Risk Management

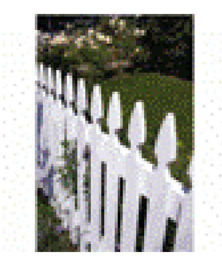
LIFE INSURANCE

Life Insurance

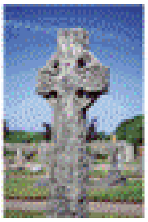
LIFE INSURANCE AS AN ESTATE SUBSTITUTE

 In your twenties and thirties when you are likely to have many dependents and few material assets, life insurance serves as an effective estate substitute. In the event of your premature death, your life insurance would provide economic support to those left behind.

LIFE INSURANCE AS AN ESTATE BUILDER

 In your forties and fifties you probably have already acquired a home and other substantial assets. Now life insurance should be viewed as a savings and investment tool that helps build your growing estate.

LIFE INSURANCE PROVIDES ESTATE LIQUIDITY

 In your sixties and seventies you usually have few dependents and more assets (estate). At your death your spouse will be taken care of by Social Security, pensions and/or other retirement funds. Life insurance, a protection against premature death, will provide liquidity for your estate after your death. A more in-depth discussion of this topic is covered in the workbooks dealing with estate planning and the role of insurance after the insured's death.

KINDS OF LIFE INSURANCE

There are as many kinds of life insurance as the mind of man can conceive. For the sake of brevity we will discuss three arbitrary categories; individually purchased policies, group insurance and government sponsored coverage.

INDIVIDUALLY PURCHASED INSURANCE

Term. This kind of insurance affords the greatest projection for your dollar. Because it is the most inexpensive kind of coverage, young people with limited financial resources often find term insurance meets their short range needs. Term insurance is purchased for a specific period of time. There is no cash value build-up over time; the entire premium goes for protection. It is sometimes used to supplement other policies or when extra protection is desired temporarily. Since no portion of the premium is set aside as savings or investment, it is possible to purchase a high dollar amount of coverage for less than a lower dollar coverage would cost for other types of insurance. Premiums can be paid at a *level* amount over the term of the policy or in *decreasing* amounts if coverage needs decrease over the same period of time.

Whole Life. Whole life insurance, as its name implies, is coverage for the whole life of the insured as opposed to a specific period of time (term). Payments (premiums) do not necessarily have to continue over the life of the policy (which, by the way, corresponds to the life of the insured) but if they do, the policy is referred to as a *straight* or *ordinary life* policy. If premiums are to be paid only until the insured attains a specified age or for a certain number of years, the policy is called a *limited payment* policy. It differs from term insurance in another important way. A portion of the larger premiums is set aside with each payment and becomes a savings account. The build-up of this extra premium keeps compounding interest over time and results in a cash value far beyond what is paid in. Of course the cash value of the policy varies at any given point in time.

Whole life insurance is probably the most popular form of life insurance for those who can afford the premiums because it combines savings with protection.

In the last several years all sorts of policies have arisen with ways of using the savings portion of the premium for investments (variable life policies) or tailoring the size of the premiums to the

desires of the consumer; i.e. allowing smaller payments during anticipated leaner periods of the client's life.
Premiums can be paid monthly, quarterly or any convenient way you and your agent agree upon. The most economical way, if you can do so without significant hardship, is to make annual payments. That way your premium will be compounding interest from the beginning of the year and there will be no service charge. It may also be useful to note that it is less expensive to buy one large policy than several small policies.

Endowment. An endowment policy is another type of savings account. Although it insures against death for a specified period of time rather than for the whole life of the insured, the premiums are higher than term insurance premiums, the extra cost going into the build-up of a cash value. Endowment policies are actually a hybrid of term and whole life insurance.

GROUP POLICIES

Group policies have been mentioned earlier when discussing health and disability insurance. This kind of life insurance has the same characteristics earlier noted in group plans. Premiums are usually lower than individually purchased policies thanks to group rates. When provided by an employer, group life insurance is considered a fringe benefit. Another feature which distinguishes group policies from individual life policies is the fact that evidence of insurability is not required; i.e. there is no necessity for a qualifying medical examination as there is when you apply for an individual life insurance policy.

