UNDERSTANDING Life Insurance

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UNDERSTANDING *Life Insurance*

Contents

Most families consider life insurance to be an important part of their economic security program because it provides protection for the future. But the amount of protection needed and the reasons for needing it vary between families, so it is not always easy to decide which policy to buy. This publication explains the most common life insurance options and discusses how those options can help protect your family. A glossary explains the various terms used concerning life insurance.

Three situations — the sound of screeching brakes on an interstate highway, a widow beginning her first job at age 55, and a young man dropping out of college — brought three families to us asking for information on life insurance.

When Paul Martinez, on the road for a business trip, heard the squeal of brakes and then watched the automobile crash that killed the parents of three young children, he began to worry about his own family. What would happen to his two daughters if he and his wife were to die suddenly? Where would they live? Who would pay for their food, their clothing, the rest of their everyday expenses? He decided it was time to talk with his wife about making provisions for their daughters.

Eugene and Vera Clark saw the determination on their neighbor's face when she got her first job at age 55, shortly after her husband died. They watched her give up membership in many organizations she enjoyed, and they sympathized when she said she was just too tired to join them for an evening's entertainment. She struggled to make her small earnings pay the mortgage, buy food and clothing, and cover her other living expenses. The Clarks decided they needed some advice on providing for Mrs. Clark in case Mr. Clark, the wage earner for their family, were to die prematurely.

Bob Price couldn't believe it when he heard that Gary Williams, whose goal was to become a doctor, had dropped out of college in his freshman year. This happened shortly after the death of Gary's father, who had been Bob's business partner. Bob found out that his partner had only enough life insurance to pay his burial expenses and to meet the family's mortgage payments. Since Gary's mother needed some additional training before she could earn enough money to support the family, it was decided that the best solution in the meantime was for Gary, the oldest child, to interrupt his education and to work. Bob Price didn't want that to ever happen to his wife and children.

This publication presents the kind of information we gave these three families to help them understand and meet their life insurance needs.

Life Insurance and Protection

Families buy life insurance for protection. In the event of a family member's death, life insurance replaces the income that the person earned and that his or her dependents relied on. Some families also buy life insurance as a part of their retirement planning or when planning how their assets and income will be distributed after death **(estate planning)**.

Life insurance is based on the law of large numbers. A large number of families share the common risk of losing a wage earner, and each family pays a certain amount of money (called a **premium**) each year. Then the dependents of the insured persons who actually die during that year receive a much larger amount of money than the annual premiums they have paid. The life insurance company uses mathematical **mortality tables** to calculate the risk that those who are insured will die during the year, collects premiums from the persons sharing the risk, and pays proceeds to beneficiaries of any insured individuals who die.

The type of life insurance a family needs varies with their income, resources, goals, composition, and stage in the family life cycle. Used correctly, life insurance can make a valuable contribution to family economic security. Having too much life insurance or paying for insurance when it isn't needed for financial protection can be an unnecessary drain on family finances. ❖

Ways to Buy Life Insurance

You can buy life insurance through an individual policy or a group policy. You can buy an individual policy from an insurance agent or through the mail. Often you must pass a medical examination to qualify.

You usually buy a group policy through your employer or an organization to which you belong. Your employer may pay part of your premium as an employment benefit. Unlike health insurance, rates for group life insurance rates may not be lower than individual rates. However, you usually aren't required to pass a medical exam to qualify for a group policy.

Group insurance is often term insurance. When you leave a job, you may have the opportunity to convert your group insurance coverage into a term or whole life individual policy. Some group policies can also be continued into retirement. (Both term and whole life insurance are discussed in the next section.)

When you apply for a loan or mortgage, you can buy credit life insurance from the lender. Credit life insurance pays the remaining balance on a loan to the lender if you die before you repay the full debt. You don't need credit life insurance if you are already adequately insured. But if you have health problems that make life insurance difficult or expensive to buy, credit life insurance might be worth considering. Otherwise, it is almost always more expensive than other life insurance coverage. ❖

What Is the Best Type of Life Insurance?*

All policies are not the same. Some give coverage for your lifetime and others cover you for a specific number of years. Some build up **cash values** and others do not. Some policies combine different kinds of insurance, and others let you change from one kind of insurance to another. Some policies may offer other benefits while you are still living. Your choice should be based on your needs and what you can afford.

