Industry Brief: Life Insurance Multi-Part Series

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Summary

The origins of life insurance dates all the way back to the ancient Romans back in 100 B.C, however, in the United States, life insurance can be traced back to 1759. In the period between 1787 and 1837, twenty-six companies offered life insurance to the public, where the industry took form and evolved into what we have today. The life insurance industry has since flourished and tried to accomplish many things over the centuries, such as protecting loved ones, gaining from tax benefits, enabling wealth transfer, and for financial planning purposes. These core reasons continue to persist today and drive the life insurance industry.

This report will take a multi-dimensional look at the insurance industry for those seeking an understanding. Matters such as why people buy life insurance, the type of products that exist in the marketplace, the technology ecosystem that has been developed, and other critical matters.

This is the first in a multi-part series looking across the industry from these perspectives. The series will address topical areas such as the Industry, Life Insurance Technology, Distribution Models, and the Future. We recommend the series be read in its entirety.

Part 1: The Industry

This report provides a historical overview of the industry, definition of life insurance product types, and why people buy life insurance. This foundational report sets the stage for the subsequent chapters.

Author

Don Desiderato
Founder and CEO Mantissa Group
d.desiderato@mantissagroup.com

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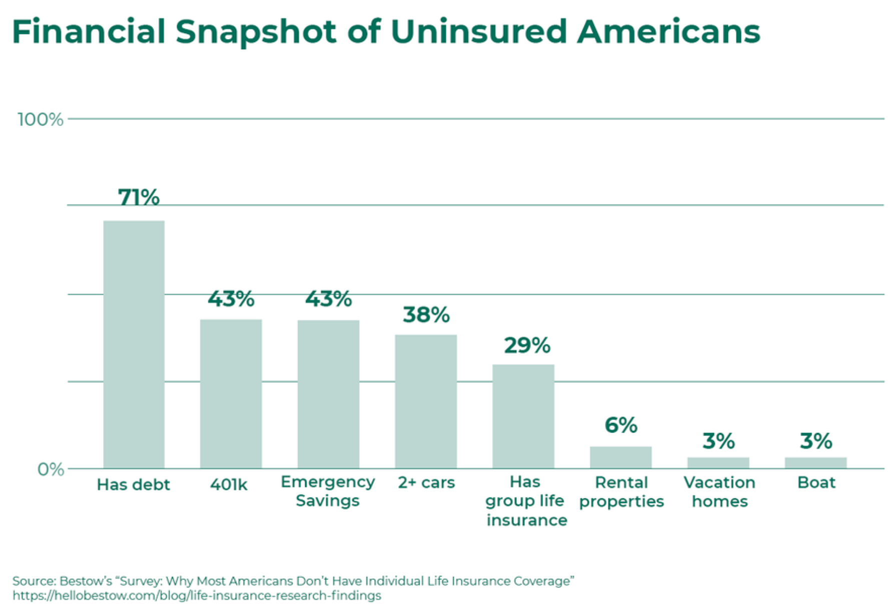
Life Insurance History

The history of life insurance dates to the ancient Romans back in 100 B.C. The Romans believed that anyone who was not given a proper burial would return as an evil spirit, but much like today, funerals were expensive. To help with this, a military leader named Caius Marius formed burial clubs. These clubs would help members cover funeral expenses should another member die. It is commonly noted as the earliest form of life insurance.



Since then, there have been many iterations of life insurance in early modern society. In the United States, life insurance can be traced back to 1759. During that time, the Presbyterian Synods in Philadelphia and New York started the Corporation for Relief of Poor and Distressed Widows and Children of Presbyterian Ministers.

In the period between 1787 and 1837, twenty-six companies offered life insurance to the general public. Companies that had the most success were the Pennsylvania Company for Insurances on Lives and Granting Annuities, the Massachusetts Hospital Life Insurance Company, the Baltimore Life Insurance Company, the New York Life Insurance and Trust Company, and the Girard Life Insurance, Annuity and Trust Company of Pennsylvania.