GOVERNMENT SPONSORED LIFE INSURANCE

Social Security, while not commonly thought of as life insurance, is really just that. It provides benefits to the family of a deceased worker through a formula determined by taking a percentage of what the insured would have received as retirement benefits had he reached age 65. You should familiarize yourself with eligibility requirements and benefits. For more detailed social security information consult the reading list at the end of this chapter.
Another government sponsored life insurance program is SGLI (Servicemen's Group Life Insurance). It provides inexpensive coverage for persons on active duty in one of the services. I would advise anyone with an eligible family member to check with the respective service for more information.

A COMMON RIDER FOR PEOPLE WITH YOUNG FAMILIES

There are many variations of the *family income* life insurance policy or rider. People with young children should discuss with their agent, the desirability of obtaining this special coverage. Basically a policy for a certain amount is purchased to cover the period when the children are dependent. The insurance company is obligated to make payments to the beneficiaries of $10, $15, or $20 for each $1,000 of face amount if the insured should die before the time period is up. For example; if the insured should die four years after purchasing a policy which was written for $70,000 over a 20 year period at $10 per $1,000 the surviving family would get $700 per month for 16 years (20 yr. term minus the four years the insured lived after purchasing the policy) and $70,000 face amount at the end of that time. The coverage combines a basic whole life insurance policy with a term coverage, either decreasing or level depending on the particular variation. It is a popular form of coverage and may provide just the projection you need if you are a young person starting to raise a family. Of course it costs more than term insurance. Your particular financial circumstances must be considered by you and your agent or other professional planner to determine if it should have a place in your financial plan.

DIVIDENDS

Dividends are issued only by *participating* life insurance companies. These companies can be regular stock companies or mutual companies where every policy holder owns a piece of the company; a co-op system. In order to issue a dividend, the company must charge premiums in excess of what is actually distributed to its holders as death benefits. The amount of dividend, if any, is determined on the mortality rate of its presently insured participants as well as on how efficiently the company is managed and how well its investments have done. All mutual life insurance companies are *participating*.

The stock companies that are *not participating* charge a fixed rate for their premiums. The premium is calculated to cover all expenses with no *extra* to be refunded in the form of dividends.

It is not possible to determine in advance which type of policy will be cheapest in any given year. When the dividend of a participating company is small the fixed premium of the non-participating company would save you money. On the other hand, in a year when high dividends are returned to policy holders, the participating company would be your best bet.

WHAT HAPPENS WHEN
YOU STOP MAKING PREMIUMS?

Term life insurance coverage is similar to putting your dime in a dryer at a public laundromat; when the time paid for runs out, the dryer stops. If you want more drying time you put more money in the machine. Under the provisions of term life insurance contracts, when payment stops, the coverage simply terminates. After all, you were only paying for a certain period of coverage.

Whole life coverage with cash value poses a different problem. If for some reason you can no longer continue paying premiums do you lose everything that has been built up over time?

The answer is *no.* A choice that is always open to you is to cancel future protection and take the cash that has accumulated in the policy up to that point in time. A second alternative is to reduce your amount of coverage and replace your former policy with a newer smaller paid-up policy. However, if you still need the full amount of coverage provided by the original insurance policy, you can buy a paid-up term policy instead. Just how long a term you can purchase will be determined by the cash value of the old policy and your age at the time of the conversion.

USING YOUR WHOLE LIFE POLICY
AS A FINANCIAL TOOL

It is always possible to borrow against the cash value of your whole life insurance policy if you should need cash for any reason.

TO MAINTAIN PREMIUMS

It may be wise to include provision for an automatic premium loan in your policy. When a premium is not paid the premium amount is automatically deducted from the cash value. An agreed upon interest rate is charged, usually below market rates. The loan can be paid back at any time, and should be whenever possible, because if it is still outstanding at the insured's death the proceeds due the beneficiaries will be reduced accordingly.

GRACE AND REINSTATEMENT PERIODS

It should be noted that there is usually a thirty-one day grace period which keeps the policy in full force during this time even though the premium is overdue. This is useful to cover inadvertent lapses.

Even when the grace period has ended, the insured generally has three years to reinstate the policy without losing any benefits. The payment of all back premiums is required as well as the ability to show evidence of current insurability.

Why not get a new policy and save all those back premiums? If you had taken out the policy and had been making payments for twelve years before you found yourself unable to continue, you would be (counting the reinstatement period) at least fifteen years older and subject to higher premiums because of your age.

There are numerous other reasons that would make your older policy more desirable than starting again with a new policy. For instance, you don't have to start all over building a cash value from day one; your older policy may have better interest rates, as well as options and other liberal provisions no longer available in a new policy.

