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Chapter 4: Exploring whole life insurance as a dual tool for lifetime coverage and wealth accumulation

4.1. Introduction

Life insurance is a highly regulated financial product sold and marketed in the form of modified indemnity contracts. The goal of insurance is to provide certainty and protection against adverse events, with the insured paying a premium to transfer risk of loss to the carrier in exchange for a guarantee against loss of income or wealth due to death. Beyond providing certainty against catastrophic loss, life insurance can be used as an investment tool and provide the policyholder with a means of disposing of his estate and paying estate taxes. Whole life insurance has both investment and risk transfer characteristics. The death benefit can provide your heirs with much needed liquidity upon your death; the premiums subsidize the underwriting loss experienced due to the risk transfer; and when needed, the policy cash value can be accessed as a source of lifetime funding. Life insurance provides lifetime coverage and wealth accumulation at a higher cost than term insurance with savings outside of the policy. A policy's investment feature makes the policy economically comparable to a bond. By complying with minimum liquidity requirements set by regulators, a whole life policy gains a cash value that grows in a tax favored manner, equal to the future value of a corporate bond. The cash value attracts fund flows and begins to support sales and expense ratios when sufficient to support minimum liquidity ratios. For wealthy and high-income consumers, life insurance offers benefits not available through other investment vehicles; thus, excessive premiums are not viewed as a cost, but rather as part of a tax-preferred financial solution (AltexSoft, 2024; Luxoft, 2024; Mobilunity; 2024).

Instead, they would prefer it, because it would pay a premium if the insured did die during the premium payment phase. Whole life insurance has two significant limitations when it comes to efficient and effective precommitment savings. The first is obvious: the policyholder automatically loses all investment returns since he began saving if he dies before the vesting period of the investment. If buying term life insurance is cheaper, people whose beneficiary would be badly off in case of death of the primary earner could buy it, and the primary earner would then set aside the difference between whole and term life insurance in an investment yielding net after-tax and after-inflation returns (Ulavan, 2024; Stratoflow, 2025).

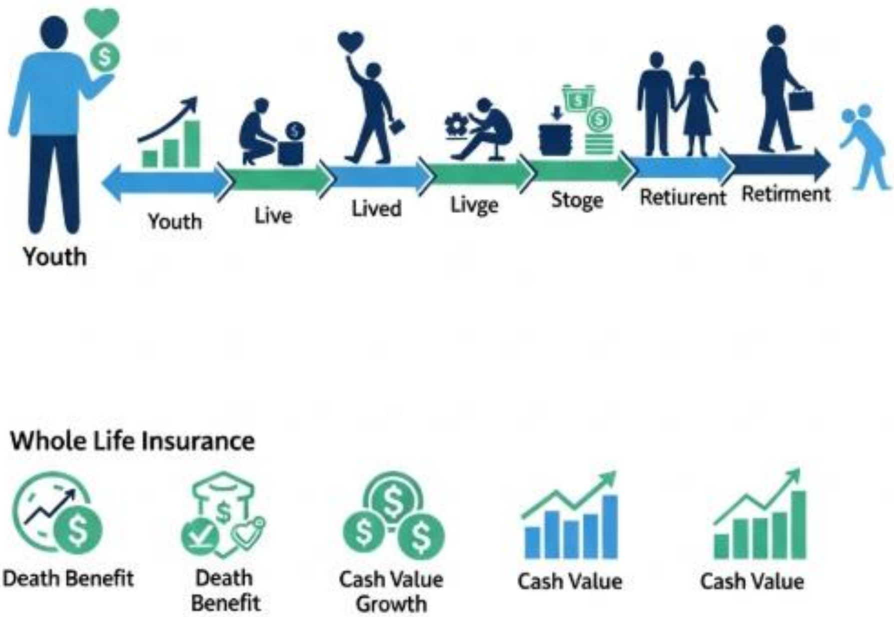

Fig 4.1: Exploring Whole Life Insurance

4.1.1. Background and Significance

A whole life insurance is meant to provide benefits for a policyholder at some point in their life, underwriting both the risk of death and risk of old age. Like others in the category of permanent life insurance products, it distinguishes itself from term life insurance due to both its dual protection function as well as savings component built into the contract. One area in which it has received sustained popularity is as a tool for wealth accumulation, in addition to its normally intended function of providing protection against risk of death. In effect, it has two sets of clients, the insured as well as the beneficiaries. A typical whole life insurance contract provides the policyholder with permanent coverage, with level premiums as well as guaranteed benefits at old age. Although product providers claim their premiums are lower than those available in the market for alternative investments, other studies evaluating the effectiveness of whole life insurance on risk and wealth accrual conclude that these products are inefficient for generating savings, compared to the expected utility loss associated with such precommitments.

