Life Insurance - Risk Management Essentials

IFE Academy

Education Simplified

INVESTORS FINANCIAL EDUCATION ACADEMY

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Why you need Life Insurance and why it needs to be Term Insurance

- Life insurance offers peace of mind by protecting the family financially.
- Term insurance is one of the least expensive types of coverage you can have. Rs. 1 crore Term insurance costs around Rs.20/- per day for a male aged 30.

The best gift you can give.

Life insurance can give your family the gift of financial security. And there's no better present.

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About this book

It's all good to protect your family with a life insurance policy. But knowing everything about, how life insurance works and how to use life insurance to your advantage is more important.

This book compiles the risk management essentials in Life Insurance . It provides awareness among the readers about their own risk taking capability and managing their risk with Life Insurance Policies.

We hope you would find this information useful.

Happy Reading!

Rs.40/-

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Life Insurance - Risk Management essentials

Life is unpredictable and it is not possible to protect us against every potential risk we may face.

In reality, risk is an inherent part of life, embedded in each and every moment of every day. We have to accept this fact, that even regular routine activities involve an element of risk. To put simply, whether we desire to safely make the journey to work from our home or seeking an adrenaline-rush from skydiving, the risks vary but they are present.

Cycling is part of her every day routine for my daughter till she injured her collar bone in a minor accident. This affected her daily life for 4-6 weeks till she bounced back to normalcy.

The risk of harm and injury isn't reserved for those participating in extreme sports. Its effects aren't confined to those who act without due care and attention. Risk is present in each and every moment of each and every day, in the routine tasks and the mundane things that we do. It is lurking in the events which unfold around us constantly.

Each person must reconcile themselves to this fact and determine how much risk they are comfortable with taking. As much as we may consciously decide that we don't want to pursue risky activities (which for many may constitute bungee-jumping, scuba-diving or riding a motorcycle) it's not sensible to think that risk is only present at the extreme ends of the spectrum.

It's not just risk to our physical health and wellbeing that most juggle on a daily basis. In professional pursuits too, we deal with the risk of things unfolding contrary to our plans and intentions.

It's not that option A is risky and option B is safe. In virtually all of the daily choices that we make, most options exist at a point along a scale of risk and reward. We have to make a considered evaluation as to where on that scale we are willing to place ourselves.

Life is a process of finding balance.

In each and every day, we consciously and sub-consciously process and react to all risks around us. It's an inherent part of navigating the chaos of the world and part of what makes positive events rewarding, and negative events rich as a source of learning.

Financial Risks

Financial risk is the risk of losing money or valuable assets. In the context of financial markets, we may define risk as the amount of money one can lose when trading or investing. So, the risk is not the actual loss, but what can be eventually lost.

The process of assessing and dealing with financial risks is often referred as risk management. There are multiple ways of classifying and defining financial risks. Notable examples include investment risk, liquidity risk, compliance risk and market risk.

Since we are working very hard, earn, save money and invest it for the well being of the family, it makes sense to protect them as best as we can.

Risk in insurance terms

In insurance terms, risk is the chance something harmful or unexpected could happen.

This might involve the loss, theft, or damage of valuable property and belongings, or it may involve someone being injured/ suffer from illness / face a sudden demise.

Insurers assess and fix a monetary value to various risks and decide how much they would need to pay out if a policyholder suffered a loss for something covered by the policy. This helps the insurer determine the amount (premium) to charge for insurance.

To be able to put a financial value on a risk, insurers calculate the probability for the insured item or property that might be accidentally lost, stolen, damaged or destroyed, how often this might occur and how much it would cost to repair or replace. When it comes to human life, it is dependent on the age, lifestyle, nature of job, family history etc.

Safeguarding the Future

Each of us needs to define our strategy to prepare and protect us from risk in congruence with our goals, responsibilities and personality.

Cornerstones of financial stability are cash savings and long-term investments. By cash savings, we mean liquid investments to meet the short emergencies. It is suggested that you should maintain at least 6 months expenses as emergency fund.

Long-term investments

The longer money is invested, the more potential it has to grow – that's how Warren Buffett used stock investment strategies to

his advantage: patience. Equity has been a proven asset class to generate inflation, adjusted return in the long run.

