PERSONAL INSURANCE

PREPARING FOR THE UNEXPECTED

In the event of an early departure, unexpected turbulence, or a longer-than-anticipated journey, acquiring appropriate personal insurance is key to avoiding a financial crash.

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2 This is the second of a five-part personal financial planning series sponsored by the Peery Institute of Financial Services. The next installment, addressing property, casualty, and health insurance, will appear in the Summer 2005 issue.

Insurance is the pooling of resources by a large number of individuals in anticipation that a certain number of those individuals will make a claim requiring a distribution of the pooled resources. Many seek insurance as a hedge against the possibility they will be one of those making a claim.

Personal insurance refers to life, disability, and long-term care insurance. It is underwritten on and covers people, while property and casualty insurance is underwritten on and covers homes, autos, businesses, and catastrophes.

Many questions arise when addressing the subject of personal insurance: Why do I need insurance? What kinds of insurance should I consider? If I need insurance of any kind, how much do I need?

GLOSSARY

UNDERWRITE–assume liability

PREMIUM–what a customer pays for a contract of insurance

ACTUARIAL–relating to statistical calculation especially of life expectancy

RIDER–adjustment to a life insurance policy if current policy doesn't meet holders' needs

LIFE INSURANCE

Among all the unknowns in this life, death is one certainty. If we love or owe an obligation to someone, we must consider whether or not we have sufficient resources, beyond our own industry, to provide in our absence what we have provided while living. If we can provide for our loved ones or satisfy obligations through other means, then there is no need for life insurance in the traditional sense.

There may be, however, in the presence of substantial available resources, a need for life insurance in trust to satisfy estate tax obligations at death. If there would not be sufficient resources to provide adequately for your loved ones in your absence, or that a debt or obligation would not be met, then life insurance should be considered.

There are a number of ways to calculate how much life insurance is appropriate:

1. Life value—fifteen times your current annual earnings, establishing a present value today of your earnings in the future;

2. Cash and capital needs analysis—this involves the determination of the amount of cash required to secure the survivors of a breadwinner, and to provide for their maintenance, education of children, etc., and sufficient capital to provide an adequate long-term income stream to allow them to remain in their current financial condition; or

3. Debt and obligations—the amount required to satisfy long-term obligations or pay off debts.

There are a host of other ways to determine the appropriate amount of insurance; these are but a few of the more common approaches (See table 1).

With the need for life insurance established and the appropriate amount determined, the next questions would be: What type of life insurance is right for my situation? How long do I want the life insurance to be in force? What do I want the life insurance to accomplish and for whom? (See table 2.)

Term Insurance

There are two types of life insurance—temporary and permanent—with several categories within each. Temporary life insurance is called "term" insurance because it is designed to be in force for a term of time. Term insurance is the cost of risk for an insurance company to undertake the possibility you might die before your actuarial life expectancy. It is inexpensive when you are young and healthy; costs rise as you get older and less healthy. Good health and sound living habits, such as not smoking or avoiding dangerous activities, are rewarded with additional discounts.

Costs continue to rise as you get closer to your life expectancy, when, if the insurance is in force, the insurance company will need to pay the claim. Term insurance comes in several categories. One is annually renewable, meaning that the premium (what you pay) increases each year. Another includes the option that the policy is "convertible" to a cash-value policy at the option of the holder. Finally, others have premiums that are averaged over a selected period of time for five, ten, or twenty years. Your premiums do not build equity or cash value in the policy.

Permanent Insurance

If the life insurance need will be longer than twenty years, it may be prudent to look into the benefits of permanent insurance. Aside from providing death benefits, permanent insurance can be useful for estate planning, retirement, personal loans (loans against your policy accrue interest and decrease the death benefit by the amount of the outstanding loan and interest), and the onset of serious medical problems.

Permanent insurance can be helpful in estate planning to ensure that sufficient funds are available to pay estate taxes. Because the cash-value portion of this insurance earns tax-exempt interest, more money may also be available for retirement. Low-cost loans can sometimes be secured against the cash-value portion of permanent insurance policies. And, such policies can only be cancelled if premiums are not paid—a particularly important benefit for those with a history of medical problems.

Permanent life insurance is divided into three categories: whole life, universal life, and variable universal life. These categories differ according to the type of investment you choose to build your tax-deferred savings.