COLLATERAL

Beside taking loans against the cash value of the policy, the policy itself may be offered as collateral for a bank or other commercial loan. If the loan amount is not paid back according to the terms of the agreement, the lender becomes the owner of the policy. Of course any person or entity can become owner of a policy insuring the life of a third party as long as he can show an insurable interest. Indeed, this is often advisable, as we shall see when we discuss probate costs in another workbook.

HOW MUCH LIFE INSURANCE
SHOULD YOU PURCHASE?

The worksheet at the end of this chapter will help you make this decision. After the insured's death there are special, continuing and future expenses which must be calculated in dollar terms. The object is to ensure the deceased's family can live in the manner they are used to or could have looked forward to had the deceased not died prematurely.

Because of the constant changes in laws and the uncertainty some people feel about social security, you may want to calculate needs without taking government insurance into consideration. Of course, if all goes well, you will be that much ahead. However, to plan without relying on governmental promises you must be willing to stretch, if need be, to afford the larger premiums necessary for higher coverage. Don't forget to take into consideration other investments and possible inheritances which may make extra dollars available when the kids are ready for college, for example.

Some planners as a rough calculation, suggest you should have life insurance coverage equivalent to five years expenses; that being the time thought necessary for a family to get back on its feet. Unfortunately the determination is not as simple as that. If you are not mathematically inclined, you may need help in figuring future values. Inflation, interest compounding and time must all be figured to determine the amount of insurance that will cover your future needs in terms of future dollars. Your insurance agent or other professional can do the calculations for you once you have gathered the information. After all, that is the purpose of this book and especially the worksheets; to help you gather information for consultation with your professional at a reduced fee.

DESIGNATING BENEFICIARIES CAN BE TRICKY

In most cases the insured is the owner of the policy on his own life and as such reserves the right to appoint and change the beneficiary of the policy at any time up to his own death. We will see in our discussion in the workbook dealing with Estate Planning, why this arrangement is not always desirable. For now, however, let us concentrate on who these beneficiaries might be.

Most often the spouse is designated as beneficiary with children as contingent (alternate) beneficiaries. It is always wise to appoint more than one beneficiary in case the first appointed fails to survive the insured. It is also a good idea to name the beneficiary as well as adding a descriptive phrase. For instance; Mary Smith, if she is my wife at the time of my death." If you simply say, "Mary Smith" or " to my wife", she may have divorced you and is now known as Mary Jones and the wife of another. To you, "my wife" means the person you are married to at the time of your death but legally this is not clear. The law cannot distinguish from those two words whether you refer to the woman you were married to when the policy was written or the woman you may have subsequently married.

 Because of the technical difficulties so often encountered in this area, I would urge you to get an attorney to look over this important aspect of your policy. The small fee involved is nothing compared to the court costs which are a natural product of such ambiguities.

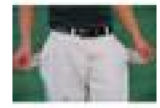
INSURANCE PROCEEDS

There are several alternatives to receiving life insurance proceeds all at once; i.e. in a lump sum.

INCOME FOR LIFE

The income for life option is similar to a normally purchased annuity. Here, in exchange for letting the insurance company have the use of the proceeds due you as beneficiary (as a result of an insured's death) the company promises to provide you with an income for life. If you, as beneficiary, are in poor health this would, of course, be a foolish option. Even if you are relatively young and in excellent health you might be able to make better use of the insurance proceeds yourself. It may be possible to generate a better cash flow through sound investments than what the insurance company is offering. Before opting to receive proceeds under a *for life* plan, weigh the consequences carefully. Once proceeds begin to flow it is too late to make a change. The life income option may take many forms:

Pure life income. The pure life income option provides the highest monthly income. The company simply promises to pay a predetermined amount each month to the beneficiary until his death. Since there is no provision for refunds it is quite possible the insurance company can come out way ahead. If the proceeds are large the monthly income payments must be equally large in order to use up the proceeds during the beneficiary's lifetime. When the beneficiary dies before all the proceeds are paid the insurance company pockets the remainder.  On the other hand, the beneficiary could come out ahead if he could mange to outlive the proceeds. In such an



event the insurance company would have to dip into its own pockets to come up with the promised monthly payments. But don't bet on it; the payments are pre-determined to avoid just such a catastrophe for the insurer!

Refund Option. Under this option, if you choose to receive smaller monthly payments for life, any proceeds remaining at your death would be "refunded" to a predetermined third party; either in a "lump-sum" or in installments.

