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Policy Provisions, Options, And Other Features

By this point, you should have a solid working knowledge of the different types of life insurance policies and their suitability for different types of insured individuals. Now you will learn about available provisions, riders, and options that can make two policies of the same type different in significant ways.

Provisions define the characteristics of an insurance contract and are fairly universal from one policy to the next. **Riders** are added to a policy to modify provisions that already exist. **Options** offer insurers and insureds ways to invest or distribute a sum of money available in a life policy. It is essential for you to have a good understanding of the different provisions, riders, and options for future life insurance transactions.

TERMS TO KNOW

Activities of daily living (ADLs) — a person's essential activities that include bathing, dressing, eating, transferring, toileting, continence
Assignment — transfer of rights of policy ownership
Contingent beneficiary — a beneficiary who has second claim to the policy proceeds after the death of the insured (usually after the death of the primary beneficiary)
NAIC — National Association of Insurance Commissioners, an organization composed of insurance commissioners from all 50 states, the District of Columbia and the 5 U.S. territories, formed to resolve insurance regulatory issues
Primary beneficiary — a beneficiary who has the first claim to the policy proceeds after the death of the insured
Principal amount — the face value of the policy; the original amount invested before the earnings
Trust — an arrangement in which funds or property are held by a person or corporation for the benefits of another person (trust beneficiary)

A. Policy Provisions

While there is no "standard" policy form in life insurance, the standard policy provisions adopted by the National Association of Insurance Commissioners (NAIC) create uniformity among life insurance policies.

1. Entire Contract

The *entire contract* provision stipulates that the **policy and a copy of the application**, **along with any riders or amendments**, constitute the entire contract. No statements made before the contract was written can be used to alter the contract. Neither the insurer nor the insured may change policy provisions once the policy is in effect without both parties agreeing to it and the change being affixed to the contract.

Know This! Entire contract = policy + copy of application + any riders or amendments

2. Insuring Clause

The insuring clause (or insuring agreement) sets forth the basic agreement between the insurer and the insured. It states the insurer's promise to pay the death benefit upon the insured's death. The insuring clause usually is located on the policy face page, and also defines who the parties to the contract are, how long coverage is in force, and the type of loss insured against.

3. Free Look

This provision allows the policyowner **10 days** from receipt to look over the policy and if dissatisfied for any reason, return it for a full refund of premium. **The free-look period starts when the policyowner receives the policy (policy delivery)**, not when the insurer issues the policy. Certain life insurance transactions, such as replacement, may require a longer free-look period.

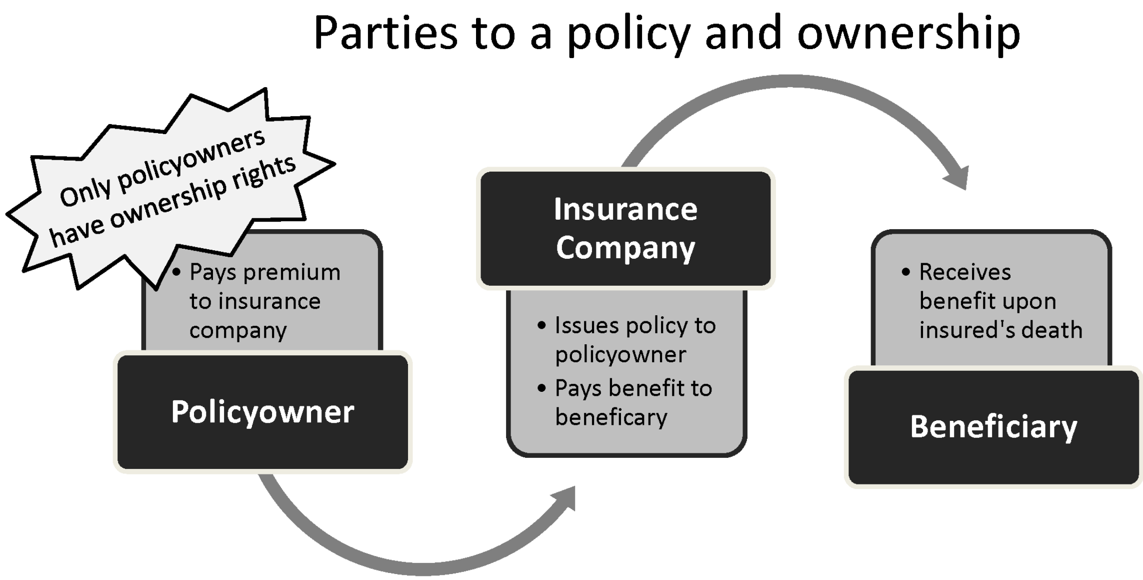
Example:

Life insurance agent Bob delivers a policy to his new client Marie on December 10th. Bob will tell Marie that she has 10 days to look over the policy and return it to the company for a full refund if she is dissatisfied. On the 17th, Marie decides to return the policy and mails it to the insurance company. The company must then refund her Marie her premium since it was within the 10 day free-look period.

4. Owner's Rights

The parties to the insurance contract are the insurer, the policyowner, the insured, and the beneficiary. The policyowner and the insured may be the same person or different persons. Regardless, only the policyowner has the ownership rights under the policy, and not the insured or the beneficiary. Among the ownership rights are naming and changing the beneficiary, receiving the policy's living benefits, selecting a benefit payment options, and assigning the policy.

The *policyowner* has the responsibility of paying the policy premiums, and is also the person who must have an insurable interest in the insured at the time of application for the insurance. When the owner and the insured are not the same person, the insurance arrangement is referred to as the third-party ownership.



5. Assignment

The policyowner of a life insurance policy has the right to transfer partial or complete ownership of the policy to another person without the consent of the insurer. However, the owner must notify the insurer in writing of the assignment. Without a written notice, the insurer may not recognize the assignment and would not assume responsibility for its validity. The company's major concern is paying the claim twice. Transfer of the life insurance policy **does not change the insured or amount of coverage**; it only changes who has the policy ownership rights.

The assignment provision specifies the policyowner's right to assign (transfer rights of ownership) the policy. The policyowner must advise the insurer in writing of the assignment. There are 2 types of policy assignment:

- **Absolute Assignment** – involves transferring **all rights** of ownership to another person or entity. This is a permanent and total transfer of all the policy rights. The new policyowner does not need to have an insurable interest in the insured.
- **Collateral Assignment** – involves a transfer of **partial rights** to another person. It is usually done in order to secure a loan or some other transaction. A collateral assignment is a partial and temporary assignment of some of the policy rights. Once the debt or loan is repaid, the assigned rights are returned to the policyowner.

