

Class 5 Outline
Business Finance 640 - Insurance and Risk
Autumn, 2007

In this class, we make the transition to Life Insurance. We begin by examining the meaning of premature death, and the economic consequences and costs of premature death. The central premise is that life insurance is economically justified, if a person earns an income, and others are financially dependent on that income, for at least part of that support.

We will review three approaches for estimating the amount of life insurance to own. The two basic methods of paying premiums will be examined—yearly renewable term method and level-premium method. From this, we move into a more detailed review of the types of life insurance.

The major term insurance and ordinary life insurance products are compared and important variations of Whole Life are reviewed. These include variable life, universal life and variable universal life contracts. While reviewing these variations, we will take a more detailed look at universal life. We will review the major characteristics of the universal life product and spend some time understanding its limitations.

A continuing theme will be the trade-off between the savings goal and protection element of life insurance. We will see how this trade-off is manifested in the design of the various life insurance products that we review.

I. Premature Death

- A) Meaning of Premature Death
- B) Costs of Premature Death
- C) Chances of Dying Prematurely
- D) Economic Justification of Life Insurance

II. Financial Impact of Premature Death on Different Types of Families

- A) Single People
- B) Single-Parent Families
- C) Two-Income Families
- D) Traditional Families
- E) Blended Families
- F) Sandwicheed Families

III. Amount of Life Insurance to Own

- A) Human Life Value Approach
 - 1. Estimates the value of the breadwinner's earnings
 - 2. Principal advantage
 - 3. Major defects
- B) Needs Approach
 - 1. The amount of insurance depends upon the existence and extent of certain needs

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2. Major advantages
 3. Major disadvantages
 4. Example from the text
- C) Capital Retention Approach
1. Assumes the retention of capital
 2. Review of steps involved

IV. Methods for Providing Life Insurance Protection

- A) Yearly Renewable Term Method
1. Pure premium—determined by the death rate at each attained age
 2. Prohibitively high cost at advanced ages
- B) Level Premium Method
1. Level premiums are possible because the premiums paid during the early years are higher than necessary to pay current death claims. The redundant premiums paid during the early years plus compound interest are used to supplement the inadequate premiums paid during the later years of the policy. Since the redundant premiums will be needed later, a legal reserve is required.
 2. Fundamental purpose of the legal reserve is lifetime protection. As the legal reserve increases, the net amount at risk declines. As a result, the cost of insurance is reasonable at all ages.
 3. Cash values are the by-product of level premium method.

II. Types of Life Insurance

- A) Term Insurance
1. Temporary protection—pays the face amount if the insured dies within a stated period or before reaching a stated age
 2. Renewable—policy coverage may be extended for additional time periods without evidence of insurability
 3. Convertible—a permanent policy can be obtained without evidence of insurability
 4. Types—yearly renewable; 5, 10, 15, or 20 years; term to age 65; decreasing term; and reentry term
 5. Uses of term—amount of income that can be spent on life insurance is limited; need for protection is temporary; term insurance can also be used to guarantee future insurability

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6. Limitations of term insurance—premiums increase with age; not suitable for lifetime protection; no saving component
- B) Whole Life Insurance
1. Ordinary whole life—level premiums and protection to age 100
 2. Limited payment whole life—premiums are payable only for a certain number of years such as 10, 20, 30, or to age 65
- C) Endowment Insurance
1. Pays the face if the insured dies within a stated period or if the insured is alive at the end of the period
 2. Not widely sold at the present time

III. Variations of Whole Life Insurance

- A) Variable Life Insurance
1. Death benefit and cash values vary according to the investment experience of a separate account.
 2. Premiums are invested in equities or other investments.
 3. Cash values are not guaranteed.
- B) Universal Life Insurance
1. Unbundling of component parts
 2. Two forms of universal life insurance available
 3. Considerable flexibility
 4. Cash withdrawals permitted
 5. Favorable income tax treatment
 6. Limitations of universal life
 - a. Misleading rates of return
 - b. Possible consumer dissatisfaction if interest rates decline
 - c. Right of the company to increase the mortality charge
 - d. Lack of firm commitment to pay premiums
- C) Variable Universal Life
1. The cash values can be invested in a wide variety of investments (e.g., stock fund, bond fund, global fund, money market fund).
 2. There is no minimum guaranteed rate of interest, and cash values are not guaranteed.
 3. Policy has relatively high expense charges.
 4. Policy has a substantial investment risk.
- D) Current Assumption Whole Life Insurance
1. Nonparticipating whole life policy in which the cash values are based on the insurer's current experience with respect to mortality, investment income, and expenses
 2. Guaranteed minimum cash values; higher cash values are based on current interest rates
 3. Two forms

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- a. Low premium products
- b. High premium products
- E) Indeterminate premium whole life insurance—allows the company to adjust premiums based on anticipated future experience

IV. Other Types of Whole Life Insurance

- A) Modified Life Insurance—lower premiums during the early years
- B) Insurance for Preferred Risks
 - 1. High minimum amounts
 - 2. Lower rates and more selective underwriting
- C) Second-to-Die Life Insurance
- D) Savings Bank Life Insurance
- F) Industrial Life Insurance
- G) Group Life Insurance