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How to Shop for Term Life Insurance

by
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Consumers are bombarded daily by advertisements for term life insurance. Over the radio, in the newspapers, by direct mail, through their professional associations and trade groups comes a host of confusing messages about term insurance. More of them these days promote the alleged ease and low expense of purchasing term insurance through the Internet. The choice of companies and the range of products, prices and methods of purchase have grown. But how does one sort through the noise and confusion? It's fair to say that shopping for life insurance, even basic term insurance, is more perplexing than ever. In an effort to make more sense out of this process, this article offers some basic preliminary advice about term insurance from one who provides fee-only advice in this area but does not sell the product.

We begin with the all-important question of the amount of insurance you want to purchase. You may already have made your own calculation of the coverage that you want or need. In case you haven't, the following guidelines are offered. We assume for this purpose that the term insurance is intended to assure continuing income and support for surviving family members in the case of the premature death of a breadwinner. Life insurance, including term insurance, has several other purposes in an estate and business planning context, but providing ongoing support for survivors is its most basic function.

How Much Is Enough?: An adequate amount of term insurance to support surviving family members is that which replaces income, or at least that portion of current income that you would want your family to continue to receive. That income figure would need to grow from year to year to keep up with inflation, so the amount of capital producing replacement income would need to grow as well.

For example, with an 8 percent pre-tax rate of return and a 3 percent inflation rate, only 5 percent of capital before taxes would be available for spending, because 3 percent would need to be reinvested in order for future income to keep pace with inflation. Assume that there is a need for $100,000 of replacement income before taxes, increasing with inflation. At a 5 percent rate of return, $2 million would be required in the form of insurance and other liquid assets. The capital need for replacement income, using the 5 percent income rate of return assumption, is therefore calculated by multiplying the pre-tax replacement income need by 20.

Consider also whether this stream of replacement income will be adequate to provide for education costs or other special needs. For example, a private education at one of the most expensive colleges requires almost $150,000 in today's after-tax dollars.

Needs Analysis: By following the simple analysis outlined below, you can arrive at an approximate estimate of the additional life insurance needs you may have:

Before-Tax Replacement Income Goal ______________ x 20 = $ ___________

Special Needs for Capital (Education, etc.): + $ ___________

Total Capital Needs: $ ___________

Less: Existing Insurance: $ ___________

Less: Existing Liquid Assets: $ ___________

Additional Insurance Need: $ ___________

Once you have settled on the right initial amount of insurance, here are other factors you need to consider? Most of these factors hold equal importance if the term insurance will fill a business or estate planning need, such as funding buy-sell agreements or providing key man coverage, than if it will serve the traditional purpose of providing support for family members.

- **Duration of Policy:** Term insurance is just that. It provides coverage for a period of years, not for life. If you need all or a portion of the insurance for 20 years, make sure that the policy will offer competitive rates for that period of time. Do not, for example, buy a 10-year guaranteed level term policy if your needs may last longer. Premiums go through the roof on these polices when the guaranteed period ends, and you may not qualify for another favorable 10-year rate.

- **Level Premiums vs. Annually Increasing or Banded Rates:** With a level premium policy, you will pay higher premiums in the early years and lower prices in the later years than with premiums that increase either annually or periodically every 5 or 10 years. Level premiums are most often guaranteed. However, you will pay more than necessary if you end up canceling or replacing the level premium policy before the full level premium period ends. Your greater outlay in the early years for the level premium policy will deprive you of the alternative use of that money, including possible investment gains. Whether you are better off paying less in the early years and more later with annually increasing or banded rates will depend on a variety of factors - the number of years involved, the premiums and the rate at which they increase, and the cost of money that you assume in the form of interest or investment earnings that you might earn by deferring the higher outlays to later years. For this purpose, you need to reduce each alternative set of expenditures to a “present value,” meaning a current total cost in today’s dollars. To translate a series of future expenditures to a present or current value requires the application of a “discount rate” equal to the after-tax rate of return that you assume. The lower “present value” cost, as between level premiums or the alternatives, is obviously preferable, provided you are comfortable with your discount rate assumption and the insurance companies’ projections of any non-guaranteed premiums.

- **Guaranteed vs. Non-Guaranteed Rates:** Level premiums are most always guaranteed for at least a certain period of years. Annually increasing or banded rates generally are not. A preference for guaranteed rates might seem obvious. However, the absence of a guarantee need not cause concern if the insurer is highly reputable and well-known, as you will not likely experience a rate increase with such a company unless it is well justified by unforeseen factors affecting all life insurers. In addition, under new regulations, guarantees of more than 5 years impose higher reserving requirements and costs on insurers that could affect their financial strength.

