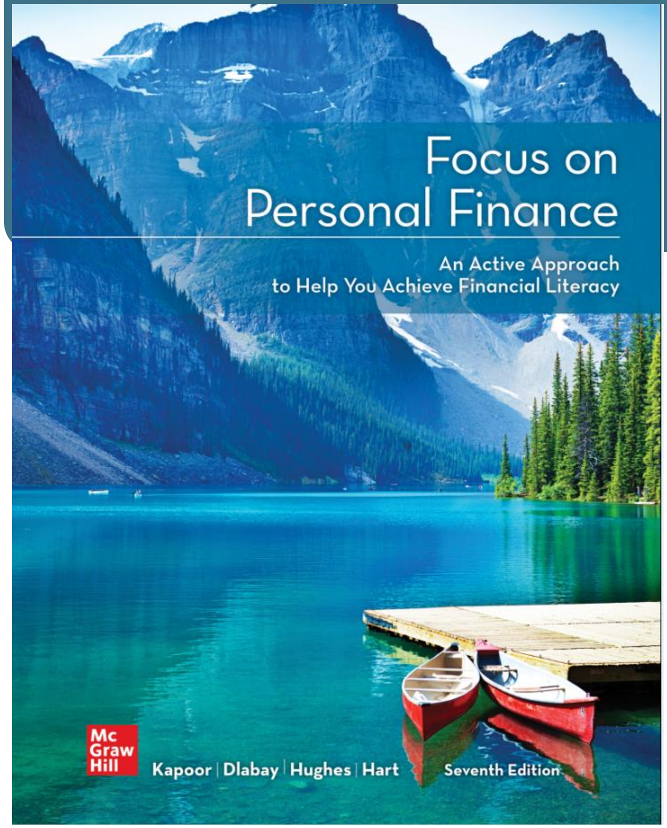


YinYang/Getty Images

Chapter 10

Financial Planning with Life Insurance

Financial Planning with Life Insurance
Chapter Learning Objectives

LO10.1 Define life insurance and determine your life insurance needs.

LO10.2 Distinguish between the types of life insurance companies and analyze various life insurance policies these companies issue.

LO10.3 Select important provisions in life insurance contracts and create a plan to buy life insurance.

LO10.4 Recognize how annuities provide financial security.

What is Life Insurance?
LO10.1

- When you buy life insurance, you're making a contract with the company issuing the policy
  - You agree to pay a certain amount of money—the premium—periodically; in return the company agrees to pay a death benefit, or a stated sum of money upon your death, to your **beneficiary**
  - A **beneficiary** is a person designated to receive something, such as life insurance proceeds, from the insured
- Purchase requires time, research, and careful thought
- Life insurance is one of the most important and expensive purchases you may ever make; therefore, it is important that you budget for this need

The Purpose of Life Insurance

- Most people buy life insurance to protect the people who depend on them from financial losses caused by their death
- Life insurance benefits may be used to:
  - Pay off a home mortgage or other debts at time of death
  - Lump-sum endowments for children
  - Provide an education or income for children
  - Make charitable donations after death
  - Provide a retirement income
  - Accumulate savings
  - Establish a regular income for survivors
  - Set up an estate plan
  - Pay estate and gift taxes

The Principle and Psychology of Life Insurance

- Over the years, insurance companies have compiled tables that show about how long people live
- Using these tables, the company will make a rough guess about a person's life span and charge him or her accordingly
- The sooner a person is likely to die, the higher the premiums he or she will pay

How Long Will You Live?

- Most likely, you will live longer than your ancestors
  - In 1900, an American male's life expectancy was 46.3 years
  - By 2017, life expectancy had risen to 76.1 years for men and 81.1 years for women

EXPECTATION OF LIFE IN YEARS		
Age	**Male**	**Female**
0	76.1	81.1
1	75.6	80.5
5	71.7	76.6
10	66.7	71.6
15	61.8	66.7
20	57.0	61.8
25	52.4	56.9
30	47.8	52.1
35	43.2	47.3
40	38.7	42.6
45	34.2	37.9

EXPECTATION OF LIFE IN YEARS		
Age	**Male**	**Female**
50	29.8	33.4
55	25.6	28.9
60	21.7	24.7
65	18.0	20.6
70	14.5	16.7
75	11.3	13.0
80	8.4	9.8
85	5.9	7.0
90	4.1	4.8
95	2.8	3.2
100	2.0	2.2

Source: Centers for Disease Control and Prevention, National Vital Statistics Report, https://www.cdc.gov/nchs/data/nvsr/nvsr68/nvsr68_07-508.pdf, accessed March 11, 2020.

