

ECONOMIC BASES OF LIFE INSURANCE (323-1)

Obj 1-1. **LIFE INSURANCE PROVIDES A FINANCIAL SAFETY-NET** for families by providing funds to compensate for the monetary support lost due to the primary earner's premature death.

Life insurance fulfills the provider's moral obligation to support his family in the event of his death.

That's why failure to buy enough life insurance can be viewed as an immoral act.

A human life has an economic value if it has **both** earning potential **and** pecuniary value to another person or entity that expects to receive financial benefits from the existence of that life.

Obj 1-2. **FIVE STEPS TO ESTIMATE THE ECONOMIC VALUE OF THE FAMILY INCOME-EARNER:** Determining the correct amount of life insurance to buy requires an objective calculation of the primary earner's economic value to his family.

1. **Estimate average annual earnings**--Depending on the provider's skills and profession, earnings may level off early in life or continue to increase until shortly before retirement. Inflation, technology, and competition affect earning potential.
2. **Estimate the basic costs of life**--State and federal income taxes, life insurance premiums, and the earner's own living costs usually total less than 50% of gross income, leaving the balance available to support one's family.
3. **Determine the number of years until retirement**--Ignoring the possibility of death, find the difference between the earner's current age and his projected retirement age.
4. **Select a discount rate**--A conservative rate, such as the current life insurer's rate payable on policy proceeds or the Pension Benefit Guaranty Corporation rate is recommended.
5. **Perform the calculation--The calculation requires three steps:**
 - a. Subtract the amount determined in Step 2 from the amount determined in Step 1.
[Example: Estimated average earnings per year are \$50,000. Subtracting taxes, insurance premiums, and self-maintenance costs estimated at \$20,000, leaves \$30,000 devoted to family support.]
 - b. Using a compound-discount table, find the present value of \$1 for the number of years determined in Step 3 at the rate selected in Step 4.
[Example: A 45 year-old, expected to retire at age 65 has 20 years of earning potential. He selects a discount rate of 4.5%. The present value of \$1 would be the amount listed in the discount table under 20 years at 4.5%, or 13.0079.]
 - c. Multiply the value found in Step 5b by the value found in Step 5a.
[\$30,000 X 13.0079 = \$390,237.]

Obj 1-3. **PRESENT-VALUE CALCULATIONS** recognize that a dollar due in the future is worth less than a dollar at today's value.

The lost opportunity to use the dollar to earn profit decreases the value of the dollar as the specified time before receipt increases.

Obj 1-4. **TWO METHODS TO DETERMINE AMOUNT OF LIFE INSURANCE NEEDED:**

1. **Human life value approach**--capitalizes the value of the income-earner's net earnings over his productive life. **Human life value** is calculated using the method described in Obj 1-2.
2. **Needs approach**--analyzes the cash requirements of a family if its primary earner dies.
Cash needs are divided into six general categories:
 - a. **Immediate expenses**--Medical expenses of last illness, burial/funeral costs, outstanding loans, past bills, estate administration fees, and various taxes may require an amount of cash approximating one-half of the family's annual income.
[These immediate expenses are also called the clean-up fund, probate fund, and estate clearance fund.]

- b. **Readjustment income**--If the family must readjust to a lower standard of living, it should be allowed some time period (usually six months to two years) to maintain its current standard of living before altering its lifestyle.
- c. **Support for dependents**--The number and current ages of children and other dependents determine the amount and time of support income needed.
Critical period income supports children during their periods of dependency.
- d. **Support for surviving spouse**--Age, education, and work skills of the surviving spouse affect the amount of income required to support him or her.
- e. **Special needs--Not all families require cash for the following categories:**
 - 1) **Mortgage pay-off**--Reducing or eliminating housing costs greatly reduces the amount of family income required. It also eliminates the risk of foreclosure if a financially inexperienced surviving spouse fails to meet the mortgage payments.
 - 2) **Educational expenses**--Prep school and/or college for dependent children (and/or the surviving spouse) must be considered.
 - 3) **Emergency fund**--A fund to cover cash needs for major illnesses, home repairs, and other unexpected situations should be established.
- f. **Retirement income**--This requirement usually determines the *type* of insurance to buy rather than the amount, but proper planning requires an objective evaluation of retirement period needs.
[I recommend a type of life insurance that yields a cash value at retirement equal to the sum of premiums paid. That way, the value of the life insurance protection provided is paid for by investment earnings that escaped income taxation.]

[Those two methods usually result in estimated amounts of insurance that are within about 10% of each other if allowances are made for other sources of income, such as surviving spouse earnings, federal support programs (OASDI aka Social Security), and the family's current financial obligations.]

Obj 1-5. **FOUR BUSINESS USES OF LIFE INSURANCE:**

- 1. **Key person indemnification**--Ordinary life insurance (or term, if the need is temporary) provides the business (named beneficiary) federal income-tax-free proceeds to cover the costs incurred or revenues lost (or both) due to the death of an employee who is key to the success of the business. However, premiums paid by the business are *not* tax deductible.
- 2. **Credit enhancement**--Life insurance increases the business's stability and liquidity from the creditor's viewpoint (particularly if there is a key individual). Some life insurance (especially if cash value insurance) can be used as collateral to secure higher lines of credit than would otherwise be available.
- 3. **Business continuation**--Partnerships, closely-held corporations, and sole-proprietors with key employees use life insurance proceeds to finance buy-sell agreements among the parties, allowing the businesses to continue operating after the death of a partner, owner, or key employee.
- 4. **Employee benefit plan**--Employer-paid life insurance (either partially or wholly) provides employees with designated amounts of disability, death, and old-age benefits.