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Life Insurance:
How Much and What Kind?

by
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By any standard of risk management, most people are very underinsured against the possibility of premature death. For some reason, while they immediately insure their cars and their homes for their full value, they frequently overlook and often refuse to face up to the proper protection of their own lives and incomes. That may be because of the perceived cost of more adequate life insurance or a reluctance to face the possibility of premature death. For those who are prepared to think rationally about this grim and often confusing subject, here are some helpful hints.

How Much Is Enough?: An adequate amount is that which replaces income, or at least that portion of current income that you would want your family to continue to receive. That income would need to grow to keep up with inflation, so the amount of capital producing replacement income would need to grow as well.

Consequently, with a 3 percent inflation rate, the amount of pre-tax income generated each year, even with a 8 percent rate of return, could only be about 5 percent of capital, because 3 percent would need to be reinvested as capital to have future income keep pace with inflation. Assume, for example, the goal is $100,000 of replacement income before taxes, increasing with inflation. At a 5 percent rate of return, $2 million would be required in the form of insurance and other liquid assets. The capital need for replacement income, using the 5 percent income rate of return assumption, is therefore calculated by multiplying the pre-tax replacement income need by 20.

Consider also whether this stream of replacement income will be adequate to provide for education costs or other special needs. For example, a private education at one of the most expensive colleges requires almost $150,000 in today's after-tax dollars.

Needs Analysis: By following the simple analysis outlined below, you can arrive at a very close estimate of the additional needs you may have:

Before-Tax Replacement Income Goal ______________ x 20 = $ ___________

Special Needs for Capital (Education, etc.): + $ ___________

Total Capital Needs: $ ___________

Less: Existing Insurance: $ ___________

Less: Existing Liquid Assets: $ ___________

Additional Insurance Need: $ ___________

What Kind Of Policy?: Once you have settled on the right initial amount of insurance, consider the type of policy. There is no one-size-fits-all right answer, but here is some basic advice:

- **Do Not Skimp On The Amount:** Having the right amount of insurance is a far more important preliminary decision than the type of policy you buy. If it is with a top company with a quality "permanent" insurance product, term insurance can be converted to permanent later on favorable terms.[1] If you are certain that you will never want or need anything but term insurance, you need only be concerned that the insurer will be around to pay a death benefit in the future.

- **Job Mobility -- Group Employer vs. Individual Term Coverage:** Given a choice between group term life insurance through work and individual coverage, always choose the latter if you are a healthy non-smoker or if you must take a medical exam anyway to apply through the group plan. You never know where your future career will take you, and an individual policy with a good company will always be cheaper, at least over the long run, and it cannot be cancelled.

- **Focus On Long-Term Cost:** Many companies will try to lure you in with a low-ball initial premium, when the longer-term rates may greatly exceed the premiums of a policy with a somewhat higher first-year cost. In addition, do not buy 10-year level term if your needs may last longer (they almost always will). Premiums go through the roof on these polices when the ten years are over, and you may not qualify for another favorable 10-year rate.

- **Think Of Long-Term Needs:** If you need insurance for the long run (12 years or more), either for dependents' survivor income or eventually to keep Uncle Sam from claiming the bulk of your estate if estate tax laws do not change significantly, there is more reason to consider some form of permanent insurance. Of course, this assumes that your current or anticipated cash flow is sufficient that you can afford the higher short-term cost of permanent insurance.

  The choice between term and permanent insurance is not at all-or-nothing proposition. You can buy the coverage you need, have a portion of it take the form of permanent coverage, and retain the option to convert more of it later from term to permanent insurance. Note, however, that the amount of the level premium for a given amount of permanent insurance will increase with age.

  While term insurance effectively solves an immediate short-term need, opting for permanent insurance instead gives you more flexibility for retirement and estate planning. It also gives you an additional source of cash to borrow and, at some point in the future, an ability to quit paying premiums without losing the insurance.

- **The Tax and Cost Advantages Of Permanent Insurance:** The earnings that build up inside a permanent policy are tax-free if received as death proceeds or loans and are otherwise tax-deferred. Also, the cost of pure insurance (the mortality and expense charges) is generally lower with a permanent policy than with term insurance, and, because that cost is borne by a portion of the tax-free earnings inside the policy, your insurance cost is paid with pre-tax dollars.

- **Investment Flexibility -- The Variable Life Option:** With the advent of variable life insurance within recent years, those using permanent life insurance as a savings vehicle now have the option of allocating the investment portion of their premium dollars into mutual fund-like investments, including stock funds, rather than into the insurer's general portfolio. Variable life policies typically offer a greater variety of investment options than 401(k) plans.

[1] The term "permanent insurance" is used generically here to include whole life and universal life policies, where the investment component of the policy takes the form of the insurance company's fixed-income oriented portfolio, and "variable" life, where the policy owner chooses underlying mutual fund-type investments, most of which include equities.