Most investments fall into one of five asset classes that range from "conservative" to "risky." Cash equivalents (including money market funds, Treasury bills and short-term CDs) are on the more conservative end of the spectrum, while equities (stocks) are on the riskier end. Generally falling somewhere in the middle are guaranteed investments (fixed deposits), fixed income investments (bonds and NCDs) and real estate.

Five principles for a long-term investment strategy :

Risk Management and Insurance Coverage

Insurance offers the most comprehensive and flexible means to manage the personal financial risk of total loss of your home, your car, your life, your ability to generate income, long term care expenses and the cost of a hospitals, doctors, labs and medicine.

The building blocks of a solid insurance plan include;

Life Insurance – Depending on the objective, Life Insurance range between Term Insurance, Whole Life Insurance, Endowment Plans and ULIPs. You may seek the help of an Insurance advisor to determine the amount required and the type of policies that may best provide for a safe and secure future.

Disability Insurance – In the event you become unable to work, disability insurance provides for income replacement. Often overlooked, this coverage helps to protect your family and your assets in case you are unable to earn income due to an accident or illness.

Health Insurance - Health insurance protects the individual from unexpected, high medical cost.

Major Risks faced by Individuals:

1. **Disability :**

   A disability is an umbrella term, covering impairments, activity limitations, and participation restrictions. Impairment is a problem in body function or structure; an activity limitation is a difficulty encountered by an individual in executing a task or action; while a participation restriction is a problem experienced by an individual in involvement in life situations. Disability is thus not just a health problem. It is a complex phenomenon, reflecting the interaction between features of a person's body and features of the society in which he or she lives.

2. **Suffer a prolonged illness :**

   Prolonged illness refers to the disease that is present for extended period. The sickness might be lethal or long-standing. It might make the person unable to carry on with the day-to-day activities for a longer period. The recovering process is very slow. The one with prolonged illness should undergo treatment for a longer time to avoid spreading of the disease. They would need caring, consolation and moral support to be in good mental health.

3. **Premature death:**

A number of costs are associated with premature death. These costs include: loss of the family's share of the breadwinner's future earnings, costs associated with death itself (unpaid hospital bills, funeral expenses, etc.), possible reduction in the standard of living, and non-economic costs such as emotional distress and loss of a parental role model.

4. **Outlive their resources :**

For individuals, rising life expectancy increases the risk of outliving financial resources that had been set aside for their retirement years.

Risks must be identified, market and non-market solutions considered, and a plan developed and implemented.

Important factors in Life Insurance

Key Determinant: Your marital status, number of dependents, family size, income, and wealth

How to Calculate the Life Insurance Needs

1. Multiple of Income Approach

Objective : To replace salary for a specific no .of years

Formula : Current Annual Income x No of years. (Recommended : 7 to 10 years)

Suitability : May be suitable for a small family with one child where spouse is not employed. It doesn't take into account inflation or future salary increases. Using this approach may lead to over-insuring or underinsuring, but it's a start.

2. **Human Life Value Approach**

Objective : Considers age, gender, occupation, current and future earnings, and employee benefits.

Formula:

1. Estimate the earnings from now until a set point in the future — typically expected retirement age. Be sure to factor in future salary increases as well.
2. Subtract the Annual taxes and living expenses from the total. It's usually safe to assume 15-20 percent of salary will go to taxes.
3. Subtract the income you expect to earn on your investments.
4. Add the cost of additional benefits provided through employment, such as health care, that will need to be replaced. Remember to account for inflation.

Suitability : The primary goal of this method is to replace the income lost. It doesn't necessarily account for other costs such as children's educational expenses or other specific future needs.

3. Capital Needs Analysis

Objective: The capital needs analysis is the most widely-used approach for estimating life insurance coverage. In addition to replacing the salary, it also accounts for other sources of income and the specific needs of survivors.

Formula :

