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Term and Whole Life Insurance

Overview and Learning Objectives

Chapter 2 reviews the features of the life insurance policy and contract. The focus is on the two major types of products, term insurance and whole life insurance. It then briefly introduces a few of the main variations of these basic policy designs, which will be the topic of Chapter 3.

By reading this chapter and answering the questions, you should be able to

- 2.1. Describe the nature and features of term life insurance.
- 2.2. Explain the renewability and conversion provisions.
- 2.3. Compare term insurance variations and their usefulness.
- 2.4. Describe the features of whole life insurance policies.
- 2.5. Explain how joint life policies work and compare them with single life policies.
- 2.6. Compare the differences between limited-payment policies and ordinary life policies

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Term Insurance

There are five basic types of life insurance contracts: term, whole life, universal life, endowment, and annuity. The function of the first four is to create a principal sum or estate, either through the death of the insured or through the accumulation of funds set aside for investment purposes. The function of the annuity, on the other hand, is to liquidate a principal sum in a scientific manner, regardless of how that sum was created. This dissimilarity in the basic functions of life insurance and annuities has caused some to question the propriety of classifying annuities as a type of life insurance contract, but there appear to be enough similarities to justify the practice. This section discusses term insurance contracts.

Note: Endowment life insurance policies are still viable and popular in other countries, but United States tax law changes have nearly eliminated endowment sales in this country.

Nature of Term Insurance

Term insurance provides life insurance protection for a limited period only. The face amount of the policy is payable if the insured dies during the specified period, and nothing is paid if the insured survives. The period may be as short as one year, or it may run to age 65 or above. The customary terms are one, 5, 10, 15, and 20 years. Such policies may insure for the agreed term only, or they may give the insured the option of renewing the protection for successive terms without evidence of insurability. Applications for term insurance are carefully underwritten; various restrictions may be imposed on the amount of insurance, the age before which it must be obtained, the age beyond which it cannot be renewed, and the like.

Term insurance may be regarded as temporary insurance and, in principle, is more nearly comparable to property and casualty insurance contracts than any of the other life insurance contracts in use. If a person insures his or her life under a 5-year term contract, no obligation is

incurred by the insurance company unless the death of the insured occurs within the term. All premiums paid for the term protection are considered to be fully earned by the company by the end of the term, whether or not a loss has occurred, and the policy has no further value. This is similar to auto and homeowners insurance.

The premium for term insurance is initially relatively low, despite the fact that it contains a relatively high expense loading and an allowance for adverse selection. The reason premiums can be low is that most term contracts do not cover the period of old age when death is most likely to occur and when the cost of insurance is high. In other words, a term policy, because its term may end prior to the insured's death, insures against a contingency, and not a certainty as do other kinds of policies.

Renewability

Many term insurance contracts contain an option to renew for a limited number of additional periods of term insurance, usually of the same length. The simplest policy of this type is the yearly renewable term policy, which is a one-year term contract renewable for successive periods of one year each. Longer-term contracts, such as the 10-year term, may also be renewable. The following is a typical renewal provision:

Renewal Privilege. The insured may renew this policy for further periods of 10 years each without medical examination, provided there has been no lapse in the payment of premiums, by written notice to the company at its home office before the expiration of any period of the insurance hereunder and by the payment in each year, on the dates above specified, of the premium for the age attained by the insured at the beginning of any such renewal period in accordance with the table of rates contained herein.

The key to the *renewable* feature is the right to renew the contract without a medical examination or other evidence of insurability. Where the term policy contains no renewal privilege, or where it can be renewed only upon evidence of insurability satisfactory to the company, the insured may find that coverage cannot be continued as long as needed. Because of poor health, a hazardous occupation, or some other reason, the insured might be unable to secure a renewal of the contract or to

obtain any other form of life insurance protection. The renewal feature prevents this situation. Its chief function is to protect the insurability of the named insured.

Under a term insurance contract the premium increases with each renewal, based on the attained age of the insured at the time of the renewal. The term insurance premium for a person aged 50 or above, for example, is higher than the premium for a whole life contract acquired before age 35. Within the contract period, however, the premium is level. Over a long period of time, punctuated by several renewals, the premium will consist of a series of level premiums, each series higher than the previous one. Moreover, the rate will continue to increase with each renewal. The scale of rates at which the insurance can be renewed is published in the original contract and cannot be changed by the company as long as the contract remains in force. Evidence of renewal is usually provided in the form of a certificate to be attached to the original contract, although some insurance companies issue a new contract with each renewal.

Insurers have mixed feelings about renewable term insurance. There is no question that properly used it fills a real need. However, it presents certain problems to the company that writes it. Whether the policy is on the yearly renewable term plan or a longer-term basis, there is likely to be strong selection against the company at time of renewal, and this adverse selection will become greater as the age of the insured—and hence, the renewal premium—increases.

Resistance to increasing premiums will amuse many of those who remain in good health to fail to renew each time a premium increase takes effect, while those in poor health will tend to take advantage of the right of renewal. As time goes on, the mortality experience among the surviving policyowners will become increasingly unfavorable. While dividend adjustment can provide for adverse mortality experience, it requires substantial margins in the premium rates. As a result, each dollar of protection on the term basis tends to cost middle-aged or older policyowners more than under any other type of contract.

As a further safeguard against adverse selection, companies generally do not permit renewals to carry the coverage beyond a specified age such as 65, 70, or 75 (although some insurers guarantee renewability to age 95 or 99). In addition, limitations on yearly

Renewability Features
<ul style="list-style-type: none">• Can renew without medical or other evaluation• Premiums change upon renewal• Some insurers prohibit renewals beyond a specified age

renewable term are usually more stringent; coverage is frequently restricted to 10 or 15 years or, occasionally, to age 65, whichever is earlier. Renewable term insurance, therefore, is satisfactory for individual coverage to both the policyowner and the company when coverage does not extend into the higher ages.

Convertibility

In addition to the renewable privilege, a term policy may contain a *convertibility* provision that permits the policyowner to exchange the term contract for a contract on a permanent plan, likewise without evidence of insurability. In other words, a term insurance policy may be both renewable and convertible. The convertible feature serves the needs of those who want permanent insurance but are temporarily unable to afford the higher premiums required for whole life and other types of cash value life insurance. Convertibility is also useful when the policyowner desires to postpone the final decision as to the type of permanent insurance to be purchased until a later date when, for some reason, it may be possible to make a wiser choice. Thus, convertible term insurance provides a way to obtain temporary insurance and an option on permanent insurance in the same policy.

