Financial Planning Newsletter

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Life Insurance

Hello!

At Clarity, one of the services we offer our clients is reviewing their current insurance policies to ensure they are sufficiently covered in the event they pass away, become disabled, or incur a loss on an asset such as a home or car. This month's newsletter focuses on life insurance, a topic that some find difficult to discuss, but an important area as it provides a foundation to ensure that loved ones are financially taken care of in the event one passes away.

Characteristics of Life Insurance

- A policy can be on a single life or on two lives; the latter is commonly referred to as a survivorship or second-to-die policy and is used for estate planning purposes.
- A life insurance policy can be personally-owned or offered through an employer. With employer coverage, it is usually a group term insurance policy in which one can purchase coverage based on a multiple of their income. This type of coverage is not usually portable so it ends if and when the employee leaves.
- Life insurance premiums are calculated based on the insured's age and health history, the death benefit amount, and the type of coverage. From this information, the insurance company's underwriters determine the insured's rating (ranging from preferred best to standard) and the policy premium.
- Proceeds from life insurance in most cases, are not subject to federal income taxes.

Need for Life Insurance

There are several scenarios where the amount of life insurance coverage should be evaluated and these include:

- Individuals with dependent children
- Married or engaged couples
- Individuals who financially support aging parents or siblings
- Business owners for succession planning and key person coverage
- Retirees or pre-retirees

Amount of Coverage

Many individuals believe that it is sufficient to have anywhere from two to ten times their gross income in terms of life insurance coverage. There is no "one size fits all" approach when it comes to determining an appropriate amount of coverage as it depends on one's situation. There are three types of needs to review: immediate, ongoing, and future expenses. Immediate needs relate to the decedent's estate, while ongoing and future needs pertain to one's beneficiaries.

Immediate:

- Funeral costs
- Debts and liabilities (mortgage, auto loans, credit cards, and student loans)
- Taxes (income and estate)
- Uncovered medical expenses

Ongoing:

- Basic Living Expenses (food, housing, utilities, transportation)
- Insurance
- Taxes

Future:

- College Education
- Retirement

It is important to take into account the current and future financial obligations, as well as the income and assets of the surviving spouse/partner.

Types of Life Insurance

There are two primary forms of life insurance: term and permanent coverage, and there are subsets of each.

Term Life Insurance

This form of coverage is the cheapest form of protection as the coverage is for a specific time period (typically between 10 to 30 years). There is no cash value component and the policy can be canceled at any time without incurring a penalty. It is similar to automobile and homeowner's insurance coverage, where annual premiums are paid, but if there is no claim made in that year, the premiums remain with the insurance company.

With term life insurance, there are three forms:

- **Level Term** – premiums are fixed during the term period and the policy renews automatically each year as long as the premiums are paid.
- **Annual Renewable Term (ART)** – even though the policy renews automatically on an annual basis, the premiums increase each year.
- **Decreasing Term** – premiums remain fixed but the death benefit amount decreases each year. This is usually appropriate for a specific liability that gradually decreases, such as a mortgage or business loan.

Sometimes, individuals want to have permanent coverage, but due to the higher premiums, they cannot currently afford this type of coverage. They feel that as their financial situation improves, they want to have the ability to convert the coverage from term to permanent. Many term policies provide a guaranteed convertible feature in which it gives the insured the option to convert to a permanent policy without having to go through underwriting. Upon conversion, the premium would be based on attained age, not the age when the term policy was originally established.

Permanent Life Insurance

For those that want to have lifetime coverage, this type of insurance is appropriate. The premiums are higher than term insurance as it has a cash value component. There is also a surrender charge (penalty) in the event the policy is canceled within a specified number of years since it was established (usually 5 to 10 years).

With permanent life insurance, there are three primary forms:

- **Whole Life** – the premiums are fixed, there is a guaranteed death benefit, and there is a minimum percentage return for the cash value component. These types of policies can be issued as "participating" or "non-participating". With participating policies, dividends can be paid by the insurer and they can be applied to reducing the premium, to purchasing additional coverage, to reduce a loan (in the event a loan was taken out), or withdrawn as cash. It is important to note that dividends are not guaranteed. As a contrast, with non-participating policies, these offer no dividends to the insured. Lastly, with a traditional whole life policy, only the death benefit is paid to beneficiaries no matter how much cash value has been accumulated. Insurance companies do offer alternative payout options such as the death benefit plus cash value or the death benefit plus return of premium, but these are at an additional cost to the insured.

- **Universal Life** – this provides for flexibility in the timing and amount of premium payments. These policies are tied to an interest rate and a guaranteed minimum death benefit as long as sufficient premiums are paid into the policy.

- **Variable Universal Life** – this has the same features as a universal life policy, but the insurance company provides subaccounts similar to mutual funds in which the insured selects from. If the rates of return of these sub-accounts do well, the cash value will increase, and vice versa.

Optional Riders

Many insurers offer various policy add-ons; some are free while others come at an additional cost.

- **Waiver of Premium** – this waives premium payments in the event the insured is disabled.

- **Accidental Death Benefit** – this pays the beneficiaries an additional amount (typically two times the death benefit) if the insured dies due to an accident.

- **Accelerated Death Benefit (Living Benefits)** – this pays the benefit early if the insured becomes terminally ill.

- **Option to Purchase Additional Insurance (OPAI)** – this enables the insured to purchase additional amounts of life insurance coverage at set intervals without proving insurability.

- **Child Rider** – this is a term insurance rider on a parent's life insurance policy which provides coverage for a child under age 17, until the child turns 25. Most child riders can then be converted to a regular policy without proving insurability.

- **Long-Term Care** – it pays for long term care expenses in the event the insured is not able to do some of the activities of daily living (ADLs) such as dressing or bathing.

As one's personal situation changes, this will likely affect their life insurance needs so it is important to periodically review current coverage to determine if the amount is still sufficient. Please consult with your financial advisor to determine if you have the appropriate amount and type of life insurance coverage.