THE GLOBE AND MAIL

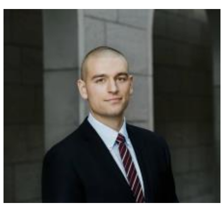
GENYMONEYADVISER Q&A

Do I really need life insurance? The costs vary greatly so choose with care

Globe GenYmoney Q&A

Question from Maha Anj through our GenYmoney Facebook group: What are your thoughts on life insurance/critical illness insurance? Is it best to go through an insurance broker or do it on your own?

Answer from Benjamin Felix, an associate portfolio manager with PWL Capitalin Ottawa.



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LIFE INSURANCE

If there is anyone relying on you financially, you need life insurance. The day that you die, your income stops. But your dependants will still have to pay for your mortgage, groceries, heat and all of the other bills. Life insurance should replace your contribution to the household budget for as long as your family needs it to. For example, if your family needs you to cover at least $2,800 a month of household expenses to maintain their lifestyle for the next 20 years, you would need $500,000 of life insurance coverage, assuming a 5-per-cent after-tax rate of return and 2-per-cent inflation.

People have the greatest need for life insurance early in their adult lives when there are minimal financial assets coupled with high costs, such as child care, and significant debt, such as a mortgage. The unexpected death of a spouse at this stage of life would be financially devastating. Conversely, a retiree likely has substantial financial assets in investments or pensions, independent children and minimal debt. The death of a spouse at this stage of life would have less of a financial impact.

There are two main types of life insurance: term insurance and permanent insurance. Term insurance has a guaranteed premium (cost) for a fixed term, usually 10 or 20 years. After the term has expired, the premium goes up, often substantially. If the insurance planning was done well, your life insurance need at the end of the term will be minimal, and you can cancel the policy instead of paying the higher renewal rates.

Permanent insurance has a fixed premium forever, but it is more expensive. This makes sense from the perspective of the insurance company – term insurance is cheap because you are unlikely to die in the 10 years between the ages of 30 and 40, but permanent insurance is expensive because you are guaranteed to die eventually.

There are multiple forms of permanent insurance. The simplest form is Term 100, which is like a term-insurance policy that has a fixed premium until the age of 100. Whole-life insurance is similar in that it is payable with a fixed premium until 100, but it also has a cash value building up in the policy over time. You can borrow against the cash value, or use it as collateral for a loan, and you keep the cash value if you cancel the policy. In most policies, the cash value also earns non-taxable interest over time. Limited-pay whole-life is similar to whole life, but the premiums only need to be paid for a fixed number of years, and then the policy is guaranteed until death.

The costs for each type of life insurance are very different, making choosing the right one important. Let's compare the monthly cost of a $500,000 life insurance policy for a 30-year old of average health. I have used Term4Sale for this comparison, a free online tool that anyone can use.

	MALE	FEMALE
Term 10	$24.30	$18
Term 20	$33.75	$24.30
Term 100	$195.65	$157.81
Whole life	$257.40	$224.10
Whole life limited pay 20	$445.50	$319.92

Data source: lowest cost policy of each type on Term4Sale.ca

Based on the lower cost of term-life insurance, and the typically declining need for life insurance over time, term-life insurance tends to be the most sensible solution for most people.

Permanent life insurance is often positioned as an investment; it's similar to the rent vs. buy debate for home ownership – why rent your life insurance when you can be building equity (cash value) in the policy? The reality is that permanent life insurance is not a very good investment for most people. It has high built-in costs, a high cost of insurance, low returns and the funds in the policy cannot be easily accessed.

Permanent insurance can make sense for tax and estate planning in a few very specific cases, but unless you currently have wealth in excess of what you will require in your lifetime to cover your own needs, I would approach permanent life insurance with skepticism.

If you do not have a life insurance need now but want to buy term-life insurance now while you are younger, healthy and the rates are lower, I see no problem with that. It is so inexpensive it's almost like deciding whether or not to keep Netflix.

DISABILITY INSURANCE

Like life insurance, if you are earning an income and have anyone relying on your income, you need disability insurance. You are far more likely to become disabled than you are to die prematurely. Personally owned disability insurance is often hard to get. The underwriting process – the process where the insurance company decides how risky you are – is rigorous, and coverage can, in many cases, be declined.

On the other hand, many employers will offer disability insurance as part of their group benefits package. Group disability insurance is much easier to qualify for, but it will typically only cover you for two years of "own occupation" – this means that the benefit continues to pay for two years if you can't go back to your own occupation, but it goes away after two years if you can go back to a different, potentially less desirable, occupation. If you are unable to return to any type of work, the disability insurance will typically pay to the age of 65.

Generally, if you are in a specialized field earning a high income, it makes sense to have your own disability policy with a longer "own occupation" period, even if you have group disability insurance. You need to have an income to insure in order to qualify for disability insurance.

CRITICAL ILLNESS INSURANCE

Critical illness insurance pays you a lump sum if you are diagnosed with a covered illness; there are typically 25 of them, including heart attack, stroke and cancer. You should not consider critical illness insurance until adequate life insurance and disability insurance are in place. Let's think about why this is true.

- If you are diagnosed with a covered illness and you die, your family is covered by life insurance. It is also worth noting that if you die from a critical illness within 30 days of diagnosis, a critical illness policy does not pay.

- If you live through the illness, but become disabled, then disability insurance will kick in, delivering a much more valuable long-term benefit.

Sure, a lump sum of cash could be nice to cover expenses when you become sick, but you should have enough savings to cover three to six months of expenses on hand anyway. Maybe there is an argument that critical illness insurance will give you the cash to seek additional or experimental medical care, but that seems to me like buying a lottery ticket that pays if you get sick.

In most cases, critical illness insurance does not replace financial loss in the way that life and disability insurance do, so it is not a necessary part of a financial plan. What critical illness insurance does do is give you a lump sum of cash at what is presumably a terrible time in your life. If it gives you peace of mind, I see no problem with buying a small amount of critical illness insurance. It is more of an emotional decision than a financial one. For a 30-year old male or female, a Term 20 critical illness policy for $50,000 might cost around $25 a month.

There are some cases, such as self-employed people who have trouble qualifying for disability insurance, where critical illness insurance could be thought of as a substitute for disability insurance. Keep in mind, though, that critical illness insurance only pays once. It will not be helpful in the event that a covered illness results in a long-term disability.

Insurance is heavily regulated and must be purchased through a licensed life and health insurance agent, so there is no DIY route. With all of the tiny details that can differentiate one policy from another, it is probably worth dealing with an agent anyway. One word of caution is that insurance agents receive commissions based on the products that they sell you, and products with higher premiums pay higher commissions. Keep this is mind when evaluating insurance advice.

Are you a millennial with a question for our adviser? Send it to us.

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