Insurance companies use mortality tables to predict expected deaths in a population and establish risk-based premiums, which are considerably higher during consumer's age at which risk is highest compared to at old age. This is because insured's expected premiums paid will be less than expected claims during their productive prime, as people do not die at random. If such risk-based premiums were high enough to generate adequate profits for whole life insurance companies, investors would be indifferent with respect to contract savings due to the same loss of flexibility.

4.2. Understanding Whole Life Insurance

Whole life insurance is a powerful tool in the financial tool kit. Whole life insurance is permanent insurance that provides double protection, paying a stated amount to the designated beneficiary at the death of the insured and also accumulating a cash value during the life of the insured. Whole life policies are the most basic and popular type of permanent coverage. This is due, in part, to the simplicity and ease of design of such policies. Whole life insurance enjoys a couple of features that are unique to permanent insurance. One unique feature is the guaranteed death benefit. Unlike term insurance, in which death coverage ceases during the term of the policy, a whole life policy is designed to mature at the end of its term, which is the date of death of the insured. However, if the insured dies prior to maturity, the stated death benefit is paid to the beneficiary. The other unique feature of whole life insurance is the accumulation of cash value. Whole life policies are designed such that they accumulate a cash value during the life of the insured.

Over the years, whole life has been the backbone of affordable permanent insurance. Money is invested into the disclosure and insurance function of the policy, during which time the policy builds up cash value to provide additional coverage. Through dividends or interest credits, insurance companies enable the policy to gradually build its savings function, or cash value. These credits allow for the speed of building cash value, but they are minimal for the first few years. But once the policy begins to mature and attain full cash value, it provides a steadily growing stability to the increased savings function. The face amount paid at death continues to grow through dividends or interest credits as the cash value continues to build, allowing for a growth in the total insulation function as additional payments occur.

4.2.1. Definition and Key Features

Whole life insurance, the most common form of cash value life insurance, is a contract between an insurance purchaser and an insurance company for the provision of a death benefit at some date in the future in exchange for certain agreed-upon premium payments during the lifetime of the insured. A key feature of whole life insurance is that it provides a guaranteed death benefit, because the actuarial tables used to price the insurance contract assume that all individuals will die eventually. The insurance premiums are paid at certain intervals during the insured's lifetime, typically either annually or semiannually, quarterly, or monthly. Upon the insured's death, the claim is settled by the insurance company's paying the agreed-upon death benefit to the beneficiaries designated by the insured, less the insurance company's deduction of any outstanding policy loans and accrued but unpaid interest on those loans. For a fixed level premium to be maintained throughout the insured's life, initial premiums are paid for whole life insurance on an unlevel basis. The first few years' premiums are much lower than the cost of insurance during this stage. The difference between the annual premium and the cost of insurance goes toward cash value accumulation.

4.2.2. Types of Whole Life Policies

Due to the wide spectrum of whole life policies, it becomes highly complicated for an individual to select the most appropriate option from the available choices. The least learned in insurance policies will find terminology with which they are unfamiliar. Here we will clarify some of the terminologies used, but it is advisable to not purchase your policy based solely on the information given here.

Straight Life Policy: In this policy, the premium payment continues with the policyholder during his entire life until when the insured dies, the policy would pay the face value. Thus, it is better to think of this policy as going to lifetime maturity.

Limited Payment Life Policy: This plan is modified in such a way that the premiums are not payable for the entire life of the policyholder. Instead, as its name indicates, it has limited maturity in the sense that the premium payment continues for a limited number of years. The policy then matures at a known age of the policyholder. Thus, the limited-payment position matures but only at a known advanced age.

Modified Life Policy: The theory of this policy is to permit the insured to carry a lower premium in the early years facing the maximum risk of death, usually in early working years, when there are other pressing demands for money, and then to accept increases in premium during the middle of life, when he is normally at or near the peak of his earning years, and then to return to a more or less standard situation during the third stage, when family or financial obligations are lower.

Graded Life Policy: In this policy, the amount of premium increases every year for the first five or ten years and then remains constant for the rest of the life of the insured.

