

Learning Objectives

An understanding of the material in this chapter should enable the student to

1. Describe the role of the financial advisor.
2. Identify the content areas of a financial plan.
3. Discuss the basic needs and risk exposures in the foundational level of the financial planning pyramid.
4. Discuss the financial planning pyramid and how it can be used with clients.
5. Identify the needs of individuals and families for which life insurance can provide a solution.
6. Define the concept of human life value and explain how it relates to life insurance.
7. Identify and describe the benefits of life insurance.
8. Explain the use of mortality tables to predict life expectancy.
9. Explain the three elements that are the building blocks of a life insurance policy.

The financial advisor can play an important role in helping individuals and families establish a firm foundation of financial security. Financial advisors should be able to address the fundamental financial needs and reasons for owning insurance and the benefits derived from it. Using the financial planning pyramid as a model, the advisor uses the financial planning process to address the needs and risk exposures that must be met to establish a foundation of financial security for clients.

THE ROLE OF THE FINANCIAL ADVISOR

There is much to learn to be a competent financial advisor. To be effective you must know how to help people structure their financial goals. To become

a professional and trusted advisor, you must help prospects and clients recognize and accept their financial needs, and encourage them to act to take care of those needs. That is rarely an easy job. People face many financial challenges, and the ability and commitment to plan and save for the future is too often put off for the pressures and pleasures of today.

People expect more today from financial advisors than they did in the past. There have been violations of trust from financial institutions and those who work for them throughout history, and presently this situation is especially acute. You are expected to act professionally and give accurate and valuable advice, based on your knowledge, skill and experience.

Financial advisors assist people facing the challenges of life: preparing for retirement, the possibility of disability or needing long-term care, and death, for example. We help people address the problems these life events inevitably create. These are tough issues. Our task is to focus on these issues, the needs and dreams of our prospects and clients, and to devise the best ways to fulfill their goals and dreams. When we do this, our relationships with clients become meaningful to them and us, and we all benefit.

If you can dedicate yourself to helping people solve the financial issues they face, you will build a clientele of lifetime acquaintances and friends. They will look to you for advice as you help them discover, accept and fulfill their financial needs and goals. Through you, they will find financial and emotional security, having protected and provided for themselves and the people they love.

The financial services industry is very competitive. As you progress in your career, you must develop your knowledge, ideas and skills. This must become the difference between you and the competition in some meaningful way. You must ask yourself, how well do you understand your client's financial problems and goals? What ideas do you have to help him or her address them? How skilled are you at carrying out the selling and planning process? You must know your products and how they relate to other financial products that your clients will be offered. You must master the core skills of your business, including marketing, prospecting, selling, business organization, planning and management, communications, technical and product knowledge, and financial acumen.

However, just because you want to help people does not mean that they want your help. Many people do not think they need your help because they are "do it your selfers", or they do not recognize that they have a financial need.

Many of those that do need your help do not have the money or willingness to pay for it. Success will depend on finding people who want and need your help, and are willing and able to pay for it.

Most people are not looking for help. Most people engage advisors in the midst of or after triggering life events, not proactively, but reactively. Get in front of this fact with targeted marketing. Retirement, death, divorce, having children, paying for college, layoffs and unemployment, long-term care events, and disability are critical triggers for prospects to either seek or accept professional financial help.

How many people you see will determine how successful you become, not how much you know. Knowledge supplements a successful practice; it does not create it. Activity is the key to staying in the business and eventually becoming successful. Make two appointments everyday for some time in the future. Having two appointments every day for the foreseeable future is the path to success.

Selling is a complex, psychological use of questions and statements that motivate people to make a decision and take action. It is neither simplistic nor devious, if done well and professionally. People fail to act in their best interest and tend to stay put, regardless of their discomfort, unless motivated by a fear of loss or hope of gain that is greater than the cost of a solution or doing nothing. No amount of professional knowledge will make a bit of difference to this critical process unless you have someone to talk with. Expertise is useless until the prospect is engaged in the process. Most new advisors will need four or five strategic and repetitive marketing activities to be successful. With time and experience, these activities may be reduced to one or two core activities discovered through actual results over time. Quality comes from experience, and experience comes from repeated activity, and many failures.

Draft a budget and business plan. Figure out how many of what type of clients you need to make your income goal. Be honest about your target market and if you are known in that market. You need to be known in your target market. If you are not, you need to find a way and work at becoming known. A strategy in targeted markets, with a focused specialization, will improve your chances of success.

THE FINANCIAL PLANNING PROCESS

financial planning process

The financial advisor uses a planning approach to marketing insurance and financial products. This course emphasizes life insurance, but the skills and processes covered can apply to all financial product sales. Financial planning is a process that accomplishes both of the following:

- determines the client's financial problems and/or financial goals
- develops a plan to solve the client's problems and/or achieve the client's goals

Although some people may benefit from comprehensive financial planning, the process of addressing all aspects of one's financial life at one time, most people do not require this approach, and even if they do, they are unwilling to spend the time and money it requires. It is difficult to deal with the totality of one's financial problems and goals all at once. This is also challenging for the financial advisor, who needs specialized education, experience and training to take on this challenging task. In most cases, you will be addressing only one or a few of the most important financial needs for the prospect or client at the initial and subsequent meetings.

The Content of a Financial Plan

There are six areas addressed in the most comprehensive financial plans. While you may not be the provider of solutions and recommendations within each of these areas, understanding what is covered in each of them will help you establish a valuable framework and perspective. It is not necessary that a financial advisor be a comprehensive financial planner who addresses all of these areas. Your company, business model, experience, education and professional goals may not support a comprehensive approach. However, the more you can identify financial issues and risks needing attention, even if you do not work with them directly, the more value you bring to the client. As a trusted advisor, you can direct your client to other advisors who can address those identified issues that need attention, or work jointly with an advisor experienced in the applicable planning areas.

**financial plan
content**

The following are the areas most commonly included in financial planning:

1. Current Financial Position

- managing cash flow (income and expense) within a budget
- improving balance sheet (assets and liabilities) and debt management
- building cash reserves for emergencies and/or opportunities

2. Protection Planning

- managing personal, business, property, and liability risks
- incorporating employee insurance benefits (e.g., health, disability, life, key person and long-term care)
- working with risk management professionals where indicated

3. Tax Planning

- incorporating earned, investment and business income, as well as asset transfer (estate, capital gains) tax liabilities
- integrating tax management with the other five areas of the plan
- working with accounting professionals, where indicated

4. Investment Planning

- building, managing, and distributing investments for a specified purpose (e.g., children's education, retirement, asset purchase)
- determining client risk tolerance and portfolio risk/return balance
- working with investment professionals where indicated

5. Retirement Planning

- identifying preretirement capital and income requirements to meet client retirement goals
- developing postretirement sources of income, including distribution of assets
- incorporating employee retirement benefits (e.g., defined contribution and defined benefit plans)

6. Estate Planning

- planning for the preservation of assets and their orderly, efficient passing at the end of life
- integrating charitable giving, where desired
- working with estate planning professionals, where indicated

Integrated Financial Planning

integrated financial planning

Although comprehensive financial planning is not predominant as a financial planning approach, it is important to consider a prospect's or client's overall financial picture to ensure that recommendations that address one need do not conflict with other important needs or goals. For most people, income and assets are limited. A dollar of life insurance premium, for example, is a dollar that cannot be spent meeting other financial needs. As one's income and assets increase, there is an increasing need for integration within one's financial plan. As a result, most people address their financial planning needs through a multi-purpose sequential approach, concentrating on the most pressing need or goal at a given time, then addressing another as it becomes more prominent. As a result, over a period of years, they eventually have a fairly comprehensive plan in place as they progress through the financial life cycle. We call this an *integrated planning approach*. The one drawback of this approach is that what is needed may not be in place at the time it is needed.

Those advisors who do not conduct comprehensive financial planning still have an obligation to propose recommendations regarding their products within the context of a prospect's overall financial situation and needs. For example, a life insurance agent should not recommend utilizing all of a prospect's disposable income to buy permanent life insurance if the prospect has other financial needs, such as disability income insurance and retirement savings. If you lack experience or licensing in a certain area, consider referring prospects to noncompeting advisors who can assist them. The ideal situation is to form a team of advisors, called a strategic alliance, where you can coordinate the team's efforts regarding specific clients and provide expertise in your areas of specialization.

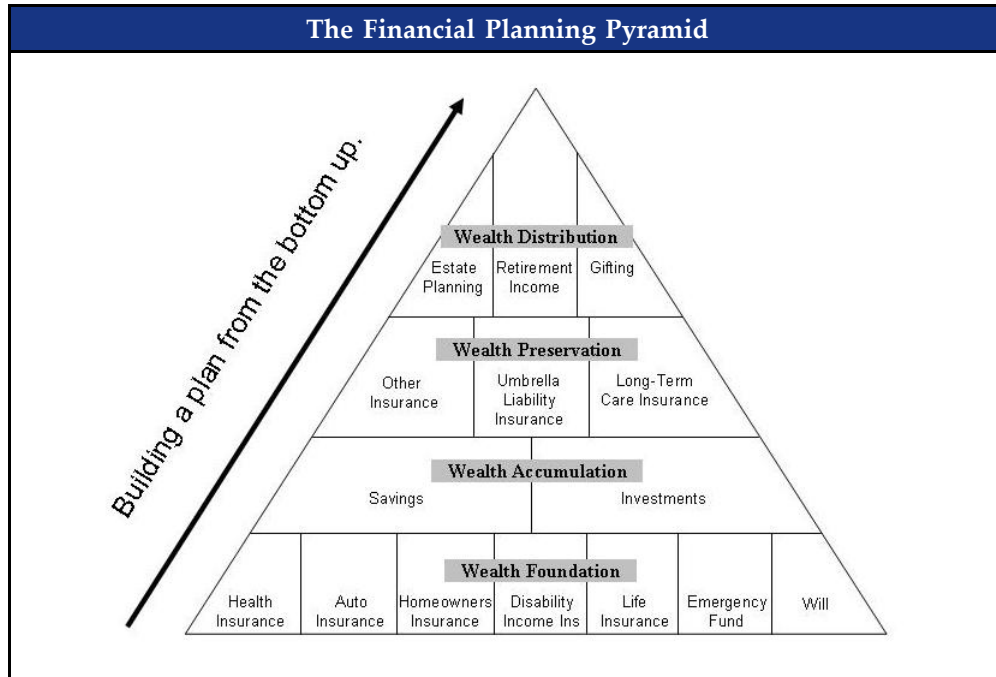
The Financial Planning Pyramid

At some point in the beginning of the initial sales interview, the advisor describes his or her philosophy for meeting financial and insurance needs. A

few minutes should be spent discussing the advisor's purpose and process. You should discuss the format and content of the client-advisor relationship and begin to define each other's expectations. The advisor and prospect can review the time commitment that may be involved and the kinds of outcomes that the client might reasonably expect. The advisor should also emphasize the importance of an integrated financial plan and outline how the advisor can help prospects build and implement one and keep it current. At some point early in the process, you want to define with the client what is known in financial planning as "the scope of the engagement"—what financial needs will be addressed and what time commitment will be needed to accomplish agreed upon objectives. One method for discussing these points is the financial planning pyramid.

