

Life Insurance Evaluation: Interest-Adjusted Cost Methods



In the 1970s, in accordance with regulations issued by the National Association of Insurance Commissioners, insurance companies began using two interest-adjusted cost methods when making cost comparisons for consumers purchasing cash value life insurance. These methods are the net payment cost index method and the surrender cost index method. If you are thinking about purchasing a life insurance policy, the insurance company can supply you with both indices for the policy you are considering. These indices measure the cost of \$1,000 of coverage for a certain time period (often 10 or 20 years). You can use this information to compare one policy against another policy of a similar type in order to determine which policy is a better buy. Providing these indices is a legal requirement in some states.

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The Net Payment Cost Index

The net payment cost index assumes that the policy will stay in force and estimates how much \$1,000 worth of coverage will cost you per year (your net premium). The net payment cost index may be useful to you if you are buying life insurance mainly for its protection value because it essentially measures the relationship between the premium you pay and the eventual death benefits you will receive, not taking into consideration any cash value. For instance, if the policy you are considering has a net cost index of 5.50 for a 10-year period, this means that the policy is estimated to cost \$5.50 per \$1,000 of coverage per year (\$550 for a \$100,000 policy). This net cost index is calculated by considering the premiums paid each year, and the dividends received each year and adjusting the figures by an interest factor (5 percent is usually used). This will tell you how much the life insurance policy costs per year on average. According to this method, the lower the index, the better the price.

The Surrender Cost Index

The surrender cost index may be useful to you if you are buying life insurance as an investment, because it measures the cost of insurance, considering the cash value aspect. The surrender cost index assumes that the policy will be surrendered at a certain time. Premiums and dividends are adjusted for interest, and the dividends and the cash surrender value at the end of a certain time period are deducted from the net premiums. The result is the net cost of the policy over that time period, which is then converted into an index of the average yearly net cost per \$1,000 of protection. This shows the cost of buying \$1 of the policy's cash surrender value over the time period chosen, which can then be compared to the cost of other similar policies.

Strengths

Considers the Time Value of Money

The interest-adjusted net cost method was designed to be more accurate than the traditional net cost method it replaced. Unlike the traditional net cost method, which did not consider the time value of money and thus was inaccurate and easily manipulated, the interest-adjusted net cost method considers the time value of money by adjusting annual premiums and dividends through an interest rate.

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Does not Require Advanced Mathematics

Unlike other comparison methods that must be completed using a computer, interest adjusted methods calculate costs using a relatively simple mathematical formula. However, calculations can be time-consuming to complete and require the use of annuity or discount tables. In fact, most illustrations are not completed by the consumer or by the insurance agent or financial planner but by an actuary who is employed by the insurance company.

Tradeoffs

Policies Compared Must be Similar

Interest-adjusted cost methods are useful for comparing similar policies, not dissimilar ones. For instance, if one policy's premium is lower than another policy's premium, that policy will always appear to be the better deal. Even though these indices were designed with term and whole life policies in mind, a term policy should be compared with a term policy and a whole life policy with another whole life policy; otherwise, results will be skewed.

Universal life policies should not be evaluated using these methods, in part because universal life policies have historically been around a shorter period of time than term and whole life policies, and because universal life premiums are flexible, meaning that you may not contribute the premium each year. Therefore, projections involving these policies may be particularly inaccurate.

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