GE1202 Managing Your Personal Finance

Lecture 6
Insurance

Basic Insurance Concepts

- Basic purpose of insurance
  - Protect you and your dependents from the financial consequences of losing assets or income when an accident, illness, or death occurs
- What is Risk?
  - Chance of economic loss
- There is a risk of losing something which you have a financial interest
  - Life, Health, Home, Car and Business
- **Risk Management**
  - Devise strategies for anticipating and dealing with such risk exposures

Risk Management Techniques

- Risk Avoidance
  - Avoiding an act that would create a risk
- Loss Prevention
  - Any activity that reduces the probability that a loss will occur
- Loss Control
  - Any activity that lessens the severity of loss once it occurs
- Risk Assumption
  - You choose to accept and bear the risk of loss

Risk Management Techniques

- Example
- How can a driver avoid the risk of having traffic accidence?
  - Not driving!
- How to reduce the chance of having an accidence?
  - Driving within the speed limit to lessen the chance of being in a car accident
- How to reduce the loss when an accidence occurs?
  - Wearing a safety belt or buying a car with air bags

Insurance

- An **insurance policy** is a contract between you (*the insured*) and an insurance company (*the insurer*) under which the insurance company agrees to reimburse you for the losses you suffer according to specified terms
  - You are *transferring your risk of loss* to the insurance company
- Why are insurance companies willing to accept this risk?
  - They combine the loss experiences of large numbers of people and use statistical information, called actuarial data, to estimate the risk of loss for the given population.
  - If they pay out less than the sum of the premiums and the earnings on them, they make a profit.

Insurance

- Will they insure everyone?
  - NO!!! Normally high-risk clients are not welcomed.
- Who are more likely to apply for an insurance?

- **Adverse selection**
  - Only high-risk clients apply for and get insurance coverage

Insurance

- Underwriting
  - Insurance company decides whom to insure and premium to be charged
- Underwriting practices and standards also vary among insurance companies
- You can often save money by shopping around for the company offering the most favorable underwriting policies for your specific characteristics and needs.

Why buy life insurance?

- Primary purpose is to protect your dependents from financial loss in the event of your *untimely* death
- Benefits
  - Financial protection for dependents
    - Able to maintain their current lifestyle
  - Protection from creditors
    - A life insurance policy can be structured so that death benefits are paid directly to a named beneficiary
  - Savings vehicle
    - Some types of life insurance policies can serve as a savings vehicle, particularly for those who are looking for safety of principal

Life Insurance Decision

- Before apply for a life insurance, you will need answers to the following questions:
  - Do you need life insurance?
  - If so, how much life insurance do you need?
  - Which type of life insurance is best, given your financial objectives?
  - What factors should you consider in making the final purchase decision?

