

A Perspective on Term vs. Permanent

By Bruce W. Gordon, CLU

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Both Term and Permanent life insurance products provide certain advantages, and either may be more appropriate than the other in specific situations. But, if you are among the majority of people who believe that Term life insurance costs less than Permanent life insurance, and therefore Term life insurance must be the better choice, please read on:

Most everyone equates the **cost** of life insurance to the **premiums** they pay, i.e. the amount of the check they write to the insurance company each month, or each year, etc. But, **cost** and premium really have two different meanings and calculations as they pertain to life insurance.

And, like the saying, "You get what you pay for", lower **premiums** may restrict benefits or produce consequences unintended or unknown to the policyholder. When the key differences between Term and Permanent life insurance are understood from a **cost** and **premium** perspective, the choice of products may be a function of affordability only.

Cost

The actual **cost** of life insurance is fundamentally the same for all policies with the same death benefit amount, regardless of policy type, because it relates to the probability, or the risk, that an insured will die at a certain age or point in time, and the insurance company will have to pay the death benefit. Thus, the older someone is, the higher the probability is that he/she might die at that point in time. Consequently, the insurance company must continuously increase its **cost** to continue to provide the death benefit protection. (See Fig 1)



Fig 1

When an insured is very young, the probability of dying at that time is very small, so the cost of providing the protection is relatively low. However, if an insured is 95, for example, the probability of dying is extremely high, so the **cost** of providing the protection for that year is almost the same as the death benefit itself.

Note that **cost** is an internal calculation done by the insurance company and not something that a policyholder sees. It is also generally a point-in-time calculation, which means that it has nothing to do with **costs** calculated for prior years or any **premiums** paid by the policyholder in the past. In other words, as far as **cost** is concerned, there is no price break for having been insured, but not died.

And, **cost** is a key part of, but not the same as, **cost of insurance** (COI), which is a monthly expense deduction taken from the cash values of universal life and certain other permanent policies. Similarly, **cost** is a key ingredient in **premium**.

Premium

Premium is where everyone sees the difference between Term insurance and Permanent insurance, but the reasons for this difference may be a surprise. After all, if the underlying **cost** of the protection is the same, why are the **premiums** so different?

The answer lies primarily in three key areas:

- (1) The expected duration of the **cost** (i.e. how long does the insurance company have to remain on the risk);
- (2) The **premium** structure (i.e. does the policy have increasing **premiums** or level **premiums**); and

(3) The insurance laws that govern certain policyholder rights (which are different for Term insurance compared to Permanent insurance in one very important area);

Let's start with "the expected duration of the **cost**." (See Fig 2) Term insurance (or "temporary" insurance) normally cannot be purchased above certain ages, and normally expires before the insured gets too old. Thus, the insurance company not only may avoid paying the death benefit, but also the **cost** of that benefit never really gets too prohibitive, i.e. close to the death benefit amount itself.

But, Permanent insurance can stay in force until the insured dies, whenever that might be. So, not only is it more probable that the death benefit will be paid, but it is also possible for the **cost** of Permanent insurance to get extremely high at the oldest ages. Thus, the expected duration of the **cost** will, in part, make the **premium** for Permanent insurance higher. But, when compared to the amount of continued death benefit protection, that should be very acceptable.

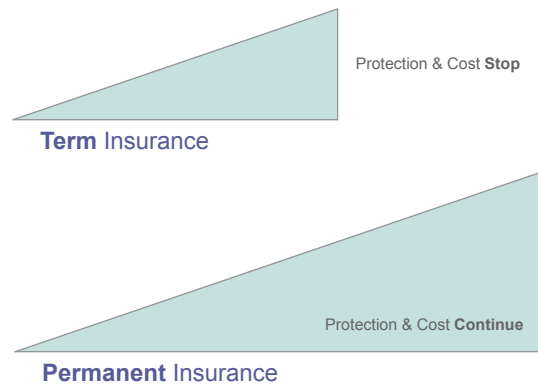


Fig 2

Next, let's look at **premium** structure, i.e. increasing or level, where the differences between Term insurance and Permanent insurance can become even more pronounced.