Whole Life Insurance

Whole life is the oldest form of life insurance and probably the least understood. The premise is that the insurance company assesses the specific pool of individuals insured by age, gender, and health, and assumes the worst case scenario—a disproportionate number of those individuals will die too early, and the premiums paid by individuals in the pool will provide a less than satisfactory rate of return to the company. The pricing is based on these assumptions.

Then, each year, as the actual mortality experience occurs and actual investment performance of the premiums is determined, the difference between the worst case scenario and the actual current-year experience is returned to the policyholders in the form of a dividend. The dividend is not taxable because it is considered a return of an overpayment of premium, which had been previously taxed.

That dividend can be 1) paid outright to the policy holder, 2) used to offset a portion of the subsequent premium, 3) retained on deposit earning interest within the policy (this option is taxable), or 4) retained in the policy, buying paid up additional life insurance, the cash value of which is tax deferred. Most policyholders, in an effort to eventually end paying premiums, choose the last option. After about fifteen years, the policy may have sufficient dividend activity to allow the policy to sustain itself without further outlay on the part of the policyholder.

At that time, the policy should have approximately the same amount of net cash value as the amount of premiums paid into the policy cumulatively. Hence, the life insurance has been and will be paid for in the future with the yield of the policyholders' dollars as opposed to policyholders' dollars, thus allowing the policyholder to retain control over his/her money.

With whole life, guarantees are very important. The death benefit is guaranteed, as long as the premium is being paid, either by policyholder or by the policy itself; the premium is guaranteed never to increase; and the cash value is guaranteed and is stated in the policy as to what the exact dollar amount of cash value increase will be each year of the policy. The only element that is not guaranteed is the dividend, because it is dependent on mortality and investment performance each year.

TABLE 1: CASH AND CAPITAL NEEDS

CASH NEEDS	HUSBAND	WIFE
Immediate Money Fund		
Debt Payoff		
Mortgage Payoff		
Emergency Fund (6 Months Income)		
Child/Homecare Fund		
Education Fund		
TOTAL CASH NEEDS		
CAPITAL NEEDS	**HUSBAND**	**WIFE**
Annual Income		
Total Household Income		
Less: Spouse Income		
Less: Social Security (Child Death Benefit)		
Equals: Income Shortfall		
Divide By ______% (Yield Factor)		
TOTAL CAPITAL NEEDS		
TOTAL CASH & CAPITAL NEEDS		

Universal Life Insurance

A much newer category of permanent life insurance is universal life. Universal life insurance foregoes the worst-case scenario approach and, instead, makes an assumption each year based on actual mortality and investment performance. As such, the universal life policy holder has a myriad of options with regard to how the policy can be designed, and those options can change as the policy holder's circumstances change.

For example, if the policyholder's income is inconsistent—one year high, the next year low—the policy has the flexibility to be sustained at different premium levels throughout the life of the policy. When circumstances permit, years of underfunding can be made up, or if overfunding is accomplished early in the policy's life, the universal life policy could get to the point of being able to fund itself without further outlay on the part of the policyholder.

With flexibility, however, comes compromise, in that there are fewer guarantees and more risks taken on by the policyholder. The insurance company has more latitude with regard to the internal charges for mortality and expenses. However, if the policyholder is not in a position to afford to pay the premiums for whole life, but wants a permanent life insurance solution, then universal life should be considered. If done properly, the universal life approach allows the policyholder to pay for insurance with the yield of the policyholders' dollars as opposed to policyholders' dollars, thus allowing the policyholder to retain control over his/her money.

Variable Universal Life Insurance

Variable life products are flexible premium, permanent life insurances policies that allow the policyowner to have premium dollars allocated to a variety of investment options (which will fluctuate with market conditions), including a fixed account. Variable products generally provide tax-free death benefits on income, have cash values that grow tax deferred, and are accessible through policy loans and/or withdrawals (loans against your policy accrue interest and decrease the death benefit by the amount of the outstanding loan and interest). Variable life products are sold through prospectus only.

DISABILITY INSURANCE

The most valuable financial asset is one's ability to earn a living. However, there is a one-in-four chance you will be disabled for at least six months during your working lifetime (from twenty-two to sixty-five years old).

