Research Paper

Life Insurance – The Basics

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DISCLAIMERS

1. The information in this material is not intended as tax or legal advice. Please consult legal or tax professionals for specific information regarding your individual situation.
2. Clients are encouraged to talk to licensed insurance professionals for specific policy recommendations and details.
3. The content herein was developed from sources believed to be providing accurate information.
4. Investing is subject to risk, including the possible loss of the money you invest.
5. All final investment and planning decisions are at the discretion of the client.

INTRODUCTION

This white paper is intended to provide the reader with introductory information related to life insurance, including its purposes, the types of life insurance offered, key factors to consider when purchasing life insurance. We will include terms and definitions, a situational example and resources for further investigation.

Eustace Advisors offers a Financial Education Class that is based on the material in this white paper and includes additional situation examples tailored to the audience. Please contact us if you are interested in learning more about our Financial Education Services.

Eustace Advisors does NOT sell any type of insurance product – our role is to help our clients better understand how life insurance works, the factors that affect a decision to purchase life insurance, and how to calculate the amount of coverage needed. We encourage our clients to talk to licensed insurance professionals for specific policy recommendations and details.

HOW LIFE INSURANCE WORKS

In simple terms, life insurance is a contract in which the insurance policy owner makes regular payments — also known as premiums — to an insurance company. In return, the insurance company pays a lump sum of money to the policy's named beneficiaries if the insured party dies while the policy is active.

The life insurance company performs extensive analysis on projected lifetimes, health risks, investment returns and other factors to define the premiums required. Some of the other factors of merit related to the insured party include age, gender, occupation, and home location.

Note that the insurance company is in business to make a profit. Thus, the insurance company will collect premiums from a large number of policy owners (called a "pool") to spread their risk, invest those premiums to provide additional returns, keep a portion of cash value investments made by policy holders, and retain the paid premiums made on lapsed policies.

PURPOSES OF LIFE INSURANCE

For most individuals and family members, the primary purpose of life insurance is to replace the income of a primary earner in case of their death. The life insurance benefits can be used by the beneficiary to:

1. Cover ongoing expenses that would have been paid via the deceased's income, such as:
   A. Family living expenses.
   B. Higher education savings.
   C. Support of aging parents or grown children with special needs.
2. Fund the Long-term retirement needs of a surviving spouse.
3. Pay off debts owed by the deceased that are in excess of the deceased's liquid assets.
4. Pay for funeral related costs for the deceased.

Other purposes of life insurance include:

1. Estate Planning.
   a. Cover mortgage, loan, tax and other recurring costs of the deceased's estate.
   b. Pay for the legal costs associated with the probate process.
   c. Fund gifts and other bequeaths as per the deceased's estate plan.
2. Savings - use Cash-Value life policies to build savings for retirement and other uses.
3. Business Protection and Succession - use Term life policies to cover key employees of a business and to fund the buyout of a deceased co-owner's shares.

