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Life Insurance as a Personal Savings Vehicle

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LIFE INSURANCE AS A PERSONAL SAVINGS VEHICLE

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Through the medium of life insurance, millions of individuals have accumulated savings while providing protection for their families. Insurance companies have pooled these savings and injected them back into the financial bloodstream of the economy. This pool of investment funds has helped to achieve increasingly greater productivity and has raised the standard of living in our society.

This article seeks to explain how life insurance functions as a vehicle for personal savings. The protection element of life insurance is related to the level premium concept of funding insurance. The savings element of life insurance is then discussed and related to equity-based investments. Finally, an effort is made to anticipate the future of life insurance as a personal savings vehicle.

SIGNIFICANCE OF LIFE INSURANCE SAVINGS IN THE ECONOMY

Over the past decade, life insurance companies have accounted for one-eighth of all funds in the United States money and capital markets. Life insurance companies are among the three largest sources of funds, along with commercial banks and savings and loan associations.[1]

Nearly $150 billion of the $177 billion of assets held by life insurance companies in 1967 offset accumulated policy reserves, policyholder dividends, and reserves for future dividends.[2] The increase of over $10 billion in assets in 1967 alone was equal to 1.6 percent of this country's national income.[3]

At year-end 1967, seven out of ten Americans owned life insurance policies with a face value of over $1 trillion, one and one-half times the United States gross national product.[4] Benefit payments

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1 K. WRIGHT, 1968 ECONOMIC AND INVESTMENT REPORT 13 (1968).

2 INSTITUTE OF LOFE INSURANCE, LOFE INSURANCE FACT BOOK 59-62 (1968) [hereinafter cited as LIFE INSURANCE FACT BOOK].

3 Office of Business Economics, United States Department of Commerce, *Survey of Current Business*, Vol. 49, No. 1, S-18-19 (1969).

4 LIFE INSURANCE FACT BOOK, *supra* note 2, at 9.

from life insurance policies and annuities totaled more than $13 billion, nearly 60 percent of which was paid to living policyholders. Health insurance benefits paid by life insurance companies totaled over $5 billion.[5]

TYPES OF LIFE INSURANCE PLANS

The savings element in individual life insurance (pension and group plans will not be discussed) varies by type of plan. *Term insurance* gives temporary protection for a definite and limited period of time. Although there are many different forms of term insurance, this type of insurance is characterized by its exclusive emphasis on protection in the event of premature death and the absence of a savings element.

Whole life insurance, unlike term insurance, provides permanent protection. The insurer promises to pay the face value of the contract *when* the insured dies, not *if* the insured dies within a stated period of time. Whole life insurance plans are of two major forms: (1) the straight life (or "ordinary life") contracts; and (2) the limited-payment life contracts. The promise of the insurer to pay the face amount upon death is the same for both forms, the distinction being the premium paying period. Under straight life policies, the premiums are payable for the remainder of the insured's life. Under limited-payment life insurance, premiums are payable for the remainder of the insured's life or until the expiration of a stated period, if earlier. Whole life insurance (of which straight life insurance is the most popular form) is the most prevalent type of individual life insurance coverage.

Endowment insurance provides for payment of the face amount of the policy upon the death of the insured within a specified period or, if the insured survives, for the payment of the face amount at the end of the period. *Annuities* are a means of liquidating an estate; they provide for a series of income payments periodically over a specified number of years or for life.[6] Although there are many other kinds of life insurance contracts, virtually all of them basically are variations or combinations of the term, whole life, endowment, and annuity plans.

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[5] *Id.* at 7-8.

[6] Technically, annuities are not "life insurance." However, annuities and life insurance are based on the same fundamental principles, and annuities are marketed by life insurance companies. For a complete discussion of the types of life insurance, *see* D. GREGG, LIFE AND HEALTH INSURANCE HANDBOOK 37-86 (1964).

PROTECTION ELEMENT IN LIFE INSURANCE

Life insurance provides protection against economic loss caused by premature death of the insured. The protection element in life insurance is based on the principles of actuarial science for the mathematical pooling of risks.[7] Mortality tables reflect the fact that the probability of death increases with age. Therefore, the cost of providing protection increases as the age of the insured advances. Protection for short durations at early ages may be purchased for relatively little cost per unit of protection. As age advances, however, the cost per unit of protection must increase. The higher the age, the more costly the protection element becomes until it eventually reaches a level that many individuals would regard as prohibitive. Yet, it is common for individuals to desire life insurance protection until death, at whatever age it might occur.

LEVEL PREMIUM CONCEPT

Under level premium life insurance, premiums do not rise from year to year as the probability of death increases. Instead, the premiums remain constant throughout the premium-paying period.

If premiums that have a natural tendency to increase with each passing year are leveled out, the premiums paid in the early years of the contract will be more than sufficient to meet current death claims for a group of insureds, while those premiums paid in the later years will be less than adequate to meet current death claims. This is the essence of the level premium concept.[8]

The chief significance of the level premium concept lies in the fact that the redundant premiums in the early years of permanent life contracts create a fund, or reserve, which is held by the insurer for the benefit and to the credit of the policyholders. The accumulated reserve, improved by interest, is used to pay out the face amounts of insurance which become payable upon the death of policyholders.

