Protection Through Insurance

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What is Insurance?

- Insurance is the equitable **transfer** of the risk of a loss, from one entity to another in exchange for payment
- Involves **pooling** risks over a large number of similar units, such as households, persons or businesses
- Protects people and businesses against financial loss by spreading their risks among large numbers
- Involves exchanging the uncertain prospect of large losses for the certainty of small, regular premium payments
- Most appropriate for uncertain and expensive losses

ONLY 1 IN 3 FILIPINOS HAVE SOME FORM OF LIFE INSURANCE

Insurance Commission Annual Report 2014

Seven Principles of Insurance

1. Loss must occur by chance
2. Loss must be definite
3. Probability of loss occurring must be calculable
4. Large number of similar insured units exposed to the risk
5. Loss must not be catastrophic
6. Policy holder must have insurable interest
7. Premiums must be affordable

Brown, W., & Churchill, C. (1999). Providing insurance to low-income households. Part I: Primer on Insurance Principles and Products. November.

"I do not want insurance, they close down!"

- The Philippine insurance industry is 120 years
- There has been zero failures (in the insurance industry) in the past 120 years
- Pre-need companies closed down. As of February 2012…
  - 30 Pre-Need Companies placed under coservatorship
  - 11 Pre-Need Companies under liquidation

"List of Distressed Pre-Need Firms," Philippine Daily Inquirer, September 18, 2013

"Sunlife: Insurers Stable; Pre-Need Faces New Challenge," ABS-CBN News, February 14, 2012

Insurance ≠ Investment

Insurance versus Pre-need Plans

Pre-Need

- Guaranteed returns on pre-determined period
- Take the risk of rising costs (pay certain amount now regardless of future cost)
- Claims may come in bulk or in batches
- Regulator: Securities and Exchange Commission
- Main products: education plan, pension plan, memorial plan

Insurance

- Pays beneficiaries in case insurable event occurs in an uncertain time
- Regulator: Insurance Commission
- Pays fixed amount upon occurrence of insurable event (e.g. death)

De Castro, Gary, "Pre Need versus Insurance – Are They Similar or Different?" February 16, 2012

Insurance ≠ Pre-Need Plans

Types of Insurance

Life

- Gives face amount to the insured or their beneficiaries upon a certain event such as death of the individual who is insured
- Covers premature death, income during retirement, illness
- Main products: whole life, endowment, term, medical and health

Non-Life

- Protects an individual against losses and damages other than those covered by Life insurance
- Risks covered: property loss, liability arising from damage caused by an individual to a third party
- Main products: auto, fire, property, theft and travel

Sharma, Hermant, "Difference between Life and Non-Life Insurance?" November 30, 2013

Kinds of Life Insurance

- Traditional Life Insurance
  - Term Insurance
  - Permanent - Whole and Universal Insurance
  - Endowment
- Investment-linked Insurance
  - Investment-linked Whole
  - Investment-linked Endowment

Traditional Insurance

	Term	Whole	Endowment
Form	Temporary	Permanent	Permanent
Coverage duration or Policy term	Specified time period only	Entire life of the insured	Specified time period only
Premium payment	Limited time	Limited time OR Throughout the insured life	Limited time OR Throughout the insured life
If insured dies	Death benefit is paid	Death benefit is paid	Death benefit is paid
If insured survives the term	No benefit	Not applicable	Maturity benefit will be paid
Participation in insurer's profits	Not allowed	Allowed	Allowed

"A Beginner's Guide to Investing: life Insurance and Investment-Linked Products," Securities Investors Association Singapore, 2010

The Best Form Insurance: Term Insurance

- Affordable
- Serves its purpose to protect an asset – your life! your properties etc.
- What to look for:
  - Limited pay – 5-10 years
  - Coverage until longest possible life expectancy
  - Treat as expense
  - Purpose is protection not investment

Investment-linked Insurance

- Insurance policy that provides a combination of protection and investment
- Premiums are used to purchase life insurance protection and investment units
- Policyholders choose from investments funds offered by insurer
- The value of the policy depends on the performance of the market
- Policy holders bear the risk on the performance of investment funds chosen

Facts About Investment-Linked Insurance

- 7-10% of premium paid goes to fund value on the first year
- 25%-35% of premium paid goes to fund value on the second year
- Many products do not allot all of the premium paid to fund value until the fifth year
- Where does your money go? Mostly to pay commissions of agents and managers

Argument Against Investment-Linked Insurance

- You pay for charges (premium charge, insurance charge, fund management charge etc.) that should have been used to start your investment portfolio
- Unnecessary charges that only go to commissions of insurance agents
- Defies a cardinal principle of insurance: RISK TRANSFER
  - Loses transfer of risk since policy holder bears the risk of the chosen fund

Suggestion: Separate insurance and investment products

- Even if your investment do not perform well, your insurance policy remains active and enforceable
- You avoid paying fees and commissions when you buy **term** insurance and this could be used to increase your investments
- Rates of returns could be mimicked if you teach yourself how to choose appropriate investment products for you

Insurance Comparisons

	Endowment	Investment-Linked	Limited Term
Face Amount	1,000,000	1,000,000	1,000,000
Payment Term	10 years	10 years	10 years
Age of Insured	35	35	35
Maturity	65	65	65
Premium	58,000	68,400	18,000

- Amount available for Investment vs Endowment: **40,000**
- Amount available for Investment vs Investment-Linked: **50,400**

Limited Term vs Endowment

- 40,000/year for 10 years amount of investment
- No additional investment after 10 years but held to maturity for 20 years more (Age 65)

Endowment		Limited Term	
1,000,000		4% Rate of Return	1,052,274
1,000,000		8% Rate of Return	2,700,849
1,000,000		10% Rate of Return	4,288,760

Limited Term vs Investment-Linked

- 50,400/year for 10 years amount of investment
- No additional investment after 10 years but held to maturity for 20 years more (Age 65)

Investment Linked		Limited Term
305,336	4% Rate of Return	1,325,865
1,184,197	8% Rate of Return	3,403,070
2,126,846	10% Rate of Return	5,403,838

I bought investment-linked insurance, what should I do?

- Relax, don't panic
- Convert investment-linked insurance to traditional insurance – talk to your agent
- Encash the fund value of the insurance policy and use the proceeds to buy traditional insurance
- If no fund value, discontinue policy and buy traditional insurance policy

When should I buy insurance?

Life Stage	Life Insurance	Non-Life Insurance
Young Adult (20s)	If you have dependents As retirement plan If you plan to have kids	Buy accident insurance and health insurance Property insurance if any
Young Family (30s – 40s)	If you have dependents buy an equivalent of 10 years income with combination of term and endowment insurance policies	Extend health insurance to family Continue accident and asset covers
Early Nesters (50s)	Maintain insurance coverage until you are earning	Top up health cover for self and spouse Continue asset cover
Retired (Over 60)	No life cover needed unless with dependents	Continue health cover for self and spouse Continue asset cover

Mehta, Vinod et. al., "The Layman's Guide to Life Insurance," p. 13, 2008

How much insurance do I need?

- General Rule:
  - Insurance Coverage = Projected Expenses – Existing Net Worth
- Rules of thumb:
  - If single and no dependent: 3 years salary
  - With dependent: 10 years salary

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