MARYLAND COOPERATIVE EXTENSION

Fact Sheet

Fact Sheet 371

Risk Management: Life Insurance

Life insurance, wisely planned, can make a valuable contribution to a family's economic security. When insurance policies are not wisely planned and not well coordinated to meet family needs, the costs can become an excessive drain on a family's finances.

Term Definitions

Beneficiary. The person or instrument (e.g., trust) named in the policy to receive the death benefits.

Cash surrender value. The amount of money the insured is entitled to after discontinuing a cash value policy.

Face value or amount. The dollar value appearing on the front of the policy that expresses coverage limits.

Insured. The person on whose life an insurance policy is issued, usually the policyholder.

Policy. The printed document that is issued to the policyholder by the company stating the terms of the insurance contract.

Premium. The money paid for insurance protection, generally paid annually.

The Insurance Principle

Life insurance is a plan by which a group of people can pool their money to share risks. It is a protective measure, and it can be a way to build savings. Premiums are paid to an insurance company. The policy states what the company will do and when, and tells how much money the company will pay the policyholder or the beneficiaries under various conditions.

Families usually purchase life insurance for financial protection. If an insured wage earner dies, the insurance money can provide financial security for the surviving family members. When both husband and wife are wage earners, life insurance may be needed for both. If there are young children to be cared for, a full-time homemaker may consider life insurance. There is seldom, if ever, a good reason to purchase life insurance on children.

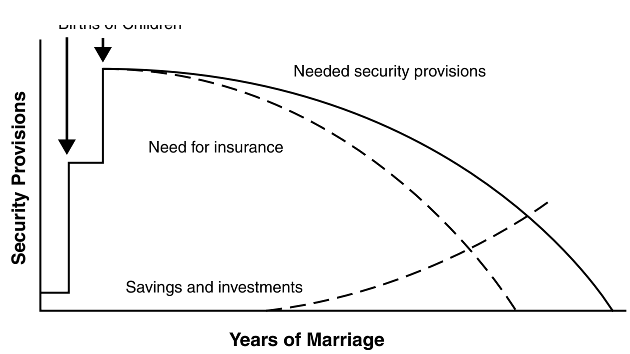
Families need and want as much protection as they can get for their insurance dollars. First consideration should be given to a policy that protects the family against possible loss of income. Building savings for future needs should come after buying this loss-of-income protection for the family.

The type and amount of financial protection a family needs from life insurance will be largely determined by:

- family income,
- other resources available,
- family plans and objectives,
- size and composition of the family, and
- stage in the family life cycle.

Life insurance needs change with time. A typical family's needs begin when the first child is conceived and reach a maximum amount when the last child is conceived. The insurance need drops to zero several years before the expected retirement age. An insurance policy should provide this lifetime pattern of insurance coverage. That is, it should provide a maximum amount of protection while the family is growing and taper off as the family gets older and smaller.

Trends of Needs and Resources for Family Financial Security



Estimating Insurance Coverage

The average amount of life insurance owned by insured families is equal to only 2 years of disposable (after-tax) income. The settlement proceeds usually are spent within 18 to 24 months of the insured's death. Based on these alarming statistics, determine your life insurance needs before shopping for that coverage.

You, not the insurance agent, should be the person to identify the amount of insurance coverage you need. Base your calculation on your dependents' needs now, not 10 or 20 years from now. The wage earner's death can create many financial needs:

- cash for last expenses (funeral and estate settlement costs),
- funds for a readjustment period,
- income for children while they are still at home,
- income for the spouse based on future ability to earn an adequate wage,
- special funds for college, and
- funds to pay off debts.

To estimate your individual life insurance needs use the following procedure.

1. Estimate how much of your current annual income your dependents would continue to need if you should die. Calculate this figure as 60 to 75 percent of your disposable income. Remember, the family will no longer incur your expenses for such things as food, clothing, and transportation.
2. Calculate the tax-free Social Security benefits your dependents are likely to receive. This can be anywhere from $3,000 to $21,000 annually depending on your wage base and the number of dependents eligible for benefits. Contact your Social Security office for this figure.
3. Find the difference between the estimated annual income needs and the Social Security benefits allowed. You will need to purchase life insurance coverage for this difference. Next, consider the number of years your spouse and children will need this income. Consult the chart for the multiplier number to determine the actual coverage needed. Multiply the calculated difference by the appropriate multiplier. (The following chart assumes that the proceeds are invested to earn 3 percent after taxes and inflation.)