Insurability is protected by the convertible feature in an even more valuable manner than under the renewable feature because convertibility guarantees access to permanent insurance—not just continuation of temporary protection. The two features together afford complete protection against loss of insurability.

The conversion may be effective as of the date of the exchange or as of the original date of the term policy. If the term policy is converted as of the current date, conversion is usually referred to as the *attained age* method since the current age determines the premium level. A conversion using the original date of the term policy for the conversion is referred to as the *original age* method or a *retroactive conversion*.

Retroactive Conversion—Some insurers allow a policy to be converted retroactively within the first few years after issue. When the conversion is effective as of the original date, the premium rate for the permanent contract is that which would have been paid had the new contract been taken out originally, and the policy form is that which would have been issued originally. It is these two features that motivate the insured to convert retroactively in most instances. The advantage of the lower premium is obvious, but in many cases, the contract being issued at the

original date contains actuarial assumptions or other features more favorable than those being incorporated in current policies.

Offsetting these advantages, however, is the fact that a financial adjustment—involving a payment by the insured to the company—is required, which may be quite substantial if the term policy has been in force for several years. This adjustment may be computed on a variety of bases, but a great number of companies specify that the payment will be the larger of (1) the difference in the reserves (in some companies, the cash surrender values) under the policies being exchanged or (2) the difference in the premiums paid on the term policy and those that would have been paid on the permanent plan, with interest on the difference at a stipulated rate. Under the second type of financial adjustment, an allowance is frequently made for any larger dividends that would have been payable under the permanent form. Some companies require a payment equal to the difference in reserves, plus a charge of up to 8 percent to provide the previously forgone investment return.

The purpose of the financial adjustment, regardless of how it is computed, is to place the insurance company in the same financial position it would have enjoyed had the permanent contract been issued in the first place. Therefore, apart from the possibility of obtaining more favorable actuarial assumptions, there does not seem to be any financial advantage to the insured to convert retroactively. The insured will admittedly pay a smaller premium but—by making up the deficiency in the term premium—will, in effect, pay it over a longer period of time; actuarially, the two sets of premiums are equivalent. Some people are under the mistaken impression that by making the financial adjustment required for conversion as of the original date, they are investing money retroactively and being credited with retroactive interest. The fact is, however, that the insured pays the company the interest it would have earned had the larger premium been paid from the beginning.

The insured should consider many factors in making a choice between the two bases of conversion, one of the most important being the state of his or her health. The insured would be ill advised to convert retroactively—and pay a substantial sum of money to the insurance company—if his or her health were impaired. The sum the insured pays

Retroactive Conversion

- Premiums after conversion based on earlier (original) age
- Must pay an adjustment to insurer
- Converts term policy to cash value type policy
- Provides level or flexible premiums thereafter
- Conversion must be made before limiting age

would immediately become a part of the reserve under the contract and would not increase the amount of death benefits in the event of the insured's early demise—or ever, for that matter. The payment would simply reduce the effective amount of insurance.

In most cases, if the insured has surplus funds to invest in insurance, he or she should consider purchasing additional insurance or perhaps prepaying premiums on existing policies, including the newly converted one. Subject to certain limitations, most companies permit the insured to prepay fixed premiums, either in the form of so-called premium deposits or through discounting of future premiums. The two procedures are very similar. The principal difference is that under the discount method, credit is taken in advance for the interest to be earned on the funds deposited. Under both arrangements, the funds deposited with the company are credited with interest at a stipulated rate and, in some instances, are credited with the interest earned by the company in excess of the stipulated rate. In the event of the insured's death, the balance of any such deposits is returned to the insured's estate or designated beneficiaries in addition to the death benefit of the policy. Some companies permit withdrawal of premium deposits at any time, in which case a lower rate of interest may be credited, while others limit withdrawals to anniversary or premium due dates. A few companies permit withdrawals only in case of surrender or death. Some companies credit no interest or otherwise penalize the insured if the funds are withdrawn.

Time Limit for Conversion—As previously noted, a retroactive conversion must take place within a specified number of years after issue. If the term of the policy is no longer than 10 years, a conversion as of a current date can usually be accomplished throughout the full term. If the term is longer than 10 years, the policy may stipulate that the conversion privilege must be exercised, if at all, before the expiration of a period shorter than the term of the policy. For example, a 15-year term policy must usually be converted, if at all, within 12 years from date of issue, a 20-year term policy within 15 years.

The purpose of a time limit is to minimize adverse selection. There is always a substantial degree of adverse selection in the conversion process. Those policyowners in poor health as the time for conversion approaches are more likely to convert and pay the higher premiums than those who believe themselves to be in good health. If the decision to convert must be made some years before the expiration of the term

policy, a higher percentage of healthy policyowners, uncertain of their health some years hence, will elect to convert. Even so, experience has shown that the death rate among those who convert is higher than normal. This accounts for the fact that premium rates for convertible term insurance are somewhat higher than those for term policies not containing the conversion privilege.

If the policy is renewable, the only time limitation may be that it is converted before age 60 or 65. In other cases, the contract will state that the policy must be converted within a certain period before the expiration of the last term for which it can be renewed. In all cases, conversion may be permitted beyond the time limit, but within the policy term, upon evidence of insurability.

Some companies issue term policies that are automatically converted at the expiration of the term to a specified plan of permanent insurance. It is doubtful that this procedure is effective in reducing adverse selection since healthy individuals may fail to continue the permanent insurance.

Re-entry Term (Select and Ultimate Term Insurance)

The life insurance industry has developed a term insurance policy intended to charge higher premiums to those in poorer health when they renew their term insurance, thereby reducing the degree of adverse selection. The product is commonly called *re-entry term insurance*. It is really a policy subject to two different premium schedules. The lower premium rate is based on select mortality (that applicable to an insured who has recently given evidence that he or she is in good health). The select rates are available as long as the insured is able to provide new evidence of insurability at each renewal date and at other dates specified by the insurer.