Do You Need Life Insurance?

- Not everyone needs life insurance
- Before you buy life insurance, you'll have to decide whether you need it at all
- If your death would cause financial hardship for somebody, then life insurance is a wise purchase
  - Households with children usually have the greatest need for life insurance
  - Single people who live alone or with their parents have little or no need for life insurance unless they have a great deal of debt or want to provide for their parents, a friend, a relative, or a charity

Estimating Your Life Insurance Requirements

- There are four general methods for determining the amount of insurance you may need:
  1. **Easy method** is based on the insurance agent's rule of thumb that a "typical family" will need approximately 70 percent of your salary for seven years before they adjust to the financial consequences of your death
     - In other words, multiply your current gross income by 7 (7 years) and 0.70 (70 percent)
  2. **DINK (Dual income, no kids) method** assumes your spouse will continue to work after your death; focuses on ensuring spouse will not be unduly burdened by debts should you die

Estimating Your Life Insurance Requirements (Continued)

3. **"Nonworking" spouse method** requires multiplying the number of years before the youngest child reaches age 18 by $20,000
   - Insurance experts have estimated that extra costs of up to $20,000 a year may be required to replace the services of a homemaker in a family with small children
4. **"Family need" method** incorporates important factors about you and your family, such as Social Security and your liquid assets
   - Thorough estimate of your life insurance needs
   - Don't forget to consider the life insurance you may already have

Types of Life Insurance Companies

- *Stock life insurance companies* are owned by shareholders and generally sell **nonparticipating policies** (i.e., *nonpar policies*), life insurance that does not provide policy dividends
  - About 75 percent of the 841 life insurance companies in the U.S. are stock companies
- *Mutual life insurance companies* are owned by policyholders and specialize in the sale of **participating policies** (i.e., *par policies*), life insurance that provides policy dividends
  - About 25 percent of the 841 life insurance companies in the U.S. are mutual companies

Types of Life Insurance Policies

- Both mutual and stock insurers sell two basic types of life insurance: temporary and permanent
  - *Temporary insurance* can be term, renewable term, convertible term, or decreasing term insurance
  - *Permanent insurance* is known by different names, including whole life, straight life, ordinary life, and cash-value life insurance
    - Permanent insurance can be limited payment, variable, adjustable, or universal life insurance
- Other types of insurance policies – group life and credit life insurance – are generally temporary forms of insurance

Major Types and Subtypes of Life Insurance

Exhibit 10-2

Term (temporary)	Whole, Straight, or Ordinary Life	Other Types
• Renewable term	• Limited payment	• Group life
• Multiyear level term	• Variable life	• Credit life
• Convertible term	• Adjustable life	• Endowment life
• Decreasing term	• Universal life	
• Return of premium		

Types of Life Insurance Policies (Continued)

- **Term insurance** (i.e., *temporary life insurance*) provides protection for a specified period of time
  - Pays a benefit only if you die during the period it covers, which may be 1, 5, 10, or 20 years, or up to age 70
  - Often the best value for customers
- **Renewable term** is an option that allows you, at conclusion of the term, to renew for another term (e.g., 5 years)
- **Multiyear level term** (i.e., *straight term*) guarantees you will pay the same premium for the duration of your policy
- **Conversion term** allows you to change from term to permanent coverage
- **Decreasing term** pays less to the beneficiary as time passes

Types of Life Insurance Policies (Concluded)

- **Return-of-premium term** returns all the premiums if you survive to the end of the policy term
- **Whole life insurance** is a permanent policy for which you pay a specified premium each year for the rest of your life; may also serve as an investment
- **Limited payment policies** charge premiums for only a certain length of time until policy is "paid up"
- With a **variable life policy**, your premium payments are fixed; cash value varies with stock market
- **Adjustable life policy** allows you to change your coverage as your needs change
- **Universal life insurance** is essentially a term policy with a cash value