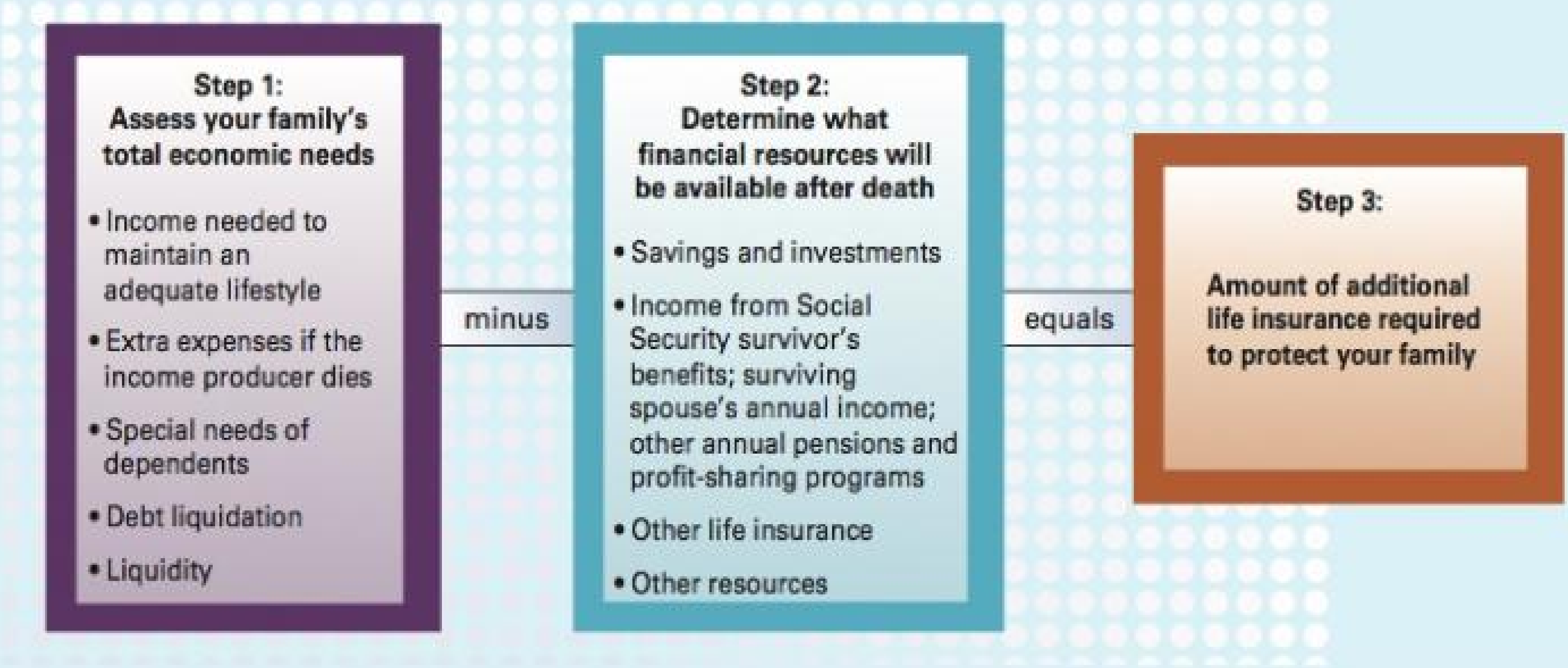
Do You Need Life Insurance?

- Yes if you have dependents counting on you for financial support
  - Married person
    - Depending on your spouse’s earning potential and assets
  - Young family with children
    - Families stand to suffer the greatest financial hardship from the premature death of a parent.
    - Even a non–wage–earning parent may require some life insurance to ensure that children are cared for adequately if the parent dies.
- No if no one depends on your support
  - A single adult who doesn’t have children or other relatives
  - Children

How Much Life Insurance Do You Need?

- Two methods to estimate how much insurance is necessary
- *Multiple–of–earnings method*
  - Multiply annual earnings by an arbitrary number
    - Rule of thumb equal 5 to 10 times your current income
  - Fails to fully recognize the financial obligations and resources of the individual and his or her family
  - Should be used only to roughly approximate life insurance needs
- *Needs Analysis Method*
  - A three steps approach to estimate needs and examine available resources

The needs analysis method uses three steps to estimate life insurance needs.



Needs Analysis Method

1. Estimate the total economic resources needed if the individual were to die
    - Income to maintain an adequate lifestyle
        - Estimate this amount by looking at your family's current monthly budget
            - Expenses for housing costs, utilities, food, clothing, and medical and dental needs
            - Property taxes, insurance, recreation and travel, and savings
            - Take into account that the amount needed may change over time
    - Extra expenses if the primary income producer dies
        - Funeral costs and any expenses that might be incurred to replace services that you currently provide
    - Special needs of dependents
        - long– term nursing care for a disabled or chronically ill dependent,
        - Emergency fund for unexpected financial burdens
        - College education fund for your children

