

Unit 12:

Life Insurance

Life insurance is a very common thing. Many people have it and understand why they need it. But how well do you understand it? It can be confusing because one person will tell you one thing and another may tell you another thing. You have learned a little about it in *The Wealthy Barber* and the textbook. The author of those two books and I feel about the same concerning life insurance. I will try to let you see both sides in this lecture. However, I admit I am biased and it will show. I feel strongly that you need to see this side of the life insurance debate because an agent will not likely show you this side at all.

Terms

There are a few terms that you should be familiar with before you talk about life insurance.

- *Owner or policyholder* - this is the person who is buying the insurance policy. It may or may not be the same person that the policy insures.
- *Insured* - the one the policy is covering. If this person dies the insurance will pay the benefit.
- *Beneficiary* - this is the person who will receive the benefit (money) if the insured dies.
- *Contingent beneficiary* - this person is second in line to receive the benefit if the beneficiary also dies.

Now, let's look at an example. Let's say that a grandmother was worried about her daughter who is a single mother and can't afford life insurance. The grandmother decides to buy an insurance policy on her daughter so that her grandchild will have some money to fall back on if his mother dies. Can you figure out who is who? The grandmother is the owner. The mother is the insured. The child is the beneficiary. Also, the grandmother may have put herself as the contingent beneficiary should the mother and child die together.

One other thing to note. If you get to the point in your life where you are worried about estate taxes, it is best to have the owner be someone other than the insured. If the insured is the owner and they die, that money will be counted in their estate. If their spouse is the owner, the life insurance benefit will not be included as part of the deceased person's estate. This can help save estate taxes if the estate is worth a certain amount.

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When Do You Need Life Insurance?

You NEED life insurance if someone is dependent on your income, especially children. If you don't have anyone dependent on your income, you may want to consider it to pay off debts and for funeral expenses. *The Wealthy Barber* does a great job explaining this concept.

How much do you need?

The book talks about two ways to figure your life insurance needs: the multiple-of-earnings approach and the needs approach. The multiple-of-earnings approach is easy but not very accurate. It would be fine to use this approach if you were just starting to look at insurance. Once you decide to get a policy, I recommend doing the needs approach. There are a lot of places to find worksheets that will help you do the needs approach. First of all, you are doing one worksheet for this class. The worksheet in *The Financial Checkup* is a needs approach method. The textbook also has a worksheet on page 330. Most county extension agents can get one for you. There are computer software programs and other worksheets available. The following website has a lot of calculators, for life insurance and a lot of other things. Once you are at the site you will see a list of the different types available.

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What Type Should You Get?

Now comes the debate. There are two basic types of life insurance, term and cash value. They each have several variations, but we will discuss mostly the two broad categories. First I will describe each type and then give the advantages and disadvantages of each.

Term- this type of life insurance provides only life insurance and only for a set amount of time. It is fairly easy to understand. You will pay a premium, usually yearly, to cover you for that period. You can get level term for longer than one year. This means that instead of getting a policy for one year only, you get one for 10, 20, or 30 years and lock in the premium for that period. You don't need to reapply each year, only after the period that you sign up for.

Advantages include more coverage per dollar. It is the least expensive way to get life insurance. It has very low commissions. This may be why an insurance agent is not likely to encourage you to buy term insurance. If you buy level term, you have a locked in premium for what may be a long period of time.

Disadvantages include increased premiums after the term ends. If you only had a one year term, after that year your premium would not only go up, but you would most likely have to qualify for the insurance again. This can be a problem with a short term policy. If you contracted a fatal illness at the end of your term, you probably would not be able to renew the policy. To avoid this, try to get a longer term. This will also keep your premium level for the same period.