By the end of the Civil War, life insurance sales increased to just under $600 million, and by 1871 was up to $2 billion. By the end of the 1800s there was stiff competition and market saturation due to presence of so many different companies. This market saturation along with a period of economic downturn caused many of these companies to cease operation, allowing only the better-established (and well-funded) companies to maintain operations.

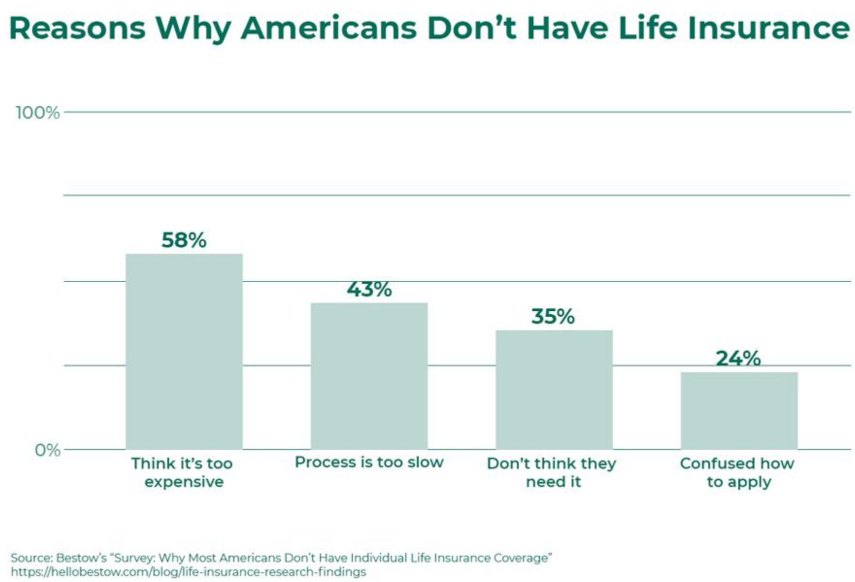
By the end of World War II, America saw an *economic boom* resulting in another boost in life insurance sales. We saw more insured households at that time, in the 1970s, than we do today, with around 72% of adults insured versus around 60% today.

This brief history of life insurance illustrates how even the most ancient of societies saw the value in this type of insurance.

Why People Buy Life Insurance

There are seemingly countless reasons why people buy life insurance. In this section we will touch on some of the most common reasons people look to buy.

One of the most basic reasons for life insurance was alluded to in the earliest examples of its history, was to **cover burial expenses**. Interesting to note in the adjoining figure why people chose to ***not*** purchase life insurance.



Even the most basic funeral service can be several thousand dollars, and most people do not think to prepay for their funeral expenses. In many cases, people are not even aware of the cost of a traditional funeral.

According to Policy Genius, the average funeral can cost anywhere from $8,000 - $10,000, and this number will continue to grow as time goes on. According to the Consumer Price Index, funeral expenses have gone up by over 200% in just the last 30 years. Thus, just having a small policy to cover burial expenses can be extremely beneficial to loved ones.

Another common reason to have life insurance is to **pay off debt**. If you have ever purchased a home, you are likely familiar with the seemingly countless offers in the mail for "mortgage insurance". This insurance is essentially life insurance that your loved ones can use to pay off the balance of the mortgage and continue to live in the home without the burden of a mortgage payment. Many insurance agents and financial planners will also consider what other loans and expenses the insured is liable for to ensure there is adequate coverage.

A third important reason to purchase life insurance is to **replace lost income**. Having a large lump sum paid upon death can help ease the burden of the loss of income that may be experienced by the insured's passing. This is a big factor in determining the amount of coverage one may need, especially if they are the primary earner of the household. Having adequate coverage will ensure that loved ones will not be left short when it comes to paying the monthly bills.

The examples discussed above are often covered with **term insurance** (which we will discuss in more detail in the coming sections) since one can attain higher coverage amount for relatively low premiums.

Other times people will look to **Whole life** insurance for some of the added benefits it provides, such as cash value buildup. Cash value is money that builds up over time in the policy that can be used by the owner at any time for whatever reason they feel necessary such as paying premiums, a loan to meet other critical or non-critical expenses, or to address a financial emergency.