**financial planning
pyramid**

The *financial planning pyramid* is a useful visual tool that depicts the necessary steps to reach financial independence. It uses four levels, starting from the base moving up to the tip: wealth foundation, wealth accumulation, wealth preservation and wealth distribution. In addition, there are blocks within each level that represent the most common insurance and financial tools used in an individual financial plan. The pyramid in its entirety represents an integrated financial plan. The individual blocks illustrate how most people feel comfortable building their financial plans—one or a few blocks at a time. Thus, the term *building block approach* is used to describe this incremental approach. As you gain experience, you may find it appropriate to conduct a more comprehensive approach to identifying and addressing insurance and financial needs for an individual client.



The financial planning pyramid can help prospects and clients understand the sequential approach to financial planning. The pyramid illustrates how a financial plan can be built from the ground up in four sequential stages in an orderly fashion, typically requiring several meetings with the client over a period of years.

At the first stage, you concentrate on protecting the client against life's uncertainties and the potential for significant financial loss and hardship. Financial success begins with establishing a solid foundation of economic security and the ability to meet emergencies. Adequate protection and cash reserves come first. The pyramid illustrates how prudent planning begins with risk management and proceeds in a systematic way to build and ultimately distribute one's wealth. At the foundational level, debt reduction, budgeting and establishing an emergency fund are important cash management goals. A will and other legal documents such as a living will and health care proxy should be created and executed.

The financial plan must be built on a firm foundation. This is where you can provide a valuable service, since for many individuals and families this stage is either missing or incomplete. Without adequate protection, savings, a workable budget, and other aspects of the foundational level, the financial

goals of the client are at risk and the entire financial pyramid could collapse. The foundational level establishes strength and stability for a healthy financial plan. Decisions made at a lower level have a great impact on what is done at a higher level. For example, if a client has not established a realistic spending plan, it may be difficult to use credit wisely and not spend more than he or she earns, which subsequently will have an impact on having money for other cash accumulation goals.

Once the foundation is in place, a person can begin buying products (savings and investments) in the wealth accumulation level—mutual funds, CDs, real estate, and so forth. Once there are assets in place, wealth preservation tools are needed. When the accrual of assets reaches a threshold, a person will need to consider products such as umbrella liability insurance to preserve assets from lawsuits and, as the client ages, the potential need for long-term care insurance to protect the client from the costs of long-term care services. Most likely, with increased wealth will come additional property that will need to be insured, such as a summer home, a boat, expensive jewelry, and so forth. As the client moves up the pyramid, the focus shifts from protection to building capital, typically for goals such as retirement, education and other wealth accumulation goals.

Finally, at the wealth distribution level products and planning are needed to manage retirement income to ensure it will last. In addition, estate planning tools are used to conserve the estate for heirs and provide for charitable causes.

Once products are in place, they should be reviewed periodically and any necessary adjustments made. Financial and life situations and goals change. For example, a divorce will probably mean a new will is necessary. Higher expenses mean that an emergency fund that was adequate 5 years ago may need additional funding to maintain an amount equivalent to 6 months of expenses.

THE FOUNDATION: BASIC NEEDS

As we begin to work with clients, we first look to see if they have established a solid foundation of economic security and the ability to meet emergencies. Adequate protection and cash reserves are the first needs to address in a financial plan. Prudent planning looks at risk management and addresses

the many risk exposures that life presents. Planning at the foundational stage involves insurance planning, establishing an emergency fund, debt and cash management, including a budget, and executing a will and other legal documents.

Financial needs and goals should be identified and prioritized. Goals provide focus, purpose, vision and direction for the financial planning process. While it is true that few people begin a vacation without a specific destination in mind, it is also true that millions of people make significant financial decisions without a specific financial destination in mind. Determining a specific financial destination, or goal setting, is critical to creating a successful financial plan. Few people actually set clearly defined goals. By leading the client through the goal-setting exercise, the financial advisor helps establish reasonable, achievable goals, and also sets the tone for the entire financial planning engagement.

Although each person sets financial goals throughout his or her life, most people want to address five basic financial objectives:

- Protect against risk
- Provide for financial security
- Develop a comfortable lifestyle
- Provide for a comfortable retirement
- Plan for the distribution of assets

At the foundational level, the basic protection needs are addressed. Failure to address these needs leaves any savings and investments vulnerable if an uncovered loss occurs. Establishing a solid base through risk identification, measurement and planning is fundamental to a client's well being.

Risk Management

risk management

The financial advisor's ability to clearly and objectively explain risks to clients can help them better prepare to meet them. Thinking about and evaluating the magnitude and consequences of economic catastrophe, or of one's demise is a task many people prefer to avoid or ignore. Financial advisors are uniquely positioned to help clients understand the risks to which they may be exposed, so that they can be managed effectively through the use of insurance and/or other risk managing techniques.

For financial planning and insurance purposes, the term *risk* means the possibility of financial loss. This can result from the loss or reduction in value of something that one possesses. For example, the value of the client's home can be reduced by fire, the value of her income-earning ability can be reduced by disability, or the value of her bond portfolio can be reduced by an increase in interest rates.

Risks can be categorized as property risks, liability risks, and personal risks:

- *property risks*—involve the possibility of
 - direct losses associated with the need to replace or repair damaged or missing property
 - indirect (consequential) losses, such as additional living expenses that are caused by direct loss
- *liability risks*—involve the possibility of
 - loss from damaging or destroying the property of others
 - loss causing the physical or financial injury to others
- *personal risks*—involve the possibility of
 - loss of income earning ability due to
 - ◆ premature death
 - ◆ disability
 - ◆ unemployment
 - ◆ retirement
 - extra expenses associated with illness, accidental injuries, or the inability to perform some activities of daily living (ADLs)

**risk management
process**

It is helpful to view the risk management process as a conscious one in which the financial advisor can play an important role. The risk management process can be

summarized by the following steps:

- Step 1 — Establishing goals
- Step 2 — Identifying risks
- Step 3 — Analyzing risks
- Step 4 — Identifying feasible alternatives for addressing risks
- Step 5 — Selecting risk treatment methods
- Step 6 — Implementing the plan
- Step 7 — Monitoring, reviewing and revising the plan as necessary

Alternative approaches to managing risks include loss control and loss financing. Approaches to loss control include risk avoidance, risk prevention and risk reduction.

- Risk avoidance eliminates the activity or condition that gives rise to a particular risk. Not living in an area prone to flooding, or not owning a car and using public transportation to avoid an accident are examples.
- Risk prevention attempts to reduce the impact or frequency of a loss. Examples include losing weight, exercising regularly and not smoking to lessen health risks.
- Risk reduction aims to reduce the severity of a loss, such as installing fire extinguishers and smoke detectors in the home, or air bags in automobiles.

The two approaches to risk financing include risk retention and risk transfer:

- Risk retention is the process of financing one's own losses, commonly called self-insuring. This may be used where the risk is infrequent or less severe and the cost of insuring is not practical or cost effective. Risk retention may be planned or unplanned. Unplanned retention may be financially devastating because the risk was unknown, unanticipated, ignored, or risk transfer was unavailable or unaffordable. Deductibles are examples of partial retention. Risk retention may also include setting aside funds specifically earmarked for a specific risk.
- Risk transfer is the use of insurance to transfer the financial consequences of a risk to another party, an insurer. Insurance involves the insurer pooling together a large number of similar risks to make losses more predictable based on probability, and to provide funding for losses.

Insurance Needs

At the foundational level of the financial plan, the advisor and client should focus on providing protection against life's uncertainties, those events that could have a devastating effect on the financial well being of the individual and his or her dependents. We will now review the significant types of risks that people encounter and the types of insurance designed to protect against the financial losses these risks impose. Special emphasis and detail is provided for life insurance needs, which is the primary focus of this course. Additional forms of insurance that should be analyzed to see if a need exists

include medical expense insurance, disability income insurance, long-term care insurance, and property and liability insurance.

The Needs for Life Insurance

A human life possesses many values, most of which are irreplaceable, priceless, and certainly not easy to measure. These values are based on religious, moral, and social relationships. Many religions believe that human life is immortal and gifted with a value beyond the human mind's understanding. Moral teachings and beliefs, often deeply connected to religious values, maintain that the human life is sacred and must be preserved and held in the highest regard. A person's relationship with other human beings creates a set of emotional and sentimental attachments that cannot be measured in monetary terms or replaced by material things.

These values, however important as they may be, are not the foundation of life insurance. Life insurance does have strong moral and social significance, but life insurance is concerned with the economic values of a human life, derived from its earning capacity and the financial dependence of others on that earning capacity. The earning capacity of a human life by itself does not create an economic value to serve as the basis of life insurance. A human life has an economic value only if some person(s) or organization depends upon or expects to receive some monetary benefit through that life. If an individual is without dependents, and no other person or organization stands to benefit through his or her living or stands to lose at his or her death, either now or in the future, that individual's life has no monetary value that needs to be insured.

life insurance needs

Life insurance products can satisfy many purposes and needs, and provide numerous economic and psychological benefits to individuals and families. Some of the common *needs for life insurance* include the following:

Survivor Income Needs. The death of a working family member usually terminates an income stream that the family or other survivors have relied on. The spouse and children need to be provided for during the dependency (child-rearing) period and beyond. There will be continuing costs for food, transportation, and utilities. The surviving family members will want to continue their established lifestyle and they will typically generate the same level of expense they encountered before the insured's death. This means a continuation of bills for cable TV services, magazine subscriptions, cell

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Techniques for Meeting Client Needs

phone service, newspapers, club memberships, entertainment, and other miscellaneous expenses. Changes in a family's standard of living are usually accomplished through a certain amount of trial-and-error adjustment over a period that often exceeds one year.

This death can leave a surviving family adrift with unfulfilled dreams and expectations, as well as outstanding financial obligations, if care has not been taken to meet the needs of those left behind.

income needs

It is common to classify the survivor's *income needs* into three categories:

readjustment period

Readjustment Income. The *readjustment period* is the interval of time immediately following the insured's death, during which income is usually provided at or near the level enjoyed by the family during the insured's lifetime. In the dependency period thereafter, the income drops to a more realistic and sustainable level.

Few individuals are able to leave an estate, including life insurance, substantial enough to provide their dependents with an income as large as they enjoyed while they were alive. This means that an adjustment will have to be made in the family's standard of living. To cushion the economic and emotional shock, however, it is desirable to postpone that adjustment for a period following the income producer's death. The length of the period depends largely on the magnitude of the change that the family will have to make in living standards. If the surviving spouse must refresh or acquire skills to gain employment, a longer period may be needed. Whatever the duration, the income during this readjustment period should be approximately equivalent to the family's share of the producer's earnings at the time of his or her death.