4.3. The Role of Whole Life Insurance in Financial Planning

Essentially, the dual purpose of whole life insurance creates the potential for this asset to participate in two very important and very related areas of individuals' and families' financial lives: lifetime coverage with a guaranteed death benefit, and the accumulation of retirement wealth. In effect, whole life insurance is a two-way street in the family financial plan. From one direction it provides funds for survivors when insureds die; from the other direction, it serves as a forced saving instrument to protect against the risks of inadequate provision for retirement.

Lifetime Coverage Benefits

Fig 4.2: Role of Whole Life Insurance in Financial Planning

The more certain a person is that he or she needs funds available at a particular age, the more that person should emphasize safe growth investments in an asset that guarantees a principled value in the events of interest. Whole life insurance, particularly its paid-up policy form, is distinguished among lifetime assets because it integrates two very essential yet vulnerable benefits in the financial planning process: the provision of annual cash value accumulation, and a full death benefit at every moment of the insurance contract.

In addition to its death benefits and the cash values that provide a logical and systematic deposit or accumulation phase and a very certain liquidity feature for low-risk investors, whole life insurance is a tool for retirement income planning. Although there have recently been many changes in the economy affecting the prices and returns on tax-deferred investment products, investing in a whole life insurance policy with a minimum, guaranteed premium and maximum insurance for the target cash accumulation need and timing can provide comparable fund growth. Tax-deferred growth and withdrawal combinations are more flexible in whole life policies than in some competitive products. Family financial planners are now likely to observe that many whole life policies are actively added to the family asset portfolio.

4.3.1. Lifetime Coverage Benefits

Due to the advancements made in modern medicine and technology, the percentage of people who live to an old age is keenly on the rise. However, this increase is not without a price, which comes in the form of soaring healthcare costs, children and often, grandchildren who will rely on the elder person for guidance, and also, an increase in lifestyle expectations, in the form of expensive holidays, entertainment and so on. In consideration of what is essentially a knowledge-driven society, which places a premium on the experience and guidance provided by old, learned individuals, and the fact that the average lifespan of individuals has increased, life insurance companies have developed whole life policies, which have coverage conditions that extend beyond the normal life expectancy. Therefore, a whole life policy has both a cash value component, which is useful to accumulate wealth, as well as a guarantee to make available the policy proceeds on the death of the policyholder, no matter when that occurs. It is this last feature that is used to ensure a transfer of wealth to the heirs, after allowing the policyholder to retain control of the accumulated wealth over their lifetime.

The entrant of a higher taxable income bracket is nudged towards incorporating an estate freeze into his financial plan, so that the bulk of the future increase in the value of his estate can be made available to someone in a lower income bracket. Traditionally, the estate freeze is achieved by the use of business loss, registered retirement saving plan tax, mortgage, company pension loss and other loss deductions, so that upon their death, the taxable value of the estate is rendered either at or close to zero by either investment in investment loss property, investments that have negligible use or consumptive value, or losses that would yield refunds or other tax benefits. Whole life insurance provides lifetime coverage of a certain amount for a predictable premium payment and also provides a collateral asset of predictable value.

4.3.2. Wealth Accumulation Strategies

Whole life insurance offers the dual function of guaranteed lifetime risk coverage and also wealth accumulation. Once the insured has passed the medical underwriting, the policy's value steadily increases as the company has the capital reserves backing up the increases in the cash value. There are multiple strategies for using the cash value either throughout the insured's life or as an estate planning tool, or both. The prudent use of the cash value insured guarantees the convenience of accessing a currency store without taxes, fees or the need for repayment. The longer the insured has the policy, the larger the cash value that is accessible. In tandem with the writing of a will and the ownership structure of the policy, with an irrevocable death benefit beneficiary, the care of the estate planning function is taken care of. Given the tax-free nature of death benefits payable to beneficiaries, the leveraging of lifetime risk coverage into an estate cash value in excess of the insured's total premium payments guarantees a family legacy.

One of the most beneficial uses of a WLI design is that of a forced savings vehicle for children. Any reluctance to carry life insurance coverage for a child while they are young and the need for planning for future living expenses can be remedied by establishing a WL policy that has a cash value that can be used to pay for post-secondary education expenses. Since the cash values grow at a reasonable rate, usually at least equal to rates available on GICs or CDs, WL policies are appropriate considerations. Further, if the cash values are not completely depleted and the savings fund is still available in the adult contingency, the tax-free nature of the death benefit guarantees that even a small policy may be cash flow assisted by additional premium payments later while also filling an unexpected family need for sudden generational change as in parental death.