There are two basic types of life insurance: **term insurance** and cash value insurance. Term insurance generally has lower premiums in the early years, but it does not build up cash values that you can use in the future. You may combine cash value life insurance with term insurance for the period of your greatest need for life insurance to replace income.

Term insurance covers you for a term of one or more years. It pays a death benefit only if you die in that term. Term insurance generally offers the largest insurance protection for your premium dollar. It generally does not build up cash value.

You can renew most term insurance policies for one or more terms even if your health has changed. Each time you renew the policy for a new term, premiums may be higher. Ask what the premiums will be if you continue to renew the policy. Also ask if you will lose the right to renew the policy at some age. For a higher premium, some companies will give you the right to keep the policy in force for a guaranteed period at the same price each year. At the end of that time, you may need to pass a physical examination to continue coverage, and premiums may increase. Your options for renewing a term policy are spelled out in the **renewable clause.**

You may be able to trade many term insurance policies for a cash value policy during a conversion period — even if you are not in good health. Premiums for the new policy will be higher than you have been paying for the term insurance. Check the **convertible clause** of your policy to see what your choices are.

Cash value life insurance is a type of insurance where the premiums charged are higher at the beginning than they would be for the same amount of term insurance. The part of the premium that is not used for the cost of insurance is invested by the company and builds up a cash value that may be used in a variety of ways. You may borrow against a policy's cash value by taking a **policy loan.** If you don't pay back the loan and the interest on it, the amount you owe will be subtracted from the benefits when you die, or from the cash value if you stop paying premiums and take out the remaining cash value. You can also use your cash value to keep insurance protection for a limited time or to buy a reduced amount without having to pay more premiums. You also can use the cash value to increase your income in retirement or to help pay for needs such as a child's tuition without canceling the policy. However, to build up this cash value, you must pay higher premiums in the earlier years of the policy. Cash value life insurance may be one of several types; whole life, universal life, and variable life are all types of cash value insurance.

Whole life insurance covers you for as long as you live if your premiums are paid. You generally pay the same amount in premiums for as long as you live. When you first take out the policy, premiums can be several times higher than you would pay initially for the same amount of term insurance. But they are smaller than the premiums you would eventually pay if you were to keep renewing a term policy until your later years.

Some whole life policies let you pay premiums for a shorter period, such as for 20 years or until age 65. Premiums for these policies are higher since the premium payments are made during a shorter period.

Universal life insurance is a kind of flexible policy that lets you vary your premium payments. You can also adjust the **face value** of your coverage. Increases may require proof that you qualify for the new death benefit. The premiums you pay (less expense charges) go into a policy account that earns interest. Charges are deducted from the account. If your yearly premium payment plus the interest your account earns is less than the charges, your account value will become lower. If it keeps dropping, eventually your coverage will end. To prevent that, you will need to start making premium payments, to increase your premium payments, or to lower your death benefits. Even if there is enough in your account to pay the premiums, continuing to pay premiums yourself means that you build up more cash value.

Variable life insurance is a kind of insurance where the death benefits and cash values depend on the investment performance of one or more separate accounts, which may be invested in mutual funds or other investments allowed under the policy. Be sure to get the prospectus from the company when buying this kind of policy and study it carefully. You will have higher death benefits and cash value if the underlying investments do well. Your benefits and cash value will be lower or may disappear if the investments you chose didn't do as well as you expected. You may pay an extra premium for a guaranteed death benefit. ❖

* Source: Reprinted by permission from *Life Insurance Buyer's Guide,* NAIC, 120 W. 12th Street, Suite 1100, Kansas City, MO 64105-1925.

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Special Policy Features

Whatever type of policy (or policies) your family decides to buy, it is important to keep your plan flexible. To do this, you can add special clauses, known as **riders,** to your policy. Two of these clauses, the renewable and convertible clauses available with term insurance, were described in the paragraphs on term insurance. Three other widely available riders add to the policy cost and may or may not be worthwhile for your situation.

A **disability waiver clause** allows premiums to be waived if the policyholder becomes permanently disabled or unable to work. If you are worried about disability, a disability insurance policy that will help you pay all of your living expenses may be a better buy than a disability waiver clause for your life insurance.

A **guaranteed insurability clause** allows the policyholder to purchase stated amounts of additional insurance at specified times without passing a physical examination. Consider whether you'll need to buy more insurance later; the need for life insurance tends to decrease as time goes by. And if you do expect to need more insurance, check that your option doesn't end after age 45 or 50, just when you might develop health problems that could make it harder to buy life insurance at reasonable rates.