The emotional turmoil following the death of a close family member typically lasts about one year or more. As survivors cope with their emotions, the grieving process often distracts them from concentrating on financial issues. They may forget to pay important bills, such as premiums on homeowner's and auto insurance that could worsen their financial position. Creditors insisting to be paid immediately can be an additional source of emotional stress at this time. Survivors who are able to show these creditors that adequate life insurance will be available are usually not pressed for collection until proceeds have been received.

dependency period

Dependency Period Income. The *dependency period* is the interval between the end of the readjustment period and the youngest child's self-sufficiency, usually assumed to occur at age 18, unless the child is mentally or physically disabled. Minor children and other dependents may need to be supported for a lifetime or at least until they become self-supporting. A surviving spouse may need to be supported during this dependency period as well, rather than being forced to enter the labor market. Life insurance proceeds can supplement other income sources that the survivors may receive. The other sources of support available to the children, like all other needs of the family, will affect the children's financial needs.

Most people assume major responsibility for the support and maintenance of their dependent children during their lifetime and consider it one of the rewarding experiences of life. In any case, the law attaches a legal obligation to the support of a spouse and children. If there is a divorce or a legal separation, the court will normally decree support payments for dependent children and possibly alimony for the dependent spouse. In some cases such payments, including alimony, are to continue beyond the provider's death, if the children are still dependent or if the alimony recipient has not remarried. In such an event, the parent and/or ex-spouse is required to provide life insurance or set funds aside in trust.

Another group of family dependents that may have a period of dependency are the husband and wife's parents. The financial demands of providing parental support can be minimal—providing room and board in the home, for example. At the other end of the spectrum, support of a parent in an institution can be very expensive.

Payments to enhance someone's lifestyle, however, are not necessarily restricted to children or other family members. Payments are sometimes extended to lifelong domestic partners, helpers, and caregivers as an informal pension, perhaps for the recipient's remaining lifetime. Life insurance can fund these payments if the benefactor dies first.

blackout period

Life Income for Surviving Spouse. In life insurance planning it is necessary to divide the widow(er)'s basic need for life income into two periods. One period runs from the youngest child's 16th birthday to the widow(er)'s 62nd, and the other starts when the widow(er) is age 62. This breakdown is necessary because the surviving spouse's income from Social Security terminates for the child at age 16, with

some exceptions and does not resume until the surviving spouse is aged 62. A permanently reduced benefit is available at age 60. The period in between is usually called the *blackout period*.

The Moral Obligation to Provide Protection

From the family standpoint, life insurance is a necessary business proposition that may be expected of every person with dependents as a matter of course, just like any other necessary business transaction which ordinary decency requires him to meet. The care of his family is man's first and most important business. The family should be established and run on a sound business basis. It should be protected against needless bankruptcy. The death or disability of the head of this business should not involve its impairment or dissolution any more than the death of the head of a bank, railroad, or store. Every corporation and firm represents capitalized earning capacity and goodwill. Why then, when men and women are about to organize the business called a family, should there not be a capitalization in the form of a life insurance policy of the only real value and goodwill behind that business? Why is it not fully as reasonable to have a life insurance policy accompany a marriage certificate, as it is to have a marine insurance certificate invariably attached to a foreign bill of exchange? The voyage in the first instance is, on the average, much longer, subject to much greater risk, and in case of wreck, the loss is of infinitely greater consequence.

Life Insurance, Dr. Solomon S. Huebner

The surviving spouse may require income beyond his or her eligibility for Social Security benefits and private pension plans. Supplemental income may be needed to support the surviving spouse indefinitely.

cash needs

Survivor Cash Needs. The above-outlined needs are income needs in which an amount of money is needed over a period of time to sustain survivors; those below are identified as cash needs. *Cash needs* are typically a one-time or otherwise lump-sum need for money which can be planned for and set aside in case of death, or provided through life insurance.

final expenses

Final Expenses. *Final expenses* are those costs related to dying. Funeral expenses are not the only expenses associated with death. Some people will incur large medical bills in a last illness that are not covered by insurance. Home or convalescent care is rarely covered by private insurance and has limited coverage under Medicare for those over 65. Prolonged medical, rehabilitative, and custodial care will often leave the family's finances devastated even before death occurs.

Many of the expenses associated with death are incurred after the funeral. There are costs of settling financial and property matters in closing the deceased's estate. Included are court fees, administrative costs, attorney's fees, probate expenses, possible investment and real estate management fees, and potential estate and inheritance taxes.

Managing the estate prior to final property disposition may be extremely complex, requiring the services of specialized investment and/or real estate managers to safeguard the property until it can be sold or distributed. The provisions of the will and the nature of the property involved may necessitate a long period of estate management before the estate can be closed. Some assets may be hard to sell in the economic conditions following death. The terms of the will may require the establishment of trusts and other legal work that is also very time consuming. Even the task of locating heirs or other beneficiaries of the estate may require a lengthy search to obtain death certificates for all potential recipients who predeceased the insured. The longer this process takes and the more complex it is, the more it will cost.

emergency fund

Emergency Fund. There is a general rule in financial planning that a person or family should set aside enough cash to cover about 3 to 6 months' expenses for emergency needs. This is of increased importance in the case of death of an income producer. Possible damage to or repairs needed for cars, home maintenance, health costs, and other expenses that may occur unexpectedly should be anticipated.

The family should have an adequate source of *emergency funds* in liquid holdings to meet any need for immediate cash prior to or following the death of an income producer, as well as at any other time. Liquid holdings might include money market funds, mutual funds, bank balances, cash management accounts, and life insurance cash values.

Mortgage Cancellation. For many families, it is important to know that in the case of the death of a parent or wage earner, the family would have a place to live debt-free. In the case of renters, a rent fund can be established that would accomplish essentially the same goal. If the family can occupy the home free of a monthly mortgage or rent payment, it will greatly reduce the amount of income that they would otherwise require.

Debt Liquidation. Some personal debts become due and payable upon the death of the borrower. This may include loans for automobiles, education, business, credit cards and other retail balances. Many families desire to

have a debt-free situation when the wage earner dies. Debt can create an economic hardship for the survivors who do not have the funds to repay it. Standard types of life insurance policies may be lower in cost than credit life policies. Adequate amounts of life insurance will give the survivor the option of paying off the debt in full or repaying it according to a schedule.

Education Funding. Although educational goals vary widely from one family to another, children commonly need financial support to reach their educational objectives. The cost of college, professional, and other postsecondary education continues to climb annually. Life insurance can guarantee that the necessary money will be there in case a parent dies.

A family's educational needs are not restricted to the children. A surviving spouse may need further education to increase future income potential to help support the family. The spouse may need a modest refresher course or training to return to a prior occupation. On the other hand, the spouse's need may be extensive, such as preparing to enter the job market for the first time or trying to upgrade to a higher-paying career. There is even the possibility that a surviving spouse may need training for a less demanding career if he or she has become permanently disabled in some manner.

Supplemental Retirement Funding. Life insurance proceeds can be an important source of funds for a surviving spouse, supplementing other sources of retirement income from corporate pensions, IRAs, other qualified plans, savings and investments, and Social Security.

Charitable Donations. Life insurance can increase the value of a gift to charity. A charity can be gifted a policy, named as beneficiary, or be the owner and premium payer on a donor's life.

Life insurance can also be used for charitable giving even if the charity is not a beneficiary of the insurance policy. The donor can use adequate amounts of life insurance to fund all of the needs of surviving family members and thereby free up personal property and other assets for lifetime gifts to charities.

Gift tax and estate tax considerations are often strong motives for making charitable gifts. Because tax laws are complex and change regularly, tax planning should be carefully coordinated by a knowledgeable tax advisor.

Gifts to Individuals. The beneficiary of a life insurance policy can be a trust for the benefit of heirs or other recipients for whom the insured cares. One advantage of life insurance gifts is that they are generally free of

probate and therefore not a matter of public record or subject to probate expenses. The grantor (donor) of the gift can increase the value of the gift using life insurance when transferring property to younger generations. Very sophisticated arrangements can be created to maximize gifts and transfer assets, often with income, gift, and estate tax advantages.

Supplemental Cash for Future Needs. Life insurance can provide supplemental funds for many financial needs by using the cash value of life insurance via policy loans or cash withdrawals prior to an insured's death, without terminating the policy itself. The interest rate for policy loans is known in advance and is usually lower than the rate available on loans from other sources. The primary role of life insurance is protection; cash accumulation should normally be viewed as a secondary purpose. Any loans or withdrawals made from a policy will reduce the death benefit protection.

Because life insurance provides a safety net and guarantees a certain sum at death, true saving is possible. Saving requires time, and life insurance provides a hedge against the possibility of a savings period being cut short. This refers to the self-completing characteristic of life insurance; it provides the money that an otherwise healthy and capable income-earner cannot because of premature death.

Medical Expense Insurance. Medical expense insurance used to pay medical bills as a result of accidents or illness is arguably the most important type of insurance protection to most Americans, and the one that causes the most anxiety if lost or if it is unaffordable. It is an expensive form of insurance if the client must purchase it, but many people have medical expense insurance as an employee benefit, where the employer pays some or all of the cost. It is important for an advisor to help a client determine if their coverage is adequate, and if not, assist them in obtaining full medical or supplemental coverage.

Disability Income Insurance. While the need for life insurance receives a great amount of attention, the need for disability insurance is often ignored and rarely discussed. Studies show that

- a 30 year old has a 24 percent chance of being disabled for at least 90 days before reaching age 65
- the chance of an individual becoming disabled during his or her working years is greater at all ages than the chance of death

- at age 45, the chance of suffering a disability is only reduced to 21 percent
- a person disabled for 90 days will probably remain disabled for at least 4 years

Despite these statistics, very few people have adequate protection against long term disability. The public may purchase life insurance for their family's protection but they have largely neglected their own income protection, even though the odds are far greater for a working-age person to become disabled than to die. Disability income insurance can provide an insured with income during a period of disability due to illness or injury. It protects the insured and his or her family from the consequences of the lost capacity of earn income, a working person's greatest asset.

Long-Term Care Insurance. Long-term care has become an important consideration in risk management planning. Long-term care is the broad range of skilled, custodial, and other care services provided over an extended period of time in various care settings due to a chronic illness, physical disability, or cognitive impairment. The likelihood that a person will need to enter a nursing home increases with age. The out-of-pocket payments for long-term care by individuals who must use personal resources can be astronomical. Today, average nursing home costs are over \$75,000 for private accommodations. It is becoming more difficult for families to provide long-term care, and most private medical expense policies and Medicare exclude convalescent, custodial, or rest care. Long-term care insurance can provide financial benefits to help offset the costs of providing long-term care services to those needing them.