In the event that an accident or illness was not terminal, but rather disabling—prohibiting the individual from being able to be gainfully employed—a similar financial scenario to death occurs, although the injured or sick person is still living. If this happens, someone with disability insurance would receive a portion of take-home income he/she did before the disability.

Normally, a disability benefit attempts to restore approximately 65 percent of the gross earnings of the insured individual. That percentage decreases as income increases. If the benefit is offered through the employer at no cost to the employee, then the benefits will be taxable in the event of disability. If the employee pays the cost for disability coverage and does not deduct the premium for income tax purposes, then the disability benefit will be tax free.

If an individual is not covered by an employer-sponsored disability plan, individual plans are available, and in many cases will provide more comprehensive coverage and more customization of benefits depending on the individual's profession or line of work.

Important questions to ask in designing an individual disability income plan include

- What is the policy's definition of disability?
- How long is the disability period before benefits begin?
- What is the maximum percentage of gross income the benefit provides?
- How does the policy integrate with possible Social Security benefits? Would those benefits be mutually exclusive?
- What are options for duration of benefits?
- What are options relating to the healing process and gradually returning to work?
- If the disability is prolonged or permanent, what cost-of-living options are available?

Depending on the insurance carrier, there are other benefits and riders that should be measured. The most important consideration when addressing your need for disability coverage is the same for life insurance: if you become disabled, what other resources are available to provide for those who depend on you? If those resources are not apparent, you should consider disability insurance.

LONG-TERM CARE INSURANCE

Professionals who study risk management say that individuals have several choices when dealing with risk. These choices include: 1) avoiding the risk, 2) retaining the risk, or 3) transferring the risk.

When it comes to the issue of long-term care, people may avoid the risk because they don't understand the potential for needing services. They may choose to retain the risk because they don't understand the potentially high cost of care. Or they may transfer the risk as part of a carefully considered retirement and financial plan. Each person's decision-making process is driven by different concerns and priorities. Here are seven reasons you should consider transferring the risk of a long-term care experience through the purchase of long-term care insurance.

Economics

Protecting your assets

In the absence of other resources such as insurance, it may be necessary to pay for long-term care expenses out of pocket. This could involve selling assets, borrowing from an investment or retirement account, or even taking a loan against your life insurance. These options, although possible, are probably not what you had in mind when you purchased life insurance or began saving for your future. Long-term care insurance may be an affordable way to help protect a much larger portion of your financial and retirement plan against an unexpected need for care.

Opportunity Cost

Freeing up your money

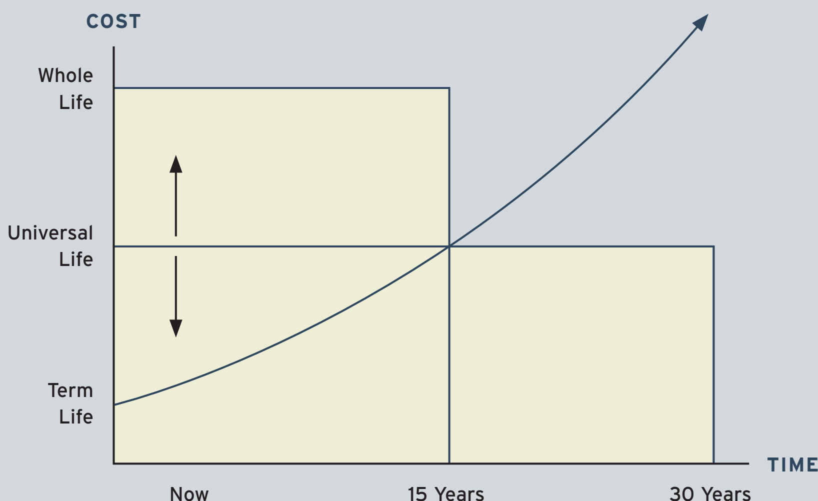
If the choice is made to retain the risk and self-fund the potential cost of long-term care, you must set aside a considerable portion of your assets as a "rainy day" fund. By insuring part of this risk, those assets are free to support the quality of life you expect for you and your spouse in retirement or to be used for other worthwhile purposes, such as charitable donations, special trusts, and gifts.

Control

Having your own way

A bottom-line issue in long-term care is control. If you someday need long-term care services, you may find that you are not able to control how the funding of those costs is handled. Would you object if your family decided to liquidate some assets or sell something you value, such as a cherished collection, antiques, or a vacation home?

