

Guidelines for buying life insurance

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Most consumers buy life insurance without much thought. They may be careful shoppers in buying commercial goods. But buying life insurance is not as easy as buying commercial goods because of its intangible nature. Shopping for life insurance involves complexities such as selection of a product and selection of a company. They usually purchase life insurance from the agents who are persuasive. As a result, they may buy a product

- a. Which may not serve their needs.
- b. Or they may pay more than is necessary for their insurance protection.

The function of insurance is to safeguard against misfortunes [ex. Incapacity, untimely death, loss of property etc.] by having contributions of the many pay for the losses of the unfortunate few. This is the essence of insurance – the sharing of losses and, in the process, the substitution of certain, small “loss” called the premium for an uncertain, large loss. Hence the purchase of insurance has to protect the identified misfortune.

Purchase of a high-cost policy rather than a low-cost policy can cost thousands of rupees over their lifetime.

Hence selection of an insurance product is not an easy job. To select a product in a competitive world they should be aware of the

- Cost of life insurance
- The rate of return earned on the saving component of a cash-value policy
- Taxation of life insurance.

Based on these factors a product can be evaluated or compared with other products. These factors are common to all. Apart from these common factors there are some **basic guide lines for buying life insurance product** according to their specific needs. The seven steps suggested by George E. Rejda are

- Determine the need for insurance
- Estimate the amount of life insurance you need
- Decide on the best type of life insurance for you
- Decide whether you want a policy with or without profits.
- Shop around for a low cost policy
- Consider the financial strength of the insurer
- Deal with a competent agent.

1. Determine the need for insurance: To determine the need for insurance we should identify loss exposures of individuals, families or businesses. Basically there are three classes of losses - **Property, liability and personal**. This article is focusing on **Personal loss exposures** which arise from the possibilities of untimely or premature death, incapacity, illness or injury, retirement, and unemployment. These losses are associated with families. Businesses also have severe adverse financial impact on the businesses with the death of a key person.

Once we identify these loss exposures we can determine the need for life insurance either for ourselves [retirement] or for our dependants [replacement income].

2. Estimate the amount of life insurance you need

The needs approach and capital retention approach are practical methods for determining the amount of life insurance needed. For this you must consider the family's present and future financial needs and the income assets currently owned.

For Ex:

Annual Income: Net Rs. 3,00,000

Age: 50 years

Children age: Son: 19 years: Daughter: 15 years

Present financial situation: It is a part of balance sheet.

<u>Liabilities</u>	<u>Assets</u>
Loan on House – 4, 00,000	House – 15, 00,000
Misc. Loans – 1, 00,000	Car – 1, 00,000
	Scooter – 15,000
	Household – 50,000
	Jewelry – 2, 00,000
	Shares & – 1, 00,000
	Bonds
	Insurance – 1, 00,000
5, 00,000	20, 65,000

Family's present and future financial needs are

- Requirement of Rs. 1,50,000 per annum income for family maintenance
- Debt obligation of housing loan Rs. 4,00,000
- Requirement of fund for education / marriages of children RS. 6,00,000

Family's currently owned income and non income assets from the above information are:

<u>Income Assets</u>	<u>Non-Income Assets</u>
Shares & Bonds– 1, 00,000	House – 15, 00,000
Insurance – 1, 00,000	Car – 1, 00,000
	Scooter – 15,000
	Household – 50,000
	Jewelry – 2, 00,000
2,00,000	18,65,000

Income Assets – 2, 00,000
 Less Debts– 5, 00,000

 - 3, 00,000

Family Income Need – 1, 50,000

@ 6% interest

Capital fund need:[1,50,000 x 6/100]	25,00,000
Marriage & Edn. Fund:	6, 00,000
Debts	<u>3,00,000</u>

Suggested capital fund to be insured for 34, 00,000

The required Life cover is Rs. 34, 00,000. If you carry a sufficient amount of life insurance, it is unnecessary to purchase additional life insurance as supplemental coverage. These coverages include accidental death insurance from life insurers, accidental death and dismemberment insurance offered by commercial banks, credit life insurance on consumer loans etc. An assessment of life insurance need shouldn't be a one-time exercise. Life cover should adjust, upwards or downwards to life circumstance changes. Frequency of this review varies from every year to once in five years. It depends on the significant milestones in your life.