Property and Liability Insurance. A financial plan that does not include property/liability insurance potentially leaves a client's entire asset base at risk. Failure to carry appropriate and adequate property and liability coverage can result in a severe uninsured loss that can ruin an otherwise sound plan for capital appreciation and preservation. Property and liability insurance is complicated, and exposures and policies must be thoroughly analyzed to determine if the client is adequately protected. If you do not provide this type of service, it is essential that your client consult with someone who does.

Cash Flow Management

Balance Sheet (financial position statement)

balance sheet

financial position statement

Financial analysis, planning and control are important techniques in financial planning. Personal financial statements that summarize your client's current situation as well as those that project future results are good planning tools. Without them, it is difficult to develop a financial plan or formulate strategies to achieve the client's financial goals. It would also be difficult to monitor whether or not he or she is achieving his or her goals without knowing the current financial position.

Personal financial statements are typically prepared when they are needed for planning. The primary statements that are used are the balance sheet (financial position statement) and the cash flow statement (income statement). In addition, it is also desirable to prepare pro forma (projected) statements that illustrate what is expected to happen in the future, based on assumptions and activities that are expected to take place. Finally, current financial position statements can be compared to past statements to see if client financial objects are being realized.

The financial position statement shows your client's (or his/her family's) wealth at a point in time and reflects the results of his or her past financial activities. It contains three classifications — assets, liabilities, and net worth — that make up the basic accounting equation: $Assets - Liabilities = Net\ Worth$.

Assets are items your client owns. It is immaterial whether the items were purchased for cash, financed by borrowing, or received as gifts or inheritances. Items that your client possesses but does not own, such as rented apartments or leased automobiles, are not shown as assets.

Personal financial position statements should show assets at their current fair market values. These values may vary considerably from the original purchase prices. At a minimum, assets should be subdivided into two categories: financial assets and nonfinancial (or personal) assets.

Liabilities are your client's debts. The liabilities section of the financial position statement should show all liabilities as of the date of the statement. This process may require your client to make estimates for such items as taxes due, utility charges owed, and credit card obligations.

Table 1-1 Financial Position Statement for Joseph and Jane Stevens: September 30, 2010			
Assets		Liabilities and Net Worth	
Cash and Cash Equivalents		Liabilities	
Cash	\$12,000	Credit card balances	\$2,000
Money market fund	50,000	Consumer loans	4,000
Life insurance cash value	18,000	Automobile loans	12,000
	<u>\$80,000</u>	Mortgage loans	220,000
Other Financial Assets		Total Liabilities	\$238,000
Stocks	\$150,000		
Bonds, taxable	90,000		
Bonds, tax exempt	80,000		
Vested pension and 401(k)	120,000	Net Worth	\$692,000
	<u>\$440,000</u>		
Personal Assets			
Residence	\$300,000		
Automobiles	30,000		
Household furnishings, possessions, jewelry, art	80,000		
	<u>\$410,000</u>		
Total Assets	\$930,000	Total Liabilities and Net Worth	\$930,000

Net worth measures your client's wealth or equity at the date of the financial position statement. To increase this bottom-line figure is one of the primary objectives of financial planning. In other words, net worth is what remains if all your client's assets are sold at their fair market values and all debts are paid. If your client has a negative net worth, he or she is considered to be bankrupt. However, clients with a negative net worth can avoid formal bankruptcy proceedings if they have a cash flow that is sufficient to service all financial obligations.

By itself, net worth reveals little about the nature of the assets or liabilities. If your client has a considerable net worth, he or she may have all his or her assets tied up in non-income-producing assets such as homes, automobiles, and other personal possessions. Conversely, if your client has a modest net worth, he or she may hold most assets in the form of financial assets that may be generating income, capital appreciation, or both. The key to understanding net worth is to realize that it is simply the difference between total assets and total liabilities.

Cash Flow Statement

The cash flow statement summarizes your client's financial activities over a specified period of time by comparing cash inflows and cash outflows, and indicating whether the net cash flow for the period is positive or negative. The cash flow statement has three basic components—income, expenses, and net cash flow—that are related as follows:

$$\text{Income} - \text{Expenses} = \text{Net cash flow}$$

which can also be stated as

$$\text{Sources of funds} - \text{Uses of funds} = \text{Change in cash position}$$

or

$$\text{Money in} - \text{Money out} = \text{Change in cash}$$

The cash flow statement for a given year indicates how your client's financial activities changed his or her wealth (net worth) position from the financial position statement at the beginning of the year (the end of the previous year) to the financial position statement at the end of the year. A pro forma cash flow statement based on projections of future income and expenses for a specified planning period gives you a means to assess the anticipated impact of various alternative planning strategies on the achievement of your client's goals. As such, the cash flow statement plays a central role in carrying out the various cash flow management activities in providing financial planning services to clients.

cash flow management

Cash flow management is another name for the budgetary planning and control process. Financial advisors adopted the change in terminology partly because cash flow management is more inclusive than budgeting. More important, the word budget carries negative connotations for many clients, making them less likely to participate in the process.

Cash flow management consists of three basic components: cash flow analysis, cash flow planning, and budgeting. In practice, you may decide to combine the three and consider them a single process.

cash flow analysis

Cash flow analysis, or income and expense analysis, is the process of gathering data concerning your client's cash flow situation, presenting the data in an organized format (the cash flow statement), and identifying strengths, weaknesses, and important patterns.

Cash flow analysis is also a good starting point for you to assist your client in developing goals and objectives. In addition, it reveals inefficient, ineffective, or unusual utilization of resources, highlights alternative courses of action, motivates your client, and makes family members aware of the need to conserve resources.

**cash flow
planning**

Cash flow planning identifies courses of action that will help optimize net cash flow. *Net cash flow* is defined

net cash flow

as the difference between income and expenses. A positive net cash flow is available for any use, whether for consumption, investment, or gifting.

Note that the goal is to optimize rather than to maximize cash flow. Maximizing net cash flow means to make it as large as possible and in any way possible. This may include working longer hours, finding a second job, or seeking employment for the non-earning spouse. On the expense side, maximization implies having a less expensive home and automobile, quitting the club, and discontinuing vacations and eating out. Clearly, these approaches represent changes in lifestyle and standard of living, not to mention family relationships. In contrast, optimization means seeking the best, not necessarily the largest, net cash flow. Optimal net cash flow implies a balance between investing for the future and maintaining and/or improving the current lifestyle. Optimization puts wealth accumulation in perspective. It also gives your clients greater control because they ultimately decide their own funds allocation according to their personal preferences.

**Table 1-2 Cash Flow Statement for Joseph and Jane Stevens
for the Period October 1, 2009, to September 30, 2010**

Annual Income	Amount	% of Total Income	
Salary/bonus—Joseph	\$110,000	71.9	%
Salary/bonus—Jane	30,000	19.6	
Dividends—investments	3,000	2.0	
Interest on savings accounts	2,000	1.3	
Interest on bonds, taxable	5,000	3.3	
Interest on bonds, exempt	3,000	2.0	
Total Annual Income	\$153,000	100.1	%*
Fixed Expenses			
Housing (mortgage/rent)	\$ 15,500	10.1	%
Utilities and telephone	7,000	4.6	
Food, groceries, etc.	10,500	6.9	
Clothing and cleaning	7,000	4.6	
Income taxes	23,500	15.4	
Social Security and Medicare taxes	7,500	4.9	
Real estate taxes	5,000	3.3	
Transportation	8,000	5.2	
Medical/dental expenses	8,000	5.2	
Debt repayment	5,000	3.3	
Housing supplies/maintenance	6,000	3.9	
Life insurance	8,000	5.2	
Property and liability insurance	5,000	3.3	
Current school expenses	4,500	2.9	
Total Fixed Expenses	\$120,500	78.8	%
Discretionary Expenses			
Vacations, travel, etc.	\$ 4,000	2.6	%
Recreation/entertainment	5,000	3.3	
Contributions, gifts	7,500	4.9	
Household furnishings	5,000	3.3	
Education fund	5,000	3.3	
Savings	3,000	2.0	
Investments	2,500	1.6	
Other	5,000	3.3	
Total Discretionary Expenses	\$37,000	24.3	%
Total Annual Expenses	\$157,500	103.1	%
Net Cash Flow	– \$ 4,500	–3.0	%

* Discrepancies in totals are due to rounding.

Budget

budgeting

Budgeting is the process of creating and following an explicit plan for spending and investing the resources available to your client. The process works through the establishment of a working budget model followed by a comparison of actual and expected results. By regularly monitoring the budget, you and your client can recognize

problems as they occur, and even anticipate them. Budgeting provides both a means of financial self-evaluation and a guideline to measure actual performance.

The following are some guidelines for establishing a budget:

- Make the budget flexible enough to deal with emergencies, unexpected opportunities, or other unforeseen circumstances.
- Keep the budget period long enough to utilize a strategy and a workable series of procedures—typically one calendar year.
- Make the budget simple and brief.
- Identify sources and amounts of income, and types and amounts of expenses occurred over a period, typically monthly, then average over a year.
- Spend less than you make. Make a commitment to being a saver and pay yourself first.
- Limit the use of credit.
- Keep good, complete, and accurate records.
- Follow the form and content of the budget consistently.
- Eliminate extraneous information.
- Estimate insignificant items.
- Tailor the budget to specific goals and objectives.
- Remember that a budget is also a guideline to measure actual results. Unforeseen results should be analyzed for possible inclusion in a revised budget.
- Pinpoint, in advance, variables that may influence the amounts of income and expenses. Income may vary because of expected annual raises and increases or decreases in interest or dividend rates. Expenses may vary because of fluctuating living costs, changing tastes or preferences, or changing family circumstances.
- Review the budget regularly.

Clients will often resist the budgeting and cash flow management process even though they are critical for reaching financial goals for people with limited resources. For example, one advisor with 43 years of experience points out that more than half of the people he encounters in his advisory practice refuse to do a budget. Since this is the very first step in creating a retirement income distribution plan, there is a fairly high probability that a client will spend more than he ought to, and that the client is headed for financial disaster.

Whenever possible, communicating the importance of these processes and helping clients use them can be among the advisor's most valuable services.

Emergency Fund Planning

Planning for emergencies is a critical financial planning activity. Emergencies are unanticipated events that can result in considerable reductions in a client's net cash flow due to an unexpected decrease in income or an unexpected increase in expenses. If not properly planned for as a part of the planning process, emergencies can result in a reduction of assets or an increase in liabilities. They can prevent or delay the achievement of the client's goals, such as accumulating adequate retirement or education funds, or maintaining a credit rating that allows the client to use credit at a favorable cost.