TABLE 2: **TYPES OF INSURANCE**



If you were to become incapacitated, you might not have a say in the matter. By insuring part of the risk, you help increase the possibility that your assets will be handled and distributed according to your wishes.

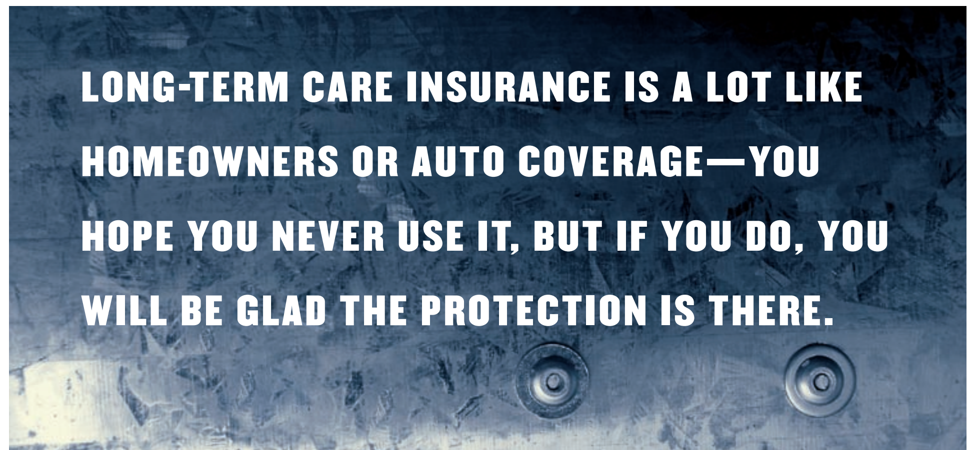
Another important element of control is deciding where care will be provided. Long-term care services may be provided in any number of settings including your home, an assisted care living facility, adult day care, or nursing facility. Being able to decide where you wish to receive care is often tied to your financial resources at the time of need.

Risk Management Logic

Recognizing a legitimate risk

Most people have homeowners and auto insurance, but if you scratched the paint on your car or a neighborhood kid threw a baseball through your window, you might pay those expenses without filing a claim because the cost is manageable. You have insurance though, because if something major happened to your car or your home, you would be protected.

The need for long-term care services may have a much bigger effect on your finances than a scratched car or a broken window. Long-term care insurance is a lot like homeowners or auto coverage—you hope you never use it, but if you do, you will be glad the protection is there.



Quality of Care

The privilege of choosing your caregiver

Most people agree that the preferred place to receive quality care is in the privacy and comfort of their own home. However, depending on the type of care you receive, home care may be just as expensive as care received in a facility. By insuring for the long-term care risk, you may be assured that care expenses will be less of a concern when receiving the best home care available. Having additional resources may also make the difference between staying at home and having to relocate to a care facility. Should institutional care better fit your needs, you may have funds on hand to pay for the facility you prefer, rather than one you can afford.

Timing

Creating a window of time

Life insurance helps provide a window of time for your heirs. This span of time helps ensure that they do not have to liquidate assets right away to pay for estate or probate costs under possibly disadvantageous circumstances. Long-term care insurance can help in a similar manner. Assets may not need to be liquidated to fund long-term care costs—or at the very least, you may have time to think about how, when, and what you might like to liquidate.

Family Considerations

Stressful decisions

An unexpected need for long-term care services may create stress for family members confronted with issues of caregiving. Caregiving may take a physical toll on family members who may have to help with bathing, dressing, and other tasks associated with custodial care. It can also have a financial impact on family caregivers who have to miss work, change from full-time to part-time employment, or even leave a job completely. Finally, caregiving may have an emotional impact on family members assisting their mom or dad. Physical and mental illness sometimes brings an unexpected role-reversal to the parent-child relationship.

Long-term care insurance helps with these considerations by providing benefits and resources to help you and your family understand the options and determine the best source of care. Long-term care insurance provides options that you and your family may not know about or may not otherwise have the money to consider.

CONCLUSION

To offset risks related to your personal insurance needs, a little planning and knowledge will help you determine the type and level of life, disability, and long-term care insurance you'll need to navigate life's journey. M

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This article is for informational purposes only. You should consult with a professional advisor to determine the appropriateness of any course of action.