M Financial Group™

CASE DESIGN INSIGHT

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Life Insurance Basics: Types of Life Insurance Policies

All life insurance policies fall into one of two general categories:

- **Term life insurance**—temporary, providing protection for a set period of time.
- **Cash value life insurance**—can provide permanent protection and involves an internal savings component.

This M Case Design Insight provides a basic overview of these categories and the types of life insurance contracts within each.

Term Life Insurance

Term life insurance pays a specified face amount (i.e., death benefit) if the insured dies during the policy term. The policy term is usually specified as a number of years, such as 10 or 20, or to a specified age, such as age 65. If the insured outlives the specified period, the term life insurance contract expires, usually with no residual value. Term insurance has no cash value.

Premiums for most term contracts are fixed and guaranteed at issue. The majority of term contracts provide level death benefit coverage, although decreasing and increasing death benefit coverage is available as well.

There are two types of term policies:

1. **Renewable Term**: the term policy's annual premium increases with the insured's age.
2. **Level Term**: the term policy's annual premium remains the same throughout the level term period.

Term policies with increasing premiums are called renewable. Renewable term insurance provides protection for a stated number of years and allows the policyowner to renew the policy for the successive periods without furnishing evidence of insurability. Yearly renewable term (YRT) features premiums that increase annually. Other term policies have increasing premiums on a basis of three, five, or ten years—three-year renewable term, five-year renewable term, and ten-year renewable term. The right to renew is usually limited to a stated number of years or up to a specified age.

Level term policies have premiums that remain the same each year. Level term policies are typically used to cover a certain number of years—10-year and 20-year term are most common. Some level term policies may have the ability to be renewed (i.e., become a YRT contract) after the specified number of years have passed.

A variation of level term provides coverage intended to last an employee's typical working life, but is not renewable. These contracts include life-expectancy term and term-to-age 65, and are rarely sold.

Another variation of traditional level term insurance is return of premium (ROP) term insurance. ROP term insurance returns all premiums if the insured survives to the end of the specified term period. ROP insurance is considerably more expensive than traditional term insurance.

Re-entry term insurance allows the policyowner to pay a lower premium at the time of renewal if he or she meets certain insurability criteria. If the insured does not re-qualify, the rates remain at the guaranteed level, which are much higher than the re-entry rates.

Many term insurance policies include a convertibility provision. Convertibility allows a policyowner to replace term coverage with permanent coverage, within a specified period, without evidence of insurability. Convertibility provisions allow the policyowner to obtain term insurance, or temporary coverage, and reserve the option to purchase permanent coverage for an amount equal to the term insurance face amount if needs change. Conversion typically must occur within a specified number of years no greater than the length of the term period.

Cash Value Life Insurance

Cash value life insurance, also referred to as permanent coverage, differs from term because the premiums paid are sufficient to cover the death claims and expenses of the insurer and also build a cash value, or savings fund, within the contract. The permanent life insurance variations described below are whole life insurance, universal life insurance (UL), indexed universal life insurance (IUL), variable universal life insurance (VUL), and no-lapse guarantee life insurance (NLG).

Whole Life Insurance

A whole life insurance policy's face amount will be paid at the death of the insured, no matter when the death occurs, as long as the policy is in force. The policyowner must pay the scheduled premiums on time and meet the requirements of the policy to keep the policy in force.

Premiums for most whole life insurance contracts remain level and are calculated to ensure that the policy will remain in force for the lifetime of the insured (i.e. age 121). The initial annual premiums can be several times higher than those of a term policy with a comparable face amount. These higher premiums fund the permanent coverage while establishing cash values within the policy. The cash value forms a reserve, enabling the insurance company to keep premiums level and still pay the policy's full death benefit. Policyowners may borrow from cash values via policy loans pursuant to the terms and conditions of the contract. Optional riders and benefits, in addition to the policy death benefit, may be added to the policy.

Whole life insurance policies can be issued as participating or nonparticipating. Participating policies are entitled to share, via non-guaranteed policy dividends, in any distribution of the insurer's surplus funds that it decides to make to those policies. Nonparticipating policies are not entitled to dividends.

Universal Life Insurance

UL policies offer more flexibility and transparency relative to whole life policies. The policyowner has the ability to modify the amount and duration of premium payments, within certain limits, and still maintain coverage for life as long as the cash value reserve is positive.

UL premiums, which are typically made annually, are reduced by the current policy expenses and the remainder is deposited into the cash value account of the policy. Each month, the cash value is credited with interest and the policy is debited by a cost of insurance (COI) charge and any other policy charges and fees drawn from the cash value. Interest credited to the account is determined by the insurer (in the form of a crediting rate) and may have a contractually guaranteed minimum rate.