An emergency fund is composed of liquid assets that the client can easily and quickly convert to cash in the event of an unanticipated reduction in net cash flow. Emergency funds neutralize the negative impact on a client's net cash flow resulting from unexpected events such as

- the loss of the client's job
- a car breakdown requiring expensive repairs
- the breakdown of a furnace, hot water heater, and so on

Financial experts commonly advise that the emergency fund should equal 3 to 6 months of either the client's take-home pay or at least the total fixed and discretionary expenses that would still have to be paid during that period. Emergency funds are commonly invested in liquid assets such as savings accounts, interest bearing checking accounts, bank money market accounts, very short (one-month) CDs, and money market mutual funds.

Will and other Legal Documents

There are several legal documents that should be a part of most everyone's financial plan. Of course, unless you are an attorney, you cannot give legal advice or draft legal documents. However, as a financial advisor you should be familiar with these documents, what they do, and what consequences can occur without them. You can discuss these documents in general terms and encourage your clients to seek legal counsel to discuss and draft the appropriate documents.

Wills**will**

Everyone who owns property should have a will, whether single or married, old or young, healthy or infirm. A will is a legal declaration of an individual's wishes for the disposition of his or her property at death. It describes matters to be taken care of after death. The will becomes legally enforceable at death and is not operative until that time. Prior to one's death, a will may be amended, revoked, or destroyed by the maker at any time.

Younger couples should name a guardian in their wills to care for their minor children in the event they become orphaned. Another crucial function of the will is to designate someone as the estate's executor. This is the person who will be responsible for taking inventory of all property, paying estate taxes and creditors, and ultimately distributing the probate estate among the heirs.

When a person dies without a will (intestate), the courts take control of the estate and, in effect, write a will in accordance with the state's intestate laws. It is unlikely that the state's distribution would match most people's personal wishes. For example, in most states a spouse does not automatically inherit all property when there are children. One state's intestacy law awards a spouse \$4,000 plus one-third of the balance of the estate. The rest is evenly divided among the children, regardless of their ages or any special needs. In most cases, that distribution is not what the deceased person desired, and dying intestate may create severe hardships for the surviving spouse.

No one should undertake to make a will without legal assistance. Regardless of how simple and straightforward the individual's wishes may be, one small error can void the whole effort. Consulting an attorney within one's resident state assures that all details comply with the laws of that state. The attorney should be familiar with the applicable state laws and should draft the will according to the state law and the wishes of the testator (person making the will).

Trusts**trust**

A trust is a legal vehicle with four key components: corpus, grantor, trustee, and beneficiary. The property transferred into the trust is called the trust corpus. The person who transfers the property into the trust is called the grantor. The person for whom the trust assets are to be used is called the beneficiary. The trustee holds and manages the corpus for the benefit of the beneficiary, according to a trust agreement. The

trust agreement is a contract between the grantor and trustee, who will have actual legal ownership of the trust corpus, which is the cash or property in the trust. The trust agreement contains the grantor's directions to the trustee regarding what can and cannot be done with the trust.

A revocable living trust (or living trust) is generally established to avoid the cost and the public nature of probate. By transferring ownership of all you own to the living trust, you avoid the costs, the time lag, and the public record aspects of probate.

In a broader sense, the living trust is more like a will, except that it bypasses probate. A will is still needed to direct possessions not included in the trust, whether intentionally or inadvertently left out of the trust. The living trust focuses on the management and distribution of assets during both life and death. It does not have tax savings as an objective. An attorney prepares it. The owner retains full control, and it is revocable and amendable at any time. Since the living trust is revocable, the trust assets are fully included in the estate at the owner's death.

The living trust can include decisions about what the owner wishes to take place in the case of disability or death. The owner names someone to be responsible for the distribution of property and can include advance directives that indicate his or her wishes in advance of a medical crisis.

Everything that is to pass through the living trust must have its title changed to ownership by the trust. This includes any property the owner wishes to include, such as real estate, vehicles, stocks, and other investments. Most personal property lacks formal title documents, so the trust instrument simply uses wording that sweeps all of the non-titled personal property into the trust.

Power of Attorney

power of attorney A *power of attorney* (POA) is a document legally signed by one person authorizing another person to act on behalf of the signer. For example, a POA can be used at a house closing when one spouse cannot be present, or to allow a parent to give an adult child access to a bank account. Rather than have an elderly parent travel to the closing of the family home, a daughter with a POA can help a senior manage his or her day-to-day affairs.

There are two types of powers of attorney: a general power and a durable power. A general power is effective as long as the person granting the power remains in good health. Failing health is often a reason for using powers of

attorney, but a general power becomes legally ineffective in cases of mental incompetence or medical incapacity. Durable powers of attorney solve this problem by allowing designated family members or advisors to step in and manage financial affairs at the point of the grantor's incapacity.

Living Will

living will

A *living will* is a legal document that describes the types of medical treatment an individual wishes to receive and chooses not to receive. The purpose of a living will is to let others know of an individual's medical wishes when they are terminally ill and in a vegetative state or otherwise unable to communicate. Encourage your prospects and clients to consider the importance of making these decisions for themselves in advance to spare their children and other family members the agony of having to make such critical decisions for them.

Health Care Proxy

health care proxy

Health care proxy, or health care power of attorney is a component of a well-drafted living trust. A living will makes the medical treatment wishes of a person known. A living will does not guarantee that these wishes will be followed. Someone still has to make the necessary decisions about whether to continue treatment. This is a difficult, emotional decision. Sometimes close relatives are reluctant to let their loved one die.

A health care proxy is a signed and witnessed legal document in which an individual names another person to make medical decisions about his or her care. As with a living will, the health care proxy goes into effect only when the person is no longer able to make health care decisions. Sometimes this is incorporated in a durable power of attorney. Depending on state law, which varies widely in directives they officially recognize, it may have to be drafted as a separate document.

LIFE INSURANCE BASICS

Life insurance, one of the largest and most important industries in America, is a business with far-reaching social and economic implications. Its first concern is economic security. It provides individuals with an important planning tool through which they can obtain financial security for their families and businesses. It also serves the economy as an important channel through

which capital is made available to individuals and businesses for economic growth.

Life insurance was once considered an isolated financial product designed to protect policyowners from the financial consequences of premature death. Little attempt was made to integrate life insurance planning with the complete array of products sold by all types of financial institutions. In recent years, it has become increasingly difficult to view insurance products in isolation from a comprehensive financial planning process. This is due in part to the growing popularity of the financial planning approach and in part to the integration of the financial services industry, where a broad range of financial products are being made available within one financial services organization.

Life insurance means many different things to people. It can serve a variety of purposes in one's overall planning for the uncertainties of the future. Life insurance is a risk management tool that can be combined with other products to provide efficient, comprehensive financial plans for individuals and businesses, especially when designing ways to attain financial goals under a variety of uncertain future conditions.

Life insurance creates capital with guaranteed results. It is property bought with a contract and contractual guarantees that will provide large amounts of money upon the insured's death. The amount of death benefit payable is typically considerably greater than the premiums paid into the policy.

If we knew when we were going to die, then life insurance would be far less necessary. The amount of money needed at that date could be saved systematically, through what is called a sinking fund (savings account). However, if the person died before the desired amount was accumulated, there would be no way to ensure that the needed money could be generated. Life insurance is essentially a financial mechanism that guarantees the desired accumulation by the time of death, regardless of when death occurs.

Life insurance is not morbid and it is not for those who die. It provides for those who live, which is why it is called life insurance, not death insurance. It is the only way you can provide a definite sum of money for an indefinite time in the future. The life insurance contract is the insurer's promise to pay the policy's face amount upon the proof of the death of the insured, backed by one of the oldest, largest, most regulated, and financially sound industries in the world.

The Economic Bases of Life Insurance

Human Life Value

human life value The *human life value* concept was developed to measure the economic value of life. The most comprehensive approach was provided by Solomon Huebner, the founder of The American College. In his book *The Economics of Life Insurance*, Huebner defined *human life value* as the production potential of the individual over his or her life expectancy. Human life value is a measure of an individual's net future earnings—that is, the expected future earnings or service of an individual after subtracting self-maintenance costs. From the standpoint of dependents, an individual's human life value is the measure of the value of benefits that the dependents can rightfully expect from their breadwinner or supporter (from *Life Insurance* by Huebner and Black).

The basic economic premise for life insurance planning is that nearly everyone has a human life value that should be assessed and protected in the same manner as any other valuable asset. Those who are capable of earning or providing service in excess of self-maintenance costs have an actual calculable monetary value to their dependents. Human life value for insurance planning purposes is the present value (today's value) of a future stream of net economic contributions a person will make to his or her family.

In many cases, an income producer's family is completely dependent on his or her personal earnings for subsistence and the amenities of life. The "potential" estate (future earnings) is far more substantial than the existing estate (the savings that the family has been able to accumulate). The family's economic security lies in the earning capacity of each income earner.

Over a period of time, these economic forces are gradually converted into income, a portion of which is devoted to self-maintenance, a portion to support of dependents, and, if the income is large enough, a portion to savings to meet future needs and contingencies. If the individual stays in good health, the total income potential will eventually be realized, all to the benefit of the family and others who derive financial gain from his or her efforts. If an income earner dies or becomes permanently and/or totally disabled, the unrealized portion of his or her total earnings potential will be lost, and in the absence of other measures, the family will soon find itself destitute or reduced to a lower standard of living than it previously enjoyed.

The Many Uses of Life Insurance, The Swiss Army Knife of Financial Products

You can use life insurance to:

- Provide a death benefit
- Provide income to survivors
- Secure a line of credit
- Fund a buy-sell agreement
- Guarantee future insurability
- Equalize an inheritance
- Pay estate taxes
- Create an estate
- Give to charity
- Supplement college, retirement, and other expenses
- Pay funeral and last expenses
- Pay mortgages and debts
- Provide an employee benefit
- Protect a business from financial loss

This need not happen, however, since life insurance contracts can create a fund that will partially or even fully offset the insured's lost income. By means of life insurance, an individual can ensure that the family will receive the monetary value of those income-producing qualities that lie within his or her physical being, regardless of when death occurs. By *capitalizing this life value* (creating a fund large enough to generate ongoing investment income similar to the salary or wages of the individual), an income earner can leave the family in the same economic position that they would have enjoyed had he or she lived.

Human life value is measured daily in wrongful death lawsuits. The economic loss to the family and other survivors is the basis for determining monetary awards in these cases. When a wrongful death suit is filed, both sides routinely retain economists to evaluate the victim's human life value. This was the method used in determining awards to families of victims of the 9/11 attacks. A family can be awarded large sums of money for their economic loss of income, services that would have been provided by the deceased, and loss of employee fringe benefits and household services. These judgments are based on the human life value concept. When a car is destroyed, it can be replaced through auto insurance. With life insurance, when the insured

dies, he or she cannot be replaced; only the financial contribution he or she makes to the family is replaceable.

Calculating this value is not an exact science because much of the calculation's accuracy depends on what actually happens in the future. There are also many noneconomic contributions of a family member, which are more difficult to measure. Regardless of precision, the purpose of life insurance is to replace someone's human life value in the event of death.