An **accelerated death benefits clause** allows you, in certain circumstances, to tap the death benefits of your policy before you die. For you to do that, most policies require diagnosis of a terminal illness with a doctor's certification that death is expected within 12 months. Some allow benefits to be used if you have been in a nursing home for an extended period and are not expected to leave.

Under this clause, the amount of the death benefit you can take is usually limited (often to 25 to 40 percent). Some companies will deduct the amount you receive, plus interest, from what your **beneficiaries** will receive after your death. Others deduct the interest in advance, based on your life expectancy. Then you get a smaller amount to use before your death, but the rest of your death benefit stays intact for your beneficiaries. ❖

Payment of Premiums

The premium is the amount of money you pay to keep your policy in force. The annual premium is almost always less when paid once a year, and paying twice or four times a year usually costs less than paying once a month. ❖

Who Needs Life Insurance?

The essential purpose of life insurance is simple: to provide income to financial dependents when an income producer dies. If both parents in a two-parent family are earning income, then both need life insurance.

But both parents should also consider life insurance even if one works in the home rather than in the marketplace. The one working at home performs valuable services, such as child care, household management, cleaning, and cooking, that would be expensive to replace. Life insurance could help pay the cost of hiring someone to take care of those responsibilities.

People without children, whether married or single, may have little need for life insurance. Coverage may be important, however, if your spouse cannot earn sufficient income to support your current lifestyle or if you and your spouse face the prospect of caring for one or more elderly parents.

Once children arrive, insurance needs usually increase sharply and stay relatively high until the children are financially independent. Retired people may not need much or any life insurance if they have no financial dependents and no desire to use life insurance to leave an estate.

Children don't need life insurance unless its benefits would be the only way the family could pay burial and other expenses associated with a child's death. Children aren't major income earners, and they don't have financial dependents. ❖

How Much Do You Need?
How Much Life Insurance Do You Need?

One simple way that life insurance needs are sometimes estimated is to multiply current earnings by a given factor to estimate the income that will be needed after a death. One approach assumes you need 70 or 75 percent of your income for seven years. For example, if you currently earn $50,000 a year, this approach would estimate your life insurance needs at $245,000 (70 percent) or $262,500 (75 percent). This may or may not be the right amount of insurance for you. Your survivors may need to replace your income for more or less than seven years. And if you invest the life insurance proceeds and earn even three percent, you'll need less insurance ($225,000).

The needs approach is a better way to estimate life insurance needs. In this approach, consider the following:

Immediate needs: Your family is likely to have several expenses upon your death which may include uninsured medical expenses, funeral costs (which averaged $4,800 in 1997), costs associated with settling your estate, and (for estates larger than $600,000) federal and state taxes.

Survivors' living expenses: What will your survivors need in the coming years to meet monthly living expenses? To estimate their needs, answer these questions:

a. How much will their living expenses be? (Seventy-five percent of current expenses is a common estimate.)

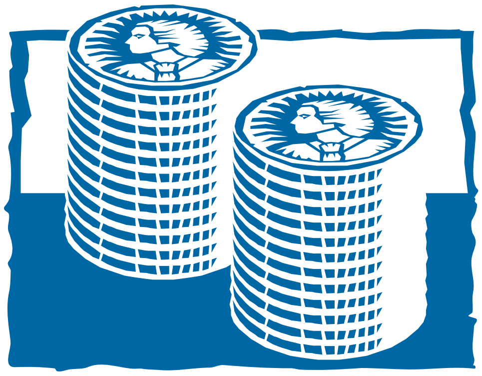
b. How much income will your family have to pay these expenses?

c. How much income can your survivors expect from Social Security? (You can get an estimate of your survivors' benefits by requesting and completing Form 7004, Request for Earnings and Benefit Estimate Statement, available from the Social Security Administration; call 1-800-772-1213 or visit their World Wide Web site at <http://www.ssa.gov>.)

d. How many years will your survivors need life insurance proceeds to help meet their living expenses? (You may want enough insurance to help pay family expenses, at least until you expect all of your children to be financially independent.)

e. How will your survivors invest the life insurance benefits? (A more aggressive investment strategy will mean a higher return and you'll need less life insurance.)

Other future expenses: You may also want to buy enough life insurance coverage to allow your survivors to set up an emergency fund; to pay for child care, private schooling, or college; to repay your mortgage and other debts; or to cover the costs of caring for a disabled child or elderly parent.