The higher premium schedule is based on ultimate mortality rates (that applicable to insureds at least 15 or 20 years after they last provided evidence of insurability). The insureds that cannot provide evidence of insurability acceptable to the insurance company when requested or required must pay the higher premium schedule rates to renew their coverage. They are known to be in poorer health and have to pay for the increased risk now and probably for each subsequent renewal, unless they experience an improvement in their health.

It is hard to argue with the logic or concept of equity in this approach. In order to get the lower premiums while healthy, the individual should be willing to pay the higher premium when his or her health deteriorates. However, it is questionable whether the policyowner

knows or realizes the full import of a decision to buy re-entry term insurance. Young people in good health believe they are immortal and will never have to pay the higher rates. Few of them stop to consider that they may actually end up paying the ultimate rates and that when that happens they will usually be precluded from buying coverage from another insurer. The single premium schedule term insurance they could have bought instead of re-entry term might have been a significant bargain. Unfortunately, when that realization sinks in, it is too late to select that option.

Re-entry term is economical for those who remain healthy into their retirement years, but it may end up being very costly for anyone whose health deteriorates at about the same rate as that of the general population. On average, people start to experience declining health between the ages of 45 and 55. If they reach their life expectancy (at least 50 percent should), they can live 40 to 50 years in an impaired physical condition—paying the higher term rates for many more years than they enjoyed lower term rates.

Example:

Mary purchased a re-entry term policy 3 years ago. She saved 10 percent based on the premiums that would have been required for a traditional renewable term policy that guarantees future premium rates. Mary suffered a severe heart attack just before she was required to have her health reassessed for the re-entry term. Her new premium is more than double what the renewal premium would have been under the traditional renewable term policy. That difference may get even larger in the future.

It is suggested that the decision to purchase re-entry term insurance should involve comparison of the high rates of competing insurers for similar coverage. If the insured cannot provide satisfactory evidence of insurability, the lower premium schedule is irrelevant. Helpful in making such comparisons are pro forma cash flow simulations of the premiums (both high and low rates) for each policy being considered at a range of premium increase dates. Another important point for evaluation is whether or not the insurer considers the policy a new contract with a new contestable period after the insured fails a re-entry test. Some insurers

treat the new premium as an adjustment on continuing coverage, but others impose a new contestable period.

Guarding Against Contestability

In general it is a good idea to keep existing coverage in force until after the intended replacement coverage has actually been issued and the policy delivered. It is important for the policyowner to realize that new policies remain contestable for at least one year (and often for 2 years). If the insured dies while the policy remains contestable, the claim will be investigated much more thoroughly and take longer to settle than one for a policy that is already incontestable.

Long-Term Contracts

While most term contracts provide protection for a relatively short period, subject to renewal for successive periods of the same duration, some term contracts are designed to provide long-period protection in the first instance. These policies often give prospective policyowners the option to purchase waiver-of-premium and accidental death benefits.

A term-to-65 contract, for example, provides protection on a level premium basis from the age of issue to age 65. It is not to be confused with yearly renewable or other forms of term insurance that can be renewed until the insured reaches age 65. The period covered by this contract is normally somewhat shorter than the life expectancy, but its termination date coincides with the age generally regarded as the normal retirement age. Hence it probably comes closest to limiting its protection to the years when the insured's income is derived from personal efforts. Because the term is shorter than that of whole life contracts, the premium will be smaller. It is customary to provide for cash and other surrender values. A conversion privilege may be offered, but if so, it must usually be exercised some time before the expiration of the policy. A typical form requires conversion prior to age 60.

Nonlevel Term Insurance

The preceding discussion has presumed that the amount of insurance is level or uniform throughout the term of the policy. This is not necessarily the case since the amount of insurance may increase or decrease throughout the term. As a matter of fact, a substantial—if not predominant—portion of term insurance provides systematic decreases in the amount of insurance from year to year. This type of term insurance, appropriately called *decreasing term insurance*, may be written in the

form of a separate contract, a rider to a new or existing contract, or as an integral part of a combination contract. Mortgage redemption insurance is probably the most familiar form of decreasing term insurance.

Increasing term insurance in the form of a return-of-premium

provision has been around for a long time, but in recent years the concept has enjoyed a much wider application in connection with various arrangements, specifically split-dollar plans, which may contemplate borrowing or encumbering the cash value of an underlying policy. In order to provide a uniform death benefit to the insured's personal beneficiaries, contracts developed for these uses frequently make provision for the automatic purchase of an additional amount of term insurance each year in the exact or approximate amount that the cash value increases. Increasing term insurance may be provided on a year-to-year basis through the operation of

Renewable Term Characteristics

- Coverage for a stated period
- Premium based on age at beginning of each new period
- Premiums increase with age
- Rate of premium increases accelerates after age 40
- Can be renewed for a new period without health assessment (up to limiting age specified in policy)
- Additional charges for adverse selection included in premium at advanced ages
- Does not provide living benefits such as cash values, policy loans, and so on

the so-called fifth-dividend option.

Critiques Of Term Insurance

Term insurance has long been a controversial type of insurance. Many people, not familiar with or perhaps not sympathetic to the principle of level premium insurance, advocate the use of term insurance in all situations to the virtual exclusion of permanent insurance. There are certain insurance "consultants" who, when they find permanent plans in an insurance program, will advise their surrender for cash and replacement with term insurance. On the other hand, the insurance companies, mindful of the limitations of term insurance and fearful of possible adverse public reaction, tend to discourage its indiscriminate use. This has given rise to a widespread impression that insurance companies are opposed to term insurance, preferring the higher-premium forms that add more to income and assets. It might be helpful therefore to point out the areas that can legitimately be served by term insurance and to analyze briefly some of the fallacious arguments that have been advanced in favor of term insurance.

Areas of Usefulness

Term insurance is suitable when either (1) the need for protection is purely temporary, or (2) the need for protection is permanent, but the insured temporarily cannot afford the premiums for permanent insurance. In the first case, term insurance is the complete answer, but it should be renewable in the event that the temporary need should extend over a longer period than was originally anticipated. Theoretically the policy need not be convertible, but since relatively few people carry an adequate amount of permanent insurance and since the loss of insurability is a constant threat, it is advisable to obtain a policy with the conversion privilege.

The second broad use of term insurance requires that the policy be convertible. The conversion privilege is the bridge that spans the gap between the need for permanent insurance and the financial ability to meet the need. In this case, since the insured's financial situation might persist longer than anticipated, the policy should be renewable as well as convertible. Thus, the renewable and convertible features serve quite different functions and, ideally, should be incorporated in all term policies.