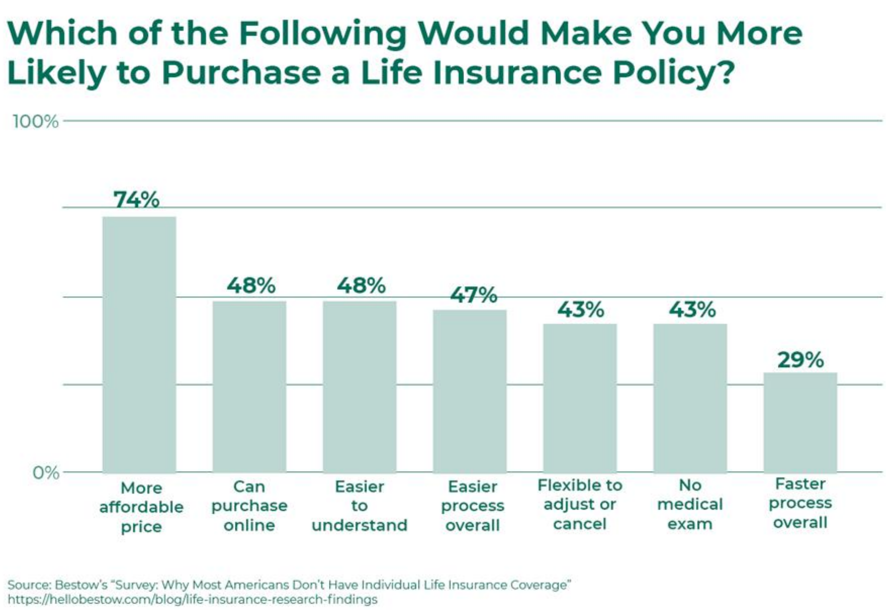
For those who own a small business, life insurance is of particular importance. For example, if one partner in the business dies, the other partner(s) will have enough cash to purchase the deceased's interests in the business from his or her heirs. In addition, it allows for payment of their share of the company's obligations without having to sell the company. This ensures proper **business continuity** in the event of an untimely passing.

One final reason worth discussing is for payment of **estate taxes**. These taxes can be expensive, so having insurance coverage to pay the taxes will avoid the need to pull funds earmarked for other things to meet this obligation.

Life Insurance Types: Permanent vs. Term

In the previous section we discussed several reasons and situations for why people purchase life insurance. The type of coverage chosen will often depend on the primary reason for purchasing the policy. In this section we will discuss the two primary types of life insurance: **term insurance** and **permanent/whole life insurance.**

Term Insurance is intended to provide coverage for a certain period. The length of the term policy is often pre-determined when purchasing, with most people choosing a 10, 20, or 30-year term. Often these premiums and death benefit will remain the same throughout the term. These policies are typically used when an insured has more expenses to cover and family to provide security for in the event of an untimely passing. The reason that term is often chosen is that it is a less expensive option that allows an insured to have higher coverage amounts than could otherwise be



purchased with a permanent/whole life policy.

In an ideal circumstance, by the end of the term an insured would no longer need the amount of coverage the policy provided and have accumulated more savings to provide a cushion in the event it is needed. It is at this point that many will convert term insurance to **permanent/whole life insurance.**

Whole life insurance is the most common form of permanent life insurance, which provides coverage for a person's entire life. There is no expiration date like there is with a term policy. In addition to lifelong coverage, these policies also have fixed premiums for life and build cash value. Cash value grows over time on a **tax-deferred** basis. The cash value accumulated allows the policy holder to borrow against the policy or even surrender the policy for cash.

Some permanent life policies also earn **dividends**, which can be taken as cash, credited to the account to earn interest, or even used to decrease premium payments, repay loans, or buy more coverage. While all these added features of permanent insurance are attractive to many, the downside is that it comes with **much higher premiums** when compared with a term policy for the same coverage amount.

