

DEMISTIFYING LIFE INSURANCE

The recent financial literacy survey showed that there were still some misconceptions about basic insurance and investment products. Financial Planning Expert David Choo explains the basics.

Alexander Pope's wisecrack came to mind when I read the recent financial literacy findings:
"A little learning is a dangerous thing."
 It is good to see the steady, if not exactly rapid, improvement in financial literacy among Singaporeans. However, when it comes to matters involving large sums of money, the standard should not just be a "little knowledge" but adequate knowledge to be able to pick a good, competent, reliable adviser and even better, to be able to evaluate the advice of the adviser.

The survey showed that there is still a need for better understanding of basic insurance and investment products.

For this article, I would like to try to demystify life insurance by unpacking the basic products. There has been a running gun battle between the proponents of term insurance and whole life insurance in recent months, with each side taking shots at the other. I do not wish to engage in this controversy and think there should not be any controversy in the first place. For the sake of the readers who are not familiar with life insurance, I will give a brief overview before unpacking each product.

There are four main types of life insurance products, namely: Term life, Endowment assurance, Whole life and Annuity

A fifth product that has become very popular is medical insurance, which includes medical expenses cover and critical illness cover (paid when one of the 30 critical illnesses is diagnosed).

Life insurance products seek to cover four key events that can be insured against, namely: Premature death, usually excluding suicide in the first year, Total and permanent disablement (TPD), Diagnosis of critical illness and medical expenses, Living too long.

To make life insurance attractive and to inject a savings element, some products have a cash back feature.

Basic term life insurance protects against death and TPD for a selected period only, e.g. 10, 15, 20 years. There is no cash back feature.

Normal endowment assurance protects against death and TPD for a selected period (similar to term life), but differs from term life because an endowment has a cash value that builds up and, on maturity, will pay a lump sum benefit.

The one thing that term life and endowment assurance have in common is the period or term of cover. This means that to decide whether it is worthwhile to have the cash build up or just buy term and do your own investment, the comparison should be between these two insurances. Figure 1 shows that for a male aged 35 and for a term to age 60, i.e. 25 years for sum insured of \$600,000 (25 years x \$24,000 income protection), the rate of return for the savings component is 3.72 per cent per annum. This should be compared with safe investments like fixed deposits and long-term bonds.

Normal whole life policy protects against death and TPD but differs from term life and endowment assurance because the period of cover is for the whole of one's life. In addition, whole life (like endowment but different from term life) has a savings cash value build up. There are two types of whole life – participating (with profits) and non-participating (without profits). The difference is that participating whole life's death benefit increases each year when the "reversionary bonuses" are declared and added to the basic sum assured. Each year, after usually the third year, a whole life policy also has an amount of cash value added to the policy. This is due partly to the system of

level premiums for both non-participating and participating policies, whereby the true protection premiums for the early years of the policy are actually lower than the level premiums, and also because certain portion of the premiums also go to build up the cash value (for participating policies only).

To compare term life with participating whole life policy fairly in order to decide whether the savings returns is worthwhile, we must compare whole life with term life to age 85, which is the usual last year of premium payment. For illustration purpose in Figure 2, the comparison is for a male, aged 35 and for sum assured of \$600,000 to age 80. The rate of return for the savings part of the premium is 3.608 per cent per annum if the cash value to age 80 is used. This rate of return, similarly, should be compared with other safe investments.

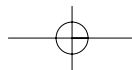
If the comparison is between a term to age 60 with a whole life, the comparison should be between a convertible term and the whole life. This is because only a convertible term allows a fair comparison since the policy can be converted to a whole life, if desired. See Figure 3. The rate of return is about 2.84 per cent per annum. Is the convertibility option really useful and how much does it cost? It is interesting to see in Figure 4 the comparison between a normal term and a convertible term. The premium for the option to convert is about 25 per cent. This means that the option is considered important (from the point of view of the insurer) as it is a passport to a whole life policy. This also means that there must be the intention to convert or good money will be paid for nothing.

