Coming to Terms with Term Insurance

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Although term life insurance is far less complex than permanent insurance, it isn't exactly a game of checkers, either. Implementing term insurance often needs more than just sorting through companies to find the least expensive one and then rushing out with the application. This isn't an all-you-need-to-know-about-term column; rather, it focuses on several creative analyses and approaches to the term insurance topic that may add value for your clients.

Why Use Term

There are two reasons to use term insurance. One is because the need is temporary. Such temporary needs can be family protection, funding a buy-sell agreement when business partners intend to sell or liquidate around retirement age, or for estate tax liquidity if difficult-to-sell assets are expected to be liquidated within a reasonable period. For life insurance needs that will extend past life expectancy or for life, permanent life insurance is needed. We might think of term insurance as *if-I-die* coverage and permanent as *when-I-die* coverage.

The other reason to use term insurance is when the need is permanent but there is inadequate cash flow to spend on permanent insurance at the present time. Term should be used in these situations, with the insured then switching to permanent insurance later. Do not fall prey to agents peddling premium financing of permanent insurance premiums in this cash-poor situation. I have observed very bad results because of interest rate changes when this has been done. Even when interest rates aren't adverse, the long-term results aren't as good as starting with term insurance and using permanent when cash flow has improved. (A good source for term pricing information to be found at www.term4sale.com.)

Low-Load UL as Surrogate Term

Estate tax liquidity needs can be filled using joint life because the estate tax is due at the second spouse's death. Not all liquidity needs are permanent. The ideal solution for joint life insurance needed for a limited period is low-load survivorship universal life (SUL) that insures both lives. In my experience, this alternative has substantially less cost than the few joint term policies available or insuring the least expensive spouse with conventional one-life term.

A California couple (ages 72 and 70) needed additional liquidity for ten years. A true joint life ten-year term policy for the $2 million needed had an annual premium of $6,285 from a major insurer. Term coverage on the wife only had premiums of $10,000 a year for ten-year term. A low-load joint life SUL funded for ten years had target premiums of $4,885.
Not only does the low-load SUL have less cost, it has a surrender value if the insurance isn't needed for the full ten years. For example, if the policy is terminated in the seventh year, the cash value is around $18,000. The SUL is permanent insurance, so it can be continued as long as it is being properly funded. While the true term policies have guaranteed premiums and the SULs do not, the short period involved means there will be little fluctuation in the SUL $4,885 target premiums. If interest rates go up, the premium could even decline a bit.

When single-life term and low-load UL underwriting is the same (preferred, for example), term insurance will have a substantial pricing advantage. But I have had situations where term underwriting is less favorable than universal life (for example, term is standard and UL is preferred). When this occurs and the premiums are similar for the period of time being considered, UL is the better choice because of the surrender cash value; furthermore, UL is permanent insurance, so no conversion is needed.

Conversion of Term to Permanent Insurance

The right to convert from term insurance to permanent without proof of insurability is very important, but judgment needs to be used in knowing if and when to convert. Most term policies have conversion rights that are the same as the term length—say, 20 years (usually with a maximum age of 75). But don't assume that the conversion right is for the level premium period. It may not be. For example, some term policies limit the conversion period to five years even though they are 20-year level term policies.

Let's examine three situations. Mike has a 20-year $1 million term policy taken out at age 40 with preferred rating. He reaches age 60 in the same health, albeit with the passage of 20 years, and wants to continue the coverage permanently. In the months leading up to the end of his low-cost premium rate, Mike should examine the entire life insurance marketplace, including the conversion, to determine the best policy. Most likely the best policy will not be the conversion policy. Because he remains a preferred insurance risk, he is not limited by the conversion.

Another situation could be that Mike has a heart attack at 51. Agents often rush in to handle an immediate conversion. This is very likely a mistake. To determine if conversion should occur early, you need to know the cost to convert now versus at the end of the conversion period. Subtract the term premium from the permanent policy premium if converted immediately. Let's say this difference is $10,855. Mike can save $10,855 for each of the next nine years by waiting. At 4.5 percent, this has a value in nine years of $122,534.

You then need to find out what the cost of permanent insurance is in nine years—the deadline to convert—and subtract the cost of doing so now. Let's say the annual premium to convert in nine years is $7,658 more. With this information you can determine how long it takes for the $122,534 *side fund* to be used up from the $7,658 additional cost starting in nine years. The answer is 27 years, using a 4.5 percent rate. That is, waiting to convert the term insurance until age 60 will be the financially astute move if Mike dies before 87. Due to the heart attack, his life expectancy at 60 is 21 years. This means he has about a 25 percent probability of making it to age 87. Therefore, there is a 75 percent probability that waiting nine yeas to convert is the right move. (I used no-lapse UL as the conversion policy. The cost of UL in nine years will change. It could be higher or lower and this will affect the relative advantage of waiting to convert.)

The third situation is that Mike finds out he has terminal cancer at age 53, with a maximum of three years to survive. The obvious decision is to keep the much lower-cost term that has another seven years until the conversion deadline occurs. In several cases I have been involved with, this hasn't been obvious to the insurance agents who have rushed into trying to convert in this circumstance.

Family Protection Insurance

For clients in the economic stage of raising families and accumulating wealth, term insurance is the major type of life insurance to use, probably mixed in with some discounted whole life that is used for the dual purposes of family protection and tax-deferred cash value accumulation. Term-insuring the non-primary-income earner also is recommended to help manage a single-parent household. Having this term insurance owned by, and payable to, irrevocable trusts should be considered. So many times I have seen such clients underinsured because they have been sold only permanent insurance. This is a mistake. *If-I-die* insurance is so cost effective in insuring for the large amounts needed to provide financial security to the family your client leaves behind that it is malpractice not to get the amounts right.