Know This! Absolute assignment is the complete and permanent transfer of ownership rights; collateral assignment is the partial and temporary transfer of rights.

Example:

Aunt Edna was just diagnosed with having the beginning stages of Alzheimer's disease. Aunt Edna makes a decision to assign the ownership rights of her life insurance policy over to her nephew, Robert, permanently. This is called absolute assignment, and gives her nephew all rights to the policy as the owner.

6. Beneficiaries

The *beneficiary* is the person or interest to which the policy proceeds will be paid upon the death of the insured. The beneficiary may be a person, class of persons (sometimes used with children of the insured), the insured's estate, or an institution or other entity such as a foundation, charity, corporation or trustee of a trust. Trusts are commonly used in conjunction with beneficiary designations to manage life insurance proceeds for a minor or for estate tax purposes (although naming a trust as beneficiary does not avoid estate taxes).

The beneficiary does not have to have an insurable interest in the insured. In addition, the policyowner does not have to name a beneficiary in order for the policy to be valid.

Designations

Individuals

The owner of a life insurance policy may name any individual as a beneficiary for the policy proceeds. The owner may name more than one individual, in which case the individual beneficiaries will split the benefit by the percentage specified in the policy.

Benefits designated to a **minor** will either be paid to the minor's guardian, or paid to the trustee of the minor if the trust is the named beneficiary, or paid as directed by a court. The guardian and trustee can be the same person. It is generally accepted not to be a good practice to have life insurance benefits payable to a minor.

Classes

A class of beneficiary is using a designation such as "my children." This term can be vague if the insured has been married more than once, has adopted children, or has children out of wedlock. An example of a class that is less vague is "children of the union of Jane Smith and James Smith." Many insurers encourage the insured to name each child specifically and to state the percentage of benefit they are to receive.

When naming beneficiaries, it is most prudent to be specific by naming each individual and by designating the exact amount to be given for that individual. Two class designations are available for use when an insured chooses to "group" the beneficiaries: **per capita** and **per stirpes**. Per capita, meaning *by the head*, evenly distributes benefits among the living named beneficiaries. Per stirpes, meaning *by the bloodline*, distributes the benefits of a beneficiary who died before the insured to that beneficiary's heirs.

For example, Bryan purchased a $90,000 life insurance policy. He named his three sons, Quentin, Steve, and Patrick, as beneficiaries for equal shares. Quentin has two children of his own, Bob and Lou. Steve and Patrick are both married but have no children. Unfortunately, Quentin predeceases Bryan.

If Bryan selected the **per capita** designation, which means "by the head," with Quentin gone, only 2 named beneficiaries remain. Steve & Patrick each will receive $45,000 ($90,000 divided by 2). Quentin's children would not receive any benefits, since they were not named as beneficiaries.

If Bryan selected the **per stirpes** designation, which means "by the bloodline," Steve and Patrick would receive $30,000 each and Quentin's sons would share his allotment equally at $15,000 each.

Estates

If none of the beneficiaries is alive at the time of the insured's death, or if no beneficiary has been named, the insured's **estate** will automatically receive the proceeds of a life insurance policy. The death benefit of the policy may be included in the insured's taxable estate if this occurs.

Know This! If NO beneficiary is named, policy proceeds go to the insured's estate.

Trusts

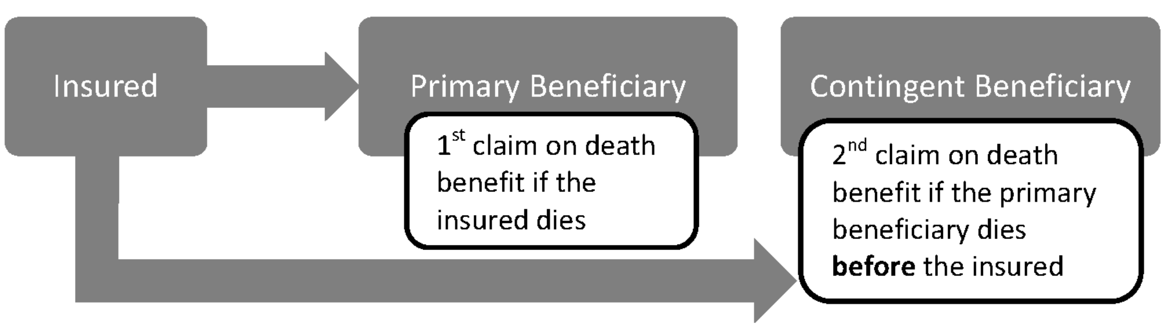
Trusts are commonly established for minors, or to create a scholarship fund. Trusts can be used for estate planning purposes, and when used properly, can keep life insurance death proceeds out of the insured's taxable estate. They are, however, expensive to administer.

Succession - Primary and Contingent

The beneficiary designation can provide for three levels of priority or choice. In the event that the first beneficiary predeceases the insured, the second (or sometimes third) level in the succession of beneficiaries will be entitled to the death proceeds. Each level in the succession of beneficiaries is only eligible for the death benefit if the beneficiary(s) in the level(s) above them has died before the insured.

The **primary beneficiary** has first claim to the policy proceeds following the death of the insured. The policyowner may name more than one primary beneficiary, as well as how the proceeds are to be divided.

The **contingent beneficiary** (also referred to as *secondary* or *tertiary* beneficiary) has second claim in the event that the primary beneficiary dies before the insured. Contingent beneficiaries do not receive anything if the primary beneficiary is still living at the time of the insured's death.



Revocable and Irrevocable

Beneficiary designations may be either revocable or irrevocable. The policyowner, without the consent or knowledge of the beneficiary, may change a **revocable** designation at any time. An **irrevocable** designation may not be changed *without the written consent of the beneficiary*. Irrevocable beneficiaries have a vested interest in the policy; therefore, the policyowner may not exercise certain rights *without the consent of the beneficiary*. In addition to being unable to change the beneficiary designation, the policyowner cannot borrow against the policy's cash value (as this would decrease the policy face value until repaid) or assign the policy to another person *without the beneficiary's agreement*.

Example:

John names his wife Michele as a revocable beneficiary on his policy; therefore, John can remove his wife as the beneficiary if he chooses to do so. He also retains the ability to apply all of his ownership rights as normal. If John had named his wife Michele as an irrevocable beneficiary, John would not be able to remove her as the beneficiary without her permission. Also, if John wants to enforce any of his ownership rights such as taking out a loan or assigning his policy, he needs to get Michele's permission for that too. It is only at the time of Michele's death that John will be able to have complete control over his policy again.