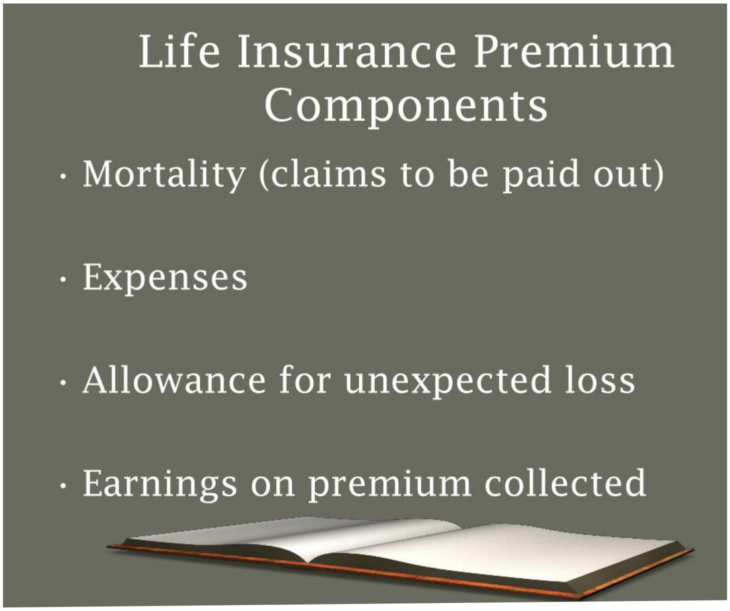
1. Assess the Current and future income of both the insured and surviving spouse.
2. Find the sum of the following:
   (I) Immediate lump-sum cash needs, debt repayment, and home loan
   (ii) Future expenses such as college, wedding and retirement funding
3. Assess Existing family assets, retirement funds, or insurance policies

Simple approach: 1 + 3 – 2

Suitability: This may be useful for planning the retirement corpus for the spouse or leave a legacy for the child.

It's always advisable to have a baseline estimate of survivors' future financial needs to ensure the policy will provide sufficient support.

Determination of cost of Life Insurance Premium :



The premium rate for a life insurance policy is based on two underlying concepts: mortality and interest. A third variable is the expense factor which is the amount the company adds to the cost of the policy to cover the operating costs of selling insurance, investing the premiums, and paying claims.

Mortality

Life insurance is based on the sharing of the risk of death by a large group of people. The amount at risk must be known to predict the cost to each member of the group. Mortality tables are used to give the company a basic estimate of how much money it will need to pay for death claims each year. By using a mortality table a life insurer can determine the average life expectancy for each age group.

Interest

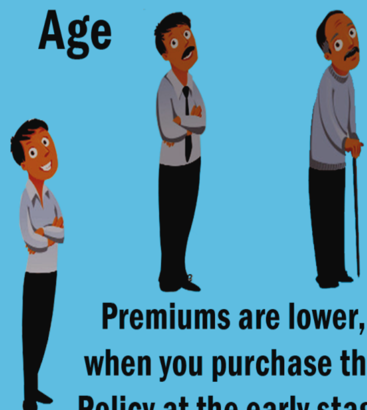
The second factor used in calculating the premium is interest earnings. Companies invest your premiums in bonds, stocks, mortgages, real estate, etc., and assume they will earn a certain rate of interest on these invested funds.

Expense

The third consideration is the expenses of operating the company. The company estimates such expenses as salaries, agents compensation, rent, legal fees, postage, etc. The amount charged to cover each policy's share of expenses of operation is called the expense loading. This is a cost area that can vary from company to company based on its operations and efficiency.

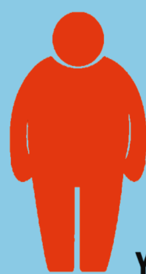
What impacts the cost of Life Insurance Premiums?

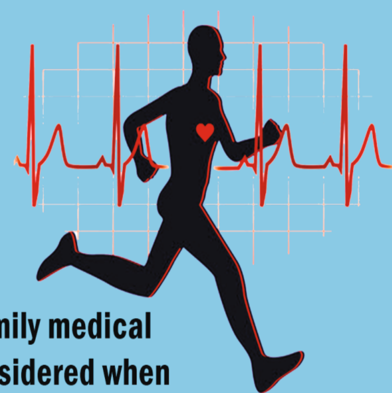
Age



Premiums are lower, when you purchase the Policy at the early stage of Life.

Health





Your BMI and family medical history will be considered when calculating premiums

Lifestyle & Occupation

If you take part in adventure sports or engaged in high risk jobs, premium is likely to be higher.

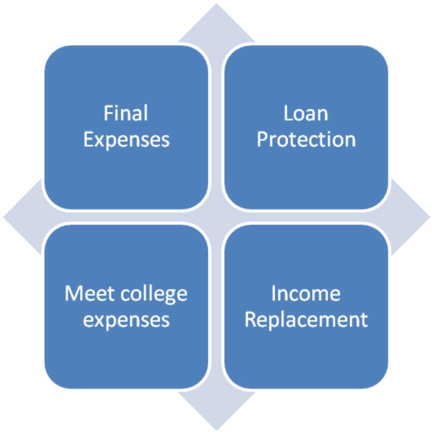
Term

Term plans are pure risk cover plans. Their premiums are comparatively lower than other types of policies.