Temporary Need for Protection—Examples of temporary needs that can—and should—be met through term insurance are encountered daily. One of the most obvious is the need to hedge a loan. A term policy in the amount of the loan payable to the lender not only protects the lender against possible loss of principal but also relieves the insured's estate of the burden of repaying the loan if the insured dies. A mortgage redemption policy serves the same purpose. An individual who has invested heavily in a speculative business venture should protect his or her estate and family by obtaining term insurance in the amount of the investment.

If a business firm is spending a considerable sum in an experimental project, the success of which depends on the talents and abilities of one individual or a few individuals, term insurance on the appropriate person or persons will protect the investment. A parent with young children is likely to need more insurance while the children are dependent than he or she will need when they have grown up and become self-sufficient. The additional insurance during the child-raising period can be—and usually is—provided through term insurance. Frequently, decreasing term insurance is superimposed on a plan of permanent insurance.

Example: Tom and Marsha have two very young children and need more life insurance to protect them. However, Marsha will become the recipient of a large trust in 8 years. At that time, they will have a diminished need for life insurance. Term insurance is appropriate for the temporary need.

Lack of Finances for Permanent Insurance—The second function of term insurance is particularly important to young people who expect substantial improvement in their financial situation as the years go by. Young professionals who have made a considerable investment in their education and training, but whose practices must be built up gradually, are likely prospects for term insurance. Young business executives are also good prospects.

Danger of Relying Solely on Group Term Insurance

In these times of fierce competition and corporate downsizing, it can be precarious to rely heavily on employer-provided group life insurance to satisfy all or most of a family's death benefit needs. Individuals should find out how much of the employer group coverage can be converted after an involuntary termination of employment—for example, mandatory early retirement, workforce reduction, plant closing, reorganization after a merger or acquisition, employer bankruptcy, statutory banning of a product (freon, for instance), or chronic health impairment resulting from accident or disease. Individual term insurance may be appropriate to cover the potential net reduction in coverage after post-employment conversion of the existing coverage. The safest way for the individual to cover this risk is to purchase an individual policy while he or she is still employed. The cost of such risk aversion is the amount spent on premiums for coverage in excess of the individual's current needs between policy formation and a premature employment termination.

Fallacious Arguments in Favor of Term Insurance

Some of the fallacious arguments in favor of term insurance can just as aptly be described as criticisms of level premium insurance. Upon analysis, most of the arguments can be merged into two sweeping allegations: (1) Level premium insurance overcharges the policyowner, and (2) the accumulation and protection elements should be separated.

The basis for the first allegation is the indisputable fact that if a policyowner dies in the early years of the contract, premium outlay under the level premium plan is considerably larger than it would have been under a term plan. It follows, then, according to the term advocates, that the policyowner paid a larger premium than was necessary. Term advocates question whether it is wise for the insured to pay in advance for something he or she may never need or live to enjoy. They argue that it is better “to pay as you go and get what you pay for.”

There is no question that insureds would be far better off financially with term insurance if they could be sure that they would die within a relatively short time. On the other hand, they would be far worse off if they guessed wrong and lived to a ripe old age. Although no one knows whether he or she will die young or live to an excessively old age, the chances of living to an age where the total term premiums exceed the total premiums paid under a level premium plan are relatively high.

The level premium plan protects the insured against the consequences of living too long and having to pay prohibitive premiums for insurance protection. In effect, it shifts a portion of the premium burden of those who live beyond their life expectancy to those who die young and produce an exceedingly large return on their premium outlay. Because at the outset no one can know which group he or she will be in, payment of the level premium by all is a fair and satisfactory arrangement.

Those who argue that level premium insurance overcharges policyowners sometimes assert that the reserve under permanent forms of insurance is forfeited to the company in the event of the insured’s death. To correct this “inequity,” they contend the normal death benefit should be increased by the amount of the reserve.

It should be apparent that this argument strikes at the very heart of the level premium plan. As stated before, the essence of this plan is a gradual reduction in the net amount at risk as the reserve increases. If the reserve is to be paid in addition to the face amount of the policy, this reduction in the amount at risk does not occur, and premiums that were calculated on the assumption of a decreasing risk will clearly be inadequate. Some companies offer a contract that promises to return the reserve in addition to the face amount of the policy, but the premium is increased accordingly.

The second allegation—that the savings and protection elements of the contract should be separated—is based on the proposition that an individual can invest his or her surplus funds more wisely and with a

greater return than the life insurance company can. Those who believe this recommend that individuals buy term insurance and then place the difference between the term premium and the premium they would have paid for level premium insurance in a separate investment program. Some suggest investing this difference in premiums in government bonds, others recommend investment trusts or mutual funds, while others advocate an individual investment program in common stocks. This argument needs to be analyzed in terms of the objectives of any investment program.

Investment Program Objectives

The principal investment program objectives are safety of principal, yield, and liquidity.

Regarding safety of principal, the life insurance industry has compiled a solvency record over the years that is unmatched by any other type of business organization. It has survived wars, depressions, and inflation; composite losses to policyowners have been relatively rare. Even the few companies seized by the regulators in recent years have been able to rescue most of their policyowners' contracts.

This excellent record has been achieved through quality investments and concentration on government bonds (federal, state, and local), high-grade corporate bonds, and real estate mortgages, and through emphasis on diversification. Investments are diversified by industry, geographical distribution, maturity, and size. Many of the larger companies have from 100,000 to 200,000 different units of investment. The individual policyowner's reserve or investment is commingled with all other policyowners' reserves. The insurance company has invested in assets to offset these liabilities (reserves). In effect therefore each policyowner owns a pro rata share of each investment unit in the company's portfolio. The insured may have as little as one cent invested in some units. Such diversification—which is the keystone of safety—is obviously beyond the reach of the individual investor. Only by investing exclusively in federal and state government bonds, with the consequent interest rate risk and sacrifice of yield, could the individual investor hope to match the safety of principal that his or her funds would enjoy with a reputable life insurance company.