Methods of Changing the Beneficiary

While changing the beneficiary through the **recording or filing method**, the policyowner completes a form with the change and submits it to the insurance company. In the **endorsement method**, the policyowner is required to send the request for change with the contract to the home office of the insurer. The home office will have to approve and make the change.

Common Disaster

If the insured and the primary beneficiary die at approximately the same time from a common accident with no clear evidence as to who died first, a problem may arise in identifying which party is eligible for the death benefit. The **Uniform Simultaneous Death Law** has been adopted by most states to address this problem, and to protect the policyowner's original intent, as well as to protect the contingent beneficiary. This law stipulates that if the insured and the primary beneficiary died in the same accident and there is no sufficient evidence to show who died first, the policy proceeds are to be distributed as if the primary beneficiary died first.

The **Common Disaster Clause**, when added to a policy, provides that if the insured and the primary beneficiary died in a common disaster (even if the beneficiary outlived the insured by a specified number of days), it is presumed that the primary beneficiary died first, so the proceeds will be paid to either the contingent beneficiary or to the insured's estate, if no contingent beneficiary is designated. Most insurers specify a certain period of time, usually 14 to 30 days, in which the primary beneficiary's death must occur in order for the Common Disaster Clause to apply. As long as the beneficiary dies within this specified period of time following the death of the insured, it will still be interpreted that the beneficiary died first. The intent is to fulfill the wishes of the policyowner in regard to payment of proceeds to beneficiaries.

Example:

James had a life insurance policy that included a Common Disaster Clause. James was the insured; his wife Maggie was named the primary beneficiary, and his son Ben was named the contingent beneficiary. James and Maggie got in a terrible car accident, and James died immediately, but Maggie died 4 days later from her injuries from the same accident. Because the policy included the Common Disaster Clause, the death benefit would be paid to Ben, the contingent beneficiary, as if Maggie, the primary beneficiary, had died *before* James, the insured.

Know This! Common disaster clause protects the contingent beneficiary.

7. Premium Payment

The policy stipulates when the premiums are due, how often they are to be paid (monthly, quarterly, semiannually, or annually) and to whom. If the insured dies during a period of time for which the premium has been paid, the insurer must refund any unearned premium along with the policy proceeds. The payment of premium provision also stipulates that premiums must be paid in advance.

Modes

The policy stipulates when the premiums are due, how often they are to be paid (monthly, quarterly, semiannually, or annually) and to whom.

The **premium mode** is the manner or frequency that the policyowner pays the policy premium. Most policies allow for annual, semi-annual, quarterly, or monthly payments. If the insured selects a premium mode other than annual, there will be an additional charge to offset the loss of earnings since the company does not have the entire premium at once, and there are additional administrative costs associated with more frequent billing.

If the insured dies during a period of time for which the premium has been paid, the insurer must **refund any unearned premium** along with the policy proceeds.

Effect of Nonpayment

A policy may be terminated because of **nonpayment of premiums**. This is known as a lapsed policy.

Level or Flexible

Most life insurance policies have a **level premium**, which means that the premium remains the same throughout the duration of the contract. **Flexible premium** policies allow the policyowner to increase or decrease the premium during the policy period.

Expense Charge
Mortality

Mortality is the ratio of the number of deaths in a specific population over a certain amount of time versus the number of living people in that population. **Mortality tables**, used by insurers, indicate the number of individuals within a specified group of individuals (e.g., males, females, smokers, nonsmokers) starting at a certain age, who are expected to be alive at a succeeding age. In other words, these tables help the insurers predict the expectation of life and the probability of death for a given group.

Interest

Because premiums are paid before claims are incurred, insurance companies invest a large portion of the premiums in an effort to earn interest on these funds (invested in bonds, stocks, or mortgages). The interest earnings help insurers reduce the premium rates for policyowners.

Expense

The insurer collects the mortality charge to pay the policy face amount if an insured dies. Since the insurer earns interest on the premiums it collects, the expected interest is subtracted from the mortality cost to arrive at the *net premium*. Then, the insurer adds its expected operating costs (underwriting, overhead and commissions) to calculate the *gross premium* that the insured pays.

Another way to view this formula is net premium plus expenses (loading) equals the gross premium.

- **Mortality - Interest = Net Premium**
- **Net Premium + Expense (loading) = Gross Premium**
- **Mortality – Interest + Expense (loading) = Gross Premium**

Calculation Example:

Assume that

\$500 Mortality cost	\$400 Net premium
- \$100 Interest	+ \$200 Operating cost
\$400 Net Premium therefore,	**\$600 Gross Premium**

Front-end load refers to commissions or sales charges that apply at the time of the initial purchase of an insurance policy or annuity. *Rear-end (or back-end) load* is a sales charge applied at the time of a sale, transfer or withdrawal from an annuity, a life insurance policy, or a security.

8. Grace Period

The grace period is the period of time after the premium due date that the policyowner has to pay the premium before the policy lapses (usually 30 or 31 days, or one month). The purpose of the grace period is to protect the policyholder against an unintentional lapse of the policy. If the insured dies during this period, the death benefit is payable; however, any unpaid premium will be deducted from the death benefit.

Know This! Grace periods protect policyholders from losing insurance coverage if they are late on a premium payment.

9. Misstatement of Age or Gender

Because the age and gender of an insured are important to the premium that will be charged for a life insurance policy, a provision which allows the insurer to adjust the policy at any time due to a misstatement of age or gender is included in the policy. If the applicant has misstated his or her age or gender on the application, in the event of a claim, the insurer is allowed to adjust the benefits to an amount that the premium at the correct age or gender would have purchased. The proceeds calculations should be based on the insurer's rate at the date of policy issue.

Know This! Misstatement of age on the application will result in adjustment of premiums or benefits.

Example:

Mark said he was age 30 on a life insurance policy, but his true age was 40. At the time of Mark's death the insurance company learned of Mark's true age. Therefore, when the insurance paid the death benefit to his beneficiary, the company adjusted the benefit that was due because of the age difference.

10. Reinstatement

The reinstatement provision allows a lapsed policy to be put back in force if reinstated within a specified maximum time limit after the policy has lapsed. Evidence of insurability is usually required. The policyowner is also required to pay all back premiums plus interest, and any outstanding loans with interest. The *advantage* to reinstating a lapsed policy, as opposed to purchasing a new one, is that the policy will be restored to its original status, and retain all the values that were established at the insured's issue age.