3. Decide on the best type of life insurance for you

You should decide the policy which suits your needs. You have to prioritize your needs. Basically there are four to five broad 'Need levels' for every one.

Need Level – 1: Security for family in case of death and requirements of lumpsum for meeting the outstanding obligations at the time of death.

Need Level – II: Increase in current income for a better life.

Need Level – III: Financial security to self and family after active working life.

Need Level – IV: Financial security for children and for children's education.

Need Level – V: Other specific needs such as covering housing loans, mortgage loans and requirement of periodical lumpsum payments.

You have to select the policy according to your needs. The best policy is the one that best meets your financial needs.

For Ex.

1. You are in the age of 25. You just joined an organization. You are recently married. Now you cannot spend more on life insurance.
2. You are in 30s. You are the eldest son in your family. One brother and sister are dependent on you for their education and marriage.
3. You are in 40s. You just started a new business. Your entire family is dependent on you. Till you settle in your business you cannot create a capital fund for your family maintenance.

4. You are in 50s; both of your children are in the middle of their education.
5. You know very well how to invest and get the best returns from the market.

For all these situations the suggested best policy is Term Insurance Policy. These plans offer life insurance cover for specific number of years, at least cost. Since entire premium goes towards the cost of insurance, there is only risk cover and no saving element is involved.

6. You are the only earning member in your family. You purchased a flat by taking loan from housing finance. As long as you are there you can pay EMIs' regularly. You want to retain the house for your family members even in your absence.
7. You purchased a car by taking loan from Auto Finance. You want to retain that car to your family members even in your absence.

The best policy for these situations is Mortgage redemption Insurance policy. These plans offer life insurance cover for specific number of years like till the loan is cleared [or on death, outstanding loan is covered] at the least cost.

8. You know that your standard of living is rising.
9. And also you want to meet the increased expenditure due to inflation.

The best policy for these situations is Increasing term insurance policy. These plans offer life insurance cover for specific number of years, at the least cost. And also the sum assured will be increased over a period of time.

10. You are in the beginning of career; you want to combine both insurance and saving. But the combination of this saving and insurance is costly. Right now you cannot invest much, having dependents and you want to invest later after settling in the career.

The best policy for this situation is Convertible term insurance policy. These plans offer life insurance cover for specific number of years, and at the same time it also facilitates to convert this policy into endowment policy [when your income increases]which includes saving element.

11. You want to leave an estate or property to your family by taking an insurance policy after you.
12. You want to get life time protection.
13. You want to raise loans on your policy when you are in need.
14. You believe that you cannot save money without being forced to do so.

The best policy for all these wishes and situations is whole life insurance policy. It provides the payment of the face amount upon the insured's death regardless of when death occurs.

15. You want to leave an estate to your family after you. But you cannot pay the premiums after retirement.
16. You want to raise loans on your policy when you are in need.

The best policy for these situations is Limited Payment whole life insurance policy. In this plan the policy remains in full force for the whole of life, but premiums are payable for a limited number of years only, after which the policy becomes paid up for its full face amount. The premium-paying period may be expressed as a set number of years or to a specified age.

17. You are undisciplined in your saving habits and you are not financially savvy
18. You want to set up a saving stream, beyond term plans
19. You want to combine insurance plans with some financial goals like children's education and marriage

The best policy for these situations is Endowment plans or money-back plans. These policies promise not only the policy face amount on the death of the insured during a fixed term of years, but also the full face amount at the end of the term if the insured survives the term.