Years	Multiplier
5	4.7
10	8.7
15	12.0
20	15.0
25	18.0
30	20.0
50	26.0

4. To this number add the sum for the last expenses, funds for a readjustment period, college fund, and funds to resolve outstanding debts.
5. Subtract other assets that your dependents can count on, such as savings accounts, real estate holdings, stocks, bonds, and retirement accounts.
6. Subtract whatever group life insurance coverage you have at work to determine your final figure.

This is an estimate of the total amount of insurance coverage you need to purchase at the present time. These figures will need to be adjusted periodically to take into account new living arrangements, inflation, and other factors.

Once you have established how much life insurance coverage you need to purchase, the next step is to determine what kind of coverage you should buy based on what you can afford.

Types of Life Insurance Policies

There are two types of life insurance policies: term and cash value. There are two variations of term insurance and numerous variations of cash value insurance.

Buying life insurance, like other major financial purchases, is an individual decision based on your particular needs. For example, term insurance is useful if you are young and want to make sure a spouse and young children would be taken care of if you were to die unexpectedly. For young persons it is also relatively inexpensive. If you are single and have no dependents or responsibilities, perhaps you do not need life insurance at all. For the older, more established family, the fixed premium and the buildup of cash value in a cash value policy might be more attractive. If you purchase cash value insurance, make sure you intend to keep it over the long haul. It can be quite expensive if you allow it to lapse in the early years.

Term Insurance

When you purchase term insurance you buy "pure" protection. These policies generally do not build up a cash value.

Term insurance offers protection that insures your family for a specified period of time, 1, 5, 10 or 20 years, or up to age 65. A term insurance policy pays a benefit only if you die during the period covered by the policy. If you stop paying premiums the insurance stops.

Term insurance is initially cheaper than other types of policies for the same amount of protection and, therefore, gives you the largest immediate coverage for the dollar. For this reason, it is useful for consumers who need large amounts of coverage for known periods of time for example, home buyers, parents of young children or people with high debt obligations.

The coverage ends at the end of the term, but it can be continued for another term if you have a policy with a "guaranteed renewable" clause. Under such a policy you need not take a medical examination when you renew. However, each time you renew, your premiums will be higher because you are older. If you have term insurance that is "convertible" you can exchange it for a cash value policy at a higher premium but without a medical examination.

There are two variations of term insurance: level and decreasing.

Level term insurance has a constant face value during the years of the policy but the premium increases each time you renew the policy. This increase reflects the higher mortality rates of people as they age.

Decreasing term insurance has decreasing face value during the years of the policy, but the premium remains the same. This form of insurance is often used to protect a long-term debt such as a home mortgage.

Cash Value Insurance

One usually thinks of straight or whole life insurance when one hears about cash value insurance, though there are variations of this insurance type. Some of these are limited payment, endowment, modified, universal, variable, adjustable, and combination plans known as family income policies and family policies. Universal is the newest and most popular form of cash value insurance.

All of these insurance policies offer a savings feature as well as financial protection should the insured die.

Cash value insurance is protection that can be kept in force for as long as you live. The premium for cash value insurance remains the same, thus the cost of your increased risk of death is averaged over the years.

An important feature of cash value insurance is the cash surrender value. This is a monetary value that increases over the years and that you receive if you give up the insurance. It encompasses the savings portion of your premium. A table in the policy states the amount of cash value available. The cash value has many uses, the most common one being the source for a loan. You can borrow the major portion of your cash value. There is no typical repayment period, though you will be charged interest on the loan. The outstanding amount of the loan will be deducted from the face value of the policy should you die before the loan is repaid.

Universal life insurance is a relatively new form of cash value insurance introduced to make life insurance inflation proof and more flexible. It permits a policyholder to pay premiums at any time, in virtually any amount, subject to certain minimums. The policyholder can change the face value of the policy unlike with traditional policies. In a universal life insurance policy the amount that the cash value increases each year reflects the interest earned on short-term investments.

Universal life policies are designed to meet long-term needs. There are fees and charges involved with these policies that frequently result in a loss to policyholders if the policy is allowed to lapse shortly after purchase. Hold these policies at least 10 years to give the cash value the opportunity to appreciate.