Payout

Larger benefit payouts will have more expensive premiums.

4 important reasons to purchase life insurance:



- **Final Expenses.** Medical bills, funeral expenses, and other costs can add up quickly and usually cost lakhs of rupees. Few people want to face their own mortality, but a life insurance policy will help family handle these expenses.
- **Mortgage Protection.** In the event of death, life insurance policies may be used to pay off outstanding balances on mortgages.
- **College Funding.** In the event of death, life insurance policy can help to pay for children's education.
- **Income Replacement.** When a couple plans to exist on two incomes, and the income is reduced to one because of death, life insurance policies can help. The death benefit paid to spouse can help to maintain the lifestyle to which the family is accustomed.

Overcome your myths on life insurance

Generally, young people have a tendency of deferring the decision of purchasing Life insurance. When it comes to Life Insurance, people are not fully aware and driven by myths. We'll try to sort the facts from fiction. The 5 common life insurance myths are:

Myth 1 –I'm young and I can wait to get insurance.

Life insurance is a product you have to buy before you need it. That means the time to purchase life insurance is when you're young and healthy. The pricing on life insurance policy depends on age, health and risk class and so it's cheaper to buy at an earlier stage of life.

Myth 2 – Spouses at home don't need their own life insurance

There's more to consider than a salary when it comes to determining how much insurance each spouse needs. Everything from housekeeping to extra-curricular activities would cost family extra money if a non-employed parent was no longer around to contribute. There is a financial cost, even if they did not have any income.

Myth 3 – No need for a private insurance plan if there is a group plan from the employer

A group plan is under the control of the employer and ends when there is a change in employment. An employer-paid policy typically offers a coverage amount based on employee's annual salary or a fixed amount and might be insufficient. A good thumb rule is that you might need atleast 10 times your annual salary and this will never be met by employer's Group Plan. It is better to have a private insurance plan and let the group plan be a supplementary or additional one.

Myth 4 – Life insurance is expensive and all policies are same

A plan can be tailor made to suit individual needs and requirements. A Combination of Term and Endowment plans can be customized. Term life insurance often gets more expensive as time goes on. Term is perfect if one needs coverage for ten years or less, or when one has limited cash to dedicate to insurance. Endowment Plans are actually one of the assets in your financial portfolio.

Myth 5 - Once you buy a life insurance policy, you can stop thinking about it.

You can't buy a policy and then just forget about it. Things change. When you got the policy, may be you had a young family. Twenty years later, your situation is likely very different. Review your policy periodically and make sure it fits your requirements.

Life Insurance
Why do I need it?

Every life has a value and is worth protecting. If an unexpected event were to happen, life insurance proceeds can help pay for:

- Bills and ongoing expenses
- Outstanding debt
- Future needs, like education
- Spouse's retirement plan

MYTH: Life insurance is too expensive.

FACT: A healthy 30-year-old could get Rs.1 crore coverage for twenty years at Rs.20 per day.

Common Insurance mistakes

No insurance

The worst mistake concerning life insurance is having a need and not having any insurance at all. Very often, people can find all sorts of excuses for not buying life insurance. But it is a source of financial support for the family.

Not enough insurance

The majority of people with insurance are underinsured. Insufficient coverage can occur as a result of buying what is affordable instead of what is needed. Failure to review coverage periodically could also result in insufficient insurance, even if started out with adequate levels. Inflation rates, career, and lifestyle might change. Insurance requirement has to be reviewed periodically.

Too much insurance

Purchasing a large policy during one point in life and then not adjusting coverage when insurance need is reduced, is possibility of too much life insurance. This is another good reason to periodically review coverage with a financial planning professional. Periodic reviews of insurance coverage can reveal opportunities to change levels of coverage to match current and projected needs.

LIFE INSURANCE mistakes

Making a mistake with life insurance can hurt the ones you love most.

01

Relying Only On Your Employer-provided Life Insurance

Cover will end when you leave your current job. Purchasing a policy after retirement, is very expensive.

02

Too young to purchase a Life Insurance

Best time to buy is when you are young. Premiums are low when you are healthy.

