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Life Insurance: Whole-Life Insurance

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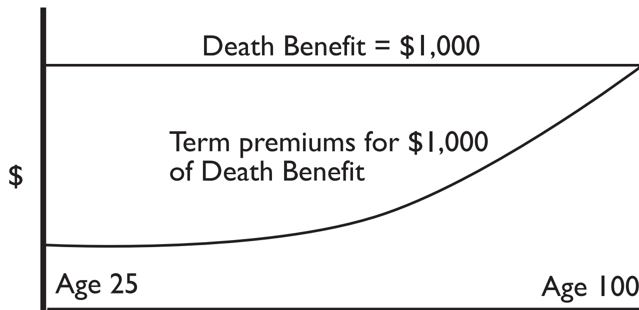
Overview

Whole-life insurance was created to address the problems with term insurance. The biggest problem with term life insurance is that it is purchased for a stated period of time. If the ***insured*** dies after the term ends, the ***beneficiary*** does not get the ***premiums*** and does not receive the ***death benefit*** because the insured did not die during the term. Many term policies will allow the owner to renew the term each year, but the owner has to pay more in premiums with each successive year.

Let us assume that a person wants a $1,000 death benefit. If the insured is 25 years old, the term premium is very low, but when they reach age 100, the annual premium will be the same as the death benefit. Chart 1 illustrates the cost of term insurance.

Chart 1

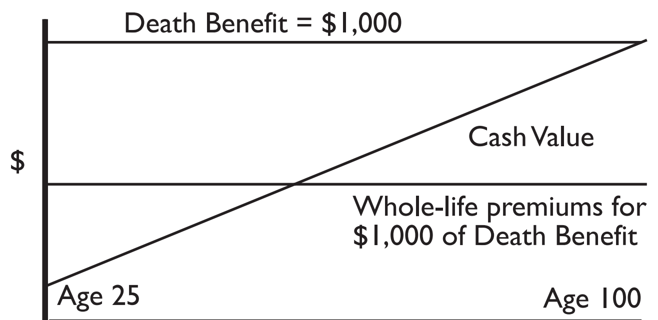


What if someone wants to buy insurance that will pay a death benefit when the insured dies, no matter when that may be?

What if the ***owner*** of the policy does not want to have to budget for the increases in the term premium?

The policy that answers these questions is a whole-life policy. When the owner buys a whole-life policy, he or she is planning for the policy to last for the insured's "whole" life. The owner pays the same premium each year. In the early years, the premium will be higher than the cost of term insurance. These extra premium dollars become the ***cash-value*** of the policy and go into the cash-value account for the policy. The cash-value account will provide a source of money to help offset the costs of the term insurance in the later years, when the premiums are no longer able to meet the costs on their own. Chart 2 may help you see how this works.

Chart 2



The Cash-Value Account

The cash-value account of a whole-life policy is similar to having a savings account within the policy. After the insurance company takes the amount of money it needs from the premium to meet the cost of term insurance, the extra dollars go into the cash-value account.

The insurance company invests the cash-value account money for the owner. The government has told insurance companies that they must invest the money in the cash-value account a certain way. Most of the investments go into highly rated bonds and mortgages. The average gross return of these investments has been between 5 percent and 6 percent over the past 75 years. While you cannot depend on future returns to be the same as past returns, this average may give you an idea of what the cash-value account may return. The insurance company keeps some of that return as a management fee. In a fixed cash-value account the insurance company guarantees a specific return. If it makes more, it keeps the excess; however, when interest rates are low, it must make up the difference between its investment

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return and the guaranteed rate. With a variable cash-value account, the insurance company guarantee is lower than with a fixed account, but if returns exceed the guaranteed rate, part of the excess is credited to the cash-value account.

