

Chapter 13: Individual Life Insurance Products & Annuities

A life insurance policy is a legal agreement that pays an amount of cash, referred to as the **death benefit**, upon the death of an insured life.

If life insurance is deemed to be needed, the next step is to determine whether the need for protection is of a temporary or permanent nature. Short-term debts, such as car payments or student loans, are of a temporary nature.

For most types of life insurance, the death benefit equals the policy's **face amount**, which is the stated amount of coverage purchased by the policyholder. However, for some policies the death benefit equals the face amount plus the cash value.

There are two broad types of life insurance products: temporary and permanent. Term insurance provides temporary protection and is well suited to those who have a temporary need. Lifelong needs are best managed by purchasing one of the various permanent life insurance policies.

Term Insurance

- provides a death benefit over a fixed term such as 1, 5 or 10 years
- typically provides pure death protection; pays if and only if the insured life of the policy dies within the stated term of the policy
- almost all term policies are **guaranteed renewable** which means that the policy can be renewed at a predetermined premium at the end of the term without having to again provide evidence of insurability

Endowment Insurance

- an endowment policy pays the face amount of the policy if the insured dies, but it also pays the face amount of the policy if the insured survives the policy term

Permanent Insurance

- provides both death protection and some savings/investment accumulation
- essentially a financing plan for the long-term death protection that results in some money being saved with the insurance company; overpayments in earlier years are used to offset the premiums that need to be paid in later and more expensive years

Whole Life Insurance

- contract length is the policyholder's entire life
- all important financial features of the product are set from the beginning of the policy

Net death protection is the death benefit minus the cash value (i.e., net death protection equals the amount the policy would pay upon death of the insured over and above the amount that the insured could receive if the policy was surrendered).

$$\begin{aligned}\text{Death Protection} &= \text{Death benefit} - \text{Cash value}_t \\ &= \text{Face amount} - \text{Cash value}_t\end{aligned}$$

Policy surrenders are called lapses. With whole life insurance, assuming that no policy loan has been taken, the amount of money that the policyholder can withdraw – the policy's **cash surrender value** – exactly equals the pre-determined cash value. However these predetermined cash values account for the recovery of the policy loading expenses and result in significantly lower cash values during the early years of a policy.

With **paid-up insurance**, the cash surrender value is used as a lump sum to purchase a whole life policy.

With **extended term insurance**, the cash value is used to purchase a single premium term policy with the same face amount as the original policy.

Most whole life policies are **participating policies**, which means that the policy can and usually does pay annual dividends.

Most whole life policies also allow the policyholder to obtain a large portion of the cash value of the policy without surrendering the policy by borrowing against the cash value in the form of a **policy loan**.

Universal life policies, like traditional whole life policies, provide permanent protection and savings accumulation. However, universal life policies differ in that (1) they offer greater flexibility with respect to premium payments and, (2) the cash value varies explicitly over time based on premium payments, expense and mortality charges, and credited interest.

Main Factors Affecting Cash Value of a Universal Life Policy

Cash value at beginning of period
+ Premium payments at beginning of period
- Mortality charge at beginning of period
- Expense charge at beginning of period
+ Interest credited at end of period
= Cash value at end of period

Questions

1. What tax benefits are provided by permanent life insurance policies?

ANS:

Permanent life insurance is when the sum assured is due to be paid out at the end of the policy and the policy accrues a cash value. The tax benefits are as follows:

- death benefits are not taxed
- no income tax paid on increases in cash value when the policy is in force
- if insured dies, returns are not taxed; if insured lives, tax is deferred until funds are received

2. Life Insurance is provided on a Term or Permanent Basis. What is the difference between the two and why might a consumer choose one over the other?

ANS: Term insurance provides coverage for a specific period, such as 10, 15 or 20 years, and is renewable after those terms are up. Permanent insurance, which includes whole life and universal life, is designed to provide lifelong financial protection as long as the policy is in force.

Initially, term life premiums are generally lower than permanent life premiums. However, term life premium typically increase upon each renewal while permanent life premiums stay the same.

With most types of permanent insurance, there is a savings component known as cash value; the longer you pay into your policy, the more its cash value grows. You can choose to cash in or borrow against your permanent life policy and use the funds as needed. Term insurance does not accumulate cash value because it doesn't have a savings component.

Both types of insurance provide life insurance protection and pay out for death claims made by beneficiaries. In cases where the policy term expires before the insured person dies, a claim would not be paid. There is lifelong financial protection with permanent life insurance, so beneficiaries will receive the death benefit as long as the policy was in force when the insured person passed away.

If you are willing to forego the long-term benefits of building up a cash value in your policy to save on premiums, term insurance is for you. If you want cash value and the other benefits, go with permanent.

What are the similarities of whole-life, universal life and variable life policies?

What are the differences of whole-life, universal life and variable life policies?

What is a contingent annuity?

How to price a contingent annuity? (example)

What is a straight annuity?

How to price straight annuity? (example)

Age	# alive in cohort	# die in cohort
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20	9,617,802	9906
21	9,607,896	10,201
22	9,597,695	10,526
23	9,587,169	10,796

S/A: Given the above table. Assuming a benefit of \$200,000, an interest rate of 5% and using the following life table, price a 3 year term insurance contract for a 20 year old man

- a. Assuming the policy is paid by a single net premium.
- b. Assuming the policy is paid annually by level premiums

M/C: *A 5-year period-certain guaranteed annuity:*

- a) *Cannot be purchased in conjunction with a life annuity based on more than one life.*
- b) *When purchased in connection with a single-life annuity, will cease payments at the death of the annuitant or the expiration of 5 years, whichever ever occurs later.*
- c) *Will cost more if the annuitant is relatively young.*
- d) *Is not available as a variable annuity, but only as a fixed annuity.*