From the standpoint of the insurance company, the pure "protection" element is the difference between the face of the policy and the reserve. Technically speaking, this difference is the net amount at risk. As the reserve increases, the amount at risk de-

[7] Occasionally, individuals will mistakenly confuse the purchase of insurance with gambling. Contrary to gambling, in which risk is created, the protection element in life insurance reduces an existing risk—the uncertainty of economic loss resulting from premature death.

[8] For an excellent discussion of level premium concept, *see* D. McGill, Life Insurance 32-39 (1966).

creases. Of primary importance is the fact that the level premium is the only arrangement under which it is possible to provide insurance protection to the uppermost limits of the human life span without the premium per unit of face amount becoming prohibitive.

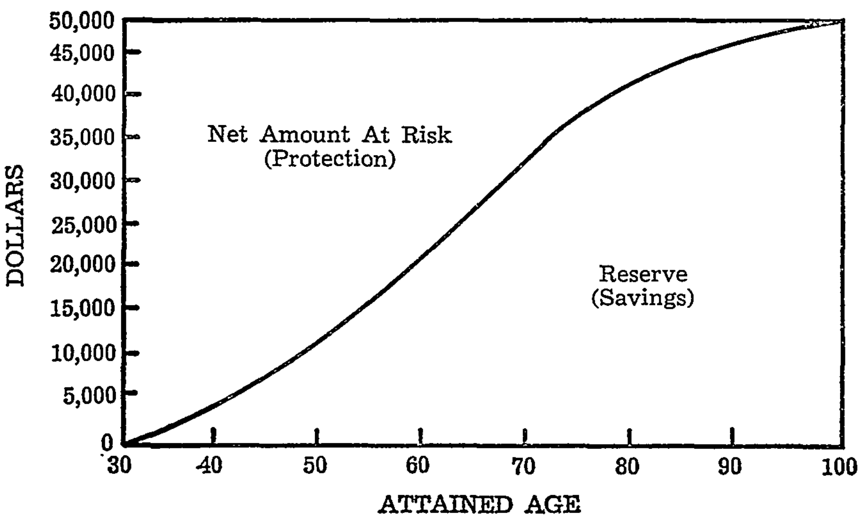
The level premium concept underlies the system of cash values and other nonforfeiture features which have made the life insurance contract one of the most flexible and valuable contracts in existence.

NATURE OF THE SAVINGS ELEMENT IN LIFE INSURANCE

Cash values comprise the basic savings element in life insurance. In addition, the policy loan privilege, dividend options, and other factors enhance the life insurance savings element.

CASH VALUES.

The amount of the actual protection element is always the face amount of the policy, less the accumulated reserve value of the policy. The reserve values are the source of funds that may be withdrawn by the policyholder at any time through the cash surrender or loan privilege, and these funds may be thought of as accumulated savings. These two elements, decreasing protection and increasing savings, are combined in such a manner that in any year their sum is equal to the face of the level premium policy. The chart below roughly illustrates this relationship for a straight life policy of $50,000 issued at age thirty.



Appropriate proportion of protection and savings elements in a $50,000 straight life (ordinary life) contract issued at age 30; 1958 CSO table and 2½ percent interest.

The reserve of a contract represents the difference between future benefits and future net premiums. Minimum cash surrender values (cash values) of permanent life insurance contracts represent the insurance company's best estimate as to the amount of funds that will be accumulated from the contributions of a group of insureds (adjusted for necessary expenses, mortality and interest) at the end of each policy year throughout the lifetime of the contracts. Thus, while cash surrender values arise out of the necessity to accumulate a reserve under level premium contracts, they are not necessarily equal to the reserve in a particular policy year. Once determined, cash values are incorporated in the insurance contract and become obligations binding on the company.[9]

POLICY LOAN PRIVILEGE.

The availability of cash values gives rise to the policy loan privilege, under which the insurance company will advance on the security of the policy, an amount which will not exceed the guaranteed cash value of the policy. The interest rate on policy loans (usually 5 percent) exceeds the rate guaranteed for accumulating cash values in the policy for several reasons, including the considerable administrative expense incurred by the company in administering policy loans.

The availability of policy loans at interest rates typically below general interest rates in the economy is another reason that cash value life insurance is an attractive vehicle for providing family protection while accumulating a savings fund for use in emergencies. The due date of a policy loan is at the maturity of the policy or anytime prior to this date at the option of the policyowner or the borrower.

The contracts of many companies now include a provision for *automatic premium loans*. This provision protects against the unintentional lapse of the contract by advancing, in the form of a policy loan, the unpaid amount of a premium due. The automatic premium loan provision is advantageous to the insured because it helps to continue the contract and all its features in full force and effect.

DIVIDEND OPTIONS.