03

Choosing the Cheapest Policy

Choose a policy based on your needs. Check whether the Insurer is a sound company and has a good track record of claim settlement.

04

Insufficient coverage

Failure to review your coverage periodically result in insufficient coverage. Insurance policy is chosen based on premium affordability rather than requirement.

05

Life Insurance as a tax saving instrument.

Don't buy Life Insurance only as a tax saving tool. Its primary objective is to provide financial protection to family.

Things to know about a Life Insurance Contract

Life Insurance is so complex because they are legal contracts that must cover a large range of diverse conditions and situations. For example, policies must provide clear language about the following:

- Who's covered and who isn't
- Term definitions
- Extensions, Options, and Limits of Coverage
- Exclusions
- Conditions
- Responsibilities and Duties of Each Party

Simply stated, everyone needs to understand two important things:

Maturity Benefit – Offers a lump sum payment / regular payment upon Survival of the policy tenure.

Death Benefit – Amount paid to beneficiaries upon death during the policy term.

Advantages of insurance policy with Maturity Benefits

The policyholder can claim the benefit after the policy matures, and the insurance company provides a fixed amount (for traditional products) and a variable amount (for market linked products like ULIPs) after the plan tenure is completed. However, this is only a possibility when the policy is being continued as per the contract terms. Usually, the maturity benefits include a sum of the premiums that have been paid till a fixed date and any other benefits as stated in the policy document.

Initially, the maturity benefits are limited to the total amount paid in premiums, but the amount gradually increases every year, which is why these plans are considered an investment avenue as well as insurance. There is a steady increase in the corpus and at the end of the maturity term the insurance company pays-out the total amount.

*****

Your Life Insurance Decision Journey

START

DECISION #1
Do you need life insurance?

1. Do people depend on you?
2. Do you have a Loan?
3. Does your retirement income depend on a spouse's Retirement Benefit?

NO — If you answered NO, you may not need life insurance.

YES — If you answered YES, you probably do need life insurance.

DECISION #2
What kind of insurance do you need?

1. Are you searching for lowest-cost solution?
2. Is your need for life insurance temporary (to cover kids or a mortgage)?

NO — If you answered NO, you may want to explore insurance + investment options.

YES — If you answered YES, a term policy may be the best option for you.

DECISION #3
How much life insurance do you need?

DIME

To calculate your potential needs, consider the DIME formula – debt, income, mortgage and education.

D How much would it take to pay off your debt? You may want your life insurance to pay this debt off, so it doesn't become a burden to loved ones.

I What would it take to replace your income? Some experts recommend multiplying your income by 10 – this should give loved ones adequate time to transition to a new source of annual income.

M How much is needed to pay off your mortgage? You may want enough life insurance to pay off your mortgage so your loved ones have affordable shelter.

E Do you want life insurance benefits to include funds to pay for your children's education?

Add up these figures to get a total life insurance need.

DECISION #4
How much life insurance can you afford?

While you want to buy as much life insurance as you can afford, you do not want to strain your monthly budget. Consider the costs/benefits of how much you buy today.

SECURITY: Some life insurance is better than none at all. Even if you can only afford to purchase half of your total need, you've created some financial security for your loved ones.

HEALTH: Those in good health typically receive better rates than those with medical conditions.

AGE: Your rates today will be lower than they might be in the future when you're older.

CONGRATS!

You've reached the end of your journey. Enjoy the peace of mind that comes with having life insurance!

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Notes

Notes

Is my Life Insurance on track?

Life insurance is the foundational aspect of your financial plan, but it's also a component that requires regular evaluation. Ask yourself these questions to make sure you have the right kind and amount of life insurance.

Do I have the right type of coverage?

Term or Traditional based on the requirements.

Do I have enough coverage?

Life events play a significant role.

Does my life insurance support my objectives?

To replace income, to fund future goals, retirement etc.,

Reviewing policies periodically is part of long-term financial planning process.

About IFE Academy

IFE Academy was established in 2011 as a Not-for-Profit entity to promote Financial Education. IFE Academy conducts Investor Awareness Programs across the country with the support of other market participants. www.ifea.in is a comprehensive website on Financial Education. It has various sections such as Videos, Puzzles & Games, Financial Calculators and Library. It gives a holistic view on financial education combining various aspects such as Savings, Investments, Credit, Insurance and Pension at a single place. IFE Academy periodically publishes Investor Educational materials and distributes it to general public.

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