[The dangers of letting your life insurance lapse]

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It's one of the life insurance industry's best-kept secrets – a great number of life insurance policies in the U.S. tend to lapse, meaning the coverage runs out and is not available if you die. Some studies claim as many as 80 percent of policies will lapse before a payout is due.

However, the reasons behind this phenomenon are far more complicated and avoidable than you may realize.

Typically, life insurance policies have a 30-day grace period for paying your premium. If you forget to pay your premium within that time, your policy will be canceled. That can be disastrous for an older person who has health problems that he didn't have when he initially bought the policy.

Another major reason for lapsing policies is that people buy more coverage than they can afford.

"People don't buy the proper type of life insurance for their specific needs and budgets," says Tony Steuer, director of financial preparedness at United Policyholders, a nonprofit consumer advocacy group.

To decrease the annual number of lapsing policies, "people need to understand all the options available and determine their needs to help make better choices," Steuer says.

Term life insurance

According to the nonprofit Insurance Information Institute,term life insurance is the simplest and cheapest life insurance product available. It pays only if death occurs during the term of the policy, which is usually one to 30 years. In 2008, about half of all U.S. life insurance policies were term life.

A study by the Society of Actuaries found that the total lapse rate for term insurance between 2004 and

2005 was 6.6 percent.

But what many people fail to realize is that all term life policies lapse unless a death benefit is paid, says Catherine Theroux, a spokeswoman for trade group LIMRA.

So let’s say you buy a 30-year term policy when you’re 40 years old. If you live to be older than 70, the term of that policy ends.

According to Edward Graves, associate professor of insurance at The American College in Pennsylvania, consumers usually buy term policies to cover a temporary financial need, such as repayment of a mortgage in case they die prematurely. When the financial need no longer exists, the coverage either is dropped or expires.

If your term policy is going to lapse, you should consider converting it into a whole life insurance policy, which can be done by calling your insurance agent. This will avoid wasting all of the premium dollars you’ve paid.

Whole life insurance

Even if you live to 110, whole life pays a death benefit. And this type of policy has been growing in popularity over the years.

About 7.1 million U.S. policies purchased in 2003 were whole life. According to LIMRA, sales of whole life policies have risen from 22 percent of industrywide sales in 2007 to 31 percent in 2011.

According to the 2009 LIMRA report, close to 12 percent of whole life policies lapse in the first year and 10 percent lapse in the second year. These rates are higher than those of term life, Steuer says, because whole life insurance is more financially complex than term.

According to the Insurance Information Institute, traditional whole life policies charge the same premium and pay out the same amount in death benefits throughout the life of the policy. So if you paid $200 a month when you bought your policy 30 years ago, you’re still paying $200 a month today.

The tricky part is that the cost of benefits goes up for the insurance company as the consumer ages, both because of inflation and because the risk of death is greater.

“The insurance company could charge a premium that increases each year, but that would make it impossible for most people to afford life insurance when they’re older,” says Mike Barry, a spokesman for the Insurance Information Institute spokesman.

Instead, insurers charge a higher premium in the policyholder’s younger years than what would be needed to pay claims. The insurer invests that money and uses it to help pay the cost of life insurance for older people.

The perils of universal whole life

Universal whole life insurance combines several stock investments, which protects premiums against the fluctuations of the market. It’s also a primary reason that policies lapse.

Each year, you pay the same premium to your insurance company, and the company invests a portion of that premium in the stock market. The theory is that as you get older, the interest rate returns on that investment will continue to go up and cover the growing expense of your insurance). If this works, your family should be covered when the time comes to pay a death benefit.

The only problem is interest rates don’t always go up; they fluctuate. This can become a serious problem for holders of universal whole life policies.

“No one ever thinks that a life insurance policy can crash the same way an investment does, but it happens all the time,” says Kirk Shamberger, a life insurance expert and analyst with the Vermont-based CK Financial Resources.

Shamberger says that anyone holding a universal whole life insurance policy needs to call his insurer and have it run an “illustration” on the account to age 100. Doing this lets you find out whether the policy will lapse before then.

Preventing lapses

Here are three tips for life insurance policyholders who want to avoid a lapse.

1. Don’t ignore your policy.

Life insurance expert Richard Newman says too many policyholders purchase life insurance, file away the paperwork and never look at it again. “People need to think of the policy as an asset that needs to be reviewed on an ongoing basis,” Newman says.

2. Set up automatic billing.
Sometimes a lapse can occur if even one payment is overlooked. This error can be devastating, as a policyholder might lose a policy that can’t be replaced if his age or health has changed since the initial purchase. “This is easily avoidable,” Florida-based financial adviser Curtis Chambers says. He recommends that policyholders pay their monthly premium through an automatic monthly bank draft.

3. Sell your policy.

If you no longer need or can no longer afford) your life insurance policy, don’t let it lapse, says Frank Darras, a California attorney who specialists in insurance matters. Instead, consider selling it on the open market. You can contact a broker who specializes in what’s called “the secondary insurance market,” where policies are bought and sold at bargain prices. “You can usually sell a policy for between 15 and 30 cents on the dollar,” Darras says.