The cash-value account belongs to the owner of the policy. The owner can borrow it from the policy or withdraw it entirely. Usually the insurance company charges a fee for both options. If the owner borrows from the cash-value account, the insurance company will treat it as a loan, and charge the owner interest. Therefore, if the owner takes a loan, he or she will owe the premiums, plus the interest on the loan until the loan is repaid. If the insured dies while there is a loan on the cash-value account, the death benefit will be paid minus the loan and any interest still owed. If the owner withdraws the money, he or she will owe income taxes if the amount received is greater than the premiums paid and the policy will be cancelled. Remember the beneficiary will not owe income taxes on the death benefit.

The Death Benefit

When the insured dies, (be it the day after the insurance is activated or at age 120), the insurance company will pay the beneficiary the death benefit only. The insurance company will use any cash-value account to lower the amount it has to pay. The beneficiaries will not get the money in the cash-value account *and* the death benefit.

As an example, say someone buys a $10,000 whole-life policy on his or her life at age 25. If the cash-value account is $8,000 when the person dies, the insurance company will pay the beneficiary $10,000 not $10,000 plus the $8,000 in the cash-value account. Thus it only costs the insurance company $2,000 ($10,000 - $8,000), since the money in the cash-value account belonged to the owner and could have been withdrawn at any time.

Buy Term and Invest the Difference?

At this point, you may be thinking that you could buy a renewable term policy with cheaper premiums, and invest the extra dollars yourself. That way the beneficiary would get both the investment account and the death benefit. However, many people find that when they try "investing the difference," they spend those dollars before they invest them. Then, without the invested money to help pay the higher term premiums in later years, they are no longer able to keep the term insurance. Another nice thing about the cash-value account is that its returns are income tax-free. You would probably have to pay taxes on the gains if you invested the money yourself. However, for some individuals, buying term and investing the difference may make sense. If you have the discipline to save the extra money, and you know you can earn a higher return on your money than in an insurance policy, then buying term and investing the difference may work.

A Final Word on Whole Life

When you buy a whole-life policy, you will probably be shown an illustration of the policy values for each year until the insured reaches the age of 100. Be sure to ask your agent what values are guaranteed. Unless the insurance company fails, then you can count on the guaranteed values.

If you like the idea of insurance that will last for the "whole" life of the insured, but are leery of paying the fixed whole-life premiums, then you may also want to look at a universal-life policy. (See *Life Insurance: Universal-Life Insurance*, Virginia Cooperative Extension publication 354-146.) This type of policy often does not promise the guarantees that a whole-life policy does, but provides more flexibility.

Definitions of Terms

Beneficiary – The person or entity receiving the death benefit at the death of the insured.

Cash-value – The amount of total premiums paid for a policy minus the costs for insurance in whole-, universal-, and variable universal-life policies. The cash-value grows tax-free in an insurance policy.

Death Benefit – The total cash payment made to the beneficiary upon the death of the insured.

Insured – The person on whose life the insurance has been purchased. If the insured dies, a death benefit will be paid to the named beneficiary.

Owner – The person or entity who owns the insurance policy. The owner may or may not be the insured. The

owner can designate the beneficiary, and is responsible for paying premiums. See *Life Insurance: The Impact of Ownership*, Virginia Cooperative Extension publication 354-142, for more information on the impact of ownership.

Premium – The amount billed to the owner of an insurance policy (usually monthly, quarterly, or annually) by the insurance company. In term and whole-life the full premium must be paid to keep the insurance. In universal- and variable universal-life, the amount billed may or may not be a mandatory payment to keep the insurance.

Other Sources

For more information on whole life insurance, see the following sites: Life and Health Insurance Foundation for Education (*http://www.life-line.org*), the American Council of Life Insurers (*http://www.acli.com*), and the Insurance Information Institute (*http://www.iii.org*).

Reference

Baldwin, B. G. (2002). *The new life insurance investment advisor, second edition.* New York: McGraw Hill.

Disclaimer: Insurance examples used in the publication are for illustrative purposes only. The premiums may not be estimates of an actual policy. Consult your insurance agent for actual insurance illustrations.