How much is the appropriate amount upon which to base a life insurance recommendation? The human life value approach can play a significant role in defining the economic need for life insurance.

The Money Machine Analogy

An example of the application of the human life value concept in selling life insurance is the money machine analogy, which compares a person's income-producing capability to that of a machine. The money machine analogy asks the prospect to imagine that he or she had a machine that could print money as it was needed. If possible, would he or she insure the machine to guarantee that if something happened to it, the money could continue to support the family and maintain their lifestyle? Most people would say yes. The advisor then points out to the prospect that the income he or she produces makes him or her very much like a money machine. In fact, the ability to earn an income is often referred to as our most valuable asset, since everything that supports our life style is dependent on our ability to earn an income. This is why life insurance and disability income insurance is so important to the foundation of financial security. What would happen to the family if the prospect died or became disabled and was no longer able to produce income? Wouldn't it make sense for the prospect to insure his or her life and earning capacity?

Another way to illustrate the value of insuring the money machine (human life value) is to compare the relative risk of each type of event we insure to the risk of death. How many homes burn down or cars have accidents? How much do we pay for these types of insurance protection? What financial loss would we suffer? How many people escape death? What financial loss would our survivors endure?

Time Value of Money

future value

If a 35-year-old man earned \$30,000 net of taxes and expenses, and worked for 30 more years to age 65 without

ever getting a raise, the economic value to his family would be \$900,000 (30 years x \$30,000). Of course, it doesn't take \$900,000 to produce \$30,000 over 30 years; a sum of money would be earning interest through the 30-year period, and all of that income will be received in the future, much of it years from today. The *time value of money* is based on the capacity to earn interest, and the time when it is paid or received. Interest is the difference between the money's value today (*present value*) and the value of the money in the future (*future value*). To the investor, interest is the money earned on invested capital; to the borrower, it is the money paid for the borrowed capital.

present value

The sum that will be needed to produce income over the next 30 years can be discounted to a present value.

Present value expresses the value of money today that is to be received in the future. This process of discounting is vital to financial products and planning because so much we are focusing on is in the future, often many years away. Present value allows us to create an equivalence between future monetary values and the present. The difference between money in hand and money due in the future depends on the rate of return that can be earned from invested capital. The longer the period until the future money will be received, the greater the expected interest earnings and the greater the difference between the present and future value. The present value of an amount due in the future is the principal sum that, invested at an assumed interest rate, will accumulate to the required amount by the due date.

The Benefits of Life Insurance

When they hear the phrase "life insurance," many people think of the policy that will pay for a funeral. Life insurance is much more than that. It has emotional as well as economic benefits, explained below.

Provision of Time and Money

Life insurance could also be called "time insurance." When someone dies and the proceeds are paid to the beneficiaries, that money helps buy time until the survivors can adjust, financially and emotionally. Life insurance guarantees large amounts of cash to pay final expenses, repair the car if it breaks down, keep the mortgage payments current, keep the utilities turned on, and provide sufficient cash so survivors can maintain a lifestyle similar to the lifestyle enjoyed before the insured's death. Most of the people who come to the survivors to talk about money come with their hands out, requesting payment for goods and services. Only the financial advisor can walk into a

tragic situation and bring new money to pay old and new bills. The insurance proceeds offer survivors the time they need to adjust and resume their life. This is the financial advisor's real contribution.

Peace of Mind

Life insurance may be the only product someone cannot buy when it is needed and desired the most (when one becomes uninsurable, or is near death). Let's look at what life insurance offers to the person who buys the policy. First, there is the peace of mind in knowing that a sound and prudent decision has been made. The life insurance contract guarantees payments in the future when cash is needed. This is why we sell life insurance and why people buy it.

What Your Work Means to Your Clients

When a person can answer either of the following questions with a "yes," who could not say that the work he or she does makes a difference in people's lives?

- Does the product you sell make a difference in people's lives?
- Does the service you perform make a difference in people's lives?

All of you who sell life insurance, especially after careful consideration, should be able to answer yes to both questions. You have a noble calling. Think about the good your work does to society and particularly for those who are privileged to call you "my insurance advisor."

Life insurance policies typically have some statutory (legal) protection against creditors of both the policyowner and the beneficiary. This protection varies widely from state to state, but can be of great benefit to those who may depend on the values of the life insurance policy or its proceeds. The principle behind these statutes is that creditors should not be permitted to make someone destitute and a potential ward of the state. Check the creditor protection and bankruptcy laws in those states where you do business to determine the provisions that apply to life insurance.

Living Benefits and Financial Flexibility

One type of life insurance, *cash value* or *permanent life insurance*, can provide guaranteed funds in case of financial emergency. It can supplement retirement income or provide money for other purposes while the insured is alive (known as living benefits). A policy can be used just once, when the insured dies and the death benefit is paid to the beneficiaries, or it can be used often during the insured's life. People who own life insurance turn to the

cash value of a policy when all else fails and they face a financial emergency. They know that the funds are there to borrow or withdraw, normally without delay or qualification.

Ben Feldman

And isn't it the same with everyone? We all must die someday. Never at the right time. Always at the wrong time. We never have quite enough time to complete our plan, make our dreams come true—and that's why it's always the wrong time. Who'll give us more time? Only The Man Upstairs. But we can give our clients the equivalent of time in the sense that we can give them the money to complete their plans. You know, we sell contracts for time and money. We can't guarantee the time—but we can guarantee the money."

Ben Feldman, *Creative Selling for the 1990's*, Longman Financial Services Publishing, 1989.

No other financial institution can do what life insurance companies can do. No other industry backs its products with reserves as sound as those of the life insurance industry. In fact, during the Great Depression of the 1930s, when the stock market hit bottom and many banks went out of business, insurance companies provided security for their policyowners that was unavailable anywhere else. While well-established companies in other industries went bankrupt, fortunes were lost overnight, and income from real estate and other property evaporated, the failure of life insurance companies was unknown. In no case was there any loss to a continuing policyowner.

A Financial Foundation with Guarantees

The record of strength and safety of insurance companies even under the most adverse conditions is a badge of pride to the insurance industry. For generations, life insurance has been the standard of security by which others are measured. Guarantee Associations that protect policyowners and beneficiaries if an insurance company becomes financially insecure have been established in various states to provide further safety. No investment or other type of business has had a safety record superior to that of life insurance.

Part of the reason for this safety is the way insurance companies manage and invest their assets. They look for real estate, mortgages, corporate and government bonds, and other investments that will bring consistent returns without compromising safety. Insurance companies invest for the long

term because people buy insurance for the long term. These investments are designed to provide a consistent and stable return that gives the insurance company a dependable income to pay its obligations and honor the guarantees that make up the life insurance contract.

I AM A LIFE INSURANCE POLICY

I am a piece of paper, a drop of ink, and a few pennies of premium.

I am a promise to pay.

I help people see visions, dream dreams, and achieve economic immortality.

I am education for the children.

I am savings.

I am property that increases in value from year to year.

I lend money when you need it most, with no questions asked.

I pay off mortgages so that the family can remain together in their own homes.

I allow people to dare to live and to die responsibly.

I create money where none existed before.

I am the great emancipator from want.

I guarantee the continuity of a business.

I conserve the employer's investment.

I am tangible evidence that a man is a good husband and father, and that a woman is a good wife and mother.

I am a declaration of financial independence and economic freedom.

I am the difference between an old man or woman and an elderly gentlemen or lady.

I provide cash if illness, injury, old age, or death cuts off the breadwinner's income.

I am the only thing that can be bought on the installment plan that a family doesn't have to finish paying for.

I am protected by laws that prevent creditors from assessing the money I give to loved ones.

I bring dignity, peace of mind, and security to the family.

I supply investment capital that makes the wheels turn and the motors hum.

I guarantee the financial ability to have happy holidays and the laughter of children—even though father or mother is not there.

I am the guardian angel of the home.

I am life insurance.

Income and Estate Tax Advantages

The following points are general rules, and are subject to limitations and exceptions. More discussion of the tax treatment of life insurance appears later in this book.

Under current tax law, cash value life insurance policies have several tax advantages for accumulating money. Cash value insurance is said to provide "double-duty" dollars, because money can be made available for the future whether the insured dies or not. The internal buildup of cash value is tax deferred. Money can be taken from the policy in the form of loans or withdrawals that are normally not taxable. The policy can provide tax-free income if the policy stays in force until the death of the insured. If the policy pays dividends, they can be withdrawn tax-free until the cost basis (the amount paid in) is recovered from the policy.

Life insurance generally offers a number of income and estate tax advantages:

- There is normally no income tax payable on death proceeds.
- Cash value policies generally allow for *tax-deferred* internal buildup of cash value as long as the policy remains in force.
- An individual can retrieve his or her investment in the policy (premiums paid) before recognizing gains.
- Dividends paid to the policyowner are generally not subject to federal income taxation until the total dividends paid exceed the total premiums paid into the policy.
- Policy loans are normally not considered income. If done correctly, a combination of withdrawals and policy loans can produce tax-free income from a permanent life insurance policy while the insured is living.
- There is no estate taxation on the death proceeds if the insured had no incidents of ownership in the policy and the beneficiary is not the insured's estate, executor, or administrator, or there is no obligation to pay estate expenses with life insurance proceeds.

BASIC INSURANCE PRINCIPLES

How the Product Is Created

All life insurance products are actuarially created by calculating the relationships of mortality, interest, expense, and the financial values attached

to each, based on time. These factors determine the premium at which a policy is sold. The premium must be adequate to pay the expenses incurred in creating, offering, and maintaining the product, paying all promised benefits, and increasing the insurer's profit and surplus.

These duties belong to the company's actuarial department, whose primary responsibility is to ensure that the company's insurance operations are conducted on a sound financial basis. This includes determining appropriate premium rates and establishing adequate policy reserves. The actuarial department develops new policies, analyzes earnings, provides statistical data from which the annual dividend scale is established, and conducts mortality, lapse, and other studies.

From an economic viewpoint, insurance is a system for reducing financial risk through the transfer of those risks from policyowners and pooling those losses by the insurer. Insurance achieves the sharing of risk by transferring risks from individuals and businesses to financial institutions specializing in risk.

From the viewpoint of society, insurance is a device for accumulating funds to meet uncertain economic losses through the transfer of the risks of many individuals to one person, a group of persons, or an organization. The social aspect of insurance involves the collective bearing of losses through contributions by all members of a group to pay for losses suffered by some group members. Insurance substitutes certainty for uncertainty through the pooling of hazards to which groups of people are exposed. Uncertain risks of individuals are combined, making the possible loss more certain, and providing a financial solution to the problems created by the loss. Small, periodic contributions by the individuals provide a fund from which those who suffer loss may be reimbursed. Insurance thus manages the uncertainty of one party through the transfer of particular risks to another party (the insurer) who offers a restoration, at least in part, of economic losses suffered by the insured individual.

