PRINCIPLES OF RISK MANAGEMENT AND INSURANCE

CLASS NOTES

Chapter 16 Fundamentals of Life Insurance

Topics

- Premature Death
- Amount of Life Insurance to Own
- Types of Life Insurance
- Variations of Whole Life Insurance
- Other Types of Life Insurance

Premature Death

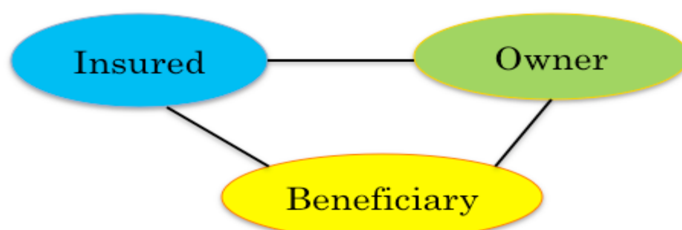
- Premature death can be defined as the death of a family head with outstanding unfulfilled financial obligation
    - Can cause serious financial problems for the surviving family members
    - The deceased's future earnings are lost forever
    - Additional expenses are incurred, e.g., funeral expenses and estate settlement costs
    - Some families will experience a reduction in their standard of living
    - Noneconomic costs are incurred, e.g., grief, loss of the parental rule model.
- Life expectancy has increased significantly over the past century
    - Thus, the economic problem of premature death has declined
    - Millions of Americans still die annually from heart disease, cancer and stroke
- The purchase of life insurance is financially justified if the insured has earned income and others are dependent on those earnings for financial support

Life Insurance Participants

Insured, owner, and beneficiary are three parties of life insurance.

- ✓ Insured: the person whose death causes the insurer to pay the claim .
- ✓ Owner: the person who may exercise the rights created by the contract.
- ✓ Beneficiary: the person receiving the proceeds when the insured dies. A person, a trust, an estate, or a business may be a beneficiary.

Three Parties of Life Insurance Contract



- One person may be both insured and owner, or owner and beneficiary but a person cannot be both insured and beneficiary.

Example:

- ✓ You buy life insurance for yourself(both owner and insured are one person).
- ✓ You buy a life insurance for your husband/wife

(both owner and beneficiary are one person).

- ✓ If you are insured and anything happens to you, you can not be the beneficiary of your own life insurance (beneficiary and insured can no be the same person).
- Three approaches can be used to estimate the amount of life insurance to own

1- Human life value approach

2- Needs approach

3- Capital retention approach

- The human life value approach
  - The amount needed depends on the insured's human life value, which is the present value of the family's share of the deceased breadwinner's future earnings

Amount of Life Insurance to Own

- To calculate the amount needed under the human life value approach:

First: Estimate the individual's average annual earnings over his or her productive lifetime

Second: Deduct taxes, insurance premiums and self-maintenance costs

Third: Using a reasonable discount rate, determine the present value of the family's share of earnings for the number of years until retirement

Types of Life Insurance

- Life insurance policies can be classified in two general categories:
  - ➢ Term insurance provide temporary protection
  - ➢ Whole life insurance or Cash-value life insurance

has a savings component and builds cash values

- There are many variations of both types available today

Term Life Insurance

- Under a term insurance policy, protection is temporary; protection expires at the end of the policy period, unless renewed
- Most term policies are renewable for additional periods
  - Premiums increase at each renewal
  - To minimize adverse selection, many insurers have an age limitation beyond which renewal is not allowed
- Most term policies are convertible, which means the policy can be exchanged for a cash-value policy without evidence of insurability
  - Under the attained-age method, the premium charged for the new policy is based on the insured's attained age at the time of conversion
  - Under the original-age method, the premium charged for the new policy is based on the insured's original age when the term insurance was first purchased

Whole Life Insurance

- Whole life insurance is a cash-value policy that provides lifetime protection
  - The death benefit amount is paid to a designated beneficiary when the insured dies, regardless of when the death occurs.
  - Why whole life insurance premiums initially are larger than term life insurance?

Because claims are a certainty with whole life policies, the insurer must collect enough premiums to pay the early death claims.

- **Traditional whole life insurance**
- ✓ Ordinary life insurance
- ✓ Endowment life insurance
- **Modern variations of whole life insurance**
- ✓ Variable life insurance
- ✓ Universal life insurance
- ✓ Variable universal life insurance
- ✓ Limited-payment life insurance

Traditional Types of Whole Life Insurance

- ✓ **Ordinary life insurance** characteristics:
- 1- Ordinary life insurance is a level-premium policy that provides **lifetime protection** to age 100.
  - The excess premiums paid during the early years are used to supplement the inadequate premiums paid during the later years of the policy.
  - The insurer's **legal reserve** is a liability that must be offset by sufficient financial assets
- Endowment insurance pays the face amount of insurance to beneficiary if the insured dies within a specified period. If the insured is still alive at the end of the period, the face amount is paid to the policyholder
- Endowment insurance accounts for less than one percent of the life insurance in force

Modern Types of Whole Life Insurance

- **Variable life insurance** is a fixed-premium policy in which the death benefit and cash values vary according to the investment experience of a separate account maintained by the insurer
  - The premium is level
  - The entire reserve is held in a separate account and is invested in common stocks or other investments
  - Cash-surrender values are not guaranteed
  - Insurers do not guarantee a minimum cash value; however they do guarantee a minimum death benefit.

- **Universal life insurance** is a flexible premium policy that provides lifetime protection under a contract that separates the protection and saving components.
    - Except the first premium, the policyholder decides the amount and frequency of premium payments
    - The protection and saving components are unbundled or separated. An annual statement sent to the policy owner shows the premiums paid, death benefit , and value of the cash-value account.

Uses and Limitation of Universal Life Insurance

- ✓ **Advantages :**
- Unbundling or separation of protection and saving components
- Considerable flexibility
    - Cash withdrawals are permitted
    - Policies receive favorable tax treatment
- ✓ **Disadvantages include**:
    - Insurers advertise misleading rates of return
    - Cash-value and premium-payment projections can be misleading and invalid
    - Insurers can increase the mortality charge
    - A policy may lapse because some policy owners do not have a firm commitment to pay premiums

- **Variable universal life insurance** is similar to universal life insurance with two exceptions:
    - The cash values can be invested in the wide variety of investments.
    - The policy does not guarantee a minimum interest rate or minimum cash value and the policy owner bears the investment risk.

End of Chapter.