Life Insurance and the Reverse Rule of 72–

How inflation impacts life insurance coverage

We buy life insurance to protect our own financial security and the security of the people we love. If something happens to us, we want to be financially stable and we want our families to be able to stay in their own worlds. We buy life insurance for its death benefit protection and the financial security that protection provides.

Whether or not we have enough life insurance coverage can best be measured at the time we die. That's when our beneficiaries actually receive the policy's income tax free death benefits.* Protecting a lifestyle really means protecting future purchasing power—the ability to buy the things that will be needed to live on. It's easy to have a false sense of security about our coverage.

> *"We may have the right amount of coverage today, but that same coverage may purchase less 5-10 years from now. Ultimately, the real value of life insurance coverage is how much financial flexibility and purchasing power it provides when the unexpected happens."*

*Death proceeds from a life insurance policy are generally income tax-free and if properly structured, may be free from estate tax.

The impact of inflation

That future purchasing power of our coverage depends on a number of factors, including inflation. Inflation is the slow, steady rise in prices over time and it is a fact of financial life. It is a "silent" financial force that's easy to overlook and which regularly erodes the value of many assets.

It's hard to notice inflation's effect from day-to-day; it's only when we look back over a period of years that we can notice and appreciate its impact. Over time, inflation may steadily decrease the purchasing power of our life insurance protection.

Measuring Inflation

There are a number of different approaches/ formulas for measuring inflation. Two of the most well-known are the American Institute of Economic Research's Everyday Price Index (EPI) and the US Department of Labor's Consumer Price Index (CPI). Different indexes estimate inflation by tracking different goods and services and using different assumptions in their calculations. Some experts prefer the EPI inflation estimate because it is weighted for what consumers actually purchase day-to-day and because it is constantly adjusted. In addition, the EPI index does not include high-tech items for which prices can decrease rapidly as new technology becomes available.

The Rule of 72

The Rule of 72 is a simple, effective way to help estimate the impact of investment growth over time. It is often used to determine how long it will take an investment's value to double at a specific annual rate of return. Dividing 72 by that rate of return tells us the number of years it will take for the investment's value to double. For example, if a $100,000 investment earns a 9% annual rate of return, it will be worth $200,000 at the end of 8 years (72 / 9 = 8).

The Rule of 72 in reverse

But some assets don't grow in value. Because of inflation, assets that have a fixed value lose purchasing power over time. By "reversing" the Rule of 72, we can get a clear picture of inflation's impact. If we substitute the inflation rate for an investment rate of return, we can see how long it will take a sum of money to lose 50% of its purchasing power. Suppose, for example, the annual inflation rate is 4% per year. Dividing 72 by 4% tells us how long it will take for $100,000 to be reduced in purchasing power to $50,000. It will take 18 years (72 / 4 = 18).

Inflation and life insurance death benefits

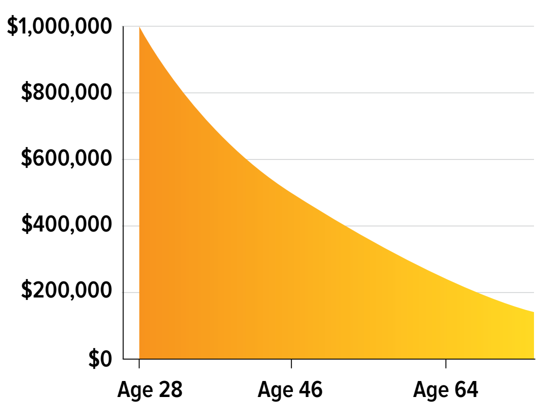
It's easy to see how inflation impacts life insurance death benefits through a hypothetical example. Suppose Dan Wilson purchases a $1,000,000 policy today when he's 28. If inflation averages 4% a year, when he's 46, the purchasing power of his policy death benefit will be reduced to $500,000. If inflation continues at that same 4% annual rate, its purchasing power will have dwindled to $250,000 when he is 64—one quarter of what it was when he originally bought it.

Possible impact on us

Inflation can also have a negative impact on us as policy owners. Many policies today have provisions that (under specified conditions) allow owners to access part of the policy death benefit while they are living. The ability to access policy death benefits early may provide us with financial flexibility should we suffer from a severe or terminal illness. These policy provisions are sometimes known as "chronic illness riders" or "accelerated death benefit riders." They may provide a source of funds to help pay medical expenses. Many policies restrict the amount of death benefit that can be used under these provisions to a percentage of the total death benefit. Different policies have different terms, so we need to review the terms of our own policies to see if this option is available.

Pre-death access to life insurance death benefits can be a valuable benefit. Many experts believe that medical expense and nursing home costs are currently growing at a rate **faster** than the general inflation rate. Inflation on such a scale can mean that the death benefit available to us for these expenses could lose purchasing power even more quickly. If, for example, future health care costs hypothetically grow at an 8% annual rate, $100,000 of available coverage will be reduced in purchasing power to $50,000 after 9 years (72 / 8 = 9). If our policies will pay benefits to us before death, we have a personal stake in making sure our life insurance death benefits keep up with inflation.

Inflation's Impact on Policy Purchasing Power
(4% annual inflation rate)



Protecting our death benefits' purchasing power

There's nothing we can do about inflation; it's an economic force we can neither stop nor slow down. What we can do is keep it in mind as we plan. We can't afford to forget that inflation is silently at work reducing the purchasing power of our coverage. And when we think about reducing our death benefits, we need to remember that inflation may have already significantly reduced its spendable value for us.

Fortunately, there are some ways we can help manage our policies to limit / reduce inflation's impact.

These are some options:

1. Factor future inflation into our decision-making process every time we purchase life insurance coverage. Although it's possible we may die early, it is also possible we could live to life expectancy or beyond. We need to ask ourselves how much of a cushion we'll want for ourselves for health care expenses and how much purchasing power we want our policies to provide our beneficiaries.
2. Consider including an Adjustable Term Insurance Rider (ATR) on the policy at the time of purchase. These riders (sometimes also called "future purchase options") give us the opportunity to purchase additional coverage at specified future times regardless of our health or insurability.
3. Instead of opting for a level coverage amount, we may be able to structure our death benefits so they are increased annually by either the sum of the premiums we've paid into our policies or the cash values which have accumulated inside them.
4. Review our policies (including their face amounts) regularly and take an active approach to reviewing and managing them. If we're insurable and our death benefit purchasing power is declining, purchasing additional coverage could make sense.

Conclusion

It's easy to have a false sense of security about our coverage and to forget that ongoing inflation could gradually diminish its purchasing power over time. We may have the right amount of coverage today, but that same coverage may have less purchasing power 5-10 years from now.

By understanding how inflation impacts our life insurance coverage, we'll be better able to manage our policies to keep ourselves and our families financially secure.

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