Note that a policy that has been surrendered cannot be reinstated.

11. Incontestability

The **incontestability** clause prevents an insurer from denying a claim due to statements in the application after the policy has been in force for **2 years**, even if there has been a material misstatement of facts or concealment of a material fact. During the first 2 years of the policy, an insurer may contest a claim if the insurer feels that inaccurate or misleading information was provided in the application. The incontestability period does not apply in the event of nonpayment of premiums; it also does not usually apply to statements relating to age, sex or identity.

12. Conversion and Change of Plan

Conversion privilege in individual life insurance policies allows the policyowner to elect to have a new policy issued prior to the expiration of an existing policy. Most commonly, a conversion right is exercised when the policyowner converts the term policy to a cash-value permanent policy.

Change of plan provision allows the policyowner to change the policy form, usually at a higher premium rate. Proof of insurability is not required. Some policies permit a change to a lower premium rate plan, in which case the insurer will require proof of insurability.

13. Excess Interest

The term **excess interest** refers to the difference between the interest rate guaranteed by the insurance contract and the actual interest rate paid on the proceeds by the insurance company. This provision is very important to a policyowner since it will directly affect the size of the cash value. Excess interest will vary from year to year depending on the financial market conditions and the returns on the investment.

14. Policy Loans

The **policy loan** option is found only in policies that contain cash value. The policyowner is entitled to borrow an amount equal to the available cash value. Any outstanding loans, and accrued interest, will be deducted from the policy proceeds upon the insured's death. The policy will not lapse with an outstanding policy loan unless the amount of the loan and accrued interest exceeds the available cash value. However, the insurer must provide **30 days' written notice** to the policyowner that the policy is going to lapse. Insurance companies may defer a policy loan request for **up to 6 months**, unless the reason for the loan is to pay the policy premium. Policy loans are not subject to income taxation.

Know This! Policy loans are ONLY available in policies that have cash value (whole life).

Interest rates for policy loans may be either fixed or variable. A **fixed interest rate** is usually a set percentage per year, and will not change during the policy period. A **variable interest rate** will fluctuate based on changes in an underlying interest rate index (such as Published Monthly Average), and must be calculated at regular intervals.

Automatic Premium Loans

The automatic premium loan provision is not required, but is commonly added to contracts with a cash value at no additional charge. This is a special type of **loan that prevents the unintentional lapse of a policy** due to nonpayment of the premium. *For example*, a loan against the policy cash value for the amount of premium due is automatically generated by the insurer when the policyowner has not paid the premium by the end of the premium-paying grace period. It is a loan for which the insurer will charge interest. If the loan and interest are not repaid and the insured dies, then it will be subtracted from the death benefit. While the insurer may defer requests for other loans for a period of up to **6 months**, loan requests for payment of due premiums must be honored immediately.

Usually, the policyowner must specifically elect this provision in writing to make it effective.

15. Exclusions

Exclusions are the types of risks the policy will not cover. Certain exclusions are standard for all policies, while others are attached to the policy as an exclusion rider. The most common exclusions found in life insurance policies are aviation, hazardous occupation, and war and military service.

Aviation — Most life insurance will cover an insured as a fare-paying passenger or a pilot on a regularly scheduled airline, but will exclude coverage for noncommercial pilots, or require an additional premium for the coverage.

Hazardous Occupations or Hobbies — If the insured is engaged in a hazardous occupation or participates in hazardous hobbies (such as skydiving or auto racing), death that results from the hazardous occupation or hobby may be excluded from coverage. The underwriter also has the option of charging a higher premium for insuring these risks.

War or Military Service — Most life insurance policies issued today do not exclude military service. However, there are actually two different types of exclusions that may be used to limit the death benefit if the insured dies as a result of war, or while serving in the military. The **status clause** excludes all causes of death while the insured is on active duty in the military. The **results clause** only excludes the death benefit if the insured is killed as a result of an act of war (declared or undeclared).

16. Suicide Exclusion

The **suicide** provision in life insurance policies protects the insurers from individuals who purchase life insurance with the intention of committing suicide. Insurance policies usually stipulate a period of time during which the death benefit will not be paid if the insured commits suicide. If the insured dies by suicide within **2 years** following the policy effective date (issue date), the insurer's liability is limited to a refund of premium. If the insured dies by suicide after the 2-year period, the policy will pay the death proceeds to the designated beneficiary the same as if the insured had died of natural causes.

LIFE POLICY STANDARD PROVISIONS	CHARACTERISTICS
Ownership	Policyowner has ownership rights
Assignment	Absolute or collateral
Entire Contract	Policy (with riders and amendments) + copy of the application
Right to Examine/Free Look	10 days to return the policy for a full refund of premium
Payment of Premium	Paid in advance

Policy Modifications	Must be in writing and signed by the insurer's executive officer
Grace Period	30/31 days after premium is due to prevent policy lapsing
Reinstatement	Specified number of years to reinstate a lapsed policy with proof of insurability
Incontestability	2 years for the company to contest misstatements of the application
Misstatement of Age or Gender	Death benefit is adjusted to the amount according to the right age or gender at policy issue
Exclusions	Aviation, hazardous occupation/hobbies, and war or military service. Suicide is excluded within a specified time period.

B. Policy Riders

Riders are written modifications attached to a policy that provide benefits not found in the original policy. Riders sometimes require an additional premium, but they also help tailor a policy to the specific needs of the insured, and can be classified according to their primary purpose.

1. Disability Riders

Some riders provide benefits in the event of the insured's disability, while other riders provide for partial payment of the death benefit prior to the insured's death, called accelerated or living benefits riders.

Waiver of Premium

The **waiver of premium** rider waives the premium for the policy if the insured becomes totally disabled. Coverage remains in force until the insured is able to return to work. If the insured is never able to return to work, the premiums will continue to be waived by the insurance company. Most insurers impose a 6-month **waiting period** from the time of disability until the first premium is waived. If the insured is still disabled after this waiting period, the insurer will refund the premium paid by the insured from the start of the disability. This rider usually expires when the insured reaches age 65.

Know This! Waiver of premium rider waives the premium for a total disability after a waiting period.