Needs Analysis Method

1. Estimate the total economic resources needed if the individual were to die
   - Debt liquidation
     - Calculate the average amount due for outstanding bills
   - Liquidity
     - It may take time for your dependents to sell noncash assets
       - Real estate is difficult to convert into cash quickly.
     - If a high percentage of your wealth is in illiquid assets, the cash proceeds from life insurance can be used to pay the bills until those assets can be sold at a fair market value

Needs Analysis Method

2. Determine all financial resources that would be available after death, including existing life insurance and pension plan death benefits
    - Savings and investments
    - Social Security benefits
    - Pension or retirement plans
    - Other life insurance
    - Income of surviving spouse or children
    - Real estate or other assets

Types of Life Insurance

1. **Term life insurance**
   - Provides only death benefits, for a specified amount and period
   - Does not provide for the accumulation of *cash value*
   - Two common types of term insurance
     - **Straight Term**
       - A term insurance policy written for a given number of years, with coverage remaining unchanged throughout the effective period

       A. Annual renewable term policies
          - The annual premium may increase each year

       B. Level premium term policies
          - The annual premium remain level throughout the policy period
     - **Decreasing Term**
       - Maintain a level premium throughout all periods of coverage while the amount of protection decreases

Features of Term life insurance

- **Renewability**
  - Allowing the insured to renew the policy at the end of its term without having to show evidence of insurability
- **Convertibility**
  - Allowing the insured to convert the policy into a comparable whole life policy
  - Useful to people who need a large amount of relatively low-cost, short-term protection immediately, and expect to have greater income that will allow you to purchase permanent insurance

Advantages and Disadvantages of Term life

- Advantage
  - Economy
    - Term life usually offers lower initial premiums than other types of insurance, especially for younger people
    - Premium pays for the death benefit
- Disadvantage
  - Temporary coverage only
  - Problematic to people who may develop underwriting factors in the future that make it difficult to qualify for insurance
  - No cash value

Types of Life Insurance

2. **Whole life insurance**
   - Designed to provide ongoing insurance coverage during an individual's entire life
     - A permanent insurance product
   - It has a savings feature, called **cash value**
     - Results from the investment earnings on paid-in insurance premiums.
     - To provide the insurance buyer with a tangible return while also receiving insurance coverage
     - The savings rates on whole life policies are normally fixed and guaranteed to be more than a certain rate
     - Upon the death of the insured, the insurer is only obligated to pay the death benefit, not the cash value, which it retains.
   - **Nonforfeiture right**
     - Right to cash value when canceled prior to death

Types of Whole Life Policies

- **Continuous premium (straight life)**
  - Level premium each year until death or policy cancellation
  - The earlier in life the coverage is purchased, the lower the annual premium
    - You pay less annually, but you pay more in total
  - The greatest amount of permanent death protection and the least amount of savings per premium dollar
- **Limited payment**
  - Level premiums paid for specified number of years while insurance in force until death
  - “larger” savings element
- **Single premium**
  - Lifetime coverage purchased with a single premium

Advantages and Disadvantages of Whole Life

- Advantages
  - Stable payment for life long protection
  - Tax benefit
    - The interest and earnings on the policy are not taxable
  - Borrow against cash value
    - Loans will also decrease the death benefit amount
- Disadvantages
  - Higher premiums than term insurance
    - Part of it goes toward the policy's cash value
  - Lower yields than many otherwise comparable vehicles
    - A whole life policy should not be used to obtain maximum return on investment

Types of Life Insurance

3. **Universal Life Insurance**
   - Permanent cash-value insurance that combines term insurance (death benefits) with a tax-sheltered savings/investment account that pays interest, usually at competitive money market rates
   - Premiums are **unbundled** into 2 accounts
     - The death protection portion and the savings portion are identified *separately* in its premium
     - Part of your premium pays for the benefit, and the remainder is put into the cash-value portion of the policy, where it earns a certain rate of return

