



Life Insurance Explained

Life insurance is protection against dying too soon. The life expectancy for a man who reaches age 60 is 81. For a woman it is 83. This however is the average. Many people will unfortunately not reach age 60. We will leave behind families, spouses, children, home mortgages and other debts. No one plans to die young. It just happens. However, using life insurance, you can plan for the survivors.

Life insurance is a versatile tool and is unique in what it does. It delivers a promised amount of cash when it is needed most. No other investment product can make this promise. Life insurance however has many forms and no one form is best for everyone. You must keep an open mind and use a methodical approach to determining both the type of life insurance and the amount needed.

The purpose of this information sheet is to discuss the various types of life insurance and present a Life Insurance Needs Analysis methodology to help you determine how much life insurance you might need.

Do you need Life Insurance?

Remember that life insurance is for the survivors. If there are no survivors or the survivors do not need the cash infusion, then life insurance may not be necessary. As shown in the graph below, our financial needs change as we age. When we are young, raising families, making house payments and have a relatively high level of debt, life insurance is paramount. The loss of the primary

income provider can destroy a family. The loss of the home maker can be equally devastating as it hampers the income provider. Thus sufficient insurance to monetarily replace either provider is critical.

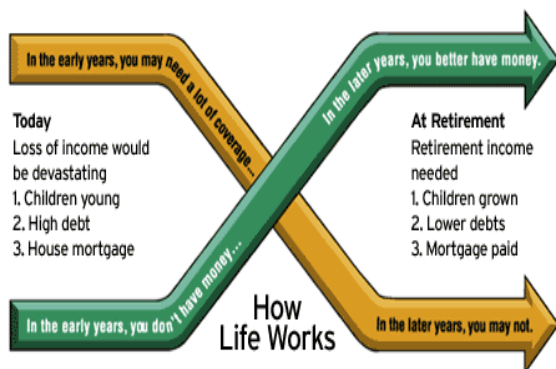
As we advance in life, our financial backstop is increased, young children are no longer in the home, the mortgage is reduced or eliminated and sufficient reserves exist to meet unexpected needs. This doesn't mean that life insurance isn't necessary; just that other priorities may take precedent over funding life insurance.

Whether you need life insurance or not is a personal choice. Use the Life Insurance Needs Analysis worksheet as a starting point for your decision making

Type of Life Insurance

The two major categories of life insurance are *term* and *permanent* but there are many variations of each.

What both have in common is the payment of the death benefit. With a term policy, the death benefit is usually the face value of the policy. With a permanent policy, the face value may be modified by additional benefits or riders that are attached to the policy. Or the owner may have an outstanding loan on the policy. Thus, the benefit paid will reflect repayment of any outstanding loans, overpayment of premiums¹, underpayment of premiums, interest earned between when the death occurred and the benefit is actually paid, dividends earned and other riders that may be attached.



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Term Insurance

Of the two types of life insurance, term is the easiest to understand and most of the life insurance policies in the United States are term. A term policy pays the death benefit if the insured dies within a defined time period. The insured period could be as short as 3 years or as long as 30 years. For this reason, many refer to term insurance as temporary insurance because it is acquired

¹ Premiums that were paid after the insured passed, but before the benefits are paid. This could occur if the premiums were set up for automatic payment.

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to protect the beneficiary from financial loss for a stated length of time.

A term policy is difficult to acquire after age 65 and almost impossible after age 70. For example, it would be impossible for a 55 year old male to purchase a 30 year term policy. The best he could hope to acquire would be a 15 year policy and that may prove to be very difficult depending on his health. Many banks, credit cards and credit unions offer their members term insurance independent of age but it is normally limited to \$5,000 to \$10,000. Higher values may be possible, but would require a medical exam and may still be denied if the requestor is age 65 or older.

There are many reasons to consider using term insurance. The purchase of a car, a home mortgage or other debt obligations of the insured may best be addressed with a limited term insurance policy. Many auto dealers will offer an insurance policy that will pay off the note should the buyer die or become disabled during the life of the note. This is term insurance under another name.

Term Insurance Variations

The term insurance variations generally center on how the annual premium is determined. Early term policies were relatively simple with the annual premium adjusting upward each year. The most popular policies today have level premiums for a stated number of years.