Waiver of Monthly Deduction

The **waiver of monthly deductions** rider pays all monthly deductions while the insured is disabled, after a 6-month waiting period. This rider only pays the monthly deductions, and not the full premium necessary to accumulate cash values. The length of time this rider will pay monthly deductions will vary based on the age at which the insured becomes disabled. This rider is usually found in Universal Life and Variable Universal Life policies.

Monthly deductions include the actual cost of insurance charges, expense charges, and costs or charges for any benefits added to the policy by rider, endorsement or amendment, and which are specified in the policy to be deducted from the account value.

Payor Benefit (Juvenile Insurance)

The **payor benefit** rider is primarily used with juvenile policies (any life insurance written on the life of a minor); otherwise, it functions like the waiver of premium rider. If the payor (usually a parent or guardian) becomes disabled for at least 6 months or dies, the insurer will waive the premiums until the minor reaches a certain age, such as 21. This rider is also used when the owner and the insured are two different individuals.

2. Riders Covering Additional Insureds

There are riders that allow the policyowner to add additional insureds under the original policy, such as children's term or family term. There is also a nonfamily term rider that allows the policyowner to change the insured under the policy.

Spouse and Other Insured Term

The **other insured rider** provides coverage for one or more family members other than the insured. The rider is usually level term insurance, attached to the base policy covering the insured. This is also known as a family rider. If the rider covers just the spouse of the insured, it can be specified as a **spouse term rider**, and allows the spouse to be added to coverage for a limited period of time and for a specified amount (it usually expires when the spouse reaches age 65).

Children's Term

The **children's term rider** allows children of the insured (natural, adopted or stepchildren) to be added to coverage for a limited period of time for a specified amount. This coverage is also term insurance and usually expires when the minor reaches a certain age (18 or 21). Most riders provide the minor with the option of converting to a permanent policy without evidence of insurability.

Children's term riders provide temporary life insurance coverage on all children of the family for one premium. The premium does not change on the inclusion of additional children; it is based on an average number of children.

Know This! Children's term rider: one premium for ALL children.

3. Riders Affecting the Death Benefit Amount

Some riders affect the amount of the death benefit paid out to the beneficiary, and either increase it through multiple indemnity or refunds of premiums, or decrease it if a portion of the death benefit was paid out to the insured while still living.

Accidental Death

The **accidental death rider** pays some multiple of the face amount if death is the result of an accident as defined in the policy. Death must usually occur within 90 days of such an accident. The benefit is normally two times (**double indemnity**) the face amount. Some policies pay triple the face amount (**triple indemnity**) for accidental death.

Each policy specifies what will be considered *accidental death*. Accidental death does not include death that results from any health problem or disability. In addition, deaths that result from self-inflicted injuries, war, or hazardous hobbies or avocations are usually not covered. They would be covered under the base policy unless specifically excluded.

This rider often expires at the insured's age 65. No additional cash value is accumulated as a result of this rider. The accidental death benefits apply only to the policy's base face amount, and not to any additional benefits that may be purchased from policy dividends.

Accidental Death and Dismemberment

The **accidental death and dismemberment rider (AD&D)** pays the **principal** (face amount) for accidental death, and pays a percentage of that amount, or a **capital sum**, for accidental dismemberment. The accidental death portion is the same as that already discussed with the accidental death rider. The dismemberment portion of the rider will usually determine the amount of the benefit according to the severity of the injury. The full principal amount will usually be paid for loss of two hands, two arms, two legs or the loss of vision in both eyes. A capital amount is usually limited to half the face value and is payable in the event of the loss of one hand, arm, leg, or eye. The dismemberment can be defined differently by insurance companies, from the actual severance of the limb to the loss of use.

Guaranteed Insurability

The **guaranteed insurability** rider allows the insured to purchase additional coverage at specified future dates (usually every 3 years) or events (such as marriage or birth of a child), without evidence of insurability, for an additional premium. When this option is exercised, the insured purchases the additional coverage at his or her attained age. This rider usually expires at the insured's age 40.

The guaranteed insurability rider is not modified or defeated by the existence of other riders.

Example:

Alan's life insurance policy contains both guaranteed insurability and waiver of premium rider. Three years after the policy was issued, Alan was totally and permanently disabled. Not only are Alan's life insurance premiums waived, but at the specified times or events stated in the policy, Alan may purchase additional amount of insurance with the premiums on those increases also waived.

Cost of Living

The **cost of living** rider addresses the inflation factor by automatically increasing the amount of insurance *without evidence of insurability* from the insured. The face value of the policy may be increased by a cost of living factor tied to an inflation index such as the Consumer Price Index (CPI).

Accelerated (Living) Benefit and Long-Term Care Rider

Accelerated death benefits allow the **early payment** of a portion of the death benefit if the insured has any of the following conditions:

- A terminal illness;
- A medical condition that requires an extraordinary medical intervention (such as an organ transplant) for the insured to survive;
- A medical condition that without extensive treatment drastically limits the insured's life time;
- Inability to perform activities of daily living (ADLs);
- Permanent institutionalization or confinement to a long-term care facility; or
- Any other conditions approved by the Department of Insurance.

The maximum benefit is typically a percentage of the face amount of insurance, usually 50%, but it is legal for the insurer to pay up to 100% of the death benefits before the insured dies. There may also be a dollar limit, such as $100,000. The face amount of insurance is reduced after the payments. The accelerated death benefit payout will not necessarily result in a reduction of the premium; however, premium may be waived.

The **Living Needs Rider** provides for the payment of part of the policy death benefit if the insured is diagnosed with a terminal illness that will result in death within 2 years. The purpose of this rider is to provide the insured with the necessary funds to take care of necessary medical and nursing home expenses that incur as a result of the terminal illness. Many insurance companies do not charge for this rider since it is simply an advance payment of the death benefit. The remainder of the policy proceeds are payable to the beneficiary at the time of the insured's death.

Effect on Death Benefit

If an insured withdraws a portion of the face amount by the use of the accelerated benefits rider, the benefit payable at death will be reduced by that amount, plus the amount of earnings lost by the insurance company in interest income.

Payable Death Benefit = Face Amount - Amount withdrawn - Earnings lost by insurer in interest

Example:

The policy's face amount is $100,000; however, due to a terminal illness, the insured had to withdraw $30,000 from the policy 3 years before his death. Since this amount was withdrawn, the insurance company lost $300 worth of interest. Upon the insured's death, the beneficiary received $69,700 in death benefit:

$100,000 (face amount) - $30,000 (accelerated benefit) - $300 (lost interest) = $69,700

Here's a breakdown of the most common riders available in life insurance policies.