Comparing the Major Types of Life Insurance

	Term Life	Whole Life	Universal Life
Premium	Lower initially, increasing with each renewal	Higher initially than term; normally doesn't increase	Flexible premiums
Protects for	A specified period	Entire life if you keep the policy	A flexible time period
Policy benefits	Death benefits only	Death benefits and eventually a cash and loan value	Flexible death benefits and eventually a cash and loan value
Advantages	Low outlay Initially, you can purchase a larger amount of coverage for a lower premium	Helps you with financial discipline Generally fixed premium amount Cash value accumulation You can take loan against policy	More flexibility Takes advantages of current interest rates Offers the possibility of improved mortality rates (increased life expectancy because of advancements in medicine, which may lower policy costs)
Disadvantages	Premium increases with age No cash value	Costly if you surrender early Usually no cash value for at least three to five years May not meet short-term needs	Same as whole life Greater risks due to program flexibility Low interest rates can affect cash value and premiums
Options	May be renewable or convertible to a whole life policy	May pay dividends May provide a reduced paid-up policy Partial cash surrenders permitted	May pay dividends Minimum death benefit Partial cash surrenders permitted

Other Types of Life Insurance Policies

- Other types of life insurance policies include the following:
  - **Group life insurance** is basically a variation of term insurance
    - Covers many people under a single policy, and people included in the group do not need medical examinations to get the coverage
    - Usually offered through employers, who pay part or all of the costs for their employees, or through professional organizations, which allow members to sign up for the coverage
  - **Credit life insurance** is used to pay off certain debts, such as auto loans or mortgages, if you die before they are paid in full
  - **Endowment life insurance** provides coverage for a specific period and pays an agreed-upon sum of money to the policyholder if he or she is still living at the end of the endowment period

Selecting Provisions and Buying Life Insurance

LO10.3

- **Key Provisions in a Life Insurance Policy:**
  - ***Naming your beneficiary*** is important as your beneficiary receives the benefits of your life insurance policy; you can also name contingent beneficiaries
  - ***Incontestability clause*** says insurer cannot cancel the policy if it has been in force for a specified period, usually two years
  - ***Grace period*** allows 28 to 31 days to elapse, during which time you may pay the premium without penalty; after this period, the policy lapses if premium has not been paid
  - ***Policy reinstatement*** occurs when a lapsed policy is put back in force, but you must again qualify as an acceptable risk
  - ***Nonforfeiture clause*** allows insured not to forfeit all accrued benefits

Selecting Provisions and Buying Life Insurance (Continued)

- **Key Provisions in a Life Insurance Policy:**
  - ***Misstatement of age provision*** says that if the company finds out that your age was incorrectly stated, it will pay the benefits your premiums would have bought if your age had been correctly stated
  - ***Policy loan provision*** permits you to borrow any amount up to the cash value of the policy
  - ***Suicide clause*** states that in the first two years of coverage, beneficiaries of someone who dies by suicide receive only the amount of the premiums paid; after two years, beneficiaries receive the full value of death benefits

Riders to Life Insurance Policies

- An insurer can change the conditions of a policy by adding a **rider**, a document that modifies coverage
  - ***Waiver of premium disability benefit*** allows you to stop paying premiums if you're totally and permanently disabled before you reach a certain age, usually 60
  - ***Accidental death benefit*** (i.e., ***double indemnity***) pays twice the value of the policy if you are killed in an accident, but the accident must occur before a certain age (generally 60 to 65)
    - Experts counsel against adding this rider to your coverage
  - ***Guaranteed insurability option*** allows you to buy a specified additional amount of life insurance at certain intervals without undergoing medical exams
    - Good option for people who anticipate needing more life insurance in the future