Life insurance companies unquestionably obtain the highest possible yield commensurate with the standard of safety that they have set for themselves. As a group, life insurance companies in the United States earned over 9.0 percent of their mean ledger assets during the 1980's and

into the 1990's, reaching 9.87 percent in 1985. This figure represents the net investment income on aggregates of all U.S. life insurance companies (but does not reflect capital gains and losses) after deducting all expenses allocable to investment operations but before deducting federal income taxes. It is the highest during the 20th century for the United States life insurance industry. In 2002 life insurers net rate of return on total assets dropped to 5.38 percent from 6.31 percent a year earlier. Excluding separate accounts, the portfolio net rate of return on general account assets was 6.64 percent in 2002, down from 7.13 percent in 2001 (ACLI's *Life Insurers Fact Book 2003*, American Council of Life Insurers, 101 Constitution Ave. NW, Washington, D.C. 20001-2133).

Net rates have been declining since 1985 as general investment returns have sagged for all sectors of the economy. Many individuals therefore may be able to secure a higher yield than that provided by a life insurance company by investing in common stocks or other equity investments, especially if unrealized capital appreciation is taken into account, and some exceptional investors will be able to do it under virtually any circumstances. It is highly questionable, however, that the typical life insurance policyowner can, over a long period, earn a consistently higher yield than a life insurance company, regardless of the type of investment program he or she pursues. Moreover, it should be noted that the annual increases in cash values are not subject to federal income taxes as they accrue, while the earnings from a separate investment program would be taxed as ordinary income. (Except in the case of death, most of the earnings on the reserve of a life insurance contract are eventually taxed to the insured, but usually at a time when he or she is in a much lower tax bracket.)

With respect to the third objective of an investment program, the liquidity of a life insurance contract is unsurpassed. The policyowner's investment can be withdrawn at any time with no loss of principal. This can be accomplished through surrender for cash or through policy loans. The insured never faces the possibility of liquidating his or her assets in an unfavorable market; nor can the insured's policy loans be called because of inadequate collateral. Certain types of investments' approach the liquidity of life insurance cash values, but no investment whose value depends on the market can match the liquidity of the demand obligation represented by the life insurance contract.

Principal Investment Program Objectives

- Safety of principal
- Yield
- Liquidity

More important perhaps than any of the preceding factors is the question of whether savings under a separate investment program would have been accomplished in the first place. Life insurance that develops cash values is a form of “forced” saving. Not only do its periodic premiums provide a simple and systematic mechanism for saving, but when the savings feature is combined with the protection feature, there is also far more incentive for the insured to save than there would otherwise be. An individual who is voluntarily purchasing a bond a month or setting aside a certain amount per month in some other type of savings account may skip a month or two if some other disposition of money is more appealing. If, however, failure to set aside the predetermined contribution to a savings account would result in loss of highly prized insurance protection that might be irreplaceable, he or she will be far more likely to make the savings effort. The insured saves because it is the only way of preserving his or her protection.

The foregoing is not to disparage other forms of investment. All have their place in an individual’s financial program. Level premium life insurance, however, should be the foundation of any lifelong financial program.

Whole Life Insurance

In contrast with term insurance, which pays benefits only if the insured dies during a specified period of years, whole life insurance provides for the payment of the policy's face amount upon the death of the insured, regardless of when death occurs. It is this characteristic—protection for the whole of life—that gives the insurance its name. The expression has no reference to the manner in which the premiums are paid, only to the duration of the protection. If the premiums are to be paid throughout the insured's lifetime, the insurance is known as *ordinary whole life*; if premiums are to be paid only during a specified period, the insurance is designated *limited-payment whole life*.

Principal Types of Whole Life Insurance

Ordinary Life Insurance

Ordinary life insurance is a type of whole life insurance for which premiums are based on the assumption that they will be paid until the insured's death. It is desirable to define ordinary life insurance this way since, in an increasing number of cases, life insurance is purchased with no intention on the policyowner's part to pay premiums as long as the insured lives. In many cases the insurance is purchased as part of a program that anticipates the use of dividends to pay up the insurance by the end of a period shorter than the life expectancy of the insured. In other cases the plan may be to eventually surrender insurance for an annuity or for a reduced amount of insurance. The point is that ordinary life should not be envisioned as a type of insurance on which the policyowner is irrevocably committed to pay premiums as long as the insured lives or even into the insured's extreme old age. Rather, it should be viewed as a type of policy that provides permanent protection for the lowest total premium outlay and some degree of flexibility to meet changing needs and circumstances for both long-lived persons and those with average-duration lifetimes. Ordinary life insurance is an appropriate foundation for any insurance

program, and in an adequate amount it could well serve as the entire program. Its distinctive features are discussed below.

Permanent Protection—The protection afforded by the ordinary life contract is *permanent*—the term never expires, and the policy never has to be renewed or converted. If insureds continue to pay premiums or pay up their policy, they have protection for as long as they live, regardless of their health; eventually, the face amount of the policy will be paid. This is a valuable right because virtually all people need some insurance as long as they live, if for nothing more than to pay last-illness and funeral expenses. In most cases the need is much greater than that.

In one sense ordinary life can be regarded as an endowment. An *endowment insurance* contract pays the face amount of the policy, whether the insured dies prior to the endowment maturity date or survives to the end of the period. If age 100 is considered to be the end of the endowment period—as well as the end of the mortality table—then an ordinary life policy is equivalent to an endowment contract that pays the face amount as a death claim if the insured dies before age 100 or as a matured endowment if he or she survives to age 100.

Lowest Premium Outlay—The net single premium for a whole life policy is computed without reference to the manner in which the periodic premiums will be paid and, at any particular age, is the same for ordinary life insurance and any form of limited-payment life insurance. Naturally, the longer the period over which the single-sum payment is spread, the lower each periodic payment will be.

The gross annual premiums per \$1,000 charged by two life insurance companies for the same two contracts at ages 25 and 35 are shown in table 2-1, below. The gross premium is the premium actually paid by the policyowner. It is the net premium increased by an allowance for the insurer’s expenses and contingencies.

Issue Age	Ordinary Whole Life		20-Pay Whole Life	
	Company A	Company B	Company A	Company B
25	\$ 9.28	\$11.90	\$13.28	\$17.70
35	\$ 13.21	\$16.90	\$19.26	\$22.50

Limited-payment insurance contracts provide benefits that justify the higher premium rates. If, however, the insured's objective is to secure the maximum amount of permanent insurance protection per dollar of annual premium outlay, then his or her purposes will be best served by the ordinary life contract.