Life insurance contracts may be "participating" or "nonparticipating." Participating contracts are characterized by higher annual

[9] The Standard Nonforfeiture Law, which became effective in individual states (with few exceptions) on January 1, 1948, applies to minimum surrender values. Many companies, however, provide surrender values in excess of those required by law.

premiums and provide that the insurance company will return annually to the policyholder premiums collected in excess of those needed to pay current costs.[10] The amount returned to the policyholders is determined annually and is called a "policy dividend."

Policy dividends represent a return of a portion of the premium paid, or a refund to policyholders. These dividends, then, are a means for the insurance company to refund the premium redundancy and should not be confused with dividends payable to corporate stockholders.[11]

Policy dividends are made available annually on the anniversary date of the participating life insurance contract. The dividend may be taken in one of four basic forms at the option of the policyholder: (1) in cash; (2) applied toward the payment of the next premium under the contract; (3) applied to the purchase of a paid-up addition to the policy; or (4) deposited with the company to accumulate at interest. In addition, many insurance companies offer a fifth option, under which all or a part of the dividend is used to buy one-year term insurance.

The first two options amount to a straight refund of the premium overcharge. The other dividend options have certain savings features of importance to policyholders.

Under the option to purchase paid-up additions, the dividend is applied as a net single premium at the insured's attained age to purchase as much paid-up insurance as possible payable under the same conditions as the basic policy.[12] It is particularly significant that paid-up additions typically are available at *net rates* (net of expenses) thereby leading to possible savings for the policyholder through proportionally lower costs of adding to the combined protection and savings elements. Usually the paid-up additions are participating as well.

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[10] The additional premium dollars collected from participating policyholders provide additional margins in case the cost of insurance coverage proves to be higher than anticipated. Whether the experience of the company is better or worse than anticipated, the policy dividend mechanism provides a means by which policyholders ultimately may pay the actual costs of coverage.

[11] Policy dividends provide the mechanism for distributing to policyholders the excess of actual over assumed investment earnings of the insurance company. However, policy dividends should be viewed as a return of premiums paid. Policy dividends, therefore, are not taxable as income for federal income tax purposes. However, the interest earned on dividends left on deposit with an insurance company are taxable as income for federal income tax purposes.

[12] The right to use dividends to purchase paid-up additions usually is granted only under permanent insurance contracts.

The fourth option provides that policy dividends may be left to accumulate with the company at a stipulated minimum rate of interest. In addition, dividend deposits participate in the excess interest earnings of the company. In the event of death, the accumulated deposits plus interest are added to the policy proceeds. If the contract is surrendered, the deposits plus interest are added to the surrender value and may also be added to the face amount extended under the paid-up term insurance option.

The "fifth dividend option," also known as the "one-year term dividend option," is a relatively new feature. The dividends are used to purchase one-year term insurance usually equal to the cash value of the policy, and any excess dividend is accumulated at interest for eventual use to purchase term insurance when term rates have risen above the level of dividends.

One final word about policy dividends. Many contracts permit paid-up additions or accumulated dividend deposits to be used to convert premium paying insurance into fully paid insurance.

OTHER FACTORS.

The savings feature in permanent life insurance also gives rise to the availability of *surrender benefits* should the policyholder wish or need to discontinue his insurance coverage. Surrender benefits may be received at the option of the policyholder in one of three forms: (1) cash, (2) paid-up insurance for a reduced amount, and (3) extended term insurance.

An individual who fails to pay a premium within the given period and therefore permits his insurance to lapse, may *reinstate* the policy under certain conditions. One advantage for reinstating a lapsed contract rather than applying for coverage under a new contract is that the older insurance policy may contain settlement options and other provisions with more favorable rates or benefits than in current contracts.

Many insurance contracts contain a valuable provision granting the insured the right, without evidence of insurability, to *convert* the policy to another form, usually to a contract involving a higher premium rate. The economic impact of the savings feature in permanent life insurance is revealed when conversion from term insurance coverage to permanent insurance coverage is being contemplated. Assuming conversion at the attained age of the insured, it is relatively simple to compare the premium for the pure protection coverage, with no cash values at the end of its term, with the higher premium of the permanent insurance coverage. The cash value of the latter at the end of a like period will represent the basic savings element in the permanent life insurance. The annual difference in premiums may be then compared with the savings element to identify the amount that will accumulate on behalf of the insured if he converts to the permanent plan.

Most companies permit the policyholder to *prepay premiums*, either in the form of "premium deposits" or the "premium discount" method of discounting future premiums. In either case, the funds deposited with the company are credited with interest at a stipulated rate. Sometimes companies credit the funds deposited with interest earned by the company in excess of the stipulated rate. In the event of the insured's death, the balance of any premium deposits or discounted advance premium payments are returned to the insured's beneficiaries or his estate in addition to the face of the policy.