Advantages and Disadvantages of Universal Life

- Advantages
  - Flexibility
    - Flexible to adjust the premiums and coverage amounts
  - Greater potential returns
    - If the insurer's portfolio earns more than the minimum interest rate, the company may credit the excess interest to your policy
- Disadvantages
  - Heavy fees
    - The front–end load
    - Commission on the first premium
    - The expense charge on each annual premium
    - Investment expense charged by the insurer in determining the “current” rate of return

Types of Life Insurance

- **Variable Life Insurance**
  - Combining death benefits and savings
  - Policyholders decide how to invest the money in the savings (cash–value) component
  - Investment accounts are set up just like mutual funds
    - Money market accounts
    - Managed stock funds
  - No minimum return
  - The amount of insurance coverage provided varies with the profits (and losses) generated in the investment account.

Advantages and Disadvantages of Variable life

- Advantage
  - Higher returns
    - Many observers view variable life more as an investment vehicle than a life insurance policy
- Disadvantage
  - Risks of reduced insurance coverage
    - Death benefit is linked to the returns on investment

Types of Life Insurance

- **Group Life Insurance**
  - Provides a master policy for a group
    - Each eligible group member receives a certificate of insurance
  - Term insurance
  - The premium is based on the *group's* characteristics as a whole rather than the characteristics of any specific *individual*
  - Provide that individual members who leave the group may continue the coverage by converting their protection to individually issued whole life policies without showing evidence of insurability
  - Temporary nature and relatively low benefit amount
  - Employee benefit programs

Other Special-Purpose Life Policies

- Credit life insurance
  - Sold in con- junction with installment loans
  - One of the most expensive forms of life insurance
- Mortgage life insurance
  - A term policy designed to pay off the mortgage balance in the event of the borrower’s death

Feature	Term	Whole Life	Universal Life
Death protection	High	Moderate	Low to high
Coverage period	Temporary for set period	Ongoing	Ongoing
Costs	Low fixed premiums, no fees	High fixed premiums; may also be charged fees	Can vary from high to low; may also be charged fees
Return on investment?	None	Yes, moderate	Yes; return can vary
Tax advantages	No	Yes	Yes

Type of Policy	Advantages	Disadvantages
Term	• Low initial premiums: simple, easy to buy.	• Provides only temporary coverage for a set period. • May have to pay higher premiums when policy is renewed.
Whole life	• Permanent coverage • Savings vehicle: cash value builds as premiums are paid. • Some tax advantages on accumulated earnings.	• Cost: provides less death protection per premium dollar than term. • Often provides lower yields than other investment vehicles. • Sales commissions and marketing expenses can increase costs of fully loaded policy.
Universal life	• Permanent coverage • Flexible: allows insured adapt level of protection and cost of premiums. • Savings vehicle: cash value builds at current rate of interest. • Savings and death protection identified separately.	• Can be difficult to evaluate true cost at time of purchase; insurance carrier may levy costly fees and charges.
Variable life	• Investment vehicle: insured decides how cash value will be invested.	• Higher risk.

Buying Life Insurance

- Compare Costs and Features
  - The cost of a life insurance policy can vary considerably from company to company, even for the same amount and type of coverage
  - Some companies are more willing to accept these risks than others
  - Make sure you're getting the features you need
  - First decide how much and what kind of policy you want, and then compare costs
- Select an Insurance Company
  - Offers reasonably priced products, attractive contract features, and good customer service
  - The financial health of the insurance company
    - The age and size of insurance companies
    - Private rating agencies
      - Fitch, Moody's, and Standard & Poor's

Buying Life Insurance

- Choosing an Agent
  - **Moral Hazard** problem
    - Is your agent really working FOR you?
    - Sales commission?
  - Potential Conflicts of Interest in Dealing with Insurance Agents
    - Agents have an incentive to recommend policies that provide the greatest commissions
      - Ask your agents about the commissions that they receive on competing insurance products
    - Agents often avoid bringing up the negative aspects of a policy or oversimplify policy features
    - Agents can be unreliable sources of advice about the performance of an existing policy
    - lawyers, accountants, and financial planners depending on life insurance agents for business referrals may not give good advices

Life Insurance Contract Features

- **Beneficiary Clause**
  - Beneficiary
    - The person who will receive the death benefits of the policy on the insured's death
    - Should have one or more beneficiaries
  - Primary and contingent beneficiary
  - The identification of named beneficiaries should be clear
    - "my wife"?