TYPE OF RIDER	AVAILABLE RIDERS
Disability Riders	• Waiver of Premium • Waiver of Monthly Deduction • Payor Benefit • Disability Income • Accelerated (Living) Benefit
Riders Covering Additional Insured	• Spouse • Children • Family • Nonfamily
Riders Affecting Death Benefit	• Accelerated Death Benefit • Accidental Death or AD&D • Guaranteed Insurability • Return of Premium • Term Riders

C. Policy Options

Policyowners have decisions to make about how the cash value in the policy should be protected, how the return of excess premium (dividends) should be invested, and how benefit payments will be made. The different choices available to them are categorized as Nonforfeiture Options, Dividend Options, and Settlement Options.

1. Nonforfeiture Options

Because permanent life insurance policies have cash values, certain guarantees are built into the policy that **cannot be forfeited** by the policyowner. These guarantees (known as nonforfeiture values) are required by state law to be included in the policy. A table showing the nonforfeiture values for a minimum period of 20 years must be included in the policy. The policyowner chooses one of the following nonforfeiture options: cash surrender value, reduced paid-up insurance, or extended term.

Know This! Nonforfeiture options are triggered by policy surrender or lapse.

Cash

The policyowner simply surrenders the policy for the current cash value at a time when coverage is no longer needed or affordable. Upon receipt of the cash surrender value, if the cash value exceeds premiums paid, the excess is taxable as ordinary income. Once this option is selected, the insured is no longer covered. A policy that has been surrendered for its cash value cannot be reinstated. A *surrender charge* is a fee charged to the insured when a life policy or annuity is surrendered for its cash value.

Example:

Matilda has a whole life policy which has a face amount of $150,000 and a cash value amount of $10,000. Matilda had paid a total of $7,000 in premium when she decided she no longer wished to keep the policy. Matilda surrendered the policy for the cash value of $10,000. She will need to pay taxes on $3,000.

Reduced Paid-up Insurance

Under this option, the policy cash value is used by the insurer as a single premium to purchase a completely paid-up permanent policy that has a **reduced face amount** from that of the former policy. The new reduced policy builds its own cash value and will remain in force until death or maturity.

Example:

Jason owns a whole life policy with a $300,000 face amount and a cash value of $25,000. Jason is tired of making premium payments, but wants to continue some sort of coverage. Jason chooses to select a reduced paid-up non-forfeiture option. The insurance company takes Jason's $25,000 as a lump sum payment for another whole life policy which will have a reduced face amount of $75,000. Jason will never have to make another premium payment and his $75,000 whole life policy will remain enforce until his death or age 100.

Extended Term

Under the extended-term option, the insurer uses the policy cash value to convert to term insurance for the **same face amount** as the former permanent policy. The duration of the new term coverage lasts for as long a period as the amount of cash value will purchase. If the policyowner has neglected to select one of these nonforfeiture options, the insurer will **automatically** implement the extended-term option in the event of termination of the original policy.

Know This! Extended term is the *automatic* nonforfeiture option: same face amount, shorter term of coverage.

Example:

Sylvia has a whole life policy with a face amount of $150,000, with a cash value of $10,000. Sylvia quit paying her premium and neglected to pick a nonforfeiture option. The insurance company will automatically give Sylvia an extended term option and use the $10,000 of cash value to buy Sylvia a term policy with a face amount of $150,000. The length of the term insurance will depend on how much time a $150,000 policy for $10,000 will get Sylvia.

Example: *(review a sample Table of Guaranteed Values below):*

If the insured chooses to exercise the reduced paid-up option at the end of 15 years, the cash value of $8,100 can be used as a single premium to purchase paid-up insurance of the same type as the original policy. The insured doesn't have to pay any more premiums, while still retaining some amount of life insurance (in this example, $21,750).

The extended-term option indicates the option to use the policy's cash value to purchase in a single premium a term insurance policy in an amount equal to the original policy's face value (in this case, term insurance with $50,000 face amount). The insurance company determines that for this particular insured, $8,100 of cash value is worth 18 years and 8 days of $50,000 of protection.

Table of Guaranteed Values
$50,000 Whole Life Nonforfeiture Table (20 years)

End of Policy Year **Cash or Loan Value** **Reduced Paid-up** **Extended Term**

YearsDays
1$0$0060
2$50$2500122
3$400$1,6002147
4$950$3,600527
5$1,550$5,6507183
6$2,150$7,6009185
7$2,750$9,4001152
8$3,350$11,10012186
9$4,000$12,85013315
10$4,650$14,500156
11$5,300$16,05015333
12$6,000$17,60016249
13$6,700$19,1001795
14$7,400$20,45017255
15$8,100$21,750188
16$8,650$23,05018116
17$9,850$24,44018208
18$10,400$25,55018227
19$11,200$26,75018231
20$12,000$27,85018200

Lasts the longest *Provides the most*

2. Dividends and Dividend Options

Dividends are paid only on participating policies. When the policyowner purchases a policy from a participating insurer, he or she actually pays a "grossed-up" premium. The higher premium is charged as a safety margin in the event the insurer's losses are higher than anticipated. If this extra amount is not needed by the insurer to pay death claims and expenses, or if actual mortality experience improves or interest earned by the company exceeds the assumptions, a dividend will be returned to the policyowner. In other words, dividends are a return of excess premiums, and for that reason they are **not taxable** to the policyowner. Insurance companies **cannot guarantee** dividends.

The first dividend could be paid as early as the first policy anniversary, but must occur **no later than the end of the third policy year**. From then on dividends are usually paid on an annual basis. Policyowners have the option of taking their dividends in one of several different ways.

Know This! Dividends are a return of excess premiums; therefore, not taxable when paid to the policyowner.

Cash

The insurer simply sends the policyowner a check for the amount of the dividend as it is declared, usually annually.

Example:

Joanie owns a participating policy with Mutual Insurance Company. Mutual Insurance Company is preparing to send out dividends of $200 to their policyowners. Joanie chooses a cash payment, so Mutual will send Joanie a check for $200. Joanie will not need to pay taxes on that dividend.

Reduction of Premium

The insurer uses the dividend to reduce the next year's premium. *For example*, if the policyowner usually pays an annual premium of $1,000 and the insurer declares a $100 dividend, the policyowner would only pay a $900 premium that year.

Accumulation at Interest

The insurance company keeps the dividend in an account where it accumulates interest. The policyowner is allowed to withdraw the dividends at any time. The amount of interest is specified in the policy and compounds annually. Although the dividends themselves are not taxable, the **interest on the dividends is taxable** to the policyowner when credited to the policy, whether or not the policyowner receives the interest.