TERMS AND DEFINITIONS

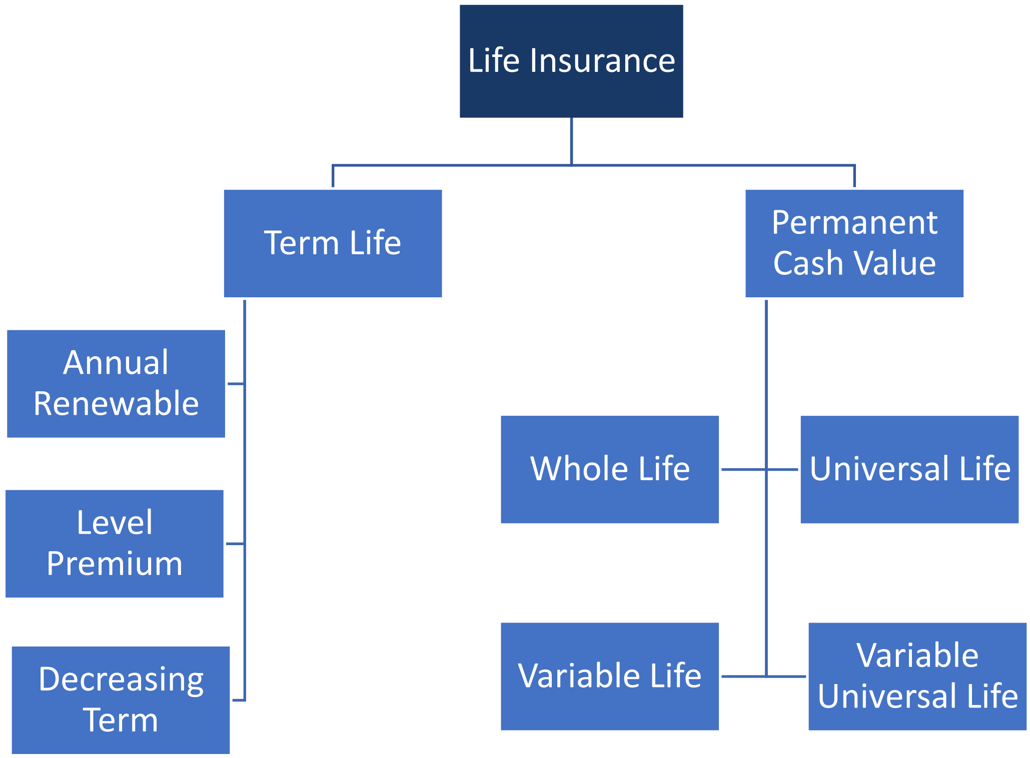
1. Agent: state-licensed insurance company representative who solicits and negotiates insurance contracts and provides service to the policyholder on behalf of the insurer. An agent can be independent (represents at least two insurance companies) or a direct agent who represents and sells policies for only one company.
2. Cash Value: the amount of money that has accrued in certain insurance policies. May be paid to the policy holder if the policy is cancelled or can be used as a loan.
3. Death Benefit: the sum of money paid to the beneficiary upon the death of the insured. Also called the Face Amount.
4. Evidence of Insurability: statement or proof of the insured's health, finances or job, which helps the insurer decide if they are an acceptable risk for life insurance.
5. Insurance: a contracted financial structure in which risk is transferred to an insurer, tied to a promise to pay, in return for equitable premiums. Insurance is used to transfer a large amount of individual risk across a wide pool of insured parties.
6. Insured: the person whose life is covered by the life insurance policy. May be different than the policy owner.
7. Insurer: a person or company that contracts to pay another party in the event of loss or damage.
8. Life Expectancy: probability of an individual living to a certain age.
9. Life Insurance: a form of insurance that provides economic protection to those who would suffer financially if the insured party died.
10. Needs Determination: the process used to calculate the death benefit amount needed to cover the immediate and projected expenses that the deceased's earned income would have covered.
11. Policy Beneficiary: the person or entity that receives the death benefit upon the death of the insured.
12. Policy Owner: the person holding the contract with the insurer and making premium payments for the policy.
13. Policy Period: the interval of time during which the insurance policy is in effect.
14. Premium: the payments made to keep a life insurance policy active. May be level or variable amounts.
15. Rider: an extra provision that can be added to an insurance policy. Riders add more coverage in exchange for increased premium cost. Riders allow people to customize their insurance policies so they can pick and choose benefits they want while not paying for benefits they don't want.

16. Settlement Option: defines how the proceeds of the insurance policy will be paid. This is typically established by the policy owner, and may be a lump-sum payment, installment payments over a fixed period or of a fixed amount, or various income-for-life options.
17. Surrender: cancellation of a life insurance policy.
18. Underwriting: the process used to assess eligibility to purchase insurance and the insured's risk classification.

INTERESTING FACTS

1. 50% of Americans have some form of life insurance.
2. The percentage of Americans with life insurance has declined by about 13% over the past decade.
3. 59% of married Americans have life insurance; 38% of single Americans have life insurance.
4. 59% of insured individuals purchased their own policy; 23% have coverage via employer; 18% have both.
5. Women are twice as likely (22%) as men (11%) to lack life insurance.
6. Only 34% of GenZ own life insurance policies; 57% of Baby Boomers own life insurance.
7. 44% of American households would encounter significant financial hardship within 6 months is the primary wage earner died; 28% would reach that point within a month; 10% within one week.
8. Factors taken into account when life insurance policies are offered: age, gender, health history, driving record, criminal record, and credit history.
9. 50% of respondents to a Forbes survey cited uncertainty about the type or amount of life insurance to buy as the primary reason for lack of personal policies. 49% report cost as the primary reason.
10. Disability is a greater risk than death for most individuals. A 30-year-old is 4x more likely to be permanently disabled than die before they reach 65 years of age. This ratio is 2.7x for a 40-year-old.

