Appendix B

More on Life Insurance

E. Jack Chandler Jr.

Our earlier discussion about the basics of life insurance drew a distinction between the two elemental types: temporary and permanent. But it painted an oversimplification of truth. Lest I leave you with the mistaken impression that there are only these two types of life insurance, I think it prudent to broaden the scope of our understanding, especially in the realm of permanent (whole life) policies. *Please understand that this appendix is also admittedly an oversimplification, as through the purchase of any number of waivers and riders, a life insurance package can be custom-tailored to suit a virtually limitless array of needs.*

Choosing the Right Policy

Given the number of choices available, it is no surprise that most insurance consumers need some guidance in making informed life insurance decisions. Three or four very basic questions can direct most people through what might seem a maze. Consider the decision tree in Figure B-1.

The first question is, *What exactly do you want an insurance policy to do for you?* It is this question that distinguishes between temporary and permanent insurance. If you are looking for an *insurance-only* solution (A), then you probably are interested in a **term life** policy.

If, on the other hand, you wish to buy a policy which also contains an investment element (B), then you are interested in one of several permanent (whole life) policies. *What is your investment personality? Do you have conservative investment leanings and prefer that the insurance company manage your investments, or do you tend more toward aggressive investing and prefer a higher degree of participation in the investment process?*

If you prefer the conservative, hands-off approach (C), then you need answer only one more question: *Do you prefer guaranteed level premiums and fairly steady (though low) returns, or are you willing to endure some month-to-month premium fluctuation in exchange for a higher guaranteed short-term rate of return?* If the former (E), then the **whole life** policy is probably for you; if the latter (F), check out **universal life**.

If you are willing to assume more investment risk in the hope of gaining higher returns, and prefer more hands-on involvement in how your funds are invested (D), then answer one last question: *How much premium flexibility do you allow?* If you want or need to make fixed monthly payments (G), then choose **variable life** insurance. If you prefer instead to make premium adjustments so that you might invest as much as you want, whenever you want (H), then choose the **universal variable life** policy.

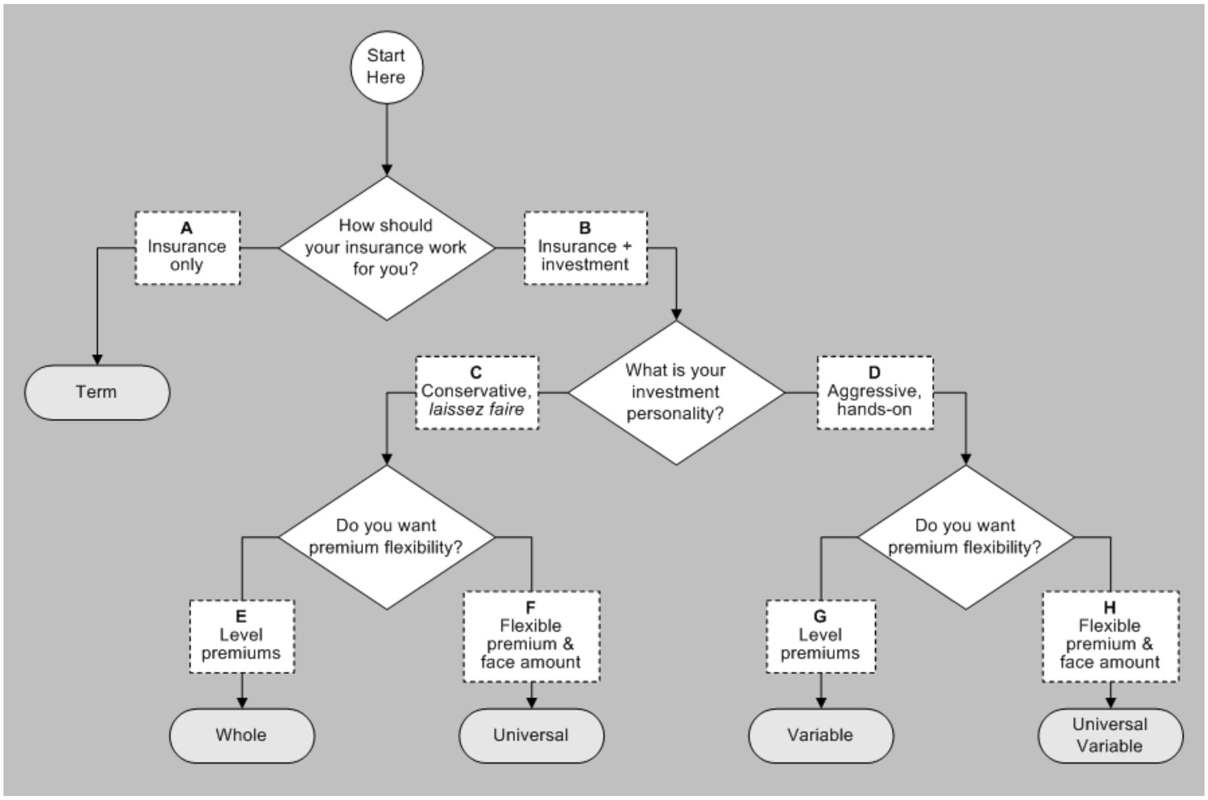
Some Definitions

The following summaries describe the various life insurance instruments cited in Figure B-1. Figure B-2 is a quick summary in table form.