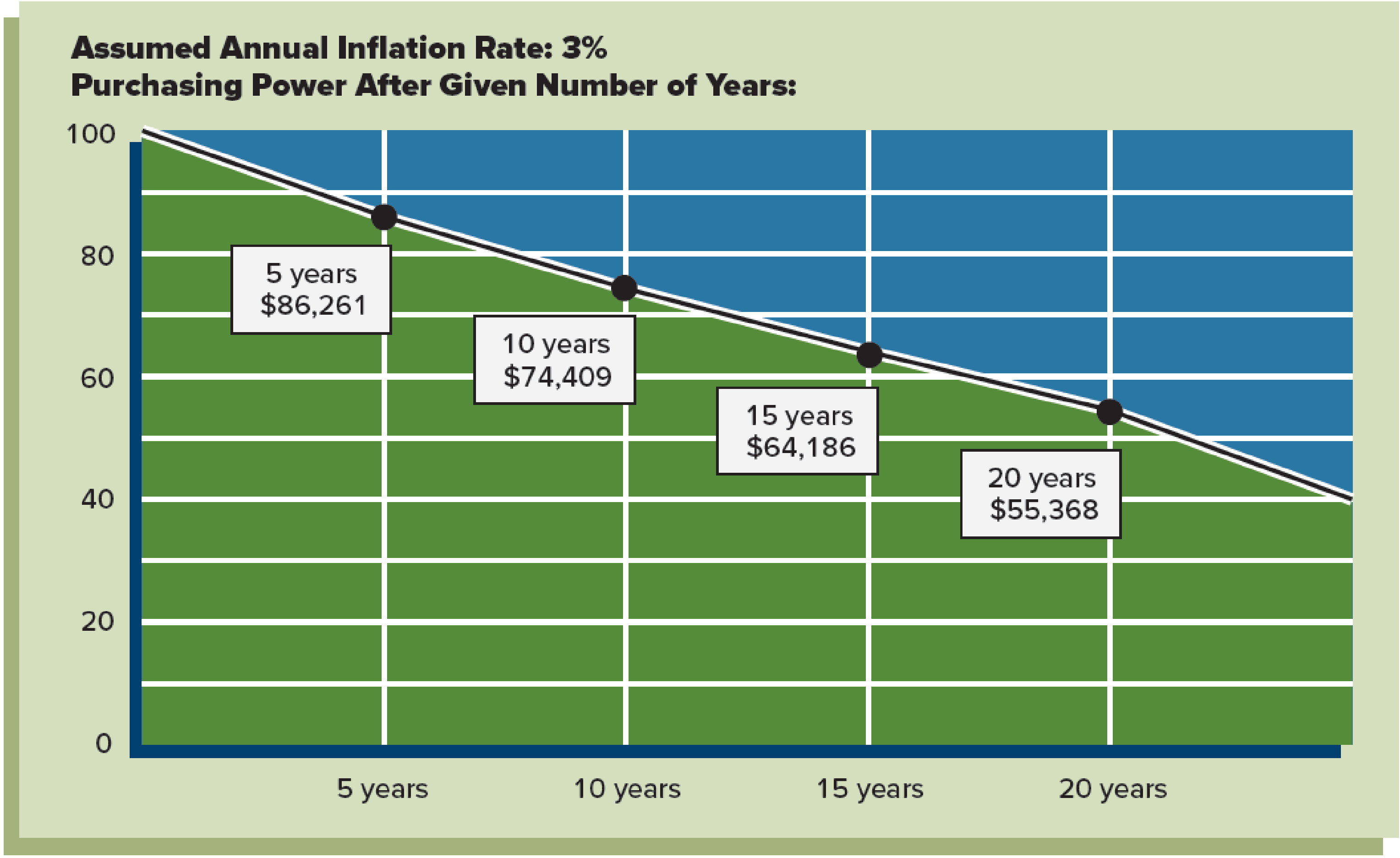
Riders to Life Insurance Policies (Continued)

- ***Cost-of-living protection*** is designed to help prevent inflation from eroding the purchasing power of the protection your policy provides

- ***Accelerated benefits*** are life insurance policy proceeds paid to the policyholder who is terminally ill before he or she dies

- ***Second-to-die option*** insures two lives, usually husband and wife; death benefit is paid when the second spouse dies

Effects of Inflation on a $100,000 Life Insurance Policy



Source: Teachers Insurance and Annuity Association, The TIAA Guide to Life Insurance Planning for People in Education (January 1997), p. 8.

Buying Life Insurance

- **From Whom to Buy?**
  - Look for insurance coverage from financially strong companies with professionally qualified representatives
- **Sources**
  - Protection is available from a wide range of private and public sources
- **Rating Insurance Companies**
  - Locate an insurance company by checking the reputations of local agencies
  - Ask members of your family, friends, or colleagues about the insurers they prefer
- **Choosing Your Insurance Agent**
  - Agent helps you select the proper kind of protection within your financial boundaries

Rating Systems of Major Rating Agencies
Exhibit 10-5

	A. M. Best	Standard & Poor's, Duff & Phelps	Moody's	Weiss Research
Superior	A++	AAA	Aaa	A+
	A+			
Excellent	A	AA+	Aa1	A
	A–	AA	Aa2	A–
		AA–	Aa3	B+
Good	B++	A+	A1	B
	B+	A	A2	B–
		A–	A3	C+
Adequate	B	BBB+	Baa1	C
	B–	BBB	Baa2	C–
		BBB–	Baa3	D+
Below average	C+	BB+	Ba1	D
	C+	BB	Ba2	D–
		BB–	Ba3	E+
Weak	C	B+	B1	E
	C–	B	B2	E–
	D	B–	B3	
Nonviable	E	CCC	Caa	F
	F	CC	Ca	
		C,D	C	