For a modest extra premium, the *guaranteed insurability option* is available which permits the holder of a permanent policy, at stated intervals, to purchase specified amounts of additional insurance without evidence of insurability. The additional insurance may be any permanent life insurance contract issued by the company. The new insurance is issued at standard rates on the basis of the insured's attained age when the option is exercised. Typically, term insurance cannot be so obtained from the companies offering the guaranteed insurability option, and disability benefits (discussed below) are available only with the consent of the company.[13]

The *waiver of premium* benefit, a form of disability insurance, is offered by virtually all companies in connection with the life insurance contracts they issue. The waiver of premium provision becomes operative whenever the insured becomes totally and permanently disabled as defined in the policy. He then becomes entitled to have waived any premium falling due after the disability commences.[14] Of particular significance in connection with the savings aspect of life insurance is the fact that the waiver of premium does not affect any other provision of the policy. Under permanent insurance contracts, therefore, cash values would continue to increase, dividends would be payable and even policy loan privileges would continue in accordance with the original contract.

For an extra premium charge, some life insurance companies offer *disability income* coverage in connection with the life insurance contracts. The coverage is intended to provide regular cash

[13] For a more complete discussion, *see* S. HUEBNER AND K. BLACK, JR., LIFE INSURANCE 466-67 (1964).
[14] D. MCGILL, LIFE INSURANCE 738-39 (1966).

income, usually monthly, to the insured person who becomes totally and permanently disabled before a specific age as defined in the provision. This form of disability coverage in connection with life insurance usually is available only under certain life insurance contracts containing the cash value savings element.

Another significant aspect of life insurance is the unique *protection against creditors* it affords. Protection against the claims of the insured's creditors, or the beneficiary's creditors, or both are available through the life insurance contract itself or through state legislation.[15]

LIFE INSURANCE COMPARED TO OTHER SAVINGS AND INVESTMENT MEDIA

It is generally agreed that no one financial instrument or institution can attain all savings and investment objectives successfully. Therefore, it is imperative that the individual consider the use of his funds in terms of his objectives. Many individuals and families have several objectives and should diversify their funds accordingly, choosing several rather than one form of savings or investment.[16]

NATURE OF SAVINGS AND INVESTMENT OBJECTIVES.

Safety of principal, yield (rate of return or income, and capital gains or appreciation), and liquidity (ready availability of funds) are three basic and generally recognized savings and investment objectives. In addition, individuals should weigh the degree of financial managerial responsibility they intend to retain and the degree of financial flexibility that is most desirable for them. Each of these objectives will be considered below in reference to fixed dollar savings instruments and variable dollar investment instruments.

Most individuals must generate a fund for savings out of income earned over time. Consequently, it is appropriate as a prelude to the analysis of financial objectives to consider alternative savings

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15 *Id.* at 624-35.

16 Two authorities, for example, have observed, "There are various savings instruments to meet different objectives. If you want a high return on your savings, you cannot expect safety of principal. If you want safety of principal, you cannot expect the same instrument to provide a good hedge against inflation. Under most conditions, if you want liquidity, you cannot hope for long-term growth. If you want certainty of continued income, you cannot expect a high yield." J. COHEN and A. HANSON, PERSONAL FINANCE 215 (1964).

and investment instruments in terms of their effect on the accumulation of principal.

ACCUMULATION OF PRINCIPAL.

Unfortunately, not all individuals who plan to save systematically display the necessary economic self-discipline to forgo today's goods and services in exchange for the accumulation of savings. Plans to encourage systematic savings have been developed by virtually all savings and investment institutions. Series E Savings Bonds, for example, may be purchased on the payroll savings plan by authorizing the employer to make regular deductions. Christmas clubs, vacation clubs, and similar programs have been established by commercial banks to encourage regular savings. Some mutual fund plans ("contractuals") provide for periodic contributions by the individual over a period of years. Investment clubs often stipulate that members will contribute a specific amount monthly to be added to a common fund for periodic investing. The Monthly Investment Plan, developed by member firms of the New York Stock Exchange, provides for the application of from $40 every three months to $1,000 each month toward the purchase of any one listed stock.

While these systematic savings plans are commendable in theory, they do not *require* rigid savings patterns. They have not resulted in allaying the tendency for persons to discontinue the savings plans or fail to contribute funds according to the appropriate timetables.

Contrary to many savings media, life insurance seems to have special advantages in functioning as a semi-compulsory form of savings. One writer observes:

> The purchase of permanent life insurance lends itself to a regular, consistent savings plan. The plan fits the psychological needs of most savers for a regular savings plan with a semi-compulsory flavor. As premiums come due, they are looked upon as any other bill and are paid more or less automatically. Where the saver might well omit making a monthly deposit in a savings bank, he thinks twice before permitting his life insurance policy to lapse. The policy is looked upon as more than just a savings medium, and indeed it is.[17]

The combination of the protection and savings elements in life insurance tends to encourage systematic personal savings. This is reflected in the remarkable consistency of life insurance premium payments, even during depression times. Except for a 4.2 percent

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[17] M. GREENE, RISK AND INSURANCE 580 (1962).

decline in 1932 and a 5.3 percent decline in 1933, the premium income of life insurance companies has increased every year since 1911.[18]

LIFE INSURANCE AND FIXED DOLLAR SAVINGS INSTRUMENTS.