TYPES OF LIFE INSURANCE



- ✓ Coverage for a defined period
- ✓ No cash value accumulation
- ✓ Less expensive

- ✓ Coverage for the life of the policyholder
- ✓ Accumulates cash value over time.
- ✓ More expensive than Term Life
- ✓ Investment options

Term Life

Term Life policies tend to be the simplest and least expensive. They offer coverage for a defined period (the “term”), do not have any cash accumulation features, and will cost less than a Permanent Cash Value policy for equivalent death coverage. Most employer-paid life insurance policies are term.

There are three main types of Term Life insurance:

> **Annual Renewable Term:** a type of term life that has a one-year term. The policy can be renewed each year, with increasing premiums as the insured party ages. Annual renewable term insurance is best for short-term life insurance needs because it is the least costly of any <u>new</u> life insurance policy, but it becomes more expensive over time than a comparable level term life insurance policy, where premiums stay the same throughout the duration of the policy.

> **Level Premium Term:** a type of coverage where the death benefit and premiums are set when the policy is purchased and remain the same over the term of the policy. Level premium term life is the most common type of term life insurance policy.

Decreasing Term: a type of coverage where the death benefit declines over time, while the premiums remain level. This type of policy may be attractive for people who want the insurance coverage to pay off a mortgage (which will have a declining payoff amount over time) or expect their death benefit needs will decline over time due to increased net worth.

Permanent Cash Value Life

All permanent cash value life insurance policies guarantee payment of a death benefit to beneficiaries in exchange for level, regularly-due premium payments. This guarantee is for the entire life of the insured (i.e. “permanent”), as long as the policy is maintained.

Unlike Term Life policies, all permanent cash value life insurance policies have a savings component, called the Cash Value, which is funded by the premiums. A key difference between the types of Cash Value insurance types is how this Cash Value is managed and invested.

Whole Life: Whole Life policies have level premiums and a fixed death benefit amount over the life of the policy. The Cash Value typically earns a fixed rate of interest, set by the insurer, on a tax-deferred basis.

Universal Life: Universal Life policies are sometimes referred to as Adjustable Life policies as they offer flexible premium payment amounts, adjustable death benefit amounts, and an adjustable interest rate on the Cash Value. The Cash Value earns tax-deferred interest based on a current market rate or the policy’s minimum interest rate, whichever is greater. The interest rate paid may change frequently and may at times be lower than the fixed rate offered by comparable Whole Life policies.

Variable Life: offering premium payment flexibility and a guaranteed death benefit, a Variable Life policy allows the policyholder to invest the Cash Value in a range of security options which include stocks, bonds and money market securities. The attraction of a Variable Life policy for most purchasers is the potential for better long-term growth of their Cash Value than in a Whole or Universal Life policy. Note, however, that there is no minimum rate of return guaranteed by the insurer on the Cash Value with this type of policy.

Variable Universal Life: offering premium payment flexibility and a flexible death benefit similar to Universal Life policies, a Variable Universal Life policy allows the policyholder to invest the Cash Value in a range of security options which include stocks, bonds and money market securities.

LIFE INSURANCE FEATURES AND SUITABILITY

Type	Features	Target Clients
Term	Provides coverage for a specified # years (term). No cash value accumulation. Least expensive.	Self-employed, Employees in-between jobs, Non-working spouses, Business owners
Whole	Permanent coverage, fixed premiums, fixed death benefit, and guaranteed minimum cash value.	Younger people. Candidates for Term Life looking to accumulate modest cash value as part of long-term savings plan.
Universal	Permanent coverage, flexible premiums, adjustable death benefit, accumulated cash value.	Young couples, due to flexibility with premiums and death benefits as life status changes. Newborns: cash value appreciation and guarantee of future coverage regardless of health.
Variable	Permanent coverage, fixed premiums, guaranteed minimum death benefit, owner-directed cash value investments.	Individuals interested in Whole Life who are willing to take risk with accumulated cash value in order to get better returns.
Variable Universal	Permanent coverage, flexible premiums, adjustable death benefit, owner-directed cash value investments.	VUL policyholders want premium and death benefit flexibility as their situation changes and are willing to take risk to increase cash value appreciation potential.