Cash Value or Accumulation Element—As level premium permanent insurance, ordinary life accumulates a reserve that gradually reaches a substantial level and eventually equals the face amount of the policy. As is to be expected, however, the reserve at all durations is lower than that of the other forms of permanent insurance. In other words, the protection element tends to be relatively high. Nevertheless, it is the opinion of many that the ordinary life contract offers the optimal combination of protection and savings. The contract emphasizes protection, but it also accumulates a cash value that can be used to accomplish a variety of purposes.

The cash values that accumulate under an ordinary life contract can be utilized as surrender values, paid-up insurance, or extended term insurance. Cash values are not generally available during the first year or two of the insurance because of the cost to the company of putting the business on the books. Common exceptions are single-premium policies and some durations of limited-payment whole life policies whose first-year premiums are large enough to exceed all first-year expenses incurred to create the policy and maintain policy reserves.

Policy Loans. All level premium life insurance policies that develop cash values (for example, whole life, universal life, adjustable life, variable life, variable universal life, and current assumption whole life) have provisions for policy loans. These *policy loans* give the policyowner access to the cash value that accumulates inside the policy without having to terminate the policy.

The policyowner merely requests a loan and the life insurer will lend the funds confidentially. The loan provisions in the policy specify what portion of the cash value is available for loans and how interest will be determined on the loan. In most policies over 90 percent of the cash value is available for loans—some policies may restrict the amount of loanable funds to 92 percent of the cash value in recognition of an 8-percent policy loan interest rate—and any portion of the cash value can be borrowed. Policyowners indicate in their requests the amount desired, and they can take out more than one policy loan as long as the aggregate

amount of all outstanding loans and accrued interest applicable to those loans does not exceed the policy cash value.

Policy loans do involve interest charged on the borrowed funds. There are two different approaches to setting the policy loan interest rate. The policy will stipulate either (1) a fixed rate as specified in the policy (commonly 5, 6, or 8 percent) or (2) a variable interest rate tied by formula to some specified index. One variable approach is to use Moody's composite yield on seasoned corporate bonds or some index that is regularly published in the financial press, such as *The Wall Street Journal* or *The Journal of Commerce*. Another index may be the interest rate being credited to the cash value plus a specified spread.

State laws impose changing upper limits on variable policy loan interest rates. These laws require that the rate charged be lowered whenever the upper limit drops to more than half of 1 percent below the rate being charged. The rate charged can be changed up to four times each year.

The policyowner has the option of paying the policy loan interest in cash or having the unpaid interest charge added to the balance of the outstanding loan(s). The latter choice can be expensive because future interest charges will be applied to the unpaid interest amount as well as the initial policy loan. The policyowner may choose to pay any part of the principal or interest charge he or she desires since there is no repayment schedule or requirement.

If the policy loan and accrued interest are not paid in cash, the life insurer can recover the outstanding balance of the loans and accrued interest from the death benefits if the insured dies, or from the cash surrender value if the policy is terminated. In fact, the policy will automatically terminate if the policy loan balance plus unpaid interest ever exceeds the policy cash value.

Some whole life policies give policyowners an automatic premium loan option. When this option is selected, a delinquent premium will be paid automatically by a new policy loan. This will keep the policy in force as long as there is adequate cash value to cover each delinquent premium. However, the policy will terminate if the cash value is exhausted.

The automatic premium loan provision does not apply to flexible premium policies because the insurer usually deducts mortality charges and other expenses directly from the cash value. Hence no interest charges are incurred for skipped premium payments.

Policy loans result in the life insurer's release of funds it would otherwise invest to earn investment income. If the rate of investment return on the insurer's portfolio is greater than the rate being applied to the policy loan, the insurer experiences a reduction in earnings. Therefore the insurance company usually takes steps to offset such loan-induced losses in order to preserve a rough equity between policyowners who leave their cash values invested and those who prevent the insurer from reaping the higher yield.

In traditional participating whole life policies, policyowner dividends were not affected by policy loans, but most participating whole life policies being sold today use what is called *direct recognition* to reduce dividends on policies with outstanding loans. This not only adjusts for the differential in earnings but also discourages policy loans.

For universal life policies and other non-participating designs, there are no dividends to adjust; insurers may compensate for lost earnings by reducing the earnings rate being credited directly to the cash value. If there are no policy loans, the insurer credits its normal crediting rate to the full cash value. However, if there are policy loans, the insurer can credit the normal rate to the unloaned portion of the cash value and a lower rate (often 2 percent or 200 basis points lower) to the portion of the cash value equal to the loan indebtedness. When the loan is repaid, the insurer resumes crediting the higher rate to the full cash value. There is no retroactive payment to eliminate the past differential.

The creation of a policy loan does have negative consequences on the policy. The death benefit payable to the beneficiary is reduced by the full amount of outstanding policy loans and accrued interest under most types of policies. Therefore, an irrevocable beneficiary's consent may be required to obtain a policy loan. A policy loan is really an advance against the death benefit; thus the death benefit is adjusted to reflect the prior disbursement.

Outstanding policy loans also reduce the nonforfeiture benefits. The net cash value available to provide either extended term insurance or reduced paid-up insurance is lessened by the loan indebtedness. In the case of extended term insurance, the amount of term

Policy Loan Features

- Available on demand of policyowner
- Interest charges apply
- Depending on the specific contract, interest rates are either fixed or variable
- Variable interest rates tied to a published index
- Unpaid interest charges added to loan balance
- Repayment of loans is at discretion of policyowner
- Outstanding policy loans plus unpaid interest is recovered from either death benefit or surrender value
- Policy terminates if loans plus unpaid interest ever exceed the policy cash value

insurance is reduced from the original amount of coverage by the amount of loan indebtedness as well. State statutes allow life insurers to delay lending funds for up to 6 months after requested, and is known as the *delay clause*. This is a form of emergency protection for the insurance company in case policyowners' demand for loans accelerates to the point that the insurer is forced to liquidate other assets at significant losses to satisfy the loan demands. In actuality, delaying access to funds is an indication of financial weakness or lack of policyowner confidence that insurers wish to avoid. Those life insurers that have failed in recent years chose not to invoke their right to delay policy loan disbursements. Quick access to cash values was terminated only after the insurance commissioner seized control of the company.