20. You want to plan for retirement at an early age.
21. You know that compounding factor is important for planning retirement.

Then Consider deferred annuity plans.

22. You want to invest your VRS funds for retirement needs
23. You do not want to take risk with your VRS Funds
24. You want safe and guaranteed returns from your investment.
25. You want safe and fixed returns from your investment.

Then the best policy is immediate annuity plans or single premium annuity plans

Like this after identifying the financial needs you have to select the product. Term, whole life, endowment, annuity policies or the combination of policies are available in the market. The best policy is the one that best meets your financial needs.

And the most important thing is that you should **avoid purchasing a policy that you cannot afford.**

4. Decide whether you want a policy with profits or without profits:

Insurance companies, which are functioning in India offer 'with' and 'without profit policies'. In with profit policies insurance companies offer only bonus. But you should remember that 'With profit policy' premiums are costlier than 'without profit policies'. When you cannot afford a costly policy, priority should be given for the basic cover by taking a 'without profit policy'.

5. Shop around for a low-cost policy:

You should not purchase a life insurance policy from the first agent who approaches you. Instead, you should compare the similar policies from several insurers before you buy.

This data can be obtained from

- Brokerage firms
- Internet.

- Agents
- Policy illustrations

The precautions for comparing policy illustrations are

- Compare only similar plans of insurance
- Ignore small variations if you are satisfied with the services of an agent or insurer and with other features of policy.
- The type of policy you buy should not be based solely on a cost. You should buy the type of policy that best meets your needs. After deciding the policy whether term, whole life or some combination then compare costs.

When you shop for a **low-cost policy**, you should also consider low-load life insurance. For Ex. For buying an insurance policy instead of approaching through a broker if you directly approach you will get some concession in premium payment.

6. Consider the financial strength of the insurer

In addition to cost, you should consider the financial strength of the insurer issuing the policy. Although Insurance Regulatory Authority has stringent rules for solvency margins, there are limits on the amount guaranteed. Hence, it is important to buy life insurance only from financially sound insurers.

In India, there are no rating organizations to rate life insurers' financial strength. It is difficult for a layman to rate the insurance company. The companies are rated based on the amount of their capital and surplus, legal reserves, quality of investments, past profitability, competency of management and numerous other factors. All these factors can be available in the annual reports of the company.

The traditional elements of **financial analysis** of an insurer include

1. **Surplus adequacy** [excess of assets over liabilities. $\text{Surplus adequacy} = \text{surplus} \div \text{liabilities}$],

2. **Asset quality** [the lower the quality of insurer's assets, the greater the surplus needed to absorb adverse fluctuations, all else being equal.

3. **Profitability** [profit is essential for an enduring, strong insurer. Four profitability ratios are potentially important. 1. Return on equity, 2. Yield on investments, and 3. Net operating gain ratio, and 4. Total operating income.],

4. **Liquidity** [adequate liquidity should be maintained to meet an insurer's expected and unexpected cash needs. One useful measure of liquidity is $\text{Current Liquidity} = \frac{\text{Unaffiliated Investments}}{\text{Liabilities}}$], and

5. **Leverage** [Leverage is a measure of how intensively a company uses its equity. Leverage increases return on equity, but it also increases risk. In the context of insurance, three measures of leverage are commonly used. 1. The ratio of liabilities to surplus, 2. The ratio of intensity of surplus use in premium writings, 3. The ratio of Reinsurance commissions and expense allowances to surplus].

