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How Does Cash Value in a Life Insurance Policy Really Work?

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When you own cash value life insurance, your premium payments are allocated three ways. First, a portion of each premium pays for the actual insurance costs. Like term insurance, a specific cost is associated with the policy's death benefit, based on your age, health, and other underwriting criteria. Second, a portion pays for the insurance company's operating costs and profits. The remainder goes toward the policy's cash value.

What is cash value?

Term insurance charges an increasing premium (annually or in bands) to reflect the fact that the insured is aging and, each year, more likely to die. Cash value life insurance has a level premium that is larger than necessary in the early years of the policy to offset the increased costs of insuring the individual in the later years. This excess premium is invested and kept in an account known as the cash value account. In the event that you surrender the policy before death, this excess premium and its earnings are returned to you.

Cash value, by any other name...

Since cash value life insurance, also known as permanent life insurance, comes in many product varieties, people often get confused. Whole life, variable life, universal life, and variable universal life are among the most common cash value life insurance products found in today's marketplace. All of these policies operate in much the same fashion. For the purposes of this discussion, where they differ is in how the cash value is invested.

How cash value grows

We've already said that a portion of every premium payment goes toward your policy's cash value. So, it's easy to understand that the cash value of a policy will grow as additional premiums are made. The cash value of a policy may also grow because of earnings.

Whole life policies offer "guaranteed" cash value accounts that increase based on a formula determined by the insurance company. (Guarantees are subject to the claims-paying ability of the insurer.) Universal life policies offer cash value accounts that track current interest rates. Variable life policies allow their owners to invest in accounts that operate like mutual funds, meaning that their cash value accounts can be invested in bond, stock, and other funds, known as subaccounts. The cash value will grow or decline based on the performance of the underlying subaccounts.

The amount of your premium that goes toward cash value decreases over time

Over time, the amount that you contribute from each premium toward cash value decreases, because the cost of insuring you increases every year. The pattern is similar to what happens with a mortgage. In the early years of a home loan, you pay mostly interest; in the later years, you pay mostly principal.

Let's take a very simplified example and assume you're paying a $25-per-month premium for cash value insurance. In the early years of the policy, it costs relatively little to insure you--say $5 a month--because your odds of dying prematurely are low. In the later years of the policy, the cost to insure you is much greater--say $20 a month--because the insurance company knows that the odds are much greater that you will die as you grow older.

The cash value part of your premium behaves just the opposite of the insurance component. In the early years of the policy, your cash value can grow quickly since more of your premium is available for cash value. In the later years, the cost of insurance consumes more of your premium, so less is left over for cash value.

The role of cash value

You probably understand that, as you grow older, the cost of insuring your life gets more expensive. That's why a term insurance policy will generally cost you a great deal more at age 50 than at age 30. With cash value insurance, the insurance company looks ahead and factors in the increasing costs of insuring you as you grow older. The insurance company calculates a premium amount that will cover the anticipated increase in insuring your life. Cash value plays a central role in this calculation.

As the cash value of your policy grows, the amount that the insurance company needs to pay out as a pure death benefit decreases. That's because part of the policy payout upon your death comes from the cash value of the policy. The larger the cash value, the greater the percentage of the policy that can come from the cash value. In effect, to avoid increasing premiums as you get older, you're setting aside funds now to make up the difference.

An example

Although grossly oversimplified, cash value works something like this:

Assume that a policy will pay $1 million upon your death. You make monthly premium payments, and each month a portion of your premium is applied to the cash value of the policy. After 30 years, the cash value of the policy is equal to $500,000. Since the policy will pay $1 million upon your death, and the policy already has a cash value of $500,000, the insurance cost needs to cover only the remaining $500,000.

Ten years later, the cash value is equal to $750,000. Because you're 40 years older than you were when you bought the policy, the pure insurance cost of insuring your life is significantly higher now. However, because of the cash value, your policy is really insuring only $250,000. The rest of your policy's payout will come from cash value.

Note: *Variable life insurance policies are offered by prospectus, which you can obtain from your financial professional or the insurance company issuing the policy. The prospectus contains detailed information about investment objectives, risks, charges, and expenses. You should read the prospectus and consider this information carefully before purchasing a variable life insurance policy.*

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