4.4. Mechanisms of Cash Value Accumulation

The cash value in a whole life policy accumulates from various inflows, namely premium payments, additional premium-loadings during the first year of policy issuance, and interest crediting. The ultimate source of the cash value is the premium payments. In the first year, however, the net cash value is actually a 'negative cash value', reflecting the first-year expenses. This is because the premium is substantially greater than the sum of the year's cost of insurance and the interest credited to the account. Whole life designs are estimated using software which calculate the net cash value after the first-year expenses.

The second flow increasing the cash value is the interest crediting. In the first year, cash value is credited with an interest growth computed on beginning-of-the-year amounts using a quarterly interest rate of either 1/20 or 1/40 of the guaranteed annual interest rate, called the 'interest credit' and 'continuance credit', respectively. These amounts are relatively small compared to the cash value's premium and insurance expense flow. The effect diminishes with longer durations due to diminishing cash values. In practice, insurance companies compound the cash values annually.

The eventual source of the interest payments into cash value is the reserves, also known as the 'policy savings component'. For most of the life of the policy, the reserve-to-cash value ratio is relatively constant; hence reserves earn the same interest rate as the cash value. Reserves are similar to those of any annuity contract primarily funded by premium payments. They are put into bonds, and the interest is used first to cover the company's costs: reinsurance payments and interest on the embedded negative reserve. Any 'profit' then goes to shareholders; the rest is also credited to the life contract's proportions of reserves.

4.4.1. How Cash Value Grows

Whole life insurance is an expensive but appropriate foundation for a family's financial plan. The death benefit is valuable, and the policy's cash value can help during emergencies, financing further education, or supplementing retirement. Premium payments are higher than a comparable term policy, but the excess funding builds cash value inside the policy. A portion of the premium is paid to the insurance company for mortality risk, while a portion is invested for the history of the policy. The insurance company guarantees this cash value increase as a percentage of the total premium paid. This low but stable growth creates cash value accumulation for the policy owner, which can be deemed an asset for net worth calculation. Additionally, insurance companies allow the policy owner to participate in the profits earned. Insurance companies use money in cash accumulation policies to invest and earn higher returns than they guarantee the policy owner. So, policy owners can earn dividends by participating in the success of the insurance company, and use them to increase their cash value. Dividends are not guaranteed, just like equity investment returns and fund manager fees, but the history of conservative insurance companies is long and reliable. The cash value growth faces two significant issues. If the policy owner borrows against the policy and dies, any outstanding loans from the policy are subtracted from the death benefit. Mortgage-type loans, where part of the payment pays interest and part pays down the debt, allow policy owners to repay the loan before death and thus protect the death benefit. The other issue facing cash value accumulation is account depletion through policy surrender. Unlike whole life insurance policy surrender, term insurance lapse is the insurance company's decision. The owner surrenders the whole life insurance policy for a cash refund. If they have owned it long enough, this refund can be substantial. If not, it can be zero, with cash value forgotten as if it had never existed.

4.4.2. Impact of Premium Payments

The premiums you choose to pay for your whole life insurance policy will affect the amount and time of accumulation of cash value in the policy, and will also most likely affect the death benefit amount. There are many factors that add to the complexity of how death benefit and cash value interact; the following are the main components. First, premiums can vary greatly among companies; some companies have relatively higher pure insurance cost versus cash accumulation cost than others. This company-specific fact will influence the interaction between cash value and insurance protection at any level of premium payment. Second, your choice of premium payment mode will greatly affect your relative ratio of premium paid to death benefit and cash accumulation ratio. Payments made on a level annual basis will have a different relative contribution than monthly payments or a single payment. In general, a single premium payment will pay higher insurance protection than a series of monthly payments. Third, your age at the time of policy issue will affect the relative lifetime cost of the insurance risk guaranteed. Typically, a person who starts at an older age will pay a higher ratio of premium to cash accumulation than a person who starts at a younger age. Fourth, the length of time before the cash value becomes available will add a dimension to the calculation of the return, because the earlier the cash value is available, the higher the dollar amount in the bank will earn a return on investment. Most insurance companies use a graded cash value schedule, whereby the cash value is no more than 60 percent of the cumulative premiums paid during the first five years and is paid upon death unless otherwise requested.