KEY FACTORS TO CONSIDER

Is Life Insurance Needed?

Not everyone needs life insurance coverage. To determine if life insurance coverage is needed, we encourage the client to assess the impact their death has, from a financial perspective, on others.

- Is someone dependent on the insured's future income? If so, the proceeds from a life insurance policy can help replace that income and cover future expenses. Example: primary income earner for a young family; retirement income for a spouse; education expenses for children.
- Does the insured have significant debt that would be shifted to another person(s)? If so, the proceeds from a life insurance policy can be used to pay off the debt so that the burden isn't shifted to others. Example: co-signed student loans, medical debt, mortgages or credit card debt.
- Is the insured a private business owner or key employee that warrants life insurance coverage to protect the company or be used to purchase the insured's equity? If so, the proceeds from a life insurance policy can be used to buy out the deceased employees equity in the business or fund the hiring and training of a replacement.
- Does the insured want to use a life insurance death benefit as an inheritance or as a gift to a charity or non-profit?

Needs Determination.

This is the calculation of the amount of future income that needs to be replaced and existing debt that needs to be paid via the insurance policy proceeds. We will cover this in more detail in the next section.

Timeframe over which life insurance coverage is needed (term).

This is a very important factor and will vary by client. Most people's insurance coverage needs will change over time. This factor will dictate if a term or permanent policy is preferred, and if term is selected, how long the policy term should be.

The Insured's life insurance (and disability) coverage via their employer.

When calculating the total amount of life insurance required, the client should include coverage offered by their employer. However, be aware that such coverage will lapse upon termination of employment, which may lead to a need for additional coverage during any periods of unemployment.

Available budget for life insurance premiums.

For younger clients, budget allowances for life insurance is a key factor. For budget-sensitive clients, a term policy will be the least expensive option.

The person(s) designated as beneficiaries.

The beneficiary named on the policy will receive the policy's death benefit. A Beneficiary can be one person or entity, or it can be a number of people. In addition to naming a primary Beneficiary (the first person who stands to benefit from your policy), you should also name at least one contingent Beneficiary.

Does the insured want to use their insurance policy as a vehicle for long-term savings?

In general, Eustace Advisors encourages clients to use Term Insurance for most life insurance needs, and manage long-term investments via separate, dedicated investment accounts. In most cases, this will lead to better investment yields for the client over time.

Price differences for comparable coverage by different insurers.

Comparing life insurance rates from multiple insurers can help you select the most cost-effective policy. A true comparison takes into account several factors, including the policy type, underwriting process or approval type, riders, and any discounts for which you may be eligible.

Online quotes may not be as detailed or accurate as those obtained directly through a broker or agent, so ensure you get a detailed quote before making a selection. And be aware that your actual premium may not be available until you complete and submit an application with a chosen insurer.

<u>Policy Type and Coverage</u>

When you begin your search for life insurance, comparing the rates between term and permanent policies is helpful. However, once you choose a policy type that you plan to purchase, compare quotes from multiple insurers for the same type of coverage.

<u>Coverage Amount</u>

The death benefit amount you choose directly impacts your rates. When collecting and comparing estimates, it helps to compare quotes for the same coverage amount.

Some life insurance carriers will offer discounted rates when you purchase a larger policy. For instance, the premiums for a $250,000 policy may be less than those for a $200,000 policy. When you are assessing quotes, request pricing for coverage at your minimum coverage amount and slightly above your required amount. Example: if you require $500,000 of coverage, request quotes for $500,000, $600,000 and $750,000 to understand if purchasing additional coverage may be possible at the same rate or possibly a lower rate.

<u>Underwriting Process and Approval Type</u>

There are several ways a company can underwrite and approve your policy. Some will use a fully underwritten approval that requires applicants to undergo a medical exam and complete a thorough health questionnaire. Others will use simplified-issue or guaranteed-issue approvals, which may eliminate the medical exam and/or the health questionnaire. Make sure that you are comparing policies of the same approval type, as simplified-issue and guaranteed-issue policies will be more expensive than a fully-underwritten policy and may not offer as high a death benefit.