Term Life. Term Life insurance is pure insurance which provides a benefit only if the death of the insured occurs during the coverage term. It is generally considered to be the most cost effective means of providing the highest amount of coverage for a young family (for whom the need for insurance is typically highest). The premium is directly related to the statistical probability of death and almost always is adjusted upward at policy renewal.

Though not depicted in Figure B-1, there are several common types of term insurance. With *Level Term,* the policy's premium is guaranteed for a specific length of time (term), which is typically five, ten, or twenty years. During that period, the premium does not change. *Annual Renewable Term*

Figure B-1. Life Insurance Selector



insurance guarantees the premium level for only one year. The policy is renewed each year, at which time the premiums generally increase. With *Decreasing Term,* the face value of the policy decreases over time. The classic example is mortgage insurance, where the death benefit reduces over time to coincide with the declining principal value of the mortgage.

Whole Life. Whole Life policies offer permanent life insurance protection and bundle both a death benefit and a cash value accumulation account in the same contract. At a minimum, the whole life contract provides a level benefit upon the insured's death, or a cash endowment equal to the death benefit at maturity. Whole life policies are more expensive than term insurance for young families, but the premiums remain constant over time. With traditional whole life policies, the death benefit (face value) consists of decreasing term insurance and your returned cash accumulation account. A mutual insurance company may also pay dividends to whole life policyholders.

The cash accumulation account offers two major benefits. The cash value accumulates or compounds on a tax-deferred basis, generally at a modest, fixed rate of interest. A whole life owner may borrow from their accumulated cash value for any reason with no tax consequences — if death occurs with borrowed amounts outstanding, however, the death benefit is adjusted downward by the amounts borrowed.

As the insurance industry has matured, it has begun to offer different variations of whole life-type policies where policyholders might receive higher rates of return and might have more flexibility in the payment of premiums and the amount of death benefit. These variations follow.

Universal Life. A *Universal Life* permanent insurance policy also contains both insurance and savings elements. It has the same basic concept and design as the whole life policy, but introduces policy flexibility into the equation. *Universal* is descriptive of the policy's coverage amount, which may, within policy limitations, be adjusted up or down to meet changing insurance needs. In the universal life policy, the insured has the flexibility to adjust the premium amount (in which case the face amount is adjusted accordingly) or the face amount (in which case the premium amount is adjusted). Typically, adjustments in face amount will require evidence of good health. These policies are also known as *Flexible Premium Adjustable Life.*

Variable Life. *Variable* in *Variable Life* refers to the rate of investment return. As the insured exercises greater control over how the monies are invested, the earnings vary based on the performance of the investment(s). The variable life policy, as other permanent policies, consists of two components — insurance and investment — but here the insured is specifically aware of the separate investment account. Typically, s/he chooses from an assortment of professionally managed investment options (money market, stock and bond funds) and is allowed to split and move monies among the different options. Interestingly, variable life introduces risk into the risk-aversion process, for if your investments perform poorly, your insurance coverage may erode.

Universal Variable Life. The *Universal Variable Life* policy, as its name suggests, marries the policy flexibility of the universal life instrument and the investment flexibility of the variable life policy. Through its premium flexibility, it basically allows the investor to invest how much s/he wants, whenever s/he wants. This policy really is suited for only the experienced investor, for it calls upon the insured to play an active role in managing the policy investments; its success as an investment is directly related to the investment decisions you make. Use caution with this instrument, especially if you are playing with your only means of insurance protection.

Figure B-2. Quick Policy Summary

		Term	Whole	Universal	Variable	Universal Variable
Benefit/Value	Provides death benefit	•	•	•	•	•
	Provides tax-deferred investment (cash value)		•	•	•	•
Flexibility	Allows flexibility in premium and face value			•		•
	Allows multiple investment options				•	•
Investment	Investment Risk: **L**ow, **M**oderate, **H**igh		L	L	M	H
	Investment Return: **L**ow, **M**oderate, **H**igh, **V**ariable		L	M	V	V