Minimum Time Period Option. Electing this option would guarantee the beneficiary monthly payments for life (again, smaller payments than under the "pure life income option") but in no case for less than a certain amount of time. If you, as beneficiary, didn't outlive the "certain time" agreed upon, monthly payments would be paid to a designated third party until the specified time period was met. The insurance company would still be ahead here, but not as much as in a pure life income situation where the beneficiary dies before many installments have been made.

Joint and Last Survivor Options. Joint and last survivor options are frequently used to pay endowment policy proceeds. The insured, and perhaps a spouse or other party, are designated beneficiaries and are entitled jointly to the income while both are living with the payments to continue to the survivor on either's death. (Remember, endowment policies, although they have cash build-up, are for a period of time only and not the whole life of the insured.)

OTHER ALTERNATIVES

It is possible to receive the proceeds of an insurance policy other than immediately or throughout one's life:

As a Savings Account. Proceeds may be left with the insurance company with either a limited or unlimited right of withdrawal. The proceeds earn interest at an agreed upon rate with a guaranteed minimum.

Proceed to be Distributed over a Predetermined Period. Under this option the amount of each installment may vary according to fluctuating interest rates (generally with a minimum rate guaranteed) but the period of time over which payments are made is predetermined.

Installment Amount Predetermined. This option states the amount of each installment is predetermined but just how long such payments will continue depends on fluctuating interest, as in the options mentioned above. The installments continue, anyway, until the entire proceeds are exhausted.

SUMMARY

Life insurance has many uses in addition to the protection it provides against the risk of premature death. The type of insurance that is right for you and how much you should buy will depend upon your age and particular circumstances. You should seek professional help in designating your beneficiaries and in determining the amount of coverage you will need to buy presently in order to meet future needs. Be aware of the many settlement options open to you before deciding how the proceeds should be distributed if you are a beneficiary. consult the recommended reading list, especially to find additional information regarding social security. The worksheets will give you a better understanding of how your present coverage compares with your ideal coverage.

May you be lucky enough to find an insurance agent like the one who wrote a policy on a 97-year-old-man. When questioned by his superior the agent replied, "I checked with the computer and statistics show that few men die after age 97!"

Worksheet

OTHER DEATH BENEFITS

1. Income producing assets that would be available to your family (heirs). Include separately owned, jointly owned and community property. Multiply by reasonable after-tax investment rate of return.

$____

2. Property likely to be acquired by family from parents, others or trusts via inheritance or gift. (Estimate amount and give some idea of time period.)

$ ____

3. Other death benefits such as: social security survivorship benefits, annuities, non qualified deferred compensation plan, pension and profit-sharing plans, HR-10, IRA, TSA, or other employer sponsored plans.

$ ____

4. Total the face amounts of all life insurance listed on previous worksheet and subtract any outstanding loans that may be against them.

$____

Sum of all available death benefits = income available to family. (#1 thru #4 above)

$____

6. Compare estimated income available to family with "BUDGET"(found in Section Four Chapter 15 Worksheet) which you should modify to your own specifications. Take into consideration your own unique projections regarding the future inflation rate and any special medical or educational needs that you can foresee for your family.

$____

7. Is your family well provided for in the event of your premature death ?

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Do you need more life insurance or are you over insured?

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Recommended Reading and Web Sites

Life Insurance: A Consumer's Handbook, 2nd eition, by Joseph Belth
How to Save a Fortune on Your Life Insurance, by Barry Kaye
The Life Insurance Conspiracy, by Spielmann & Zelman

Life Insurance, from the Editors of Consumers Reports
How Your Life Insurance Policies Rob You, by Arthur Milton
Life Insurance: How to Get Your Money's Worth by Arnold Geier
Life Insurance: Theory and Practice, by Robert Mehr
Tax Facts on Life Insurance, by Samuel Scoville
How Life Insurance Companies Rob You and What You Can Do About It, -Walter Kenton Jr.
Links below are provided courtesy Wikipedia.org where you will find information also.

- Chart Comparing Different Types of Life Insurance
- Learn About Life Insurance - Insurance Information Institute Life Insurance Learning Center
- The Life and Health Insurance Foundation for Education
- A History of Life Insurance in the United States through World War I
- Illinois Department of Financial & Professional Regulation, Division of Insurance, Slavery Era Policies Report August 2004
- Code of Ethics, National Association of Insurance and Financial Advisors