All these ratios reflect financial condition of an insurer. Emphasis is on solvency with insurer performance being relevant to the extent that it might affect solvency

Although solvency is the primary concern to purchase, you should also value product performance. Some of the **Product performance indicators** are

- A. Lapse rates** – Lapse rates can be viewed as a proxy for policy owner dissatisfaction. Insurers with low lapse rates must be providing their customers with the quality of products and services they desire. High lapse rates may be inherent in an insurer's selected market, or they may reflect policy owner dissatisfaction. Excessive lapses can have negative impact on expenses, investments and adverse selection of an insurer
- B. Investment yield** – A strong insurer investment return should translate into a superior return to policyowners. From your perspective, the spread between the actual return and the interest credited on a particular product line is the more critical performance measure.
- C. Expenses** – The insurance customer desires quality service at the lowest possible cost.
- D. Mortality/morbidity** – A low ratio of actual to expected mortality or morbidity suggests favorable experience. This is important because these savings can be passed to policy owners.

7. **Deal with a competent agent or broker:** Selling life insurance is a tough job. Most new agents or brokers receive only a minimum amount of training before they are licensed to sell life insurance. Even matured agents may engage in deceptive sales practices by misrepresenting the insurance to clients or by recommending policies that maximize commissions rather than meeting the client's needs.

To reduce the possibility of receiving bad advice or being sold the wrong policy, you should consider

- The professional qualifications of the agent or broker.
- His commission on each product.
- After sales service
- Ethical and legal characteristics of the agent or broker
- The agent should place the interest on you and on your needs first.

Conclusion:

The doctrine of Caveat Emptor [let the buyer beware] which governs the formation of commercial contracts in general, is not applicable to insurance contracts. Uberrima fides [utmost good faith] is the basis of insurance contracts. But in selecting or shopping for a life insurance policy this caveat emptor principle is necessary. You should be aware of what you need and you should get the consumer surplus out of your purchase, which means you should get more satisfaction than what price you pay for it. And your policy should serve your needs at lowest cost. By implementing these seven steps it can be possible.

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4. Decide whether you want a policy that pays dividends:

By observing market trends if you believe that interest rates will be higher in the future, you should consider a participating policy or with profit policy because excess interest has a powerful impact on dividends. However, if you believe that interest rates will continue to fall and will remain at lower levels in the future, then consider a nonparticipating or without profit policy.

Because policies that do not pay dividends generally require a lower premium outlay. After deciding to take traditional cash-value policy you should know the rate of return from that saving component. A consumer who buys a traditional cash-value policy with a low return can lose a considerable amount of money over the life of the policy. Thus, the annual rate of return you earn on the saving component is critical if you intend to invest money in a life insurance policy over a long period of time.

Professor Joseph M.Belth has developed a simple method for calculating the **yearly rate of return** on the saving component of a cash value policy. The yearly rate of return is based on the following formula:

$$i = \frac{(CV+D) + (YPT) (DB - CV) (.001)}{(P+CVP)} - 1$$

Where

i = yearly rate of return on the saving component, expressed as a decimal

CV = cash value at end of policy year

D = annual dividend

YPT = assumed yearly price per \$1000 of protection [you should get it from bench mark prices of population death rates]

DB = death benefit

P = annual premium

CVP = cash value at end of preceding policy year.

The first expression in the numerator of the formula is the amount available in the policy at the end of the policy year. The second expression in the numerator is the assumed price of the protection component, which is determined by multiplying the amount of protection by an assumed price per Rs.1000 of protection. Assumed prices per Rs.1000 of protection for various ages are benchmarks derived from population death rates [these are available from expected mortality tables of an insurance company]. Finally the expression in the denominator of the formula is the amount available in the policy at the beginning of the policy year.

For example, assume that you purchased an

- Rs.1, 00,000 participating ordinary life policy at age 35.
- And now you are at age 42, at the beginning of the eighth policy year.
- The annual premium is Rs.1500
- Cash value in the policy is Rs.7800 at the end of the seventh policy year
- Cash value in the policy is Rs.9200 at the end of the eighth policy year
- The eighth year dividend is Rs.400.
- The bench mark price at the age of 42 is Rs.4.00.