4.5. Comparative Analysis with Other Insurance Products

The last section pointed out that WLIP offers a variety of benefits to the policyholder but does not compare these unique features to the other two popular types of insurance; Term and Universal Life. It is important to understand the advantages and disadvantages of each of the popularly bought insurances since their features may overlap with some of the policy specific benefits offered by the WLIP.

Term insurance is the cheapest form of insurance available for a family but it only serves the purpose of offering a death benefit during the selected duration that has been insured. The insured amount is not accumulated and if the insured lives past the term, they have not gained anything by paying all those premiums for years. However, when a family has young children, large debts and the income earner is still earning a low salary, he may not have the ability to purchase a big WLIP policy. While the children are young and in school, it is important for the income earner to have the maximum amount of death benefit for the least amount of money possible. For this reason, term insurance works for many families. Alternatively, some families purchase a term policy at an early age and switch to a WLIP once they can afford the premium. Another alternative is to purchase a small WLIP to be used as a savings plan, which would pay for the term premium at the time of need.

Regardless of common advice that claims the term is superior, most families with hefty financial responsibilities buy WLIPs. Neither policy can truly replace the other, as they are not intended to mirror each other. As such, while selecting a policy, one's specific needs at that point in time should dictate the decision: the cheapest need bought while having young, dependent children, or the policy that does everything, bought because it remains affordable and serves as a guardian until the kids can fend for themselves. Term and WLIP take different positions in the marketplace. Additionally, WLIP can actually serve as forced savings. Some people get a tax refund every year because they contribute to an IRS, yet, in their haste to save money, neglect to consider non-qualified savings such as a fully paid-up WLIP.

4.5.1. Term vs. Whole Life Insurance

For most dual-use insurance buyers, the explicit decision of whether to select a mixture of insured work policies and fund other risks via alternative investments, or to select a whole life (or similar) mixture of insurance and investment within one policy is not critical. Term insurance is the least expensive of the three principal insurance options and usually provides adequate fund adequacy. The primary reason whole life or universal type insurance is selected is that premium payments into these products may be made without justifying the need for a policy later. The present value of future premiums is substantial in early years, especially relative to the cash value reserves. Hence, at least prior to maturity, withdrawal of cash for other investment or emergency purposes, in whole life insurance, is an unwound closing act. Surrender is therefore unreliable, and may be inappropriate while the ensuring function is necessary. In a properly tailored dual-use insurance-policy investment, insurance is adequate to fund a contingency, and is technically not needed for other purposes since there are alternative investments. Although total life does not lead to a forced surrender of insurance protection before other investments are funded, terms may simply be allowed to lapse at any time. Hence, many believe that with adequate reserves not to lapse, term policies are to be preferred due to lower costs.

