universal life is designed to be flexible, which is also its weakness. While the cost of insurance is based on mortality rates anywhere between those used for term and those for whole life, it operates on a cost-of-insurance basis. The insurance company puts your money into their money market account, offers you a very competitive interest rate, and deducts their insurance charges each month. Once the market subtracted its allowance for overhead expenses and profit, the remaining part of the interest earned on your investment became your investment account. You can borrow against it, or use it as part of the death benefit. But whatever loans you take count against the death benefit.

4.6.2. Coverage Comparison

If you're looking for coverage of final expenses or other short-term needs, term insurance is the clear choice. A 10- or 20-year term policy will provide significantly more coverage than permanent insurance for the same premium. Not only does it cover a greater risk (with a much larger benefit), but it covers that risk at a much lower price. Term insurance is also available in larger amounts than the lifetime policies without medical underwriting and higher maximums. While most people won't be financially devastated by the loss of an adult child, many people do value the extra coverage term provides while their children are dependent. True estate conservation isn't really an issue for most people until they're well past their prime earning years. Estate taxes, if they exist at all, won't cause a hardship until a person dies, so it seems illogical to pay for that with lifetime insurance. To just pay the taxes at death, however, you would need to purchase lifetime insurance for a long enough period of time that the policy would, in theory, be in force when the insured dies.

Universal Life insurance for Families and Individuals, on the other hand, may be the pattern of choice for its flexibility. Taking advantage of the extra loans available is one of the main attractions of permanent insurance cash values. As long as you're sticking with the plan, you can consider the money tax-free. When you hit an unemployment bump, it will be available for use, and, if you should disappoint all of us and die unexpectedly, it will cover the loss just when needed. The lifetime cash values of Universal and Whole Life are both available at those times, but the availability is harder to explain. In the meantime, you have one that works like a checking account and one that works like a savings account.

4.6.3. Flexibility and Cash Value

Universal life and whole life policies have strong similarities in their designs, but blend protection and savings in different ways. Both provide guaranteed death benefit protection and have a cash value component that accumulates, earning interest along the way. But universal policies allow policyholders to choose their premium payments and adjust the death benefit up or down. This extra flexibility comes at a price, however. While the savings component of whole life policies has a guaranteed interest rate and is safe from losses, sometimes amounting to more than the premiums they have paid, the universal life cash value grows based on the interest rate set by the insurer. If interest rates are low and company-specific issues arise, your cash value can stagnate, and you can suddenly risk having the cost of your insurance coverage take too much from the cash values that keeps the policy in force.

Because of the potential cash stagnation or loss risk, whole life insurance appeals to those wary of financial risks. It’s guaranteed not to lose money, as long as dividends don’t fall below the guarantees, and policyholders are certain of their premium payments and cash values in advance. However, dividend and cash value growth can be low in low interest rate environments, and the savings components of contemporary whole life policies often lag much riskier investments. On the other hand, whole life policies are less vulnerable to the whims of changing interest rates and company financial performance than universal life insurance, whose cash value growth and maintenance can be very unpredictable, as seen during the early 1990s from liberalizing premium payment patterns, along with low interest rates and company performance.

4.7. Life Insurance for Families

Families face complicated financial and emotional hurdles that single people don't have. If one of the income earners dies, the family must find a way to pay the mortgage, medical bills, loans, and other ongoing obligations. Those obligations will not disappear just because your loved one is unable to pay them; in fact, some will be worse than before. Not only must the family pay bills which had been taken care of by the deceased, but they must also cope with the emotional trauma of the situation. A death benefit provided through life insurance ensures that the loved ones left behind will not face emotional and financial devastation. If spouses are employed throughout their children's growing-up years, they will both incur expenses as to costs to protect their family. However, one spouse may very well be serving as a full-time homemaker who contributes no direct monetary income but who also is essential to providing an income-free family life and to fulfilling such roles as meal preparers, cooks, babysitters, cleaners, shuttlers of children to and from school and activities, etc. While essentially acting as the main caretaker who takes care of the children, his/her value to the family may amount to what you would have to pay someone to do all those functions. If that homemaker should pass away, the family would have to pay someone to take that person's place, thus creating a financial need. It is just as important for the stay-at-home spouse to be insured with life insurance as it is for the one bringing home the paycheck. Some experts even suggest that the family needs a larger amount of coverage on the spouse who is employed outside the home than on the one staying home, and this is simply because the take-home paycheck is not what actually puts the food on the table, etc., and needs to be raised to cover the replacement costs.