Cash Value - this type of insurance combines an insurance policy with a savings program. It is much more expensive because part of your premium is going into investments. Also, a good part of your premium in the first few years is going toward commission. If you die, your beneficiary will receive what you have saved and some insurance benefit. For most cash value policies, the insurance benefit decreases as your savings increases. For example, if you had a policy for \$100,000 and you had \$5,000 saved, your beneficiary would receive the \$5,000 you had saved and \$95,000 of insurance benefit - total of \$100,000. After a few more years if your cash value portion had increased to \$25,000 and you died, your beneficiaries would receive the saved \$25,000 and \$75,000 of insurance benefit - total of \$100,000. They would not receive more than the \$100,000. There are some types that will pay the beneficiaries a set amount of insurance PLUS any money saved. But these types are even more expensive than the regular ones.

Advantages include no premium increase. It stays the same until the policy ends. That means you don't have to worry about being denied at the end of a term. Cash value policies force individuals to save. Also, the cash value portion accumulates tax free and you can borrow from the cash value.

Disadvantages include mostly the cost. At the beginning a good portion of your premium will go toward paying commission. It takes a long time for your cash value to increase. Even when it does, your beneficiaries will not receive any more if you were to die. I have seen people who wanted to cash out their policies and thought they would get a certain amount of money back because that is what is said on their statements. However, when they cashed it out, they actually got a lot less. There were fees and other things associated with the cash out.

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As you can see, I am a bit biased. Let me tell you my preference. I think it is better to keep insurance and investments separate. If you buy term insurance, invest on your own, and die, your beneficiaries will get the insurance benefit PLUS the amount you have saved. It frustrates me that people spend so much on a cash value policy, saving, and saving, and yet when they die their beneficiaries get no more than they would have the first few years when the savings were low.

If you are worried about being denied coverage when you need to renew your insurance, here are two things you can do. First of all, you can get term insurance that will cover you for 30 and I have even seen 40 years. You would not have to qualify again in that time period. Second, if you are really worried about it, you could get convertible term insurance. This allows you to convert the term policy over to a cash value policy. You would pay more for this option however.

If you are worried about your premiums going up and being really expensive when you get older, remember that you can lock in the premiums for a fairly long period of time. An agent will probably do an illustration for you that will show how much you are likely to have if you invest through a cash value policy and they may compare it to buying term and investing the difference. Their illustration will probably show that you will be ahead if you go through the cash value policy. Just be aware that their programs will most likely show the term insurance becoming very expensive later in years. Remember that you can get level term for a long period of time and the premiums will not increase.

If you did get a 30 or 40 year level term policy, what would your life be like at the end of that term? For most of you, you will have a house paid for, children raised, hopefully adequate retirement, AND INVESTMENTS. It may be that you don't need the term insurance at that point in your life anyway. It would likely be very expensive to renew the term at that age. But with the cash value life insurance policy, you save until you have enough to cover the policy yourself anyway. Why not buy term and save enough on your own to do the same? It would take less of your own investment to do that on your own. If you are investing on your own you could have your investments increase a lot faster if you found no-load or low-load investments and didn't pay a lot of commission.

If you are worried about your own investments not growing tax-free, you can get an IRA, especially a Roth IRA. IRA's also grow tax free. There are other ways to avoid paying taxes on savings other than a cash value life insurance policy. If you think that being able to borrow from your cash value is a good idea, ask yourself if you could do the same with your own investments. Unless they are all in IRA's you can do whatever you want with the money. I hope you would be very selective about what you used it for, but it would definitely be there if you had an emergency. That is about the only reason I would recommend borrowing from your cash value also.

I had a friend that was a financial planner and we were discussing all of this. I kept telling him that people would be ahead if they bought term and invested the difference on their own. He agreed with me but said, "Alena, they won't invest on their own." I had to agree that most people won't. Now, ask yourself, will you invest on your own? Do you have the discipline to become wealthy? It actually doesn't take any more discipline if you set up an automatic investment program. You can get a mutual fund that will automatically take a set amount of money out of your checking or savings account every month. You don't have to write the check or make the effort to invest once it is set up (you do have to subtract it out of your checkbook though). It can be very easy to have the discipline to invest. We will be talking about investing next.

Well, enough of my soap box, go to the following website and read the information there:

[Life Insurance](http://www.insweb.com/learningcenter/ga/life-a.htm)

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