- **Insurance Company Financial Strength Ratings:** There are five companies that rate life insurance companies based on their financial strength – A.M. Best, Moody's, Standard & Poor's, Fitch, and Weiss Research. Only a few companies have the highest ratings from each of these agencies. The financial strength of a life insurance company issuing a term insurance policy is arguably less important than with a cash value policy since, to our knowledge, a financial insolvency has never prevented the payment of a death claim. It has only diminished the cash value of policies that have been surrendered. However, with term insurance rates lower in recent years than ever before and with increased competition in this market, it is possible that insurers' future financial problems could affect the payment of death claims. The financial strength of a term life insurance carrier is not an unimportant consideration. (For more information on life insurance company financial strength ratings, see our separate article, "What Business Owners Should Know and Ask about Life Insurance," pages 6-7).

- **Where or from Whom to Buy Term Insurance:** There are limitations with any of the distribution alternatives. Agents and brokers may only offer a limited number of companies or have too much incentive to promote the company or companies that pay the highest commissions. Internet-quoted premiums may have some of the same limitations. More often, the lowest Internet quotes assume a "super-preferred" health status for which relatively few healthy non-smokers can even qualify for a variety of reasons. For example, certain illnesses or causes of death of relatives can preclude the desired rating. Fee-only life insurance advice that can filter and make sense of this information may prove a wise initial investment for those who will be spending thousands of dollars on term insurance over a period of years. (For a description of such services, click here).

- **What If I Might Want to Convert a Portion of My Term Insurance in the Future to Permanent Insurance?:** This article assumes that you have already decided to purchase term, rather than "permanent," insurance.[1] (If you are undecided on this point, please see our separate article, "Term vs. Permanent Insurance: Points to Consider"). If there is any possibility that at some point in the future you may want to convert all or a portion of your term insurance, you will want the coverage that might be converted to come from a company with a highly competitive permanent insurance product. As a rule, companies with the absolute lowest term insurance rates do not offer the most attractive permanent insurance policies. However, it may be possible to obtain relatively low, if not the lowest, term insurance rates from a strong company that would also offer a highly competitive permanent insurance product upon conversion. With any possible future interest in converting term insurance, this point needs to be explored when buying the initial coverage.

[1] The term "permanent insurance" is used generically here to include whole life and universal life policies, where the investment component of the policy takes the form of the insurance company's fixed-income oriented portfolio, and "variable" life, where the policy owner chooses underlying mutual fund-type investments, most of which include equities.

- **Group Employer vs. Individual Term Coverage:** Given a choice between purchasing group term life insurance through work and individual coverage, always choose the latter if you are a reasonably healthy non-smoker or if you must take a medical exam anyway to apply through the group plan. The individual policy will most always be cheaper. In addition, you never know where or when your future career will take you in this age of job mobility. If you leave your employer, group coverage very rarely can convert to an individual term policy at competitive rates, and it might be cancelled at some point even if you stay. The individual policy will remain in effect for as long as you pay the premium.

- **Achieving Savings with a Policy Replacement:** It is possible that you could realize a meaningful savings through the replacement of a term insurance policy that you already own. This is most likely if your existing coverage is more than 5 years old and your health has not changed for the worse, or if you were "rated" in some manner for a health condition when you obtained the current policy and your health has since improved. Some caution is in order here, however. Most importantly, do not cancel your existing policy until you know that you can obtain the replacement on favorable terms. Also, recognize that there are certain contractual provisions governing new policies that relate to fraud in the application and death by suicide that, in rare cases, could result in the denial of a claim on a new policy.

- **Do Not Procrastinate:** As confusing as life insurance, even term insurance, can be, there is no good excuse for delay in obtaining the coverage you need today. If the worst should happen, your next of kin will not want to know just what kind of policy you had or the company that issued it, but only how much there was. Make the important decisions that are required today, and take steps to implement them.

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An estate planning lawyer prior to joining NML, Barkhausen is a member of the American, Illinois, and Chicago Bar Associations and served on the National Conference of Commissioners on Uniform State Laws for 14 years. He has written for and spoken to these organizations on estate planning and life insurance topics, and he has also conducted Continuing Professional Education seminars for the Illinois CPA Society on the business and estate planning applications of life insurance.

Barkhausen graduated with high honors from Princeton University in 1972 and in the first class of the Southern Illinois University School of Law in 1976. He and his wife, Sue, live with their sons, Wicks and Billy, in Lake Bluff, Illinois.