

Questions Haunt Sales of Certain Insurance Policies

The insurance industry has never lacked product options. If you're buying life insurance, you're not just choosing between term and permanent policies; you also need to consider the differences between universal and whole life policies, and sort through a long list of options and riders. Shopping for annuities, with their multitude of variations, can be even more perplexing. Moreover, while some creations are worthy, others-such as the life policies touted during the 1980s for their "vanishing premiums"-offer dubious value. Glenn Daily, a fee-only insurance consultant to financial advisors, points to three currently popular products and strategies that may have serious drawbacks. "The more you investigate some of these, the more likely you are to walk away," Daily says.

Borrowing to buy life insurance:

Suppose a lender charges you 5% for money you can use to pay premiums on a policy whose cash value is growing at 6%. Almost like free insurance, right? At least that's how premium financing is sometimes presented. What an agent may neglect to point out, though, is that the spread between the two interest rates could change.

"There's no guaranteed relationship between the policy's rate of return and the interest on your loan from a third party," Daily says. So a spread that works to your advantage today could turn against you tomorrow. Who knows what interest rate you'll pay if you have to renew a loan in 15 years, or what you'll earn on your policy? You could wind up paying more on your debt than you make on your insurance.

Variable annuity guarantees:

Nowadays there are annuities that guarantee a range of minimum benefits-for income, account accumulation, withdrawals, and a payment at your death. These are intended to reassure buyers who worry about the cost and unfavorable tax treatment of these products. And while such guarantees may sound enticing, they're not always easy to understand and may involve additional insurance costs. Then there's the fact that one company's guarantee may operate differently than another's, making it very tough to comparison shop.

But the deal killer here, says Daily, is determining the value of a guarantee-and if you don't know what its worth, how can you tell whether you're paying a fair price? Just as the value of an option on a stock ultimately depends on the stock's price, an annuity guarantee, which is based on the claims-paying ability of an insurer, is only valuable if it exceeds what the contract is worth. And while a few specialists armed with esoteric modeling tools may be able to put a price on annuity guarantees, most insurance buyers don't have access to that kind of expertise. "You can't really make an informed decision," Daily says. "So my suggestion is to avoid them."

No-lapse universal life insurance:

This one could be a keeper, but only if you understand the risks and how to mitigate them. With a no-lapse policy, once you have paid in a minimum target amount, the death benefit is guaranteed to stay in force, regardless of how the underlying investments perform. That can be valuable if you're unable to continue paying premiums. Consider the dire example of someone who becomes terminally ill and expects to live only a year or two. If sufficient premiums have been paid, he can remain covered without further outlays.

But there are important shortcomings:

The no-lapse guarantee may hold for only part of the policy's life-say, for the first 15 years. At the end of that period, the policy will lapse if its cash surrender value is zero, which could happen because of weak investment returns or other reasons.

How much time do your premium dollars buy? While the insurance company's formula may be complex, it's crucial to understand the calculation, says Daily. The no-lapse protection of this kind of policy is really its only selling point. Other insurance typically builds higher cash surrender values, especially during the early years.

An even bigger problem, though, is that no-lapse universal life locks you into current interest rates and insurance charges. That's fine if those factors don't become more favorable later. But suppose yields rise or the cost of insurance goes down-or both. Suddenly, other kinds of insurance look more appealing than your no-lapse policy. Yet exchanging your insurance for a better policy could be painfully expensive. "That's the ugly side of no-lapse universal life," Daily says.

Still, you may be willing to accept that possibility if a no-lapse policy fits your overall financial picture and helps you fulfill your objectives. Meanwhile, you could reduce the risk by building a diversified insurance portfolio consisting of a no-lapse policy plus some other type-you could add term insurance, or maybe a cash-value policy whose yield fluctuates with interest rates. Finding a way to surmount the disadvantages of no-lapse universal life could let you benefit from its strengths: premium flexibility and a guaranteed cost.