Limited-Payment Life Insurance

Limited-payment life insurance is a type of whole life insurance for which premiums are limited by contract to a specified number of years.

The limitation in limited-payment policies may be expressed in terms of the number of annual premiums or of the age beyond which premiums will not be required. Policies whose premiums are limited by number usually stipulate 1, 5, 7, 10, 15, 20, 25, or 30 annual payments, although some companies are willing to issue policies calling for any desired number of premiums. The greater the number of premiums payable, naturally, the more closely the contract approaches the ordinary life design. For those who prefer to limit their premium payments to a period measured by a terminal age, companies make policies available that are paid up at a specified age—typically, 60, 65, or 70. The objective is to enable the insured to pay for the policy during his or her working lifetime. Many companies issue contracts for which premiums are payable to an advanced age, such as 85, but for all practical purposes, these contracts can be regarded as the equivalent of ordinary life contracts.

Because the value of a limited-payment whole life contract at the date of issue is precisely the same as that of a contract purchased on the ordinary life basis, and because it is presumed that there will be fewer premium payments under the limited-payment policy, it follows that each premium must be larger than the comparable premium under an ordinary life contract. Moreover, the fewer the guaranteed premiums specified or the shorter the premium-paying period, the higher each premium will be. However, the higher premiums are offset by greater cash and other surrender values.

Thus the limited-payment policy will provide a larger fund for use in an emergency and will accumulate a larger fund for retirement purposes than will an ordinary life contract issued at the same age. On the other hand, if death takes place within the first several years after issue of the contract, the total premiums paid under the limited-payment policy will exceed those payable under an ordinary life policy. The comparatively long-lived policyowner, however, will pay considerably less in premiums under the limited-payment plan than on the ordinary life basis. This is because a greater portion of the insurance costs will be paid by investment earnings.

There is no presumptive financial advantage between policy forms (types of contracts and the state-mandated standard provisions that must be included). The choice depends on circumstances and personal preference. The limited-payment policy offers the assurance that premium payments will be confined to the insured's productive years, while the ordinary life contract provides maximum permanent protection for any given annual outlay. The limited-payment policy contains the same surrender options, dividend options, settlement options, and other features that make for significant flexibility.

Single-Premium Life Insurance—An extreme form of limited-payment contract is the *single-premium life* insurance policy. Under this plan the number of premiums is limited to one. The effective amount of insurance protection (i.e., the at-risk portion of the death benefit) is, of course, substantially less than the face amount of the policy, and the investment element is correspondingly greater. Such contracts therefore are purchased largely for accumulation purposes. They offer a high degree of security, a satisfactory interest yield, and ready convertibility into cash on a basis guaranteed by the insurer for the entire duration of the contract. Since the single premium represents a substantial amount of money and since it is computed on the basis that there will be no return of any part of it in the event of the insured's early death, it has only limited appeal for protection purposes.

The limited-payment principle is applicable to any type of contract and is frequently used in connection with endowment contracts. However, it is important to differentiate between a limited-payment policy (in which paid-up status is guaranteed at the end of the premium-paying period) and a premiums-paid-by-dividend approach (which uses policyowner dividends to pay all of the premiums after they are adequate to do so). Premiums-paid-by-dividend approaches have sometimes been

sold using the misnomer of *vanishing premium*. The notable difference between the two is that under the misnamed vanishing-premium approach dividends are not guaranteed and may decline in the future. If dividends turn out to be inadequate to pay the premiums, the policyowner will have to resume actual premium payments out of pocket or let the policy lapse. There is no guarantee that so-called vanishing premiums will actually vanish, or that if they do vanish they will never reappear. This concept created many sales, as well as many disappointed consumers and class-action law suits when interest rates plummeted in the 1990's.

Joint Life Insurance

The typical life insurance contract is written on the life of one person and is technically known as *single-life insurance*. A contract can be written on more than one life, however, in which event it is known as a joint life contract, also called a *first-to-die joint life policy*. Strictly speaking, a joint life contract is one written on the lives of two or more persons and payable upon the death of the first person to die. If the face amount is payable upon the death of the last of two or more lives insured under a single contract, it is called either a *survivorship policy* or a *second-to-die policy*. Such policies have become quite popular as a means of funding federal estate taxes of wealthy couples whose wills make maximum use of tax deferral at the first death. Joint life policies are fairly common for funding business buy-sell agreements.

The joint life policy may cover from two to 12 lives, but because of expense and other practical obstacles, most companies limit the number to three or four lives. (Theoretically there is no limit on the number of lives that can be insured under a joint contract. A few insurers will issue policies on more than 12 lives if they all have related business interests.) The contract is most often written on the whole life plan, either ordinary life, limited-payment or universal life. It is seldom written on the term plan since separate term policies on each life for the same amount would cost little more than a joint policy and would offer the advantage of continued protection to the survivor or survivors.

The premium for a joint life policy is somewhat greater than the combined premiums on separate policies providing an equivalent amount of insurance. In other words, the premium for a \$200,000 joint life policy covering two lives is larger than the sum of the premiums on two separate contracts providing \$100,000 each. This is because only

\$100,000 is payable upon the death of the first of the two insureds to die with separate policies, while \$200,000 is payable under a joint life policy. Moreover, since two lives are covered, the cost of insurance is relatively high, and cash values are relatively low. However, a joint life policy costs less than two separate policies providing \$200,000 each.

The provisions of the joint life contract closely follow those of the single-life contract. The clause allowing conversion to other policy forms differs in that it allows conversion policies on separate lives as follows:

1. conversion to single-life policies on the same plan as that of the joint policies upon divorce or dissolution of business
2. division of the amount of insurance among the insured lives either equally or unequally
3. dating of the new policies as of the original date of issue of the joint policy

Business partners sometimes take out a joint policy covering the lives of all partners and written for an amount equal to the largest interest involved. Upon the death of the first partner, the surviving partners receive funds with which to purchase the deceased's partnership interest. Stockholders in a closely held corporation may follow the same practice. Because the insurance usually terminates upon the first death of the partners or stockholders, the remaining members of the firm will not only be without insurance but—of greater consequence—may also be uninsurable.

Some life insurers have introduced joint life policies designed specifically for business buy-sell funding. Some of them offer a short period of extended coverage for the surviving partners or shareholders and guarantee their insurability under a new joint life policy similar to the previous one. A few insurers have even introduced joint life policies that allow allocations of unequal amounts of death proceeds to match actual unequal ownership interests.