Savings may be defined as, "the allocation from current income of certain assets to some accumulation medium."[19] These motives are among those which give rise to savings:

(1) the desire to have funds available for emergencies
(2) the desire to have funds for near-term purchases
(3) the desire to accumulate a sizeable sum for an intermediate-term need
(4) the desire to provide an estate for heirs or beneficiaries
(5) the necessity to have a means for supplementing a retirement income or to provide for old age.[20]

The first and second motives suggest the need for safety of principal and high liquidity to meet short-term needs. The savings that are gathered for the third, fourth, and fifth motives supply the funds that should be used in a long run savings and investment program.

The accumulation media recommended by virtually all financial advisors to fulfill emergency or near-term purchase needs are fixed dollar savings instruments, in which the face amount of the principal is guaranteed and the income or interest earned from the savings is specified. Since the principal is guaranteed, there is no element of appreciation or depreciation (capital gains or losses). Among these "fixed dollar" savings instruments are permanent life insurance, U.S. savings bonds, savings accounts in commercial or mutual savings banks, and deposits in savings and loan associations. These fixed dollar savings instruments are characterized by excellent safety of principal and liquidity. The rate of return varies among them, but tends to be stable for each. None of these fixed dollar savings instruments offer the chance for long-term appreciation or depreciation.

Many persons appear to make use of their life insurance savings to help cover temporary emergencies and to complete sizeable near-term purchases. The cash values in the contract may be borrowed on short notice at a guaranteed interest rate (usually 5 percent). The reason for the interest charge to the policyholder is that the insurance company *continues* to credit the contract with accumu-

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[18] INSTITUTE OF LIFE INSURANCE, LIFE INSURANCE FACT BOOK 54 (1961).
[19] W. RODDA and E. NELSON, MANAGING PERSONAL FINANCES 69 (1965).
[20] *Id.* at 70.

lations of interest even though part or all the savings may have been withdrawn for the saver's temporary use. That is, the savings fund goes on working for the policyholder while he uses it for other purposes. The only way this is possible is for the company to charge interest to make up for the time when the funds have been borrowed.

It should be noted that the flexibility of the policy loan procedure compares very favorably with other savings instruments. Whereas the fixed dollar funds for near-term use are also available on relatively short notice by withdrawing the savings, the very process of withdrawing discontinues the income-earning process in fixed dollar media other than life insurance. In fact, the penalty for immediate withdrawal of deposited savings may operate to reduce the effective paper interest that had been accumulating on the assumption of long-term savings.[21]

Although it is well known that life insurance is one of the safest savings media available (only government bonds could be said to be safer), and many individuals have recognized the liquidity and savings flexibility of life insurance, fewer persons are aware of the relatively attractive effective rate of return from the life insurance savings element. This is because the combination of the protection element and savings element in one contract tends to complicate the measurement of yield. The effective rate of return on cash values is greater than the guaranteed rate specified in the contract for two major reasons, one which presumes the purchase of insurance protection and another which does not:

(1) The protection element in life insurance, discussed previously, costs considerably less in permanent insurance than when it is purchased separately on a temporary basis. Consequently, a comparison could be made between the premium cost of temporary protection in any given period and the return on the premium dollar paid for permanent protection over and above the expenditure for temporary protection. One noted author concluded that the effective return on a whole life policy may be from 4.8 percent to 6.37 percent, depending on the age of the insured individual and the length of the period under consideration.[22]

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[21] Savings bonds and short-term certificates of deposit, for example, may have a much lower effective return on funds invested for a period less than the period specified in the bond or note.

[22] A. LINTON, *Life Insurance As An Investment*, LIFE AND HEALTH INSURANCE HANDBOOK 242 (1964). One writer has identified several variables, especially the selection of companies analyzed by Linton, that should be used to qualify Linton's conclusions before they are applied to any

(2) Unlike most other savings instruments discussed above, the interest earned by the accumulating life insurance cash value savings element is *not currently taxable* for federal income tax purposes. Therefore, the interest rates referred to above are *net of federal income taxes.*[23] Depending on the income tax bracket of the individual, the return on alternative savings instruments necessarily must be much higher to equal the *net* return available through permanent life insurance. (See Table 1).

TABLE 1

Investment Return Required to Equate With Increasing Life Insurance Cash Values—Policies Purchased at Selected Ages

	Return Required	
Age	Net	Gross: 50 Percent Income Tax Bracket
25	4.80%	9.60%*
35	4.78	9.56*
45	5.17	10.35
55	6.37	12.74

* On each of the policies issued at ages 25 and 35, the cash value at the end of the 20-year period is greater than the cost of the policy over the same period. Therefore, if the policy were not continued but surrendered for cash, there would be a taxable gain. Taking this into account for a policyholder in the 50 percent bracket, the required returns for policies issued at ages 25 and 35 become 8.80 percent and 9.16 percent respectively.[24]

Another author, using a mathematical model for determining the rate of return in life insurance policies, compared the charges for the protection element in a straight life contract and a 10-year term contract. Under his assumption, the savings element of the permanent insurance contract yielded approximately 4.4 percent *net* over a ten-year period.[25] Assuming a 20 percent income tax bracket, the effective rate of return on alternative savings must

specific contract at a particular company. BELTH, *The Rate of Return on the Savings Elements in Cash-Value Life Insurance*, JOURNAL OF RISK AND INSURANCE 569-81 (1968).