This leads to the next question – what is the rationale for a whole life policy? The reason is the certainty of claim. From an investment point of view, a term insurance for the same person aged 35 taking a term cover to age 60, or a whole life, can have the following "return on investment":

TABLE 1.1

	TERM POLICY	WHOLE LIFE POLICY
Year 1	46,981 %	5,416 %
Year 60	18.9 %	8.51 %
Year 61	- 100 %	8.51 %

As can be seen, term policy is eminently suitable for those who know or believe that they have high risks of claims within the term period. But if the



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FINANCIAL PLANNING

Comparison Between Term And Endowment For Male Aged 35 For Cover To Age 60 For Sum Assured \$600,000

FIGURE 1

	PROTECTION PREMIUM	
Term To Age 60 (\$1,274)	\$1,274	
	PROTECTION PREMIUM	INVESTMENT PREMIUM
Endowment To Age 60 (\$20,382)	\$1,274	\$19,108

Rate of return on savings portion (\$19,108) = 3.72 per cent per annum to age 60

Comparison Between Term And Whole Life For Male Aged 35 For Cover To Age 80 For Sum Assured \$600,000

FIGURE 2

	PROTECTION PREMIUM	
Endowment To Age 60 (\$3,288.60)	\$3,288.60	
	PROTECTION PREMIUM	INVESTMENT PREMIUM
Whole Life (\$10,980.00)	\$3,288.60	\$7,697.40

Rate of return on savings portion (\$7,697.40) = 3.608 per cent per annum to age 80

Comparison Between Convertible Term And Whole Life For Male Aged 35 For Cover To Age 60 For Sum Assured \$600,000

FIGURE 3

	PROTECTION PREMIUM	
Endowment To Age 60 (\$1,605)	(1,605)	
	PROTECTION PREMIUM	INVESTMENT PREMIUM
Whole Life (\$10,980.00)	\$3,288.60	\$7,697.40

Rate of return on savings portion (\$9,381) = 2.84 per cent per annum to age 60

Comparison Between Normal Term and Convertible Term For Male Aged 35 To Age 60 For Sum Assured \$600,000

FIGURE 4

	PROTECTION PREMIUM	
Normal Term To Age 60 (\$1,274)	\$1,274	
	PROTECTION PREMIUM	INVESTMENT PREMIUM
Convertible Term To Age 60 (\$1,605)	\$1,274	\$331

Difference in premium = \$331

Unpacking A Whole Life Policy (Premium \$10,986)

FIGURE 5

\$1,274	\$331	\$9,381
PROTECTION COVER	OPTION TO COVER FOR LIFE	SAVINGS PORTION
Normal Term To Age 60	Convertible Option Premium	

Rate of return for savings portion (\$9,381) = 2.85 per cent to age 60

insured survives beyond the period, his policy ceases and his premiums paid (capital) are totally lost.

By comparison, the whole life policy with a higher premium has a lower return than the term policy for the years within the cover period, but the whole life policy continues after that. In other words, given that a whole life policy is kept alive, there is a 100 per cent certainty of claim and a good positive return from inception to the end. Figure 5 shows a whole life policy unpacked.

Besides looking at the expected return on investment, we must look at the probability of getting this return. Actuaries look at mortality and morbidity (sickness) tables and compute probabilities. One actuary tells me that the probability of a male, aged 35 dying before aged 55 is 2.72 per cent only.

This low probability does not mean that the person should not be insured. The fact that there is a low probability means that the premium can be low. But it is good to know that the probability of claiming against a term policy (terminating usually before age 60 or younger) is relatively low. So, if you want to hedge against losing your premiums you have to pay, you can consider a cash value policy. But to decide whether this is worthwhile doing, you must do the right comparison.

Unpacking the life insurance products gives us a good idea of what we are paying for protection and for savings. Whether a person would go for term or whole life or endowment depends on a number of factors – affordability, savings objective (if any), alternative savings/investments, risk tolerance, investment time horizon, diversification, security of capital, charges or costs, etc. Taking all factors into consideration, there will be insured who are happy with the savings return of insurance policies (e.g. compared to fixed deposits or bonds). Yet others, who are more financially savvy or higher risk-takers, may prefer other investments. A good principle is to build a portfolio of savings and investment products. Insurance is safe enough to be regarded as savings compared to other more risky investments like unit trust or equities. A rule of thumb is to factor another two per cent for fees and charges for unit trusts as compared with life insurance.

There are other specific reasons for buying whole life products when you need to be certain about receiving a payment. One reason is to pay for your own final expenses (funeral, final illness, estate duty). Another worthy reason for buying whole life is to will the proceeds for the benefit of loved ones or for favourite charities.

Alexander Pope's other wisecrack of "ignorance is bliss, where tis folly to be wise" may be good advice in some situations, but certainly would not apply to financial matters. Be as wise as you can. Your life and life savings depend on it.



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