Example:

For example, a dividend is being paid out to you in the sum of $200, but you have decided to choose the "accumulate at interest" option. Therefore, the insurance company will hold onto your $200 and let it earn interest. You will be taxed on the interest it earns. You may withdraw on your dividend account at any time.

Paid-up Additions

The dividends are used to purchase a single premium policy in addition to the face amount of the permanent policy. No new separate policies are issued; however, each of these small single premium payments will **increase the death benefit** of the original policy by whatever amount the dividend will buy. In addition, each of these paid-up policies will accumulate cash value and pay dividends. The amount of additional coverage that can be purchased with the dividend is based on the insured's attained age at the time the dividend is declared.

If the policyowner did not chose the dividend option, the insurer will **automatically** use paid-up additions to increase the death benefit of the original policy by the amount the dividend will buy.

Paid-up Insurance

Usually, the insurer first accumulates the dividends at interest and then uses the accumulated dividends, plus interest, and the policy cash value to pay the policy up early. In other words, if the insured had a continuous premium whole life policy (in which premiums are paid to age 100), using the paid-up option the policyowner is able to pay up the policy early.

One-year Term

The insurance company uses the dividend to purchase additional insurance in the form of **one-year term insurance** that increases the overall policy death benefit. The policyowner's choice is to either use the dividend as a single premium on as much one-year term insurance as it will buy, or to purchase term insurance equal to the policy's cash value for as long as it will last. If the insured dies during the one-year term, the beneficiary receives both the death benefit of the original policy and the death benefit of the one-year term insurance.

3. Settlement Options (Life & Annuities)

Settlement options are the methods used to pay the death benefits to a beneficiary upon the insured's death, or to pay the endowment benefit if the insured lives to the endowment date. The policyowner may select a settlement option at the time of policy application, and may also change that option at any time during the life of the insured. Once selected by the policyowner, the settlement option cannot be changed by the beneficiary. If the policyowner does not select a settlement option, the beneficiary will be allowed to choose one at the time of the insured's death.

Know This! Settlement options are triggered by the insured’s death or age 100.

Cash (Lump-Sum) Payment

Upon the death of the insured, or at the point of endowment, the contract is designed to pay the proceeds in cash, called a **lump sum**, unless the recipient chooses a different mode of settlement. If no selection is made, the proceeds are **automatically** paid to the beneficiary in a single cash payment. As a rule, payments of the principal face amount after the insured's death are not taxable as income.

Example:

Beverly had a $200,000 life insurance policy, in which she named her son Richard as the beneficiary. At the time of application, Beverly selected a lump sum settlement payment for the policy proceeds. When Beverly died ten years later, Richard received the full death benefit of $200,000 in cash. He did not need to pay any taxes on the settlement.

Life Income

The **life-income option**, also known as **straight life**, provides the recipient with an income that he or she cannot outlive. Installment payments are guaranteed for as long as the recipient lives, irrespective of the date of death. The amount of each installment paid is based on the **recipient's** life expectancy and the amount of principal. If the beneficiary lives for a very long time, payments may exceed the total principal. However, if the beneficiary dies shortly after he or she begins receiving installments, the balance of the principal is forfeited to the insurer. Because there is a chance that the beneficiary may not live long enough to receive all the life insurance proceeds, insurers make options available which provide at least a partial guarantee that some or all of the proceeds will be paid out. With each of the guarantees, the size of the installment is decreased.

Know This! Under life-income (straight life) settlement option, the recipient cannot outlive the benefit payments.

Example:

Jim is the beneficiary of his wife's $100,000 life insurance policy. Because Jim's wife did not choose a settlement option on the policy before she died, Jim is free to choose the option he wants. He decides to choose the life income settlement option to make sure he cannot outlive that income. Since Jim is in his 70s, and his life expectancy is not very high, the policy will pay him a higher monthly installment than it would if he were in his 50s. It is possible that Jim could receive a total amount more than $100,000 if he lives a very long time. It is also possible that Jim could receive much less than $100,000 if he dies sooner.

Under **life income with period certain option**, the recipient is provided with the "best of both worlds" in terms of a lifetime income and a guaranteed installment period. Not only are the payments guaranteed for the lifetime of the recipient, but there is also a specified period that is guaranteed. *For example*, a life income with 10 years certain option would provide the recipient with an income for as long as he or she lives. If the recipient dies shortly after starting to receive the payments, the payments will be continued to a beneficiary for the remainder of the 10-year period. As already stated, the installments for the life income with period certain option will be smaller than the life income only option.

The **life income joint and survivor** option guarantees an income for two or more recipients for as long as they live. Most contracts provide that the surviving recipient will receive a reduced payment after the first recipient dies.

Most commonly, the reduced option is written as “joint and ½ survivor” or "joint and 2/3 survivor,” in which the surviving beneficiary receives ½ or 2/3 of what was received when both beneficiaries were alive. This option is commonly selected by the policyowner who wants to protect two beneficiaries, such as elderly parents. Unless a period certain option is also chosen, as with the life income option, there is no guarantee that all the life insurance proceeds will be paid out if all beneficiaries die shortly after the installments begin. This option guarantees, however, an income for the lives of all beneficiaries.

Example:

David is concerned about his elderly parents in the event of his death, so he chooses a Joint and Survivor settlement option at the time he takes out a policy on himself and names his parents as the beneficiaries. When David dies, his elderly parents will both receive a monthly installment from the insurance policy (so long as they too are alive) until the day each parent dies. It is possible for the total amount of payments to exceed the original death benefit if the parents live a long time. It is also possible for the total amount of payments to be much less than the original death benefit if the parents live only a limited amount of time.

Interest Only

With the **interest-only option**, the insurance company retains the policy proceeds and pays interest on the proceeds to the recipient (beneficiary) at regular intervals (monthly, quarterly, semiannually, or annually). The insurer usually guarantees a certain rate of interest and will often pay interest in excess of the guaranteed rate. The interest option is considered to be a temporary option since the proceeds are retained by the insurer until some later point when the proceeds are paid out in a lump sum or paid under one of the other settlement options. When the beneficiary is allowed to select a settlement option, the interest option is sometimes used as a temporary option if the beneficiary needs some time to decide which settlement option to select. *For example,* the policyowner may specify that interest only will be paid annually to the surviving spouse, with the principal to be paid to their children when they reach a certain age or at the death of the surviving spouse.