Joint Life Features

- Insure more than one life with one policy
- Pay only one death benefit
- First-to-die policies pay death benefit when the first death of the insureds occurs
- Survivorship or second-to-die policies pay death benefit when the second insured person dies (no benefit at first death)
- Survivorship policies often used to prefund federal estate taxes of husband and wife
- May be converted to single-life policies if insureds divorce or dissolve their business relationship

A joint life policy may be suitable for a husband and wife when the death of either will create a need for funds, as would be true if death taxes were involved. Even here, dissatisfaction sometimes arises when the survivor faces the fact that he or she no longer has any coverage under the contract.

Functions of Whole Life Insurance

At this point, the purposes served by whole life insurance should be clear. In summary, the whole life policy

- provides protection against long-range or permanent needs
- accumulates a savings fund that can be used for general purposes or to meet specific objectives

The protection function is particularly applicable to a surviving spouse's need for a life income, last-illness and funeral expenses, expenses of estate administration, death taxes, philanthropic bequests, and the needs of dependent relatives other than the surviving spouse. The general savings feature of the whole life policy is useful in a financial emergency or as a source of funds to take advantage of an unusual business or investment opportunity. The policyowner may use the policy for the specific purpose of accumulating funds for his or her children's college education, to set a child up in business, to pay for a child's wedding, or to supplement the insured's retirement income.

Chapter Two Review

Key terms and concepts are explained in the glossary. Answers to the review questions and the self-test questions are found in the back of the book, following the Glossary.

Key Terms and Concepts

renewability	ordinary whole life insurance
convertibility	limited payment whole life
attained age	permanent insurance
original age	endowment insurance
retroactive conversion	policy loan
re-entry term	direction recognition
decreasing term insurance	delay clause
increasing term insurance	single life insurance
select and ultimate term insurance	joint life policy (first-to die)

Review Questions

- 2-1. Describe the basic nature of term insurance.
- 2-2. Describe the available variations of term insurance.
- 2-3. Describe the protection provided by renewability provisions in term life insurance contracts.
- 2-4. Compare the attained-age method of converting term insurance with the retroactive conversion method.
- 2-5. Explain why there are time limitations on conversion rights for term insurance, and describe some forms of such limits.
- 2-6. Explain how select and ultimate term (re-entry term) differ from traditional forms of term insurance.
- 2-7. How do term-to-65 policies differ from shorter-duration term life insurance contracts?

- 2-8. Describe the most common situations for which term insurance is suitable and useful.
- 2-9. List the fallacious arguments against level premium ordinary permanent (whole life) insurance, in favor of term insurance.
- 2-10. Describe the general features of whole life insurance policies.
- 2-11. Describe how limited-payment life insurance differs from ordinary life insurance.
- 2-12. Describe the two types of joint life insurance policies and indicate their common uses.
- 2-13. Explain how a policy loan changes the rights of (1) the beneficiary and (2) the policyowner.
- 2-14. Explain the functions of whole life insurance.

Self-Test Questions

Instructions: Read Chapter 2 first, then answer the following questions to test your knowledge. There are 10 questions; circle the correct answer, then check your answers with the answer key in the back of the book.

- 2-1. Policy loans require the policyowner to
 - (A) have collateral
 - (B) be charged interest on the loan
 - (C) agree to a repayment schedule
 - (D) complete a form disclosing the reason for the loan

- 2-2. An unpaid loan against the cash value of an ordinary life policy will
 - (A) cancel the death benefit
 - (B) increase the death benefit
 - (C) decrease the death benefit
 - (D) not change the death benefit

- 2-3. At maturity, the face amount of an ordinary life insurance policy will
 - (A) be paid to the policy owner
 - (B) be paid to the beneficiary
 - (C) pay the cash value plus mortality adjustments
 - (D) remain in trust until death occurs, but premiums will stop

- 2-4. Term insurance policies always provide
- (A) a benefit only at the end of the term
 - (B) only temporary life insurance protection
 - (C) a small cash payment at expiration
 - (D) convertibility within the term to another plan of insurance
- 2-5. Re-entry term insurance allows insureds to keep a select premium rate after the initial period if:
- (A) they meet underwriting standards
 - (B) they are under the age of 40 at initial application
 - (C) mortality tables do not increase more rapidly than 10 percent per annum
 - (D) the company still issues insurance in that policy series at subsequent 5-year intervals.
- 2-6. The type of life insurance policy that provides insurance on two lives, with nothing payable upon the first death, is often called
- (A) estate insurance
 - (B) first-to-die insurance
 - (C) joint survivor insurance
 - (D) survivorship life insurance
- 2-7. Which of the following statements concerning limited-pay whole life insurance is (are) correct?
- I. The limitation on the number of premiums to be paid may be expressed as either a number of years or an age beyond which premiums are not payable.
 - II. If the insured dies during the premium-paying period, the total premiums paid will exceed those paid for an ordinary life policy of the same face amount issued at the same age.
- (A) I only
 - (B) II only
 - (C) Both I and II
 - (D) Neither I nor II

- 2-8. Which of the following statements concerning re-entry term insurance is (are) correct?
- I. The initial premium is based on an ultimate mortality table if the insured's health is better than average.
 - II. Future premiums will be based on a select mortality table if satisfactory evidence of insurability is periodically provided as required by the insurer.
- (A) I only
 - (B) II only
 - (C) Both I and II
 - (D) Neither I nor II
- 2-9. All of the following statements concerning term insurance are correct EXCEPT
- (A) Term insurance is comparable to property insurance in that both provide coverage for a limited time.
 - (B) Term insurance policies provide protection from a certainty (death).
 - (C) The chief function of the renewable feature in term insurance is to protect the insurability of the insured.
 - (D) There is an adverse selection opportunity against the insurer at each renewal.
- 2-10. All of the following statements are correct concerning whole life insurance EXCEPT
- (A) A whole life policy surrendered for its cash value cannot usually be reinstated unless the insured provides new evidence of insurability.
 - (B) Limited-payment life insurance policies will have higher cash values than ordinary life policies for the same face amount issued at the same age in the same year.
 - (C) Vanishing premium policy designs are really just limited payment life insurance policies.
 - (D) A whole life policy can be regarded as an endowment at age 100.