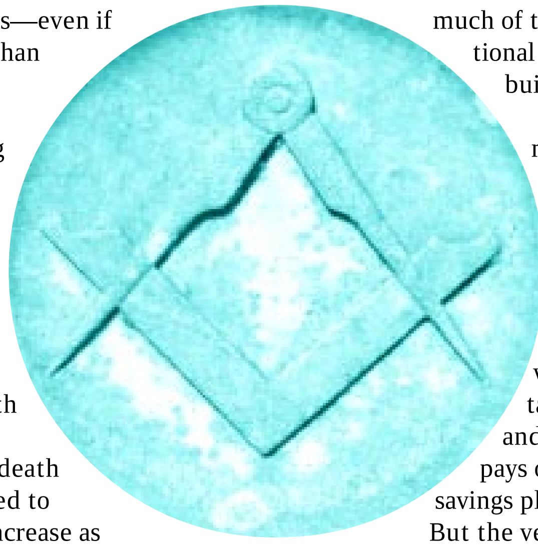
Limited Benefit whole life

Low Risk Insurance for a High Price

They say insurance is never bought and always sold, and this may be especially true for preneed funeral "whole life" insurance. Consumers shop for funeral services, but often they are actually buying whole life insurance. The policies are expensive. The funeral home collects all the benefits—including interest and dividends—even if the death benefit is ultimately larger than the cost of the funeral. And structural features of whole life that have little impact on a long term investor seeking a tax protected savings vehicle, can create problems for a preneed buyer.



Whole life insurance is a product that combines traditional life insurance, which pays a death benefit to your survivors, with a "savings" component. Whole life insurance typically offers a consumer a level death benefit (say $100,000) and a gradually increasing "cash value." Although the death benefit is relatively expensive compared to term life, the cost does not typically increase as people age, and consumers do not typically pay more in premium than the death benefit.

Preneed whole life policies, on the other hand, are very small and consumers report paying substantially more in premiums than the face value of the policy. Kathryn Anderson of Dallas purchased a prepaid funeral contract funded through a whole life policy that cost $51 per month for ten years, or a total of $6120 for a $2400 funeral. After paying for four years, she had paid $2,295 and still had six years of premiums to pay before the policy was paid up. She wrote to the company and to the Texas Department of Insurance. Homesteaders Life cancelled the policy and sent her a check for $725, the "net surrender value" of her policy. Had her money been placed in a trust account, she could have received a refund of $2,055. But, because such pricing and refund schemes are legal for insurance, the Department of Insurance could not help her.[1]

If a consumer cancels the policy by ceasing premium payments, the potential for a refund is reduced even further. Gregory Spenser Funeral Directors in Fort Worth prearranged a $3,900 funeral for Estella Myles in late 1996. Her Homesteaders policy would cost $52.65 per month over ten years, or a total of $6,318. After paying for eight months she ceased her payments and the company gave her three options—reinstate her policy by making her premium payments, cease her payments and take a reduced "paid-up" coverage that would pay out $140, or surrender the policy for its cash value of $71.58.[2]

The "cash surrender value" is the available portion of your "cash value," which is a savings component of the policy in traditional whole life. Cash value typically grows very slowly because commissions and administrative costs absorb much of the payment in the early years. In traditional whole life insurance it can take a decade to build up significant cash value.[3]

A typical cash value whole life policy may pay dividends, and consumers can use these dividends to buy additional death benefits or simply accept payments in cash. Since the IRS sees these dividends as refund of premium rather than interest, such payments are not taxable. When purchased as a long term savings vehicle, whole life policies enjoy other tax advantages as well and—depending on the price and the effective rate of interest the company pays on the policy—can make sense as part of a savings plan.

But the very features that make a traditional whole life policy valuable make it the wrong choice to fund a preneed insurance contract. A preneed funeral contract is designed exclusively to pay benefits to a funeral home after the insured dies. At its best, it locks in today's funeral prices, and the funeral home covers the higher prices after years of inflation from the death benefit. The preneed plan is not a savings vehicle. Although the policy has a "cash value" like other whole life policies, consumers cannot take policy loans under most contracts.[4] And, like all whole life policies, cash value accrues slowly in the early years due to commissions and other administrative costs loaded on to the front. Therefore consumers who cancel their preneed policy in the first few years get very little back for the premiums they paid in.

And consumers do not benefit from dividends on their policy as they would with traditional whole life insurance because the policies are designed to cover the additional cost of a future funeral by using the dividends to "buy up" additional insurance. The increased amount of insurance is paid to the funeral home, and if it is more than the cost of the funeral, the funeral home keeps the excess.[5]

Finally, many whole life polices used to fund preneed contracts do not have the same level benefits enjoyed by most consumers of whole life insurance. Instead, the policies pay substantially reduced benefits in the first two years. In 1997 Joy Rose M. signed a preneed funeral contract for $4,132, which she agreed to pay in monthly installments of $87.02 for five years (a total of $5,221.20). She died one year later. This policy paid only

25% of the face amount during the first 12 months, and 50% during the next 12, so the company only owed $1,033 in benefits although Ms. M. had paid $1,044 in premiums.

If a consumer dies anytime within the first two years of an illness that should have been reported on the application, the company can either pay these reduced benefits under the policy or refund the consumer's premium and "recind" policy—whichever is less. In this case, the company didn't really care to investigate. "Inasmuch as the premiums paid to date exceed the potential death benefit, however, there is no need to investigate the claim," wrote a Mission Life representative.[6] Benefit limits combined with high premium rates protect the life insurance company from the risk of paying a death benefit that isn't already substantially funded by the consumer's premium payments.

Like our earlier examples, Robert D. of Mission bought a $3,695 preneed funeral contract funded by an insurance policy costing $53.35 monthly for ten years (a total of $6402).[7] Consumers Union compared the value of the policy over time to the value of $53.35 placed in an account earning the current Certificate of Deposit interest rate and to funeral cost inflation for the $3,695 funeral.

In this scenario, the insurance company would pay out more than the consumer's premium payments if the consumer dies during the first five years, and after that time the additional insurance premiums plus interest would more than cover funeral price inflation. The policy is most valuable as insurance in year three, but if the risk of your death in the near future is slim, then these whole life policies are not a good way to fund a preneed funeral contract.

Insurers argue that whole life insurance offers your beneficiaries more flexibility because the policy benefits can be switched from one funeral home to another, allowing families to change arrangements if the original choices are no longer suitable. But, the law only requires that the insurer pay the face value of the policy to the new funeral provider, not the "growth." The "growth" is the additional amount of insurance purchased over time with the "dividend" or interest on your premiums. It is essentially comparable to the interest earned over time on your money and is used to make sure that the benefit is enough to cover the inflated price of a funeral. Consumers also report trouble transferring the interest on trusts (see main story, p. 14).

All in all, the preneed market insurance is difficult to navigate and full of pitfalls, and Consumers Union recommends several reforms that will ensure that elderly consumers will get value for their money when they try and plan ahead for their funeral costs by using an insurance funded plan.

- Prohibit policies where premiums exceed the face amount of the policy. The face amount should equal a minimum of the total premium payments plus 5% interest.
- Require the full value—including additional insurance purchased through dividends or other policy "growth" due to indexed or other increase—to be transferable to any funeral home selected by the family.
- Require the insurance company to report at the time of death the amount of benefits paid to the funeral home under the policy, and require any benefits in excess of the cost of the funeral at time of death to be payable to the family.
- Require minimum refunds equivalent to refunds available through trust backed preneed contracts when a consumer cancels.

Cost/Benefit Graph Based on an Actual Consumer's Premium, Estimated Interest and Funeral Inflation