Buying Life Insurance (Continued)

- **Comparing Policy Costs**
  - Five factors affect the price a company charges for a life insurance policy:
    - The company's cost of doing business;
    - The return on its investments;
    - The mortality rate it expects among its policyholders;
    - The features the policy contains; and
    - Competition among companies with comparable policies.
- **Obtaining and Examining a Policy**
  - Life insurance policy is issued after you apply for insurance and the insurance company accepts the application
  - After you buy new life insurance, you have a 10-day "free-look" period during which you can change your mind

Choosing Settlement Options

- Most common settlement options are the following:
  - ***Lump-sum payment*** is when the insurance company pays the face amount of the policy in one installment to the beneficiary or to the estate of the insured
  - ***Limited installment payment*** provides for payment of the life insurance proceeds in equal periodic installments for a specified number of years after your death
  - Under the ***life income option***, payments are made to the beneficiary for as long as she or he lives
  - ***Proceeds left with the company*** is an option where life insurance proceeds are left with the insurance company at a specified rate of interest
- ***Think twice if your agent suggests that you replace the whole life or universal life insurance you already own!***

Financial Planning with Annuities LO10.4

- An **annuity** is a contract that provides a regular income for as long as the person lives
  - *Immediate annuities* provide income payments at once and are usually purchased with a lump-sum payment
  - *Deferred annuities* provide income payments at some future date; meanwhile, interest accumulates on the money you deposit
    - A deferred annuity purchased with a lump-sum payment is known as a *single-premium deferred annuity*
  - *Index annuities* have earnings that accumulate at a rate based on a formula linked to one or more equity-based indexes, such as the S&P 500

Why Buy Annuities?

- A primary reason for buying an annuity is to give you retirement income for the rest of your life
  - You should fully fund your IRAs, Keoghs, and 401(k)s before considering annuities
- Appeal of ***variable annuities*** increased during the mid-1990s due to a rising stock market
  - A *fixed annuity* states that the annuitant (the person who is to receive the annuity) will receive a fixed amount of income over a certain period or for life
  - With a *variable annuity,* the monthly payments vary because they are based on the income received from stocks or other investments
- Some of the growth in the use of annuities can be attributed to the passage of the Employee Retirement Income Security Act (ERISA) of 1974

Costs of Annuities

- You will pay several charges when you purchase a variable annuity:
  - *Surrender charges* are assessed if you withdraw money within a certain period, usually within six to eight years
  - *Mortality and expense risk charge* is equal to a certain percentage of your account value, usually 1.25 percent per year
  - *Administrative fees* may be deducted to cover recordkeeping and other administrative expenses
    - May be charged as a flat account maintenance fee or as a percentage of your account value
  - *Fund expenses* are charged to cover the fees and expenses imposed by the mutual funds that are the underlying investment options for your variable annuity

Tax Considerations

- When you buy an annuity, the interest on the principal, as well as the interest compounded on that interest, builds up ***free*** of current income tax
- Tax Reform Act of 1986 preserves tax advantage of annuities (and insurance), but curtails deductions for IRAs
  - With an annuity, there is no maximum annual contribution
- If you die during the accumulation period, your beneficiary is guaranteed no less than the amount invested
- Drawbacks include reduced flexibility and fees that lower investment return

Chapter Summary

LO10.1: Define life insurance and determine your life insurance needs.

- Life insurance protects the people who depend on you from financial losses caused by your death.
- You can use the easy method, the DINK method, the “nonworking” spouse method, or the “family need” method to determine your life insurance needs.

Chapter Summary

LO10.2: Distinguish between the types of life insurance companies and analyze various life insurance policies these companies issue.

- Two types of insurance companies – stock and mutual – sell nonparticipating and participating policies.
- Both sell two basic types of insurance: term life and whole life. Many variations and combinations of these types are available.

Chapter Summary

LO10.3: Select important provisions in life insurance contracts and create a plan to buy life insurance.

- Most life insurance policies have standard features.
- An insurance company can change the conditions of a policy by adding a rider to it.
- Before buying life insurance, consider all your present and future sources of income, then compare the costs and choose appropriate settlement options.

Chapter Summary

LO10.4: Recognize how annuities provide financial security.

- An annuity pays while you live, whereas life insurance pays when you die.
- With a fixed annuity, you receive a fixed amount of income over a certain period or for life.
- With a variable annuity, the monthly payments vary because they are based on the income received from stocks or other investments.