23 Except for proceeds paid in the case of death, most of the earnings on the reserve of a life insurance contract are eventually taxed to the insured but usually at a time when he is in a lower tax bracket. *See* D. MCGILL, LIFE INSURANCE 56 (1966).

24 A. LINTON, *Life Insurance As An Investment*, LIFE AND HEALTH INSURANCE HANDBOOK 242 (1964).

25 S. SCHWARZSCHILD, *A Model for Determining the Rate of Return on Investment in Life Insurance Policies*, JOURNAL OF RISK AND INSURANCE 435-44 (1967). For other approaches of measuring the rate of the savings element in life insurance, *see* R. FERRARI and H. DENENBERG, LIFE INSURANCE AND/OR MUTUAL FUNDS (1967) and R. FERRARI, *Investment Life Insurance Versus Term Insurance and Separate Investment*, JOURNAL OF RISK AND INSURANCE 181-98 (1968).

exceed 5 percent to be comparable. Assuming a 50 percent tax bracket, a comparable rate would exceed 8 percent.

Table 2 presents the average annual yield on selected types of fixed dollar instruments in 1967, all of which would be taxable as ordinary income.

TABLE 2
Average Annual Yield on Selected Types of Savings[26]

Year	Savings Accounts in Savings Associations	Savings Deposits in Mutual Savings Banks	Time and Savings Deposits in Commercial Banks	United States Government Bonds
1955	2.9%	2.6%	1.4%	2.8%
1960	3.86	3.47	2.56	4.01
1965	4.23	4.13	3.74	4.21
1967	4.63	4.80	4.27	4.85

It is clear that the effective rate of return on the savings element in life insurance is relatively greater than many individuals may have realized. Considering safety of principal, liquidity and rate of return for straight life insurance for example, the combination of savings and protection is so attractive that the burden of proof for determining the most appropriate savings motives is clearly on the other fixed dollar savings media.[27]

LIFE INSURANCE AND VARIABLE DOLLAR INVESTMENTS.

The principal difference between "investing" and saving may be found in the priorities individuals place on the fundamental objectives mentioned earlier. Investing suggests a longer term for accumulation and a relatively high priority on growth of capital.[28] Income, liquidity and safety of principal are important, though less so.[29]

[26] UNITED STATES SAVINGS & LOAN LEAGUE, SAVINGS AND LOAN FACT BOOK 17 (1968).

[27] Caution should be exercised in comparing term insurance premium rates with the protection costs of permanent insurance in the same company. Conceivably, the differential savings could appear greater because the term insurance premium rates are inordinately high for that particular insurer. A better comparison would relate an average of term premium rates among various insurers to develop the amount and rate of return of the differential savings element in permanent life insurance. S. SCHWARZCHILD, *A Model for Determining the Rate of Return on Investment in Life Insurance Policies*, JOURNAL OF RISK AND INSURANCE 24 (1967). For a discussion of the elements in life insurance related to premiums, *see* J. BELTH, *The Relationship between Benefits and Premiums in Life Insurance*, JOURNAL OF RISK AND INSURANCE 19-39 (1939).

[28] E. WILLET, *Personal Finance* 391 (1964).

[29] "An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not

Nevertheless, there is evidence to indicate that safety of principal ranks high as a relevant factor among those who are investing. Table 3 shows that individuals at most income levels tend to regard safety of principal as the most important factor. This emphasis on investment safety as well as liquidity may help to account for the fact that in 1967, a total of 60 percent of American families with incomes of $15,000 or more had more than $6,000 in their bank savings accounts and 20 percent had $1,000 or more in government bonds.[30]

Those individuals with an eye toward current income from investments may attempt to adjust their savings portfolios with variations in interest rates:[31]

> Attracted by escalating interest rates which were driven upward by a tight monetary policy, savers and investors in 1966 moved their money out of depository-type savings into direct investments. As a result, the net growth in savings balances at associations sank to a low $3.7 billion, 68.8% below the $11 billion gain achieved just three years earlier.
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> A complete turnabout occurred in 1967, when the money market eased and short-term interest rates fell. Savings gains at associations responded quickly by climbing to a near historic high of about $10.7 billion—only $300 million less than the record gain in 1963. Thus, one of the best years for savings followed one of the poorest.

TABLE 3

Importance of Four Factors Relevant to Investment Management Among High-Income Families

(Percentage distribution of family units having $2500 or more in savings, investments, or reserve funds)

Importance in handling investments	High rate of return: All income groups	High rate of return: Income $10,000 & over	Safety: All income groups	Safety: Income $10,000 & over	Liquidity: All income groups	Liquidity: Income $10,000 & over	Capital gains: All income groups	Capital gains: Income $10,000 & over
Very important	28	28	60	63	20	15	26	36
Somewhat important	28	21	23	20	32	30	23	26
Not too important	36	45	9	9	38	45	39	29
Not ascertained	8	6	8	8	10	10	12	9
Total	100	100	100	100	100	100	100	100
Number of families	392	156	392	156	392	156	392	156

meeting these requirements are speculative. This is an extremely conservative definition of investment and speculation. A more common practice is to say that you are investing when you have a specific objective, such as growth, income, or safety, but that you are speculating if your only objective is to make a large quick profit." *Id.* at 396.