If **cost** is a major component of **premium**, and if **cost** starts out very low and increases every year, why don't **premiums** for all policies start out very low and increase every year?

With some Term insurance products, you can, in fact, pay annually increasing **premiums**, instead of the usual level **premiums** that don't change from year to year. These policies are called Yearly Renewable Term (YRT) products. But, this is permitted because these products are usually not expected to stay in force long enough to reach the point where the cost could make the **premium** unaffordable in the later years.

However, for most all other life insurance products, the **premiums** are calculated to stay level in order to keep the **premiums** affordable as the insured gets older. But this means that the insurance company is knowingly over-charging in the early years in order to build up a **premium** "reserve", which is invested at interest, to offset **premium** increases that otherwise would be required in the later years. (See Fig 3)

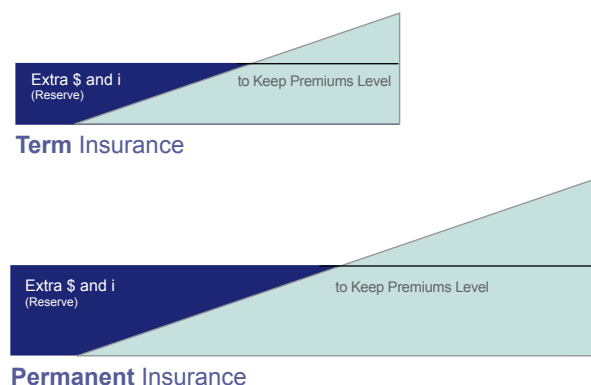


Fig 3

Since Permanent policies are designed to stay in force much longer than Term policies, the level **premiums** required for Permanent policies, must be higher than the level **premiums** required for most Term policies.

Now, this brings us to the most interesting and important point of all, and perhaps the reason why people should always consider buying Permanent insurance, instead of Term insurance, whenever they can afford it: the insurance laws that govern certain policyholder rights.

For both Term and Permanent insurance policies, the extra or over-charged **premium** that is paid into this “reserve”, and the interest that is credited to it, should belong to the policyholder. But, only with Permanent insurance does the law agree with this position, where it’s known basically as “cash value”.

This “reserve” exists with Term insurance, but the law usually does not require insurance companies to make any of it available to the policyholders, and they don’t.

But, with Permanent insurance, this “cash value” can be accessed (borrowed or withdrawn) by the policyholder, subject to certain restrictions, and all the interest that is credited to it is tax deferred to the policyholder while it remains in this “reserve”. And, if the policy is surrendered for any reason, these monies are paid (“returned”) to the policyholder.

It is a fair and wonderful advantage for the owners of Permanent life insurance.

And, that’s not all. For some types of Permanent products, the law also allows the policyholder to pay additional monies into this “reserve” – up to a legally prescribed limit – to take further advantage of the tax-deferred, cash accumulation nature of this “reserve”, with all the same protections and accessibility. (See Fig 4)

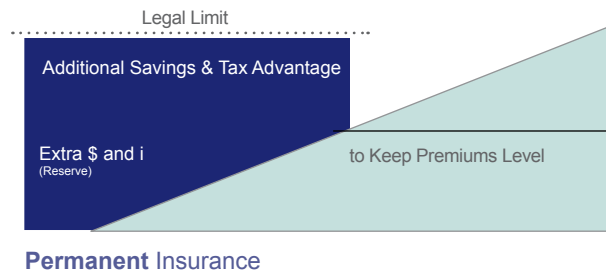


Fig 4

So, knowing that the **costs** for both Term and Permanent insurance are basically the same, and knowing that both products over-charge the policyholder in order to keep **premiums** level, if someone could afford the higher **premiums** of Permanent life insurance, why would he/she want to buy Term insurance, instead, and give up the legal rights and advantages of the Permanent insurance **premium** “reserve”?