Payment Schedule

Some carriers will lower rates for customers who choose an annual or semi-annual payment plan instead of a monthly or quarterly one. When you compare life insurance quotes, make sure you're comparing rates based on the same payment schedule.

Riders

Riders are additional coverage options or benefits you can add to your policy. Riders may include accelerated death benefits, accidental death benefits, term conversion options or children's benefits. If you are considering the addition of any riders to your policy, include the rider pricing on all quotes.

Although online quotes are useful for basic and comparative analysis, we encourage clients to take the time to meet with at least two agents offering life insurance policies from different insurers (carriers). Ideally, at least one of these agents should be an independent agent with access to multiple life insurance carriers. A good insurance agent will take the time to understand your situation, including your budget, and steer you to the best options to consider.

CALCULATING HOW MUCH LIFE INSURANCE YOU NEED

THE SIMPLEST METHOD

For the income earner, many resources cite guidance based on their gross income.

1. NerdWallet: 10x gross income
2. Dave Ramsey: 10-12x gross income
3. Most insurance companies say a reasonable amount for life insurance is at least 10 times the amount of annual salary. Some recommend adding an additional $100,000 in coverage per child above the 10x amount.

Like many “rules of thumb”, these suggestions are simple, but don’t capture a lot of important factors such as existing assets, employer’s life insurance coverage, and expenses covered by a non-working spouse (child care, cleaning, cooking, etc.), We recommend the use of a more-detailed process for determining your life insurance needs.

A BETTER METHOD

A better technique, which is the basis for many online insurance need calculators, is the DIME approach. DIME stands for debt, income, mortgage and education, four areas that you should account for when calculating your life insurance needs.

Debt and final expenses: Add up your debts, other than your mortgage, plus an estimate of your funeral expenses.

Income: Decide for how many years your family would need support and multiply your annual income by that number.

Mortgage: Confirm the amount you need to pay off your mortgage.

Education: Estimate the cost of sending your kids to school and college.

By adding all of these obligations together, you get a much more well-rounded view of your needs.

However, while this formula is more comprehensive, it doesn’t account for the life insurance coverage and assets you have accumulated, or the unpaid contributions a stay-at-home parent makes.

OUR RECOMMENDED METHOD

The Life Insurance Coverage needed is calculated in three steps:

1. Determine immediate cash needs at time of death.
2. Estimate the funds needed to maintain the survivors’ lifestyles over time.
3. Combine the amounts from Steps (A) and (B) to define the Life Insurance Coverage Amount needed.

This method is applicable for an individual who has earned income or helps cover a family's expenses in other ways (child care, cooking, home schooling, etc.).

Calculate **Immediate_Cash_Needed**

1. Using a Balance Sheet, define the Insured's Assets and Liabilities. Separate Liquid and Illiquid Assets.
2. Confirm any bequests the Insured has committed to upon their death.
3. **Immediate_Cash_Needed** equals (Debts + Expenses + Cash Bequests) MINUS (Available Liquid Assets).

Estimate **Long_Term_Funds_Needed** to Maintain Survivors' Lifestyles

1. This is best performed via a spreadsheet, listing the projected expense types as separate rows and the columns representing the future timeline.
2. Projected expenses can be broken into two basic categories: living expenses and higher education / special expenses.
3. The projected timeline should run until the Survivors are no longer dependent on the Insured's income. The total of all defined expenses over this timeline is the **Long_Term_Funds_Needed**.

The Life Insurance Coverage Amount should be equal to or greater than the sum of the Immediate Cash Needed and Long-Term Funds Needed.

If you need help defining your life insurance needs, we encourage you to speak to a financial advisor who can help you assess your assets, liabilities, income and expenses to determine your life insurance needs.

SITUATIONAL EXAMPLE

We will review one example in this white paper – additional situational examples are covered in the Eustace Advisors Insurance Education Module, which is part of our Financial Education Service.

