Virginia Cooperative Extension
2005 PUBLICATION 354-146

Life Insurance: Universal-Life Insurance

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Overview

Universal-life insurance was created to address many of the problems associated with whole-life insurance. To fully understand universal life, refer to *Life Insurance: Whole-Life Insurance*, Virginia Cooperative Extension publication 354-145, for some background information.

One problem with whole-life insurance is its lack of flexibility. For instance, with whole life, what if the ***owner*** cannot make a ***premium*** payment? What if the owner wants to lower the ***death benefit*** because he or she does not need the same level of insurance anymore? Universal life provides options for both these concerns.

A second problem with whole life is that it is much like a black box. The owner cannot see exactly how it works. With whole life, the owner may ask: What are the actual expenses this year? How much did the policy earn and where did it go? Again, universal life provides the answers to these questions.

How Universal-Life Insurance Is Similar to Whole-Life Insurance

As with whole-life insurance, universal-life insurance is a permanent policy. Its goal is to be in effect when the ***insured*** dies, no matter when that may be. As a permanent policy, universal life has a ***cash-value*** that will help the owner meet the higher insurance costs as the insured gets older.

How Universal-Life Insurance Differs from Whole-Life Insurance

A universal-life policy can be funded (with premium payments) in many ways. There is a minimum amount of premium that is needed to keep the insurance in effect that is similar to the cost of an annual term insurance policy. There are also upper limits on the amount of premium dollars the owner is allowed to put into the policy, but the range between these lower and upper limits is quite large.

In a whole-life policy, if the owner wants to take money out of the cash-value account but keep the insurance in effect, he or she must use an interest-bearing loan. With a universal-life policy, the owner still has the option of taking a loan, but he or she can also take a straight withdrawal. The owner must be careful when taking a withdrawal, to leave enough cash value in the policy to help meet the policy's expenses.

A universal-life policy also provides complete disclosure. The owner is able to see exactly what the expenses and returns are for any given period. In addition, he or she has the option of lowering the death benefit at anytime (within certain limits). In some cases, the owner can also add more death benefit to the current policy.

Death Benefit Options

In addition to allowing the owner to change the death benefit once the policy is issued, universal life also allows the owner to choose between two different death-benefit options. These are usually referred to as Option A – Level and Option B – Increasing.

Option A works very much like whole life. As the cash-value account grows, the net amount at risk (the amount the insurance company has to pay out of its own pocket if the insured dies) becomes lower. In an option B policy, the net amount at risk stays the same. Therefore, the ***beneficiary*** gets the original stated death benefit *and* the money in the cash value account.

Option B is more expensive than Option A because the insurance company will have to pay the beneficiary

Virginia Tech
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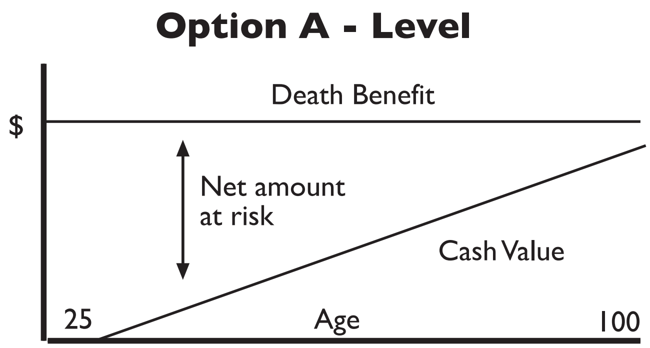
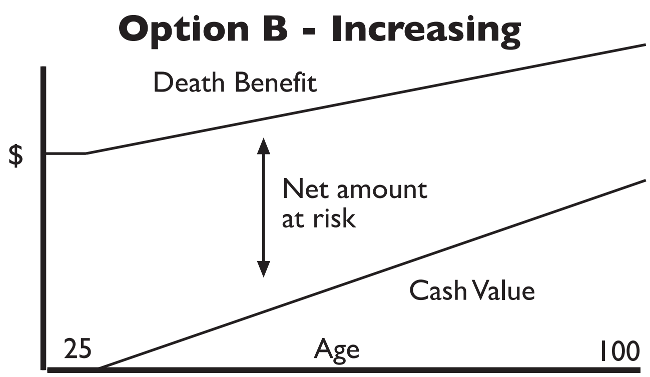
www.ext.vt.edu
Produced by Agriculture and Extension Communications, Virginia Tech

VT/0805/W/354146
VIRGINIA STATE UNIVERSITY

more of its own money when the insured dies. The owner may be allowed to switch between these options. The owner can always switch from B to A, and but may only switch from A to B if the insured is a good risk – is healthy – and this usually requires a doctor's visit. People use Option B polices to increase the amount that can be saved income tax free.





Cash-Value Account

The cash-value account of a fixed universal-life policy is invested in short-term debt. The returns are usually close to the three-year Treasury bill. (See *Life Insurance: Variable Universal-Life Insurance*, Virginia Cooperative Extension publication 354-147, for a discussion of variable universal-life polices.) Historically, these returns have averaged 5 percent or 6 percent. Many insurance companies guarantee that returns can never be below 3 percent or 4 percent. These returns are income tax free inside the policy.

Premiums

As stated above, within certain limits, the owner can choose the level of premiums he or she wants to pay. However, a person should pay more than the minimum amount of premium each year. The minimum premium only meets the insurance company's costs to cover the insured, and no money would go into the cash-value account.

Each policy will have a "target" premium payment. This target is the amount of premium that the insurance company believes to be adequate to fund the policy. It is generally a good idea to pay premiums at least equal to this target premium, assuming a conservative rate of return (5 percent for example).

Definitions of Terms

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

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

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

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

Owner – The person or entity who owns the insurance policy. The owner may or may not be the insured. The owner can designate the beneficiary, and is responsible for paying premiums. See *Life Insurance: The Impact of Ownership*, Virginia Cooperative Extension publication 354-142, for more information on the impact of ownership.

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

Other Sources

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