Yearly or Annually Renewable Term (YRT or ART) – These policies have lower initial annual costs and will renew automatically each year with an increase in the premium. The death benefit remains constant throughout the life of the policy. These policies usually have two premium levels that must be considered. The lower premium is called the current premium and is the premium the company needs to stay competitive. The second premium is called the guaranteed premium and allows the company to charge up to this level to cover unforeseen expenses like interest rate decline.

Re-Entry Term – With this renewal option, the insured may periodically choose to be re-underwritten. This benefits both the insured and the insurer. The insured benefits because his premiums may be lowered if he remains in good health. The insurer benefits due to reduced adverse selection. If the insured declines re-underwriting or fails to qualify for re-entry rates, they may have substantially higher premiums.

Level Premium Term – A popular selection as the premiums are level for up to a 10 year period. Longer

period may be available but at a significantly higher initial premium.

Decreasing Term – Also called disappearing term, the death benefit decreases over time while the premium remains constant. The term is usually limited to 30 years or less and is often used as mortgage insurance. The death benefit is usually a straight line reduction and may not reflect the actual balance due on the mortgage. Newer policies will try to match the mortgage balance. Decreasing term is often a rider on a whole life policy and marketed to young adults who are starting families and buying houses. Decreasing term is best used in concert with other life insurance coverage because the benefit decreases as the actual financial needs of the beneficiary may be increasing.

Permanent Insurance

Permanent insurance as its name implies is designed to last for a life time. Unfortunately, permanent insurance has many variations which leads to confusion on the part of the customer and the agent. There are two major categories called *traditional* and *universal* life.

Traditional Life Insurance

Traditional forms of permanent insurance can be either participating or non-participating. Participating policies earn dividends. Non-participating policies use other means to make them responsive to economy changes. Categories of traditional life insurance are whole life or a variation thereof.

Whole Life – Whole life is a basic form of life insurance with a guaranteed death benefit. Typically, the owner pays premiums until age 100 at which time the face value of the policy is paid to the owner. A variation is a limited pay life in which the policy is paid up at age 65 with coverage continuing to age 100. Another variation is 20 pay life in which higher initial premiums allow the policy to be paid up in 20 years with coverage continuing until death or age 100.

Graded Premium Life – provides for lower initial premiums that increase each year. It allows the owner to ease into the higher premiums over a period of five to ten years.

Variations – The many variations of whole life are hybrids combining combinations of term insurance, paid up dividends and additional death benefits. Some companies allow agents and customers to mix and match from a buffet of options to create a custom whole life policy

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Universal Life Insurance – Also known as “flexible premium adjustable life”. It is marketed as the only insurance a person would need. With universal life, the premiums are not fixed or tied to the face value except in the first year. Premiums are paid into an accumulation fund. Each month the various expenses, like mortality charges, rider charges and various expenses are taken from the accumulation fund. Premium payments are flexible or optional if sufficient funds are available in the accumulation fund. There are two distinct variations of Universal Life.

Fixed Interest Universal Life – Contain a minimum guaranteed interest rate and a guaranteed maximum life expectancy charges. The interest earned on the accumulation funds are credited to the accumulation fund. If the investing skills of the insurer create interest in excess of expectations, the excess is credit to the accumulation account of the policy.

Variable Universal Life – The growth of the accumulation account is based on the performance of a separate, mutual fund like account in which the funds are invested. Since these type policies are a combination of insurance and securities, both the federal government and the individual state regulate them. In addition, agents who sells these policies must also have an appropriate securities license.

Riders

Riders are additional benefits or endorsements may be added to an insurance policy. Riders can amend the policy, add benefits, decrease benefits, waive conditions or modify the original policy in some way. Agents use riders to customize a policy to better meet the policy owners’ needs. Common riders include the following.

Disability Premium Waiver waives the premium should the insured become disabled for six months. Usually the cash values, interest and dividends are treated the same as if the premiums were being paid.

Payor Death or Disability is commonly used when someone other than the insured is paying the premiums. Used frequently on a child’s policy when the parent is paying the premiums.

Presumptive Disability usually implies that should the insured lose both hands or both feet or sight in both eyes or becomes totally deaf, the company will waive the premiums. The wording of this rider must be read carefully to understand the definition of “loss of”. It may mean completely severed or simply the loss of the use.

Accidental Death Benefit (ADB) is sometime called double or triple indemnity. This provision doubles or triples the death benefit if the insured dies as a result of an accident. Be sure to understand the difference between “accidental death” and “death by accidental means”. *Accidental death* usually means death by any accident regardless of what the insurer was doing when the accident occurred. The *death by accidental means* clause implies that if the insurer is doing something intentional, then that activity caused the death and is not classified as an accident.