Finally, from a legal standpoint, an insurance contract transfers a risk (for a premium) from one party, known as the policyowner, to another party known as the insurer. By virtue of a legally binding contract, the possibility of an unknown large financial loss is exchanged for a comparatively small certain payment. This contract is not a guarantee against a loss occurring, but a method of ensuring that payment will be received for a loss that does occur.

Every insurance company will add cost and pricing variables to the actual historical results of that company in designing and pricing its products. This

is the same procedure as any product on the market, not just insurance. It also accounts for the variations in premiums between products that might appear to be the same. Variations can be created by differences in company operational efficiencies, investment performance and assumptions, underwriting practices, profit and marketing objectives, sales results, service practices, policy persistency, expenses, and other issues.

Probability — Statistical Predictability

Mortality is statistically predictable. Everyone will die eventually. Time becomes a critical factor when we recognize that we never know when someone will die, only that everyone will. Combine the reality of death with the uncertainty of when it will occur, and you have the basis for life insurance. It is the scientifically calculated pooling, growth, and distribution of money to satisfy two objectives for paying benefits:

- paying benefits to survivors of someone who dies
- providing distribution of benefits with guaranteed lifetime payments to either the insured or the insured's survivors

Only life insurance and annuities can do these things. To accomplish this, insurance companies keep extremely accurate records about births and deaths, especially when (by age) and how (by cause) people die. The size of the statistical base, now hundreds of years old, enables insurance actuaries to predict average mortality for groups of people in many different categories. This precision study of mortality and how it works helps to make life insurance a risk management tool rather than a game of chance. It is an actuarial science—mathematical calculations of probability based on huge amounts of experience—that establishes mortality tables, life expectancies, and reserve requirements that are used to create and price life insurance products.

The Law of Large Numbers

law of large numbers

The statistical group that is observed for purposes of measuring probability must have mass—that is, the sample must be large enough to allow the true underlying probability to emerge. The *law of large numbers* states that as the size of the sample (insured population) increases, the actual loss experience will more and more closely approximate the true underlying probability. This means that the insurer's statistical group must be large enough to produce reliable results, and that the group actually insured must be large enough to produce results that are consistent with the underlying probability.

Risk Pooling

risk pooling Life insurance uses what is called *risk pooling* or group sharing of losses. People exposed to a risk agree to share losses on an equitable basis. They transfer the economic risk of loss to an organization (the insurance company). Insurance is based on pooling the premiums of thousands of people and spreading the risk of losses across the entire pool. By carefully calculating the probability of losses that will be sustained by the members of the pool, insurance companies can equitably (fairly) spread the cost of the losses to all the members in proportion to the risk they pose to the group. The risk of loss is transferred from one to many and shared by all insureds in the pool. Each person pays a premium that is measured to be fair to them and to all based on the risk they impose on the company and the pool (each class of policies should pay its own costs).

Risk Pooling Examples

Homeowner's Insurance

Of 1,000 houses, each worth \$200,000, assume only one house per year is destroyed by fire. Each homeowner could contribute \$200 per year into a pooled fund that could pay out the full \$200,000 value to the homeowner of a destroyed home. Such pooling transfers the risk of bearing the full impact of a potential \$200,000 loss by an owner.

Life Insurance

Ten thousand males aged 35 contribute to a life insurance pool. Twenty-one of them are expected to die this year (based on 1980 CSO mortality tables). The mortality charge is \$2.10 per \$1,000 of benefit. If each of the 10,000 contributes \$210 to fund death benefits (ignoring costs of operation), a death benefit of \$100,000 could be paid for each of the 21 expected deaths.

The Building Blocks of the Life Insurance Policy

mortality
interest
expense Every life insurance product, regardless of type, must take into account these three factors: *mortality*, *interest*, and *expense*, in the construction and operation of a life insurance product. The assumptions made concerning these three factors will determine the policy premium and the structure of the policy. The actual results over time, called experience, will determine the profitability and solvency of the life insurance company.

Mortality, Interest, and Expense

Mortality rates project the cost of insurance (covering death claims) as they occur. *Interest* earnings reflect the income the company expects from the investment of premiums over time that will be added to the reserves, the money held aside to pay future claims and other promises made in the insurance contracts. Investment earnings will also contribute towards dividends, company profits and surplus (retained earnings). *Expenses* include the cost of creating, offering, and maintaining the product to pay all promised benefits.

Understanding Mortality Tables

National Association of Insurance Commissioners (NAIC)

2001 Commissioners Standard Ordinary (CSO) Mortality Tables

Every 20 years or so, new mortality tables are developed for individual life insurance products by the *National Association of Insurance Commissioners (NAIC)*. Because insurance is regulated by individual states, NAIC is an association of the state insurance commissioners which creates model regulations that can be adopted by the states to create product uniformity. In December 2002, NAIC adopted the *2001 Commissioners Standard Ordinary (CSO) Mortality Tables*, replacing the insurance reserve valuations based on the previous 1980 CSO Mortality

Tables. As a result of improving mortality over the previous 20 years, these tables reflect lower mortality rates and will affect many of the products you sell.

Generally, the reduction for males is more significant than for females, and for nonsmokers than for smokers. One significant change is the extension of life mortality to attained age 120 (compared with age 100 with the 1980 CSO). These changes will lower the statutory reserves, the money required by state insurance departments to back up life insurance contracts. These changes will affect newly issued policies only. The vast majority of in-force policies are and will continue to be regulated under 1980 CSO requirements.

The 2001 CSO tables include several mortality tables that vary by gender, smoking status, ultimate (in-force) and select (new issue) rates, and age-last-birthday and age-nearest-birthday bases. Select rates are for those insureds who have provided evidence of good health and have been recently underwritten. Ultimate rates are higher and used for renewal purposes, to account for the longer period since evidence of insurability was provided and the deteriorating health and insurability of the insured pool.

Review the following mortality charts and refer to them when reading about mortality and its effects on you and your prospects. Keep in mind that larger insurance companies use their own mortality statistics in pricing products. The CSO tables are used primarily for statutory (regulation by state and federal government) purposes such as reserve requirements and tax issues. These tables lower the amount the company needs to charge for mortality costs.

Life insurance must meet certain premium and cash value tests to qualify for the tax benefits afforded by the tax code. The 2001 mortality tables lower the tax reserves required by IRC Sec. 7702 (definition of life insurance) and IRC Sec. 7702A (Modified Endowment Contract) rules, which will consequently lower cash values, nonforfeiture values, maximum cost of insurance rates, and surrender charges for most issue ages and risk classes. The 2001 rates will also lower the amount of premium allowable for a policy to meet the definition of life insurance and modified endowment tests (7-pay rules).

Using Mortality Tables. The National Safety Council estimates how many hundreds of persons will be killed on highways between the Friday and Monday of a summer three-day holiday weekend. The actual number will be remarkably close to the estimate. Of course, when it makes its estimate, the Council has absolutely no idea who will be killed. It merely applies the laws of large numbers and probability to make its estimate. Because the Council has a great volume of historical information available, and because large numbers of people are involved, these predictions are generally quite accurate. For life insurers, the process is similar.

Life insurance companies pool their information to construct mortality tables that will accurately indicate the number of insured persons in any large group who will die at any particular age. The 2001 CSO tables indicate that about one of every thousand male babies born in the United States can be expected to die before their first birthday. After age 1, the death rate declines until age 4, and then begins to increase at age 6 and every year thereafter. Mortality in males averages less than one death per thousand each year until age 20. Generally, people are more likely to die each year that they live beyond early childhood.

Life Expectancy. Both 2001 and 1980 CSO table rates are included for illustrative purposes, since 1980 CSO mortality represents the vast majority of in-force life insurance. According to the 1980 mortality tables newborn males have a life expectancy of 70.83 years and newborn females 75.83 years. If a male child survives to age 10, his *life expectancy* increases to age 71.66. If he

is still living at age 60, his life expectancy is age 78.2. At age 80, he has a life expectancy of 6.18 additional years, or age 86.18. At 90, his life expectancy is 3.18 years or age 93.18. In the past, very few individuals survived past age 100, so the 1980 CSO table assumed that everyone died by age 100. With longer life expectancies, the 2001 CSO table extends to age 120.

Life expectancy rates for the 2001 tables are greater than the 1980 tables because mortality rates are lower. To compare with the 1980 mortality tables, 2001 CSO life expectancy for a newborn males is 75.67 years and newborn females is 79.87 years. At age 60, a male's life expectancy is age 79.75. At age 80, he has a life expectancy of 6.76 additional years, or age 86.76. At 90, his life expectancy is 3.20 years or age 93.20. Females have similar but higher life expectancies

The Rate Is One

"(Prospect), I must admit that when it comes to mortality tables and other actuarial statistics, I am far from expert. I don't know the mechanics of how they work.

"But I do know and understand perfectly what they mean: the death rate is no more and no less than one per person. I am going to die...and you are going to die. We just don't know when.

The odds may be one in a thousand, but when it happens to you, they are one in one and the other 999 don't matter."

Age and Expectation Differences. Notice that a person's life expectancy (age at death) is increased by each year the person survives, even though the expectation of the number of years to live decreases. Life expectancy is the combination of age and longevity, and longevity decreases more slowly as age increases. You can see in the following tables that there is no age at which longevity decreases by a full year in any one year. Thus, the older a person is, the older he or she can expect to live, all else being equal.

Life expectancy has significance only for large groups of people. To an individual, life expectancy is a meaningless figure. A 30 year old will probably live to age 70 or 75, but could die today. According to 1980 CSO mortality, if we had a group of 211,000 30-year-old men, all in good health, we could expect one to die every day during the next year (365 days divided by $1.73 \times 1,000$). Averages, however, are not applicable to individuals for predicting death. They only indicate how many people in a particular age group will probably die. Life expectancy and mortality tables are important to life insurance companies as a basis for determining the values and guarantees that go into policies, but they are not as predictable for individuals.