Consider economic conditions before purchasing cash value insurance. Inflation has had an explosive impact on almost all costs. This raises questions about the value of fixed-dollar financial instruments like traditional, cash value insurance policies. A simple answer seems to be to buy term insurance and take the difference between the annual premium for cash value insurance and the annual premium for term and invest it yourself in some other financial instrument.

The difference can be substantial because cash value insurance costs a lot more. Suppose you are 35 years old and concerned about life insurance. You think you need $100,000 of life insurance to care for your dependents. You have two choices. You can buy cash value insurance at $1,237 a year for the rest of your life. When you die your beneficiary will collect $100,000. Or, you can buy annual, renewable term insurance and invest the difference. Your term policy will cost you $196 initially. The difference available for investment is $1,041. As you age, the cost of your term insurance will rise, meaning you will have less to invest each year. In fact, somewhere around age 61, your term insurance will cost you more than the $1,237 you have been spending for insurance and investments. At this point you undoubtedly have little need for life insurance, and your investments should be worth more than $100,000.

However appealing such arguments appear, the consumer also must confront realistically what this means. Can you discipline yourself to invest the difference year after year? Do you trust your ability to select investments that will earn what you need over the next 10 or 20 years? Are you certain that you will not touch your investments until you need them, say at age 60 or 65?

Unless you are certain to invest the difference, and invest it wisely, the smartest decision may be a cash value policy.

Shopping for the Best Price

Consumers need to compare rates before buying life insurance. When shopping for coverage, talk with a number of agents representing several companies. The rate for a given policy can vary as much as 500 percent between the highest and lowest premiums. Rates have been decreasing in recent years because of increased life expectancy and competition among the insurance companies.

Insist that the agent provide you with an interest-adjusted cost index (the average annual cost per $1,000 of insurance) when comparing similar policies. This method of determining policy cost considers the time value of money. A policy with a smaller index number is generally a better buy than a comparable policy with a larger number.

To determine the yearly premium you can expect to pay, use the following table.

1. Locate your age, sex, and corresponding per-year cost.
2. Divide the amount of coverage you plan to purchase into $1,000 units.
3. Multiply the number of $1,000 units (determined in step 2) by the cost per year.
4. Add $25 to the amount determined in step 3.
5. This figure represents the maximum premium under most circumstances for the coverage desired.

Many companies offer substantially lower rates, particularly to nonsmokers in excellent health. This estimate is useful when shopping for term insurance. It does not allow for the savings portion of cash value insurance.

Cost of Insurance by Age and Sex

Male (age)	Female (age)	Per Year (dollars)
20-30	20-33	1.75
35	38	2.00
40	43	3.00
45	48	4.75
50	53	7.50
55	58	12.00
60	63	18.00

Example: If a 35-year-old male wishes to purchase a $100,000 annual renewable term policy, he can expect to pay an annual premium of approximately $225. (Cost per thousand x number of $1,000 units purchased plus $25.) $2.00 x 100 + $25 = $225.

If you decide to switch policies be sure that you are still insurable. First secure the coverage you need, then drop the old policy.

When shopping for insurance, beware of insurance policies sold through the mail or in television and newspaper advertisements. Be particularly cautious if the policy has unique guarantees for the elderly or veterans. Check these companies with the State Insurance Commissioner and, before buying, compare their prices to that of local, reputable companies. Do not buy a policy that requires the insurance agent to come to your home weekly or monthly to collect the premium. Insurance riders that insure your children's lives or pay double if you die in an accident are poor buys. But the waiver-of-premium rider that keeps your policy in force if you become disabled is considered a wise investment.

Here are nine rules of thumb to remember when buying insurance:

1. Understand and know what your life insurance needs are before any purchase.
2. Buy only the amount of life insurance you need and can afford.
3. Shop around and compare costs.
4. Select an agent who is competent, knowledgeable, and trustworthy.
5. Buy your life insurance from a company that is licensed in your state.
6. Purchase insurance from a substantial, well-established company rated A or above by insurance rating services.
7. Read your policy and make sure you understand it.
8. Inform your beneficiaries about the kinds and amount of life insurance you own and where you keep the policies.
9. Check your coverage periodically or whenever your situation changes to be sure your policy meets your current needs.

The insurance industry is not federally regulated. States regulate the industry. If you have questions or problems, contact the Maryland Insurance Commissioner located in Baltimore.

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Risk Management: Life Insurance

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