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Life and Disability Insurance: What You Need to Know

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Death and disability are two of the most difficult things for a family to discuss. But insuring against both is an important part of safeguarding a family's future. While most families have some form of life insurance, usually purchased at marriage or with the birth of children, disability insurance is not a given. But if one or both spouses become disabled during their working life, not having it is a far greater risk to family solvency. This is where disability insurance is important. This primer will examine the basics of both types of insurance.

Life Insurance

Life insurance comes in a variety of forms meant to accomplish a range of objectives, from providing for survivors to moving assets out of your estate. The prices for it depend not only upon how much coverage you want but also upon what type of policy you get, either for a finite period of time or indefinitely.

The first question you need to ask, though, is how much insurance do you need? There is not a clear answer on this because it depends on your expectations. The better question is this: What am I trying to provide for with life insurance? If your concern is your spouse, a common calculation is to take out a policy that would cover all living, personal and household expenses for at least one year. This allows the surviving spouse to grieve without worrying about bills, and it also gives the spouse a period to begin making decisions for life without you.

If there are dependent children, however, the amount of insurance you need increases. Again, the dollar value depends on several factors, including the age of your children and what you want to provide for them. The person who wants to send his three children to private school and private college is going to need a lot more than the person looking to provide for the basic needs of one child in public school.

In insurance, desire is something that does not always align with reality. How much life insurance you are going to get also depends on what you can afford in terms of premiums as well as how much insurance a company will sell you. Just because you want a $5 million policy and can pay the premiums on it does not mean a company will underwrite that amount. Like a loan to a person flush with cash, insurance companies would rather sell large policies to healthy people who are going to live for decades. This gives them time to turn your premiums into more than the face value of your policy. The person who is already sick but wants to provide for his family will, in all likelihood, struggle to get an adequate amount.

Now onto types of insurance.

TERM Term life insurance is a popular and relatively inexpensive form of insurance. It covers a person for a period of time, usually 20 years. During the term, if the insured dies, his heirs receive the full value of the policy. After the term expires, they get nothing. Furthermore, the policy never has an intrinsic value — unless the person dies during the term.

Term life, then, is a contract, not an investment, to buy peace of mind. It is a good for a particular period — say the time it takes for a child to mature and leave home — and will pay the insured's heirs the full value of the policy if he dies, regardless of how long he has been making the payments.

One variant on this, offered by a few insurers still structured as mutual companies — where their policy holders actually own the company — is convertible term life. This starts out as basic term, with its comparatively low premiums for the amount of coverage. But within a set period of time, often the first 10 years, it can be converted to whole life. The premiums will increase but the person does not have to be screened again for insurance.

WHOLE Whole life insurance plays a dual role for many people. It is both insurance in the case of an untimely death as well as an estate planning tool for when that final day comes. It is also considerably more expensive than term life. The reason is that it has an intrinsic value, from which you can draw if you need the money. And whereas term life is for a period of time, whole life lasts in perpetuity, unless you stop paying the premiums or cash in the policy.

Since whole life is also an investment for some people, some companies offer the policy holders the option of selecting the underlying securities that back the death benefit. This adds a small element of risk to the eventual payout. While the value of the portfolio can, obviously, increase or decrease, the insurer sets a floor for how low its value can fall. While investment losses are capped there are other downsides. First, there are fees associated with the trading portfolios, which can also chip away at the policy's value. And then there are those who believe that you can get better returns by investing on your own.

This is where you have to evaluate why you want a whole life policy. If it is to move assets out of your estate tax-free, then any additional upside is good. If it is to increase the amount you leave to your heirs through the underlying portfolio, then you may not see the increase that you expect during your lifetime. Buying term life for a greater amount is an option, though those prices increase as you get older (and closer to the point where the insurer is going to have to pay out). Regardless of the type of policy you select, the payment to your beneficiaries is tax-free.

Disability Insurance

The screening a person goes through for disability insurance is far more onerous than life insurance. This may seem odd since everyone is going to die, but not everyone is going to become disabled. But this is not how insurance companies think about it. Death is something an actuary can calculate fairly easily and accurately. Someone who is overweight, smokes and drinks too much, for example, could be expected to die before someone who is fit and free of harmful vices.

Predicting who will become disabled is not so easy. It is a calculation based on chance. While someone building skyscrapers would seem to be at more risk for disability than a secretary, this is not always the case. One constant, though, is that women will be charged more for disability insurance than men. Reasons for this vary, but any candid insurance agent will explain that women are more in tune with their bodies and more apt to go on disability during their working lives. This does not mean men are tougher; it means men are generally less aware, continue to go to work when they are sick, and die younger. (No one said an actuary's calculations were cheery.)

The two things that will hurt someone the most trying to buy private disability insurance (as opposed to a group policy offered by a company) are back problems and psychiatric care. These are the categories that generate the largest number of claims: lower back injuries and depression. If one of these conditions is pre-existing, the underwriter may deny coverage. Or the underwriter may attach a rider exempting those areas from coverage or, worse, limit the payout period for any disability claim. Again, this may seem deeply unfair, but insurance companies are for-profit entities.

SHORT-TERM VS. LONG-TERM DISABILITY Disability insurance is divided into two broad categories, based on the length of the claims — short and long. They are exactly as they sound. Short-term disability kicks in soon after a claim is made but generally stops within two years. Long-term takes longer to start, from 31 days to a time set by the insured, but can last until the insured's death. Among insurance products, long-term disability is among the most expensive and the one insurance companies are least eager to underwrite. The reason is simple: It is a hard product for them to make money on. Unlike life insurance, where the actuarial tables are on their side, long-term disability could cost an insurance company dearly. A man in his early 30s, for instance, could pay $5,000 annually for insurance that would replace a yearly income of $400,000. If, however, he is disabled a couple years into the policy, the insurer could be paying that claim for 40 years.

Buying Any Insurance

If two people the same age walked into an insurance agency, they could easily end up paying two different prices for the same amount of coverage, be it life or disability insurance. No matter how you purchase it — on the Web, through an insurance agent or a financial adviser — insurance is not like buying a house, a car or even a stock. The price is determined by a range of variables from age and health to past medical conditions and habits. Still, the biggest factors in determining your rate are the health examination insurers require and an exhaustive review of your medical records.

Consumers should also conduct the same type of examination of the health of their insurance company: the healthier the company, the better the chances your claim will be honored without the hassle that drives so many people to curse insurance companies. One way to judge the soundness of the insurers is to check A.M. Best, which rates the financial soundness of insurance companies. That matters far more than the agent through whom you buy your policy — not least of all because agents now regularly represent more than one insurer.

One way to select a broker is through the Independent Insurance Agents & Brokers of America. Their Web site provides information on finding agents who represent multiple insurers. The benefit here is not being constrained to one insurer's range of policies. When it comes to term life, though, there are several sites that offer quotes and allow you to circumvent a broker, among them iQuote and TermLifeInsurance.com.

Guides to buying insurance are published by the American Council of Life Insurers and the Insurance Institute of America.

Regardless of how much you buy and what it covers, all insurance is meant to mitigate risk. Life and disability insurance are no different. No one buys auto insurance because they hope to crash their car any more than a homeowner adds hurricane coverage because he expects his house to be blown away. But insurance that covers a person's life and livelihood gives even more comfort: these policies let you know that if you can no longer provide for your family, they will be able to get along without you.