Life Insurance Contract Features

- **Policy Loans**
  - An advance made by a life insurance company to a policyholder against a whole life policy
  - Secured by the cash value of the life insurance policy
  - Although these loans do not have to be repaid, any balance plus interest on the loan remaining at the insured's death is subtracted from the proceeds of the policy
  - Fixed-rate loan or a rate that varies with market interest rates on high-quality bonds
  - Take out a policy loan only if your estate is large enough to cover the accompanying loss of death proceeds when the loan is not repaid

Life Insurance Contract Features

- **Premium Payments**
  - Policyholder may elect to pay premiums annually, semiannually, quarterly, or monthly
- **Grace Period**
  - Policyholder retain full death protection for a short period after missing a premium payment date
- **Nonforfeiture Options**
  - Paid–up insurance
    - Policyholder uses the cash value to buy a new, single premium policy
  - Extended term insurance
    - The insured uses the accumulated cash value to buy a term life policy for the same face value as the lapsed policy

Life Insurance Contract Features

- **Policy Reinstatement**
  - Policyholder may reinstate the original policy
    - Paying all back premiums and Interest at a stated rate
    - Providing evidence that he or she can meet any other insurability requirements
- **Change of Policy**
  - A provision that permits the insured to switch from one policy form to another with– out penalty

More Features

- **Multiple indemnity clause**
  - Increase the face amount of the policy if the insured dies in an accident
  - A small additional cost
- **Disability clause**
  - A *waiver–of–premium* benefit
    - Waiving payment of premiums if the insured becomes totally and permanently disabled prior to age 60
- **Guaranteed purchase option**
  - An option in a life insurance contract giving the policyholder the right to purchase additional coverage at stipulated intervals without providing evidence of insurability

More Features

- **Suicide clause**
  - Voids the contract if an insured commits suicide within a certain period
- **Exclusions**
  - Aviation, war, and hazardous occupation or hobby
- **Participation**
  - A life insurance policy that pays policy dividends reflecting the difference between the premiums that are charged and the amount of premium necessary to fund the actual mortality experience of the company

More Features

- **Living benefits**
  - Accelerated benefits
  - The insured can receive a percentage of the death benefit from a whole or universal life policy *prior* to death
  - If the insured suffers a terminal illness that is expected to result in death within a specified period
  - Needs an expensive treatment to survive
  - *Living benefit rider*
    - Pays a portion of a policy's death benefit in advance for long-term health care

Understanding Life Insurance Policy Illustrations

- **Life insurance policy illustration**
  - A hypothetical representation of a policy's performance
  - Reflects the most important assumptions that the company relies on when presenting the policy results to a prospective client
  - Specifies factors affecting the cash value
    - Premiums paid and interest credits
    - Mortality charges and expenses
- Often exaggerate the financial success of an investment

Understanding Life Insurance Policy Illustrations

1. Request *two specific* illustrations from each prospective insurance company
   - One using the current interest rate throughout the entire life of the policy
   - Another using an interest rate 2% lower than the current rates
2. Compare the two illustrations provided by each company
   - The less the two insurance illustrations vary the more conservative the company is and the more likely their predictions will be accurate

- It is difficult to really assess which company is better if you are comparing two different policy types
  - Permanent life insurance relies heavily on economic trends

Buying the Right Life Insurance for You

- Don’t let an insurance agent tell you how much insurance you need
- Consult an independent insurance broker
- Just say no to one-meeting recommendations
- Always do some comparison shopping
- Know how your agent is compensated
- Avoid replacing old whole-life insurance policies
- Keep your insurance and investment decisions separate
- Avoid buying expensive riders
- Consider your budget when buying insurance