Because life insurers are required by state laws to invest conservatively, mostly in a bond and mortgage-oriented, "fixed income" type of portfolio, the gross rates of return from even the best insurer's investments will likely be, over a period of years, less than that which the stock market has historically provided.

Those choosing the variable option must realize that, unlike traditional whole life, variable life offers no cash value guarantee; policyowners assume the risk of poor investment performance just as do owners of mutual funds. However, certain variable policies do at least guarantee that the original death benefit will be paid, if a stipulated premium amount is paid, no matter what happens to the underlying investment.

Also, the greater policy expenses of variable life, largely as the result of the costs of SEC compliance, probably increase the margin between gross and net investment returns by at least 50 basis points, as compared with the best whole life product. However, the hope and reasonable expectation based on historic rates of return is that the lack of guarantees and the somewhat higher costs might be more than offset by the higher returns that have been experienced over long periods of time by equity, as compared to fixed income, investments.

In any case, variable life offers investment flexibility and the chance to take greater risks in an effort to obtain higher returns, all within the tax-advantaged wrapper of a life insurance policy. To the extent life insurance dollars are to be invested relatively conservatively, however, the most competitive traditional whole life policy, with its lower expense charges, remains the best option.

- **Asset Protection:** Professionals and investors, concerned about the possibility that a liability judgment could exceed any insurance policy limits, should understand that, under the laws of many states, the cash value in life insurance policies for which dependents are beneficiaries is exempt from creditors (other than the IRS). For those who are especially exposed to lawsuits, this may be an important additional consideration that tips the scales in favor of permanent insurance. Other investment dollars outside of qualified retirement plans could be seized by creditors, while the cash value in life insurance and annuity policies could not. By shifting your existing savings assets and future savings vehicles, you can protect your financial future without sacrificing investment rate of return.

- **Permanent Insurance As A Supplemental Retirement Plan:** You might consider permanent insurance as a form of retirement savings. You likely need the insurance anyway (remember, it takes $2 million just to produce $100,000 of pre-tax, inflation-proof replacement income), and savings dollars allocated to the policy grow on a tax-deferred or tax-free basis. Policy proceeds are generally received free of income taxation upon death. In addition, withdrawals of cash value are tax-free up to the amount of premiums paid and thereafter may also be tax-free if taken as loans.

  The death benefit is reduced by the amount of any outstanding loan. If completely tax-free distributions are desired, care needs to be taken to avoid borrowing an amount that would cause the policy to lapse. If that occurs, the amount of policy loans in excess of premiums paid would be subject to income taxation. Otherwise, distributions from a policy that is surrendered are subject to income taxes only if they exceed the premiums paid.

- **Choice of Life Insurer and Policy Structure Determine Results:** The possible advantages of permanent versus term insurance depend on choosing the right kind of life insurance policy. Rates of return on permanent life insurance policies vary considerably - by 2 percent (200 basis points) or more - even when the underlying investments of the policy are identical. That is because differences in the pure insurance costs of an insurance policy (the “mortality and expense” charges) can account for variations of at least 100 basis points. In addition, the savings from a policy with a low commission versus a standard commission premium structure can reduce commissions by 80 percent or more and can also enhance the investment return by 100 basis points.

To put these differences in perspective, imagine an investment in insurance premiums of $25,000 annually for 30 years with one such investment producing an internal rate of return at the insured's death of 6% and the other 8%. These returns are, of course, after-tax rates, since life insurance death benefits are (in almost all cases) not subject to income taxation. The first such investment produces $1,976,454, and the second yields $2,832,080 – a difference of $855,626, or 43%.

Other articles from Life Insurance Advisors, Inc. provide further insight into the ways to assure the best results and the advice required to obtain them. (See, among others, "What the Sophisticated Investor Should Know and Ask about Life Insurance").

In any case, those who take the time to understand the basic factors that account for the relative performance of life insurance companies and products will recognize the attractive returns that can be realized from the best-performing, low-commission policies and will obtain the best returns from their investments in permanent life insurance.

- **Do Not Procrastinate:** Whatever your ultimate preference for type of policy, there is no good excuse for postponing obtaining the coverage you need today. If the worst should happen, your next of kin will not want to know what kind of policy you had, but only how much there was. Make the important decision about the amount of coverage first. With a term policy that can convert to the best permanent insurance, you can, if you prefer, postpone the term vs. permanent choice for a future day.

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An estate planning lawyer prior to joining NML, Barkhausen is a member of the American, Illinois, and Chicago Bar Associations and served on the National Conference of Commissioners on Uniform State Laws for 14 years. He has written for and spoken to these organizations on estate planning and life insurance topics, and he has also conducted Continuing Professional Education seminars for the Illinois CPA Society on the business and estate planning applications of life insurance.

Barkhausen graduated with high honors from Princeton University in 1972 and in the first class of the Southern Illinois University School of Law in 1976. He and his wife, Sue, live with their sons, Wicks and Billy, in Lake Bluff, Illinois.