Other Life Insurance Product Types

For those who want coverage that will last the rest of their lives, but are also interested in additional investment options, there are some other forms of permanent life insurance in the form of **universal life Insurance, variable life insurance, and indexed universal life insurance.**

Universal life (UL) provides more options than does whole life insurance in that it allows policyholders to adjust their premiums and death benefits. UL has a "cost of insurance" (COI) amount which is essentially the amount of premium payment required to keep the policy in force. Premiums that are received above the COI are added to the cash value of the policy. The cash value earns interested based on the greater of the current market or minimum interest rate. As this cash value accumulates, the policy holder has the option to access a portion of it without affecting the death benefit. Withdrawing a portion of the cash value is a taxable event. However, there is the option to borrow against the cash value, like a whole life policy. Unpaid loans do reduce the death benefit.

Variable life (VL) is another form of permanent life insurance that has an added **investment** component, which is the primary appeal. Since this is a form of permanent insurance, it builds cash value, but the difference is that the cash value account is invested in sub accounts, like a mutual fund. There are a variety of sub accounts to choose from depending on investment objective. With VL, the cash value can grow as the sub accounts grow, but also is susceptible to loss if the sub accounts decrease in value. These types of policies also have expenses to manage the sub accounts in addition to policy charges and fees.

Indexed universal life allows the policyholder to tie the amount of cash value to either a fixed account or an equity index account. Oftentimes the indexes used are the Nasdaq 100 or S&P 500. This practice mitigates some risk as none of the money is invested in an equity position, but rather is tied to the index. Like the other forms of permanent insurance discussed, the cash value grows tax deferred. When premiums are paid, a portion pays for annual renewable term insurance. Policy fees are paid with the premium and any excess is added to the cash value. The cash value earns interest based on the increases in the equity index selected (sometimes multiple indexes, depending on the policy). Oftentimes there is a guaranteed minimum fixed interest rate. The value of the index that is selected is compared at the end of the month with what it started at in the beginning of the month. The policyholder will receive a percentage of the index gains between 25%-100% (although it is typically set at 100%) depending on the policy. This is considered the **participation rate**. To give an example of how this may look, if the account gains $10,000 and the participation rate is 25%, the account will be credited $2,500.

Living and Accelerated Benefits

Many are familiar with the death benefit a life insurance policy provides, as that benefit is the primary reason people look to purchase life insurance. There are, however, benefits that can be used while the insured is still alive, even with term insurance. This comes in the form of **accelerated benefit riders**, which will pay money to the insured while still alive. The ability to obtain this money comes with preconditions, one being a **terminal illness.** In such a case, a portion of the death benefit is paid out to the insured in advance to address the terminal condition.

Another instance where an insured can access a portion of the death benefit early is if **chronically ill**. If this is the case, it has been determined that the insured cannot perform several of the six activities of daily living (often considered with Long Term Care Insurance). The third case is when **critically ill.** Examples would be if an insured has been diagnosed with cancer, had a heart attack or stroke, or other serious illness with an expected critical outcome.

Concluding Thoughts

In many ways, life insurance is an underappreciated industry, while having been in existence for centuries. The diversity of product types and the social good the product offers families is substantial. There are many insurance companies in the United States today, and of particular importance is the ability for the insurance company to pay on their obligations. That is why many consumers, agents, and financial advisors believe that the overall strength of the insurance company and their ability to withstand poor economic conditions is a critical factor in selecting a life insurance product.

In the coming chapters, we will look at other factors such as how life insurance is distributed, , the vast technology ecosystem that has emerged as a result of this thriving industry, as well as our views of the future of the industry.

About the Author

Don Desiderato is a former insurance industry Fortune 100 CIO executive and founder of Mantissa Group LLC, a strategy consulting firm serving the CIO executive and their extended leadership teams. Don is a recognized industry expert, business leader, and a deeply experienced senior technology executive helping leaders with their **technology strategic plans,** as well as simultaneously focusing on **leadership development and culture**.

About Mantissa

Mantissa Group provides business and technology strategic consulting services. Mantissa supports the Chief Information Officer executive and their leadership teams, with a focus on CIO engagement as a business leader. Mantissa has practical experiences supporting leaders with **technology strategy, executive coaching, leadership development**, and relevant **research** for technology organizations.