Life insurance

How much is enough

Term vs. cash-value

Life insurance

- An insurance contract that protects against financial losses resulting from death
  - Part of overall personal risk-management plan
  - Policy is a contract between the insurer and the policy owner
    - Insured person could be the policy owner or another person
    - Beneficiary is person who will receive death benefits
    - Contingent beneficiary is back-up in case first dies before insured
- Why life insurance?
  - Protects survivors and heirs of the deceased
    - Homeownership is safeguarded
      - Mortgage can be paid off
    - College and education plans remain intact
    - Retirement income for surviving spouse

Premiums and your profile

- Actuaries calculate probabilities of death for individuals based on age, health, life-style
  - Premiums charged are based on probabilities
    - 60-year old, chain-smoking race car driver pays a higher premium than a 22-year old aerobics instructing librarian
  - Death rates have declined due to advances in medical treatment

Changing needs

- Need for life insurance changes over a person's life-cycle
  - Near 0 as a kid
  - Low in early years of marriage
    - Burial costs, school and car loans?
  - Big increase with arrival of first kid
  - Decrease as kids become independent
  - Near 0 again at retirement
    - Social security and retirement benefits sufficient?

Income replacement needs

- Obvious lost income
  - Maybe health plan benefits
- Lost household work
  - Hire gardener, maid, child-care facility
- Funeral expenses
  - $5,000 to $10,000
- Debt-repayment
  - Mortgage, cars, consumer loans
- Separate college-expenses of children

Estimating dollar amount of loss

- Income replacement needs
  - $50,000/yr for 25 yrs discounted at 5%
    - $700,000
- Expenses associated with death
  - $5,000 plot, $5,000 coffin, $5,000 funeral
    - $15,000
- Readjustment period needs
  - Spouse stays with kids for 6 months
    - $25,000
- Debt repayment
  - Car loan and credit cards
    - $30,000
- College tuition/expenses
  - $50,000 x 3 kids
    - $150,000
- Minus PV of social security survivor benefits
  - Same 5% discount rate for number of years benefits will be received
    - -$360,000
- Minus employer's group policy
  - Often employer provides this benefit
    - -$50,000

If my math is correct

- ❑Need income of $920,000
- ❑Already have benefits of $410,000
- ❑Need $510,000 in life insurance coverage
- ❑Obviously this is not exact but gives a ballpark figure
- ❑Find a life insurance agent that you trust
  - Some agents work for only one company
  - Independent agents can choose from several companies to get the best-suited policy

Types of life insurance

- ❑**Term insurance**
  - **Pure protection** - pays benefits only if insured person dies within the coverage period
  - Must be renewed for additional periods
- ❑**Cash-value insurance**
  - Pays death benefits plus savings component that provides benefits while insured person is still alive
  - Costs a lot more than term and is NOT a good investment strategy
    - ❑**Historically returns have not matched mutual funds**

Term life insurance

- ❑Issued for 1, 5, 10 or 20 years purely for pay-off at death – premiums rise over time
- ❑New physical required for each renewal
- ❑Premiums rise with each renewal
  - Higher probability of death
- ❑Much, much cheaper than cash-value insurance

Term insurance options

- Guaranteed renewal
  - Protects you from being turned down at renewal
- Level premium term
  - You pay constant premiums over the policy's life
    - Expensive in beginning - cheap at end of policy
- Decreasing term
  - Tries to match your changing insurance needs
- Convertible term
  - You can switch term to cash-value life in early years

Converting term to cash-value

- Must be done in first few years
- Premiums will jump immediately and the savings-investment starts at conversion
  - Or you can fork over a large cash amount to make cash-value retroactive and savings-investment begins when you took out the policy
    - Not a bad idea since your premiums will be based on your age when you originally bought the term policy

Cash-value life insurance

- Pays death benefits plus has a savings element that provide benefits while you're still alive
  - Cash value belongs to owner of policy, not beneficiary
  - Owner gets the cash value out by surrendering the policy
- Permanent insurance as long as you pay the premiums
  - No need to renew or get a new physical

Big premiums

- Premiums on cash-value life are much bigger than for equal coverage of term insurance
  - Portion of premium is for death benefits
  - Remainder is for building the cash value
    - **In early years, much of premium pays agent's commission**
  - Take out a $100,000 policy at age 25
    - Term premium = $120/yr or $10/month
    - Cash-value premium = $840/yr or $70/month
  - Over 40 yrs investment builds to face value
    - Increasing cash value – decreasing term insurance

Increasing cash value decreasing term insurance

- After a few years your cash value has grown to $3,000
  - If you die, beneficiary still gets $100,000
    - But $3,000 is really your money
- If you live long enough value > $100,000
  - All still goes to beneficiary
- Prior to death you can get cash from policy
  - Cash in policy – cancels insurance coverage
  - Borrow from the cash-value
    - Must repay or else amount owed at death is subtracted

"Whole life" life insurance

- Type of cash-value
  - Provides life time insurance but must continue to pay premiums for life
  - AKA
    - Straight life insurance
    - Ordinary life insurance

Interest-sensitive life insurance

- ❑Return on savings portion varies with changes in interest rates and investment returns
  - Developed in response to criticism that people should buy term and invest premium difference in higher yield investment opportunities
  - Still does not fully answer that criticism

Term vs. cash-value??

- ❑Insurance agents recommend cash-value
  - Premiums stay constant over time
    - ❑Don't rise with age and deteriorating health
    - ❑Provides protection for life
    - ❑Includes savings/investment component
    - ❑**Bigger commissions for the sales agent**
- ❑Independent fin planners recommend term
  - Invest premium difference in other securities
    - ❑**Bigger commissions for the sales agent**
- ❑70+% of all new policies are for term insurance

Recommended strategy

- ❑Buy term only when it is needed by your loved ones (usually your kids)
  - Guaranteed renewable term insurance
  - Can't be rejected at renewal for bad health
- ❑**Discipline yourself** to invest difference between cash-value premium and term premium in higher yielding mutual funds
  - In early years most of cash-value premium is not invested – goes toward sales commission