Death benefits in a UL contract may be fixed at a specified level or may increase each year by an amount equal to either the accumulated cash value or the premiums paid. Similar to whole life contracts, loans may be taken out against the cash value and riders may be added.

Indexed Universal Life

IUL is a UL variation with the same operational characteristics and platform, but with an interest crediting rate determined by reference to an equity index, such as the S&P 500 without dividends. The index return is typically adjusted by a participation percentage rate, then subject to a maximum interest rate cap and minimum interest rate floor. IUL offers the potential for a higher yield than UL, with indirect participation in the equity market, as well as a guaranteed minimum crediting rate (i.e., floor) that provides downside protection for the policyowner.

Variable Universal Life Insurance

VUL insurance policies are also based on the UL platform, varying in their investment flexibility and risk/return opportunity. VUL products permit the policyowner to allocate a portion of each premium payment into one or more "separate account" funds. Separate accounts, which are similar to mutual funds, are not subject to the restrictions of the carrier's general account portfolio, reducing the policyowner's exposure in the event of carrier insolvency.

VUL policies are monitored and subject to the rules established by the Securities and Exchange Commission (SEC), as the investment options are deemed to be securities. All VUL policies must be accompanied by a prospectus that provides detailed information on policy mechanics, policy expenses and changes, and general information regarding the inherent risks associated with securities.

VUL is most appropriate for individuals willing to accept greater risk for greater reward, as the policy's cash value is dependent on non-guaranteed market value changes.

No-Lapse Guarantee Universal Life Insurance

NLG life insurance policies are UL policies with a guarantee that if a specified minimum premium is paid regularly, the policy will not lapse for a specified period, or for life, even if the cash value decreases to zero.

NLG insurance is often characterized as having minimal or no cash value accumulation. It is best suited for individuals focused on ensuring the life insurance death benefit will be available at a guaranteed cost, and where cash value accumulation may be less important.

NLG may also be offered as a rider on other forms of life insurance, including VUL and IUL. In some instances, the duration of the NLG policy may be contractually fixed by the insurance carrier. In contrast to a pure NLG insurance policy, NLG riders may be available on products where cash value accumulation is a key benefit of the policy. These types of contracts can serve the dual purpose of providing cash value accumulation, and a death benefit that is contractually guaranteed, as long as the policyowner meets certain requirements.

Summary

Life insurance serves a wide variety of purposes, providing financial support to heirs and charitable organizations, indemnification against the loss of a key person of a business, funding of a business continuation plan, and as a benefit for executives and employees. Between the two basic types of life insurance, term and cash value (Appendix A summarizes the characteristics of each), there is a solution for a wide range of planning needs and objectives.

For More Information

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Appendix A: Term and Cash Value Life Insurance Comparison

	Term Life Insurance	Cash Value Life Insurance				
Attribute	**N/A**	**Whole Life**	**UL**	**IUL**	**VUL**	**NLG**
Accumulates Cash Value	No	Yes	Yes	Yes	Yes	Yes
Coverage Duration	Fixed	Life	Flexible	Flexible	Flexible	Flexible
Premium Flexibility	No	No	Yes	Yes	Yes	Yes, but will impact NLG
Guaranteed Elements	Death Benefit and Premium	Death Benefit, maximum premium, and minimum cash values	Death Benefit, maximum charges, and minimum interest crediting rate	Death Benefit, maximum charges, and minimum interest crediting rate	Maximum charges	Death Benefit, premium, maximum charges, and minimum interest crediting rate
Nonguaranteed Elements	None	Dividends	Current interest credits and charges	Equity index changes and current charges	Market value changes and current charges	Current interest credits and charges for cash values
Primary Appeal	Guaranteed coverage for a specific period and low premium outlay	Guaranteed lifetime coverage, backed by investments made by the issuer	Flexibility, transparency, and backed by conservative investments	Flexibility, transparency, and limited equity-like returns in return for a guaranteed floor	Flexibility, transparency, and mutual fund returns	Guaranteed lifetime coverage at a potentially low premium outlay
M Proprietary Product	Yes	No	Yes	Yes	Yes	Yes

Variable life insurance products are long-term investments and may not be suitable for all investors. An investment in variable life insurance is subject to fluctuating values of the underlying investment options and it entails risk, including the possible loss of principal.

Variable Universal Life insurance combines the protection and tax advantages of life insurance with the investment potential of a comprehensive selection of variable investment options. The insurance component provides death benefit coverage and the variable component gives you the flexibility to potentially increase the policy's cash value.