Table 1-3 IRS Life Expectancy Table (Partial) 1980 CSO		
Age Male	Age Female	Life Expectancy (Years)
55	60	21.6
56	61	21.0
57	62	20.3
58	63	19.6
59	64	18.9
60	65	18.2
61	66	17.5
62	67	16.9
63	68	16.2
64	69	15.6
65	70	15.0

Table 1-4 Life Expectancy Table (Partial) 2001 CSO			
Age Male	Life Expectancy (Years)	Age Female	Life Expectancy (Years)
55	23.86	55	27.34
56	23.02	56	26.49
57	22.19	57	25.65
58	21.37	58	24.82
59	20.55	59	23.99
60	19.75	60	23.18
61	18.96	61	22.37
62	18.18	62	21.58
63	17.42	63	20.79
64	16.67	64	20.02
65	15.94	65	19.24

Male Lives—per 1,000 lives				Female Lives—per 1,000 lives			
Age	Composite	Nonsmoker	Smoker	Age	Composite	Nonsmoker	Smoker
0	0.97			0	0.48		
1	0.56			1	0.35		
2	0.39			2	0.26		
3	0.27			3	0.20		
4	0.21			4	0.19		
5	0.21			5	0.18		
10	0.23			10	0.22		
15	0.61			15	0.35		
20	1.00	0.95	1.27	20	0.47	0.45	0.58
25	1.07	0.98	1.63	25	0.54	0.50	0.77
30	1.14	1.02	1.80	30	0.68	0.64	1.03
35	1.21	1.09	2.00	35	0.97	0.89	1.53
40	1.65	1.46	2.77	40	1.30	1.20	2.12
45	2.65	2.33	4.57	45	1.87	1.71	3.13
50	3.76	3.32	6.45	50	3.08	2.81	5.39
55	6.17	5.50	10.56	55	5.10	4.68	9.08
60	9.86	8.92	16.29	60	8.01	7.40	13.97
65	16.85	15.47	26.63	65	11.85	11.05	20.34
70	25.77	24.10	37.89	70	17.81	16.82	29.82
75	41.91	40.03	57.29	75	27.90	26.64	45.23
80	70.14	67.87	90.07	80	43.86	42.43	66.99
85	116.57	114.07	140.09	85	74.45	72.84	105.41
90	187.66	185.06	214.13	90	121.92	120.65	153.05
95	269.17	267.19	291.05	95	193.66	192.92	214.97
100	363.19	362.10	376.40	100	275.73	275.46	289.27
105	459.21	459.13	460.15	105	410.57	410.56	411.32
110	589.64	589.59	590.27	110	581.77	581.76	582.26
115	765.7	765.67	766.01	115	763.41	763.4	763.66
119	949.22	949.22	949.29	119	935.11	935.11	935.16
120	1000	1000	1000	120	1000	1000	1000

Chance of Death. Mortality tables can be important to individuals only as a means of recognizing that young, healthy people will die every day of the year. Consider the 30-year-old prospect who wants to buy life insurance, but waits to make the purchase. Shouldn't this person be made aware that

some 30-year-olds will not live long enough to buy the insurance they need if they wait?

Although the chance of dying at age 30 is remote, it does exist. With odds better than 877 to 1 ($1000 \div 1.14$ (2001 CSO composite rate) = 877), it does not appear that there is a very large chance of dying within the year. Then why should this life be insured when the odds are so heavily in favor of survival for the next 12 months? The answer is simple: Even with such favorable odds, the prospect might still be the 1 in 877 to die. If death would create financial problems, as it usually does, then insure. If death will not create any financial problems whatsoever, then there is no reason to insure. The focus is on solving the problems *when* death occurs, not *if* death occurs. Because knowledge of when death will occur is unknown, the need to insure is critical. It is the sensible response.

Interest and Investment Earnings

Insurers invest the premiums that are received and accumulate them for future claims and other obligations, such as policy loans and withdrawals, cash surrenders, dividends, or nonforfeiture or settlement options. The cash generated by these investments represents a significant portion of the capital needed to operate the company, pay claims, and generate profits. Life insurance company portfolios emphasize safety of principal and predictable rates of return, based on the insurer's long-term obligations. Typically two-thirds or more of this capital is invested in bonds and mortgages, which meet the above criteria. A smaller percentage of common stocks represents under 10 percent of invested capital, due to the volatile nature of stock.

The company will credit interest to policies based on the *new money rate* or on its *portfolio rate*. The new money rate reflects recent investment experience—returns on money that was recently invested. The portfolio rate reflects the insurance company's overall investment return on money invested at various times over the years. During periods of rising interest rates, new money rates benefit; the reverse is true where rates are declining. Because insurance companies expect a block of recently issued policies to have low claims experience as a whole until years later, there is an adjustment to the premium calculation for the time value of money (compound interest). Investment returns are assumed to be at some minimum rate and are factored into the premium calculation.

If the investment results exceed the guaranteed minimum, policyowners benefit either from participating dividends or from excess interest crediting

to the policy cash value. The insurance company's operating results may benefit from any investment earnings that are not transferred to policyowners.

Life Insurance as an Investment. Life insurance is not an investment in the usual sense of the word. In fact, the product was not originally intended to be an investment in any sense. There is much disagreement, as well as controversy, as to what extent life insurance can be viewed as an investment vehicle.

Life insurance should be one of the first financial products a person with financial obligations should buy because it pays for the necessities of life at the very time the decedent (deceased) cannot. This is why life insurance is at the foundational level of financial security in the financial planning pyramid. This is the first of many steps that are needed to provide for the future of the decedent's survivors.

The primary function of life insurance is to pay a death benefit. Life insurance has expenses and mortality charges that pay for that death benefit that other investments without that feature do not have. One should buy cash value life insurance primarily for protection needs, but because of its accumulation features, many advisors advocate its use as a competitive and tax-advantaged vehicle for retirement and other accumulation needs. Because of the many uses for life insurance described in this text, it is the “swiss army knife” of financial products, saving being one of them. Variable life insurance products certainly have an investment component, as well as the added risk they present. Traditional cash value products emphasize safety of principal and cash value returns reflect the conservative investment philosophy that back them.

The principal economic purpose of life insurance is to provide capital. Although it should not be viewed primarily as an investment, this is essentially what life insurance is. All conventional investment vehicles serve the same purpose, but the unique feature of life insurance is that it assures a desired accumulation at the specific but uncertain time of the insured's death. No other investment can make such a guarantee.

Expense — The Cost of Doing Business

Just as with any other business, life insurance companies incur costs in the course of doing business. These break down into two principal types: *acquisition expenses* and *administrative expenses*. Acquisition expenses

include all the costs incurred in obtaining the business and placing it in force, and can include some or all of the following items:

- advertising and promotion expenses
- commissions and fees paid to advisors and brokers
- underwriting expenses, such as medical exams, attending physicians' statements, inspection reports, and credit histories
- home office processing costs, policy printing, and related fees
- an addition to the insurer's reserve, surplus, and profits
- state premium taxes

Additionally, ongoing administrative expenses incurred by the insurance company must be covered by the premium:

- cost of collecting premiums and distributing dividends
- cost of continuing producer compensation
- investment expenses
- home office overhead

Any cost the insurer incurs must be recovered, either through premium charges or reduced investment credit.

CHAPTER REVIEW

Key Terms and Concepts are explained in the Glossary. Answers to the Review Questions and Self-Test Questions are found in the back of the textbook in the Answers to Questions section.

Key Terms and Concepts

financial planning process	emergency fund
financial plan content	balance sheet
integrated financial planning	financial position statement
financial planning pyramid	cash flow management
risk management	cash flow analysis
risk management process	cash flow planning
life insurance needs	net cash flow
income needs	budgeting
readjustment period	will
dependency period	trust
blackout period	power of attorney
cash needs	living will
final expenses	health care proxy

human life value
future value
present value
law of large numbers
risk pooling
mortality

interest
expense
National Association of Insurance
Commissioners (NAIC)
2001 Commissioners Standard
Ordinary (CSO) Mortality Tables

Review Questions

1. What is the role of the financial advisor in the financial planning process?
2. Explain the financial planning process and the content of a financial plan.
3. Explain the integrated planning process.
4. Explain the financial planning pyramid and how it can be used in the financial planning process.
5. Briefly explain the risk management process.
6. Describe the income and cash needs presented by the death of a family breadwinner.
7. Briefly explain cash flow management, the balance sheet and income statement and the budgeting process.
8. Discuss how wills, trusts, powers of attorney and living wills contribute to the foundation of a financial plan.
9. What is the concept of human life value and how does it relate to life insurance?
10. What are the general insurance principles that are the basis for life insurance?
11. What are the benefits of life insurance?
12. Explain the three elements that are the building blocks of a life insurance policy.
13. How can mortality tables be used to predict mortality and life expectancy?

Self-Test Questions

Instructions: Read the chapter first, and then answer the following questions to test your knowledge. When finished with the test, check your answers with the answer key in the back of the book.

1. The human life value approach assumes a person's economic value is an amount equal to the
 - (A) capitalized value of a person's gross future earnings
 - (B) capitalized value of a person's net future earnings
 - (C) needs of the family if the person should die
 - (D) life income needs of the surviving dependent spouse and children
2. Which of the following investments accounts for the largest share of assets of U.S. life insurance companies?
 - (A) bonds and mortgages
 - (B) policy loans
 - (C) stocks
 - (D) real estate
3. The newest mortality tables currently being introduced by the NAIC are called the
 - (A) 2001 Mortality Tables
 - (B) 2005 Mortality Tables
 - (C) 2010 Mortality Tables
 - (D) The New Mortality Tables
4. The national organization that offers model regulations to the individual states to provide uniformity to insurance regulations is
 - (A) IMSA
 - (B) NAIFA
 - (C) The American College
 - (D) NAIC
5. What is the basic concept behind the financial planning pyramid?
 - (A) Financial planners should focus on building investments and wealth first.
 - (B) Income tax management is one of the blocks within the foundational level.
 - (C) Establish and protect the client's current financial position is at the top of the pyramid.
 - (D) You must first lay the foundation of financial security upon which wealth is built.

6. Which of the following statements concerning dependent income needs is (are) correct?
- I. A child's dependency period can continue beyond the death of both parents.
 - II. The readjustment income period extends between the breadwinner's death and the youngest child's self-sufficiency.
- (A) I only
(B) II only
(C) Both I and II
(D) Neither I nor II
7. Which of the following statements regarding budgeting is (are) correct?
- I. Budgeting is a process of creating and following an explicit plan for spending and investing available resources.
 - II. The budget should be flexible enough to deal with unexpected circumstances
- (A) I only
(B) II only
(C) Both I and II
(D) Neither I nor II

READ THE FOLLOWING DIRECTIONS BEFORE CONTINUING

The questions below differ from the preceding questions in that they all contain the word EXCEPT. So you understand fully the basis used in selecting each answer, be sure to read each question carefully.

8. All of the following statements regarding the balance sheet (financial position statement) are correct, EXCEPT
- (A) It reflects the client's net worth at a specific time.
 - (B) It has three basic components — assets, liabilities, and net cash flow.
 - (C) It measures net worth, which is the client's assets minus liabilities.
 - (D) It commonly shows assets at their current fair market value.

9. All of the following are correct regarding family life insurance needs EXCEPT
- (A) The readjustment period is the interval of time after the insured's death and the surviving spouse's retirement
 - (B) The dependency period extends from the insured's death until the youngest child is self-sufficient.
 - (C) The blackout period last from the youngest child's 16th birthday until the surviving spouse is age 62.
 - (D) Cash needs include final expenses, emergency fund, and mortgage cancellation.
10. All of the following would be included in the wealth distribution level of the financial planning pyramid EXCEPT
- (A) estate planning
 - (B) retirement income
 - (C) savings and investments
 - (D) gifting