4.7.1. Importance of Life Insurance for Families

The loss of a family member is one of the most difficult experiences one can bear. But in the case of the untimely passing of a breadwinner, or other individuals whose work is essential to a family's success, the emotional pain can also generate severe financial stress. Billions of dollars would be depleted from the economy each year if life insurance proceeds were not paid to the survivors of deceased individuals. In such large quantities, those payouts are not mere grief gifts but immediate financial assistance following a tragedy. Life insurance is a protective measure that enables families to pay bills, offset future lost earnings, fund the education of children, and even carry on with certain family traditions. It is peace of mind for the policyholder.

Life insurance for families is not limited to just the breadwinners. Spouses and children can also be insured; at different times in the family's life cycle, it may be important to protect the multiple “breadwinners” that provide and maintain the financial stability for family. When a new child arrives in the family, and until that child is completely through college, both parents need to take care of their kids in case anything happens to them. Life insurance can help provide the funds to care for the family so you will not have to worry about that. A stay-at-home spouse is also entitled to coverage. Remaining at home, taking care of the children, maintaining the household means you deliver many significant services. If something were to happen, the family might need help around the house at that critical moment, and funds for assistance might be required.

4.7.2. Choosing the Right Policy for Families

In this discussion, I'm assuming that the family consists of a couple where at least one spouse works outside the home and there are children (stepchildren also count) under the age of 18 at home or attending school. The need for life insurance is often greatest when children are still living at home.

Understanding and determining when insurable needs cease is important for a finish-time analysis. The focus of end-of-life financial needs then shifts. However, this shift may not end your need for life insurance. There are a variety of decisions that parents should consider when determining when to cease their insurable needs, and the degree of complexity of this analysis usually increases as parents approach retirement age. Would you still want debt reduced at death? Was college funding provided and the money used as intended? Is there an inheritance expectation? What tax ramifications if any exist? Will any dependents continue to need support from the deceased parent? The professionals that you use in your planning should work together and share information with you to help you clarify your end-of-life financial needs and how your insurance will fit into that picture.

Insurance exists to fund short-term needs and long-term needs, and throughout the life of an insured, these needs change. Parents' original need for life insurance was for income replacement. As the parents' needs decrease prior to retirement and their children's college costs begin to increase, the amount of income protection needed will decrease and the need for life insurance to fund children's education with after-tax money will increase.

4.7.3. Case Studies of Family Insurance Needs

As financial planners, it is common for us to be asked what kind of life insurance a family should acquire and how much. The question may be vague or slightly specific. Whatever the case, we generally ask questions about a family's financial condition, a couple's financial goals, and their children's future needs. Most of our families expect us to use some formulas to solve their questions, but we dislike using generic computations since each family's needs are different, varying with their unique financial situations, desires, and objectives. That said, it can be particularly useful for you, the layperson, to use sample case studies to arrive at your life insurance numbers.

In life insurance planning, one way to estimate a family's life insurance needs is to think about what may have to be paid for in the event of a breadwinner's death: perhaps funeral costs, debt, future college and wedding expenses for children, and so on. Family income replacement for a certain number of years is often the highest life insurance value and may be the main reason to buy life insurance—the economic well-being of the surviving family members. We have developed a life insurance need guide based upon these potential family expenses. This guide allows you to enter your numbers and use it as a calculation tool to obtain a rough estimate of your life insurance needs. Because all family situations are unique, there is no way for us to create a "one-size-fits-all" life insurance need computation without further asking lots of detailed questions and discussing personalized financial objectives.

4.8. Conclusion

This report has covered the basic concepts and rules behind the three types of life insurance available today to help families and individuals replace income upon the unexpected and untimely death of a primary or vital income earner. By now, you should have a working knowledge of how term, whole life, and universal life insurance policies are constructed and how they avail you, the prospective purchaser, of certain choices. You should be better equipped now to evaluate your insurance agent's presentation when it comes time to fulfilling this element of your financial plan.