30 G. KATONA, *et al*, v967 SURVEY OF CONSUMER FINANCES 123, 128 (1968).

31 UNITED STATES SAVINGS & LOAN LEAGUE, SAVINGS & LOAN FACT BOOF 63 (1968).

The questions were: "Here are some of the things people tell us are important to them in managing their investments. Would you tell me which of them is very important for you and which is not too important? How about high rate of return (interest, dividends, profits)? How about safety, absence of risk? How about liquidity, ease in cashing? How about capital gains, an increase in market value over time?"[32]

In spite of the strong desire for safety of principal and rate of return, more and more individuals are seeking to hedge the inflationary trend by investing in stocks or mutual funds that presumably will appreciate in value as prices and the cost of living rises.[33] Fourteen million families owned common stock in 1967.[34] Nearly 40 percent of the families with incomes of $15,000 or more held stock valued at $5,000 or more. Mutual funds have grown enormously in the past decade and a total of $44.7 billion was invested in mutual funds in 1967.[35]

Life insurance is not a variable dollar savings medium and therefore is not susceptible to market appreciation or depreciation. While it is true that the policyowner "creates an estate by the stroke of a pen" when he purchases life insurance, the resulting proceeds for the estate arise from the protection element, the fixed dollar savings element, or a combination of both. Therefore, any excess of proceeds above cumulative net premiums paid to the company is created through the pooling of mortality experience and the performance of the company as it invested the pooled fixed-dollar savings.

Interestingly, were it not for the unique combination of protection and savings in life insurance, there would be little need to consider life insurance as more than another fixed dollar savings alternative to variable dollar investing. Yet, by including permanent protection for the whole of life, life insurance and its attendant savings element become a primary long-term ingredient in the economic lives of families.[36]

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32 G. KATONA, *et al*, 1964 SURVEY OF CONSUMER FINANCES 118 (1965).

33 For an incisive treatment, written more than a decade ago, of the role of life insurance in personal savings and investment, *see* D. Gregg, *Are Fixed-Dollar Investments Becoming Obsolete?*, C.L.U. JOURNAL 67-73 (1959).

34 G. KATONA, *et al*, 1967 SURVEY OF CONSUMER FINANCES 121, 129 (1967). This figure is in accordance with the findings by the New York Stock Exchange that about 22 million individuals owned stock at that time.

35 ARTHUR WIESENBERGER SERVICES, INVESTMENT COMPANIES, MUTUAL FUNDS AND OTHER TYPES, 1968 EDITION, 12 (1968).

36 One of the interesting uses of whole life insurance is found in the variable deposit concept (also known generally as minimum-deposit plan). A description of this concept will provide an interesting second look at the relationship of the protection and savings element in whole life insurance.

To the extent that individuals elect to satisfy medium and long term economic objectives with less volatile fixed dollar savings, life insurance ranks as a prudent and highly competitive alternative. We have already noted the high degree of safety and liquidity that life insurance enjoys. In addition, we have seen that whole life insurance may have an excellent effective rate of return on cash values that is virtually unequalled among fixed dollar savings institutions in the United States.

In addition, there is an advantage connected with life insurance that arises out of the *settlement options* referred to previously. The interest income that accumulates over the life of the insurance contract is taxed under favorable annuity-taxation rules. The interest income from the bank would be taxable at ordinary federal income tax rates. The annuity rate may be more favorable in existing life insurance contracts than the person could expect to receive if he decided at retirement to purchase an immediate annuity with funds accumulated elsewhere.

Typically, the *dividends* from participating life insurance are used to reduce the next annual premium or are received in cash. If used to buy paid-up additions, the policyowner can keep adding to his protection and savings "holdings," receiving these accumulating benefits in addition to the values in his basic permanent policy. Dividends left on deposit with the insurance company will probably earn about 4 percent interest in 1969, depending on the interest earnings of individual companies.[37] These accumulations

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The net annual premium paid for a whole life contract by the policyowner is equal to the gross premium less the dividend each year. As the cash values are applied each year (there may be little or no cash value in the first and second year), they are *borrowed* by the policyowner to pay the next premium. This procedure greatly reduces the policyowner's annual cash outlay for coverage because the result is that the policyowner pays the net premium minus the increase in cash value plus interest at 5 percent on the paper loan. It is evident that the variable deposit concept may result in little or no accumulation of cash values. Thus, the policyowner is buying a permanent life insurance contract with protection dollars and obtaining the option to replenish his cash values at any time. At least one insurance authority notes that the variable deposit procedure leads most of his clients to repay the paper loan of the cash values by making deposits. The policyowners make deposits because they can see that such deposits actually earn approximately 5 percent tax-deferred accumulating interest under properly established plans. Within specified limits, the interest on most policy loans may be deductible for federal income tax purposes. E. BUDNITZ, JR., THE MAGIC OF THE WHOLE LIFE CONTRACT 56-57 (1969).