Accidental Death & Dismemberment (AD&D) is a variation of ADB and provides for partial payment of the benefits should the insured experience loss of a limb or sight. Common in group insurance policies.

Guaranteed Insurability permits the insured to purchase at periodic intervals additional coverage without evidence of insurability.

Spendthrift is available to preclude the beneficiary from having the right to commute, alienate or assign his potential interest in the policy. In other words, the beneficiary cannot benefit from the policy until the insured dies.

Other riders will likely be available. It is important to read each very carefully. Each rider will likely increase the premiums and may or may not add value to the policy.

Buy Term and Invest the Rest

A popular marketing slogan used by term insurance salesman. The difference in premiums for the same death benefit between permanent and term life insurance can be significant. Many advisors advocate buying term and investing the difference between the premiums is the best option. While this may be a good option, the policy owner must give this choice serious thought. The first flaw with this plan is human behavior. Few people successfully invest the difference over time. They may do well for the first year or so, but soon the excess cash gets spent elsewhere – like a car payment, vacation, dining out, etc.

The second flaw is considering insurance as a temporary need and that life insurance later in life will not be needed. This may well prove to be an invalid assumption. Insurance beyond age 65 is difficult to obtain.

The third flaw is the assumption that invested monies will not be touched until the death of the insured. While there are investment strategies (a trust for example) that will

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ensure the funds remain untouchable until death, many families fail to put these safeguards in place.

Beneficiaries do not care if the insurance is a term policy or permanent policy. A vast majority of the paid death claims are for insured aged 65 and older.

When considering your insurance needs, it is important to obtain insurance that is right for you and meets your needs. If providing a long term (i.e. lifetime) of income for the beneficiaries is needed, then buying the right type of insurance and making intelligent investment choices is critical.

Life Insurance Needs Analysis

A Life Insurance Needs Analysis is a process that enumerates specific financial needs and subtracts identified assets that can be used to meet these needs. The difference is the potential financial shortfalls that may best be filled using life insurance. The focus is not on the minimum needs, but rather on how much money should be available for the survivors.

The process itself is not difficult, but can be time consuming and frustrating unless guided by a knowledgeable advisor. An advisor can bring experience and the ability to ask the right questions and assist in developing the correct answers. He or she will also bring to the table the financial experience to consider external events like inflation or human frailties considerations.

The Process

Step One – Gather Information. Involves gathering all the pertinent information about the individual and family members. Identify and record current and future needs and when the specific need will need to be met.

Step Two – Identify Existing Assets. Available assets that are already liquid or can easily be sold after the death of the insured. Keep this section focused on liquid assets and those that would be available for liquidation.

Step Three – Identify Liabilities. These are liabilities to be paid in full at death. Some people will want to pay off

the mortgage while others may prefer to receive monthly income to pay on the mortgage. Debt contracts may control this issue. Include all short term cash requirements, i.e. burial expense, medical expense, funeral expenses, etc. as liabilities.

Step Four – Identify Shortfalls. This involves subtracting liabilities and immediate cash needs from liquid assets. It determines if available liquid assets will cover all of the immediate cash needs.

Step Five – Determine Income Needs. Include monthly income needs of survivors' specialty those of dependent children. Survivors should have to just scrape by. Factor in sufficient income to cover the wants also.

Step Six – Education Funding. Provide for secondary and or post secondary education. Consider the school i.e. state or Ivy League, and factor in inflation when doing the calculations.

Step Seven – Funding Long Term Income Needs. The period between when the youngest child leaves the home and before the surviving spouse qualifies for social security is known as the Blackout Period. The income provided should allow for a comfortable life.

Step Eight – Retirement Funding. At some point the surviving spouse will want to retire. Some funding strategy should be in place to adequately provide for this eventual retirement. There are various ways this can be handled.

Step Nine – Analyze Results. Add steps four through eight. Add emergency funds to the total if not already included. Take into consideration inflation, investment returns, other sources of income and desires to provide funds for other than family members. Any shortfalls must be made up with life insurance.

Step Ten – Identify Products and Services to Implement the Plan. There are many products on the market to help you address your insurance needs. By taking the time to do the needs analysis, being honest with yourself and keeping assumptions close to reality, you will have a plan that can be implemented and provide for the needs and wants of the survivors.

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