Certainly, you have many choices in choosing life coverage, including the type of policy and the amount of insurance. Your choice of policies may include a combination of term, whole life, or universal life. At various times in your life, your coverage requirements will be different, which is why the life coverage you initially select may not be the same as the life coverage you ultimately retain. Life insurance is a dynamic concept, and even though once selected, many families and individuals ignore their protection, the insured events are certainly going to happen: death or create the need for major expenditures. The need for life insurance and the right amount for specific individuals may depend on many factors to consider, including the degree of financial dependence, the timing of death, the substitute services required, and the value of the services lost.

In conclusion, life insurance can serve a plethora of purposes. Choosing the correct type of life insurance is crucial to compiling a well-balanced financial portfolio. The complexities and nuances of the insurance world can overwhelm any consumer, but many times you only need to communicate your concerns to an agent. The right professional can take the burdens of the decision off your shoulders and help you arrange the protection you want as part of a sound financial plan.

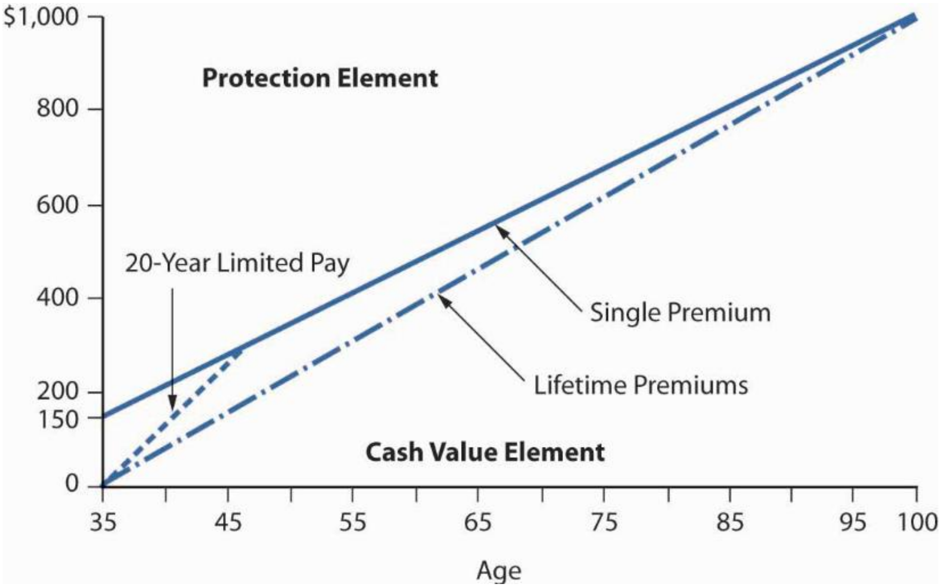

Fig 4 . 3 : Life Insurance Market Conditions and Life Insurance

4.8.1. Final Thoughts on Life Insurance Choices

Selecting a life insurance policy is an important financial choice for everyone, especially those with a family, and as such is one that should be given serious thought. This considers the cost of the various types of life insurance available; how long you need the policy in place, and the reason for having life insurance. The major reasons for carrying life insurance are to have enough money in place to pay off debts, including the mortgage on your home, on your death as carrying these debts would put financial strain on your family; to replace your income should you die unexpectedly at a young age; to leave enough money to cover funeral costs when you die; and to leave an amount of money for your heirs to invest in their own future, either by providing for their education or as a nest egg to set them up in life. You should consider term insurance to cover your debts and replace your income if you die young, as it is by far the cheapest type of insurance available and the policy can be tailored to meet your specific needs. Whole life or universal life insurance can be considered for covering funeral costs and providing your heirs with a lump sum of money to help them invest in their future, as they provide a cash amount after your death. The downside is that whole and universal life insurance is a lot more expensive compared to term insurance. Keep in mind that life insurance is not an investment vehicle, and investing your surplus income would be your best option to make the most effective use of your money.

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