Example:

After Beverly's death, Richard chooses the interest only settlement option. The insurance company will retain the $200,000 death benefit and sends Richard the interest that the benefit acquires. Richard likes the flexibility this option provides to choose any of the other options at a later date. After some time has passed Richard decides to take a lump sum payment and the insurance company sends Richard a payment for the $200,000.

Fixed-Period Installments

Under the **fixed-period installments option** (also called **period certain**), a specified period of years is selected, and equal installments are paid to the recipient. The payments will continue for the specified period even if the recipient dies before the end of that period. In the event of the recipient's death, the payments would continue to a beneficiary. The size of each installment is determined by the amount of principal, guaranteed interest, and the length of period selected. The longer the period selected, the smaller each installment will be. This option does not guarantee income for the life of the beneficiary; however, it does guarantee that the entire principal will be distributed.

Example:

When Barbara's husband died he left her $300,000 from an insurance policy. Barbara was concerned about replacing her husband's monthly income for the next 10 years, so she chose a fixed-period settlement option. This option provided her monthly installments for the next 10 years that consisted of the principal plus interest divided over 120 months.

Fixed-Amount Installments

The **fixed-amount installments option** pays a fixed, specified amount in installments until the proceeds (principal and interest) are exhausted. The recipient selects a specified fixed dollar amount to be paid until the proceeds are gone. If the beneficiary dies before the proceeds are exhausted, installments will continue to be paid to a contingent beneficiary until all proceeds have been paid out. With this option, the size of each installment will determine how long benefits will be received. The larger the installment, the shorter the income period will be. As with the fixed-period option, this option does not guarantee payments for the life of the beneficiary, but does guarantee that all proceeds will be paid out.

OPTION TYPE	AVAILABLE OPTIONS
Nonforfeiture Options	• Reduced Paid-up • Extended Term *(automatic)* • Cash
Dividend Options	• Cash • Reduction of Premium • Accumulation at Interest • Paid-up Additions *(automatic)* • Paid-up Insurance • One-year Term
Settlement Options	• Cash *(automatic)* • Life Income • Interest Only • Fixed Period • Fixed Amount

D. Education Highlights

Take another look at the topics discussed in this chapter. Try to answer the following questions on your own and then verify the correct answers:

1. *What constitutes the entire contract?*
   The policy and a copy of the application, along with any riders or amendments, constitutes the entire contract.
2. *What does an absolute assignment do to a life insurance policy?*
   An absolute assignment permanently transfers all rights of ownership to another person or entity.
3. *Under what circumstances does the contingent beneficiary receive the death benefit?*
   The secondary beneficiary (who is also referred to as contingent beneficiary) has second claim to the death benefit in the event that the primary beneficiary dies before the insured.
4. *Under what circumstances can a revocable beneficiary be changed?*
   The policyowner, without the consent or knowledge of the beneficiary, may change a revocable designation at any time.
5. *What is the common disaster clause? Who does it protect?*
   The Common Disaster Clause protects the rights of the contingent beneficiary in cases when the insured and the primary beneficiary die at approximately the same time from a common accident with no clear evidence as to who died first.
6. *What are the 3 factors that determine the premium for a particular policy?*
   Mortality, interest and expense determine a policy's premium.
7. *Can a policy be reinstated after the grace period expires? If so, how?*
   The reinstatement provision allows the policyowner an opportunity to put a lapsed policy back in force, subject to the policyowner proving continued insurability.

8. *If a claim is made, what happens if the insured has misstated his or her age?*
   If the applicant has misstated his or her age on the application, the insurer, in the event of a claim, is allowed under the Misstatement of Age provision to adjust the benefits to an amount that the premium at the correct age would have otherwise purchased.
9. *What is the purpose of the Automatic Premium Loan provision?*
   It prevents the unintentional lapse of a policy due to nonpayment of the premium.
10. *How does the guaranteed insurability rider work?*
    The guaranteed insurability rider allows the insured to purchase additional coverage at specified future dates or events, such as marriage, or birth of a newborn child, without evidence of insurability.
11. *What does the term "double indemnity" mean and what rider is it used with?*
    Double indemnity means the insurer will pay the benefit twice the face amount. It is used with the Accidental Death rider.
12. *What are the 3 nonforfeiture values a policyowner has to choose from?*
    Cash surrender value, reduced paid-up insurance or extended term option
13. *What happens if a policyowner takes the reduced paid-up option?*
    The policy's cash value is used as a single premium to secure a completely paid-up policy for a reduced amount.
14. *Which nonforfeiture option is automatically selected if the policyowner does not choose one?*
    If the policyowner has neglected to select one of these nonforfeiture options, the insurer will automatically implement the extended term option in the event of termination of the original policy.
15. *What are policy dividends?*
    Dividends are a return of excess premiums, and for that reason they are not taxable to the policyowner.
16. *Under the cash option, how does a policyowner receive the dividend?*
    The insurer sends the policyowner a check (usually annually).
17. *With the reduction of premium option, how must a policyowner use the dividend?*
    The dividend is applied to next year's premium.
18. *With the accumulation at interest option, what happens to the dividend?*
    The insurance company keeps the dividend, and it accumulates interest.
19. *Which dividend option increases the death benefit?*
    Paid-up additions increase the death benefit of the original policy by whatever amount the dividend will buy.
20. *Explain how the number of installments might determine the amount of the installments in settlement options with fixed period installments.*
    The size of each installment is determined by the amount of principal, guaranteed interest, and the length of period selected. The longer the period selected, the smaller each installment will be.
21. *What could potentially be a downfall of selecting the life income option?*
    The beneficiary could die shortly after receiving payments. If this happens, the balance of the principal is forfeited.
22. *Assuming a similar initial premium, which settlement option pays more, a life and 20-year certain or a life only?*
    The installments for the life income with period certain option will be smaller than the life income only option.
23. *How long will a life income with 10-year certain settlement option pay?*
    It would provide the recipient with an income for as long as he or she lives. If the recipient dies shortly after starting to receive the payments, the payments will be continued to a beneficiary for the remainder of the 10-year period.
24. *When do benefit payments stop under a Joint and Survivor settlement option?*
    The Life Income Joint and Survivor option guarantees an income for two or more recipients for as long as they live.
25. *With regards to the Interest Only Option, what are the roles of the beneficiary and the insurance company?*
    The beneficiary receives payments of the interest on the policy proceeds. The insurance company retains control of the policy proceeds until the proceeds are paid.