You can use the chart here to estimate your survivors' financial needs. What investment assets do you and your survivors currently have that could be used to produce an income after your death? The difference is your life insurance need. ❖

Expenses to Be Covered After Death

	Example	Your Family
1. Immediate needs (funeral, estate taxes, etc.)	$5,000	________
2. Survivors' living expenses		
A. Expected average annual expenses	29,000	________
B. Expected spouse's average annual income after taxes	–22,500	________
C. Annual Social Security benefits	– 5,000	________
D. Net annual living expenses (A – B – C)	1,500	________
E. Years until spouse is 90	55	________
F. Investment rate factor*	x 22	________
G. Total living expenses (D x F)	$33,000	________
3. Settling of mortgage and other debt	12,000	________
4. Emergency fund	10,000	________
5. Child care, private schooling, or college fund	76,800	________
6. Other needs	0	________
7. Total monetary needs (1 + 2G + 3 + 4 + 5 + 6)	$136,800	________
8. Total investment assets in hand	-10,000	________
9. Life insurance needs (7 – 8)	$126,800	________

*** Table of investment rate factors:**

Years until spouse is 90	25	30	35	40	45	50	55	60
Conservative investment	20	22	25	27	30	31	33	35
Aggressive investment	16	17	19	20	21	21	22	23

* Source: Adapted from Personal Finance, 3rd ed., by Jack Kapoor, Les R. Dlabay, & Robert J. Hughes. Irwin Professional Publishing, 1994.

Settlement Options

Settlement Options

Upon the death of the policyholder, the beneficiary should contact the insurance agent, who will help file the claim. How the beneficiary collects the **proceeds** depends on his or her individual circumstances. The proceeds may be paid in a lump sum, paid in fixed installment payments, or turned into an annuity. An annuity pays an income from a death benefit for a specific number of years or for life. The survivor can also leave the money with the insurance company and receive the annual interest the death benefit earns. The policyholder can choose the settlement option before death or can leave the decision to the beneficiary. ❖

Taxes and Insurance

Taxes and Insurance

The proceeds from life insurance are not taxed as income to the beneficiary. However, if the insurance proceeds are left with an insurance company to earn interest, that interest is taxable as income. If proceeds are taken in installment payments, the portion of each payment attributable to the basic death benefit is tax-free, but the portion attributable to interest earned on the proceeds is taxable.

Participating (versus **nonparticipating**) insurance companies pay **dividends** on both term and whole life policies. A dividend is not, as the name implies, an earned return on an investment; it is actually a return of an overpayment on the premium paid. For this reason, dividends are not taxable. ❖

Regulation of Insurance

Regulation of Insurance

Your state's Department of Insurance is responsible for regulating the insurance industry. Before a company can sell insurance in a state, it must be licensed by the department. This rule applies to companies that maintain offices and agents in the state as well as to those that sell mail-order insurance there. Insurance agents and brokers working in a state must also be licensed by the department before they can represent a company. Each company's assets, claim-payment records, agents, and general practices are examined at regular intervals to ensure that the company is continuing to do business in a reputable way. The various policy forms used by companies throughout the state must be approved by the department.

The Illinois Department of Insurance also maintains a consumer complaint division to respond to any concern you have about an insurance company in Illinois. For example, you might have a problem with unpaid claims, or you might question the practices of a company or an agent. If you need help from the Department of Insurance, write or call: 320 W. Washington, Springfield, Illinois 62676 (217-782-4515); or 100 W. Randolph, Chicago, Illinois 60601 (312-814-2427). Or visit the department's World Wide Web site at http://www.state.il.us/ins. ❖

Insurer Can't Meet Obligations

If Your Insurer Can't Meet Its Obligations

If a company can't meet its obligations, the state guaranty association pays claims, subject to some limitations, and keeps some types of policies in force while the state Department of Insurance takes control of the company. In Illinois, the limit is $100,000 on cash values of life insurance policies and $300,000 on combined benefits from all policies. The Department of Insurance will take over management of the company to decide if it can be rehabilitated. If it cannot and must be liquidated, the Insurance Department may help to find other insurance companies to buy as many of the existing policies as possible so people don't lose their coverage or their rights to benefits.