<u>Situation background</u>:

- Anne and Jacob are a married couple with two children aged 8 and 10.
- Both Anne and Jacob are aged 50. Both plan to retire at the age of 67.
- Anne works and has $100,000 of life insurance coverage at work. Her employment compensation is $60,000 per year, after taxes.
- Jacob is a stay-at-home parent, with no employment income.
- The couple's assets and liabilities are defined in the Balance Sheet below.
- The family's living expenses are currently $35,000 per year, <u>not including mortgage payments</u>.
- Anne and Jacob expect both children will attend college, at a cost of $25,000 per year, per child.
- Each child leaves home upon completing 4 years of college.
- If either parent dies, each child receives $5,000 per year in Social Security benefits until they reach age 18.
- Our model preserves all Illiquid Assets for future post-retirement use and assumes that the mortgage is paid off with life insurance proceeds.
- Our model also presumes that the illiquid assets and social security, along with the lump-sum noted in year 18 below, will cover the surviving spouse's expenses in retirement (year 18 and beyond).
- The inflation rate is equal to the couple's investment rate of return.
- In this example, Ann dies unexpectedly, and Jacob will opt for a lump-sum payment as the settlement option.

<u>Step 1 – Determine Immediate Cash Needed</u>

Assets		Liabilities	
Liquid (cash, taxable accounts)	$50,000	Mortgage	$100,000
		Other debt	$25,000
Illiquid Assets (home, retirement accounts, cars)	$250,000	Funeral Expenses	$5,000
		Bequests	$0

Immediate Cash Needed = ($100,000+$25,000+$5,000) - $50,000 = <u>**$80,000**</u>.

Step 2 – Estimate Long-Term Funds Needed to Maintain Survivors' Lifestyles

This is better shown in a spreadsheet but is summarized below for this white paper format.

Years	1	2-7	8-9	10-11	12-13	14-17	18
Family funding requirements	$25,000	$25,000	$30,000	$35,000	$30,000	$25,000	$0
College funding	$0	$0	$25,000	$50,000	$25,000	$0	$0
Emergency Fund	$20,000	$0	$0	$0	$0	$0	$0
Additional Lump Sum needed for Retirement	$0	$0	$0	$0	$0	$0	$250,000
TOTAL	$45,000	$25,000	$55,000	$85,000	$55,000	$25,000	$250,000

Long-term funds needed = 45,000+6*25,000+2*55,000+2*85,000+2*55,000+4*25,000+250,000.

Long-term funds needed = **$935,000.**

Insurance needed = $80,000 + $935,000 = **$1,015,000**. Since Anne's beneficiaries will receive her $100,000 work life insurance proceeds shortly after her death, the net amount of additional life insurance needed is **$915,000**.

A key assumption in this analysis is that the rate of inflation will equal the rate of investment return. With adequate planning and based on historical rates of return of a balanced equity and fixed-income portfolio of ~8% per year, the amount of additional life insurance needed is likely less than **$915,000**.

ONGOING LIFE INSURANCE CONSIDERATIONS

We recommend all clients assess their insurance coverage and estate planning documents as part of an annual financial plan assessment, or in the case of other life events that warrant an assessment of life insurance coverage, such as:

1. Job loss or transition (employer's life insurance coverage will lapse).
2. Family changes (marriage, divorce, new child, emptying of nest).
3. Significant inheritance (reduces need for life insurance).
4. Retirement.
5. Estate plan changes.

The core of every re-assessment is to recalculate how much life insurance is needed via the process discussed earlier and ensure that ample coverage is in place.

If additional life insurance coverage is needed, assess the cost of an increase in your existing policy's death benefit vs. adding a new policy to close the gap.

BOTTOM LINE

Life insurance is a key component of most financial plans. It is always helpful to understand how life insurance is used, how much life insurance you may need, and the type of life insurance you favor before meeting with an insurance agent. This knowledge will make your discussions with an insurance agent less overwhelming and more relevant to your situation.

RESOURCES

The articles below were referenced in preparing this information and are excellent resources to better understand this topic.

1. www.investopedia.com – this is a great resource for financial, tax and estate related topics.
2. https://www.policygenius.com/life-insurance/life-insurance-calculator/
3. https://www.nerdwallet.com/article/insurance/types-of-life-insurance
4. https://www.policygenius.com/life-insurance/how-to-buy-life-insurance/
5. https://trustandwill.com/learn/life-insurance-beneficiary-vs-will
6. Kaplan College for Financial Planning AAMS® Course Study Material.
7. STC Series65 Exam Course Study Material.