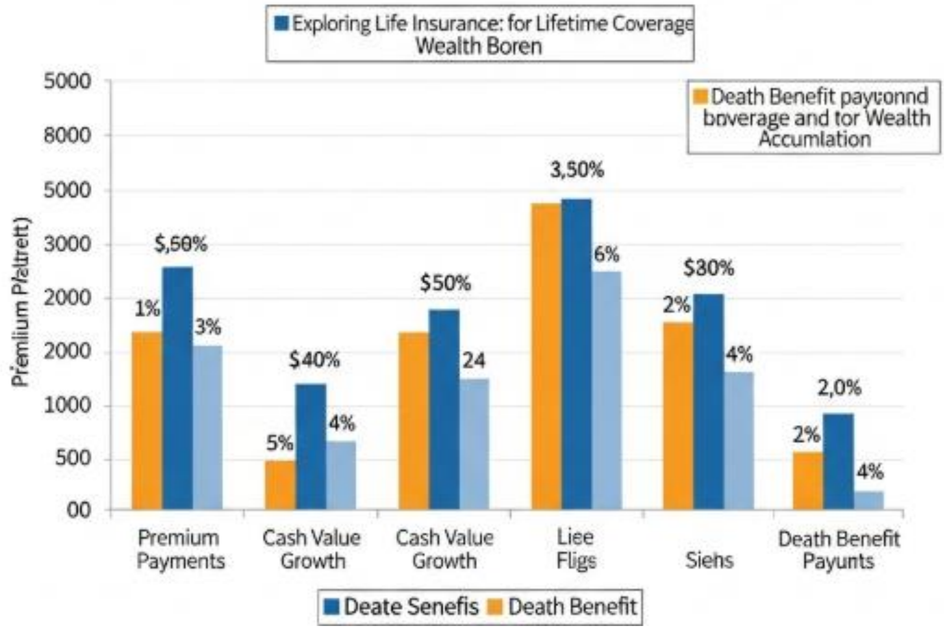

Fig : Dual Tool for Lifetime Coverage and Wealth Accumulation

Term is less expensive but is inflexible against the worst that happens during both the insuring and savings-building phases of life. A whole life product – or predicted dual-use whole life product – on the contrary would be a higher expense product designed to avoid forced policy lapsing, providing contingent liquidity very largely free of policy surrender tax. A close look at how some of its product attributes function, suggests that life insurance is an accumulation tool, not just because policies allocate excess premiums to reserves, but primarily because, arranged properly as dual-use policies, term and reserves both function as investment vehicles.

4.5.2. Universal Life Insurance Overview

Several hybrid fusions of term and whole life insurance have developed, as market demand favors tax-sheltered vehicles for savings relative to pure protection. Because the growth of the cash value is a crucial factor for comparison for both UL and WL, be sure to consider your time horizon carefully. If you have a reasonable investment horizon as the policyholder — ideally, 20 years for retirement accumulation purposes — and you have an investable cash flow to dedicate toward your policy, the ranking of these alternatives is likely to favor the product with the lowest design expenses and mortality charges. Universal life is the product that has diverged the most from what traditional insurance has been in the past by applying market values and prices to the insurance and savings aspects of the policy. Ultra-low-cost term insurance has been the last nail in the coffin of traditional whole-life insurance appealing to those who want to cover long horizons of lifetime protection for their families without regard to cash value. UL provides flexible premiums, with the ratio of mortality charges to savings costs determined by the policyholder. Low savings needs lead to low premiums while cheap term covers temporarily larger risks. Any delayed payments lead to a larger last payment, whereas for WL policies, each premium usually rides at the same level throughout the term. Some companies have attempted their own version of no-load UL but have added costly charges in place of a low commission in the first year in an effort to hold policyholders for the lifetime of the policies.

4.6. Conclusion

One of the downsides to whole life insurance (WLI) is its premiums are generally very expensive compared with the amount of face value protection the insured receives, particularly early in the insured's life. As the insured ages, however, the WLI plan becomes relatively more attractive than term insurance. WLI also can provide tax-deferred capital accumulation over long periods of time. Indeed, WLI can be structured to provide the insured with not only death coverage but also capital accumulation and enhancement functions for retirement as the insured retires and reaches the end of their life cycle. The plan can also be structured to pay out death benefits during the life of the insured, although there would be a reduction in death benefits to the beneficiaries in that case. The extreme longevity found in many developed countries makes the concepts of lifetime protection and lifetime capital accumulation especially attractive. However, WLI is not without its downsides as a tool for wealth accumulation. The insured, through the policy's cash value, is unable to participate in the substantial returns on extra-economic returns generally available through investments in equities. The application of the stock and bond premiums associated with life insurance to the stock market instead would produce a portfolio that grows dramatically compared with the relatively modest returns found in the cash value of WLI. Unfortunately, stock returns are subject to considerable volatility. For example, the stock market for U.S. equities over the past 40 years has produced average annual returns of over 10%, but during periods of downturn, stock prices fell by about 40% to 50% from their highs just prior to the downturn. Further, short-term money market investment returns have produced a little over 5%, actually consumed by taxes and inflation during the past 40 years.

4.6.1. Future Trends

One future trend is the growing demand for specialized advice. As more consumers become aware of the diverse options within whole life insurance, they're likely to seek specialized guidance on how to wield these policies as effective financial planning tools. The fact that policy cash values can be employed to help fund a significant life event like paying for a child's college education, or business financing, should help whole life insurance gain traction among all segments. Certainly, these uses have long been embodied in financial analysis done with respect to whole life policies. Clients would also benefit if more financial advisors add whole life insurance to their tool kit and receive training and support from their affiliate companies.

One prediction about the future of whole life insurance underscores the issue of product adaptability in meeting consumer needs. Innovation and ingenuity also may account for the new take-up of whole life insurance by recognizing client concerns and tweaking the benefits offered by whole life insurance to address those concerns. Recognizing consumer concerns such as those noted earlier regarding equity, flexibility, or costs associated with whole life insurance, insurers could adapt their whole life products accordingly. As innovators often note, trying to anticipate the future can be a tricky exercise and certain market predictions can easily turn out to be off the mark.

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