To learn about an insurance company's financial strength before you buy from it, check with one of the insurer rating services. A.M. Best, Duff & Phelps, Moody's, Standard & Poor's, and Weiss all rate insurers. Each rating service uses letters to describe its evaluation of a company, but each service's scale is different from the others. Generally, however, experts recommend that you buy from companies that have earned a top financial rating from at least two rating services. That's an A++ from A.M. Best, AAA from Duff & Phelps and Standard & Poor's, Aaa from Moody's, and A+ from Weiss. Many public libraries have publications from one or more of the rating services, and insurance agents can provide ratings for the companies they represent. The state Department of Insurance may also be able to give you information about insurer rating services. ❖

Keeping Insurance Effective

Keeping Your Insurance Program Effective

When life insurance is used to meet the changing needs of your family, it can be one of the most important parts of your economic security program. Consider the various types of life insurance policies that might meet your needs. Then, before you buy, check the costs and features of policies from different companies. Read any policy before buying it to be certain it includes everything you have asked for.

Every two or three years, review your situation and the amount of insurance protection you have to see if your insurance needs have changed. Be sure the beneficiaries you now want are the same as those named earlier.

It is a good practice to keep your insurance policy (or policies) in a place where your beneficiaries can locate it easily in the event of your death. Include the name and phone number of the agent to be notified. If a policy is stolen, lost, or destroyed by fire, ask your insurance company to replace it. Record your policy number in a different place from where you keep the policy itself so that you can get a replacement easily. Let the family, a friend, a relative, or your lawyer know where your policy is kept, and ask them to notify the agent at once in case of death.

Be sure to let your insurance company know if you change your address so that your premium notice will not get lost. With some types of policies, your protection stops if you do not pay your premium on time.

In general, your family gets no more than it pays for when buying life insurance. By planning carefully, however, you may get more insurance protection at the time you need it most without increasing the amount you pay in premiums. It is up to your family to build a program to meet your changing life insurance needs. ❖

Suggestions For Further Reading

American Council on Life Insurance. (1994). *What You Should Know About Buying Life Insurance.* (Request a copy from ACLI at 1001 Pennsylvania Ave. NW, Washington, DC 20004.)

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Consumer Union. (1998, July). Life insurance report. *Consumer Reports,* pp. 34–43.

Roha, R.R. (1996, June). The 30-minute life insurance workout. *Kiplinger's Personal Finance Magazine,* pp. 71–73.

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Life Insurance Terms

accelerated death benefits clause — a policy clause that allows the policyholder to use death benefits before death.

beneficiary — the person (or persons) named in a life insurance policy to receive the face value if the insured dies.

cash value — the amount of money accumulated by a life insurance policy as the policy matures and available to be borrowed while the policy is in force or paid to the policyholder when the policy is cancelled.

convertible clause — a policy clause that gives the policyholder the right to convert term insurance to whole life insurance.

decreasing term — term insurance in which the face value decreases on a specified schedule. This type of policy is often used for insuring home mortgages.

disability waiver clause — a policy clause that waives premiums if the policyholder becomes permanently disabled or unable to work.

dividend — the money paid back to the policyholder at the end of a year if an insurance company has collected more premiums than necessary to meet its expenses, death benefits, and reserve build up.

estate planning — the process of planning to protect wealth from taxes and other costs and to distribute assets and income after death.

face value — the amount of money a life insurance policy pays if the insured dies.

guaranteed insurability clause — a policy clause that allows the policyholder to purchase stated amounts of additional life insurance at specified times without passing a physical exam.

mortality table — a mathematical table indicating the average length of life for a group of persons at any particular age.

nonparticipating life insurance — coverage that is calculated as closely as possible to actual cost so that no dividends are paid to policyholders.

participating life insurance — coverage that pays dividends to policyholders.

policy loan — a loan made to a policyholder for part of the policy's cash value.

premium — the amount of money paid by the policyholder at regular intervals to keep the policy in force.

proceeds — the money the beneficiary receives upon filing a claim after the death of the policyholder.

renewable clause — a policy clause that allows the policyholder to renew coverage for another period without a medical examination.

rider — a clause that, when added to the policy, expands or restricts its benefits or excludes certain conditions from coverage.

term insurance — a policy that pays death benefits to survivors but doesn't accumulate a cash value.

universal life insurance — a flexible policy that lets the policyholder vary the premium payments and the face value of the policy.

variable life insurance — a policy in which the death benefits and cash value depend on the investment performance of one or more separate accounts.

whole life insurance — a policy that builds a cash value and gives protection through the policyholder's lifetime as long as premiums are paid.