[37] Earnings from dividends left on deposit are taxable as ordinary income.

may be distributed to the policyholder or his beneficiary at retirement in the form of cash or an annuity. Of course the dividends may be applied to buy additional units of annual term insurance, thereby greatly increasing the protection element of the policyowner's insurance program.

The flexibility of the whole life contract is such that it is difficult to justify the use of the option to surrender.[38] If a contract has been surrendered, the policyowner may be far better off to *reinstate* the original contract than to purchase a new one. This will depend on the relative value of the original and new contract. To reinstate, the insured must provide evidence of insurability and the financial adjustment must be made to put the original policy in the same financial state that would exist if the policy had never been discontinued.

If the policyowner should want to *convert* his original contract to one providing accelerated savings, he has that option with virtually all companies. For investors who seek to balance their savings and investments and hedge their "appreciation" dollars with fixed-dollar savings, permanent life insurance offers a flexible and highly competitive vehicle.

EQUITY-BASED INSURANCE

Inflationary pressures, increasing levels of discretionary income, and other factors, have encouraged larger proportions of American families to place more of their savings into investments whose values may appreciate with rising costs and prices. In response to this trend, a growing number of life insurance companies have broadened their financial services. In addition to the traditional fixed-dollar savings instruments discussed above, many life insurance companies offer equity based products such as variable annuities and mutual funds.

VARIABLE ANNUITIES.

Designed to provide stable purchasing power, variable annuities have been developed to provide benefits adjusted to changes in the market value of the assets (typically common stocks) in which the annuity reserves are invested. In the long run, it is theorized, the market value of a representative group of common stocks will tend to conform to changes in the consumer price level.

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[38] As a general rule, it is not economical for policyowners to surrender a current policy to purchase another. "Replacement" results in a double payment of the sales and administrative costs incurred in putting the plan on the books of the insurance company.

Variable annuities combine equity investing with actuarial science to provide retirement programs for a lifetime that tend to reflect the costs of living. More and more life insurance companies are offering group variable annuity contracts and at least five of the ten largest companies (in terms of assets) will be offering individual variable annuity contracts by 1970.[39]

A growing number of life insurance authorities feel that some kind of protection against inflation is needed by annuitants and believe that a common stock investment program administered by a life insurance company is the best approach yet developed to meet the need.

MUTUAL FUNDS.

One way to achieve diversification and investment guidance in making equity investments is to purchase common shares in an investment company. A mutual fund is one kind of investment company; it stands ready to buy or sell its common shares continually, from or to the buying public.

By becoming holding companies, many insurance companies have developed the flexibility to diversify financial services and offer mutual funds to clients. By the end of 1968, eight insurance companies had acquired 28 mutual funds with assets totaling $2.6 billion. Eight companies had initiated 13 new mutual funds with assets of $58 million.[40] It is likely that more insurance companies will add a variety of mutual funds to their list of financial services.

THE FUTURE OF LIFE INSURANCE AS A SAVINGS VEHICLE

Most individuals place their accumulated funds in some combination of two types of financial media: fixed dollar savings and variable dollar investment. As inflation has become more a way of life and discretionary incomes have increased, relatively more persons have been placing larger portions of their funds in the latter.

Fixed dollar savings typically are applied to "debt" investments, such as bank accounts, bonds or cash value life insurance that represent the debt of the government or of corporations. Such savings are characterized by safety of principal, liquidity and fixed return, but no capital appreciation. Variable dollar investments or equities are usually ownership investments of either stock or real

[39] Sheehan, *Life Insurance's Almighty Leap into Equities*, FORTUNE 142-80 (Oct. 1968).

[40] *Insurance Giants Move Into Funds*, BUSINESS WEEK 114-18 (Mar. 15, (1969).

estate. Such investments are characterized by greater risk, some return (such as dividends from stocks or rental incomes from real estate) and the possibility of capital appreciation or depreciation.

Virtually all financial advisors recommend a comprehensive program of life insurance to provide protection for the income stream of individuals during their productive lifetime. The unique combination of protection and savings in permanent life insurance has made it a fixed dollar savings vehicle that millions have considered indispensible. If the whole life insurance contract is clearly understood, it will continue to be one of the most attractive and flexible instruments for personal savings available.

The versatility of the savings element in permanent insurance and the combination of safety, liquidity and tax-deferred return recommend life insurance as an appropriate depository for the fixed-dollar portion of many personal savings and investment portfolios. It is likely that discerning investors will take advantage of the insurance savings technique in the future.

Finally, it is becoming increasingly clear that life insurance and equity products are compatible financial instruments. Life insurance companies will probably continue to broaden their financial services to include a wide range of savings and investment programs, and life insurance will continue to hold an even stronger place of primary importance as a savings vehicle for American families.