The yearly rate of return on the saving component for the eighth year of the policy is calculated as follows:

$$i = \frac{(9200+400) + (4)(100,000 - 9200)(.001)}{(1500+7800)} \quad _ \quad 1$$

$$= \frac{9963}{9300} \quad _ \quad 1 = 1.071 - 1 = .071 = 7.1\%$$

The yearly rate of return for the eighth policy year is 7.1 percent, assuming that the yearly price per Rs.1000 of protection is Rs.4. The information needed can be obtained by referring to your policy and premium notice, or

by contacting your agent or insurer. The same methodology can be used to evaluate an existing life insurance policy.

5. Shop around for a low-cost policy:

You should not purchase a life insurance policy from the first agent who approaches you. Instead, you should compare the interest-adjusted cost of similar policies from several insurers before you buy. Interest-adjusted cost can be measured by taking the time value of money into consideration and by applying an interest factor to each element of cost.

There are two principal types of interest adjusted cost indexes:

- The surrender cost index and
- The net payment cost index.

The surrender cost index measures the cost of life insurance if you surrender the policy at the end of some time period, such as 10 or 20 years

Ex:

Total premium for 20 years [Each accumulated at 5%]	Rs.4586
Subtract dividends for 20 years [Each accumulated at 5%]	- 824
Net premium for 20 years	<hr style="width: 100%;"/> 3762
Subtract the cash value at the end of 20 years	-2294
Insurance cost for 20 years	<hr style="width: 100%;"/> 1468
Amount to which Rs. 1 deposited annually at the beginning of each year will accumulate to in 20 years at 5% [annuity due factor]	34.719

Interest-cost adjusted cost per year [1468/34.719]	42.28
Cost per Rs.1000 per year [42.28/10]	4.23

By dividing the total interest-adjusted insurance cost [Rs.1468] with an annuity due factor [Rs.34.719] we will get annual interest-adjusted cost [Rs.42.28 or 4.23 for each Rs.1000 of insurance]. As you can see, the interest adjusted cost is positive, which means that it costs something to own life insurance when foregone interest is considered. In this case, the average annual cost is Rs.42.28 if the policy is surrendered after 20 years.

Net payment cost index measures the relative cost of a policy if death occurs at the end of some specified time period, such as 10 or 20 years. It is based on the assumption that you will not surrender the policy. Therefore, it is the appropriate cost index to use if you intend to keep your life insurance in force.

The net payment cost index is calculated in a manner similar to the surrender cost index except that the cash value is not subtracted.

Ex:

Total premium for 20 years [Each accumulated at 5%]	Rs.4586
Subtract dividends for 20 years [Each accumulated at 5%]	- 824
Insurance cost for 20 years	<u>3762</u>
Amount to which Rs. 1 deposited annually at the beginning of each year will accumulate to in 20 years at 5%	34.719
Interest-cost adjusted cost per year [3762/34.719]	108.36
Cost per Rs.1000 per year [108.36/10]	10.84

In the interpretation of these indexes, the lower the index number, the less costly is the policy. Hence when buying life insurance you should consider interest-adjusted cost data instead of premiums for comparison with other insurance company products. Because considering premiums alone provides an incomplete comparison. Interest –adjusted cost data will give you more accurate information about the expected cost of a policy.

This data can be obtained from

- Brokerage firms
- Internet.
- Agent
- Policy illustrations

The precautions for comparing policy illustrations are

- Compare only similar plans of insurance
- Ignore small variations if you are satisfied with the services of an agent or insurer and with other features of policy.
- These Cost indexes apply only to a new policy. This cost data should not be used to replace an existing policy. You should consider other factors to replace.
- The type of policy you buy should not be based solely on a cost index. You should buy the type of policy that best meets your needs. After deciding the policy whether term, whole life or some combination then compare costs.

When you shop for a **low-cost policy**, you should also consider low-load life insurance. For Ex. For buying an insurance policy instead of approaching through an agent if you directly approach you will get some concession in premium payment.