Life Insurance Policies

Now that you have studied general life insurance concepts, you are ready to learn about the different types of life insurance policies. By the end of this chapter, you will know the major types of life insurance policies, their characteristics and functions, and who would be best served by each type. As you are reading about a policy, ask yourself what makes this type of policy different from the others. The process of determining the suitability of certain policies for different life situations can make it easier for you to distinguish between the many types of policies covered in this chapter.

TERMS TO KNOW

Accumulate — build up
Attained age — the insured's age at the time the policy is renewed or replaced
Cash value — a policy's savings element or living benefit
Deferred — withheld or postponed until a specified time or event in the future
Endow — to have the cash value of a whole life policy reach the contractual face amount
Face amount — the amount of benefit stated in the life insurance policy
Fixed life insurance products — contracts that offer guaranteed minimum or fixed benefits
Lapse — policy termination due to nonpayment of premium
Level premium — the premium that does not change throughout the life of a policy
Nonforfeiture values — benefits in a life insurance policy that the policyowner cannot lose even if the policy is surrendered or lapses
Policy maturity — in life policies, the time when the face value is paid out
Securities — financial instruments that may trade for value (for example, stocks, bonds, options)
Variable life insurance products — contracts in which the cash values accumulate based upon a specific portfolio of stocks without guarantees of performance

A. Term Life Insurance

There are many types of life insurance products available for consumers. Although all life insurance products offer death protection, each type also includes its own unique features and benefits and is designed to serve different insureds' needs.

Regarding the length of coverage, all life insurance policies fall into 2 categories: temporary and permanent protection.

Term insurance is *temporary* protection because it only provides coverage for a specific period of time. It is also known as pure life insurance. Term policies provide for the greatest amount of coverage for the lowest premium as compared to any other form of protection. There is usually a maximum age above which coverage will not be offered or at which coverage cannot be renewed.

Term insurance provides what is known as **pure death protection**:

- If the insured dies during this term, the policy pays the death benefit to the beneficiary;
- If the policy is canceled or expires prior to the insured's death, nothing is payable at the end of the term; and
- There is no cash value or other living benefits.

Know This! Term insurance provides the greatest amount of coverage for the lowest premium.

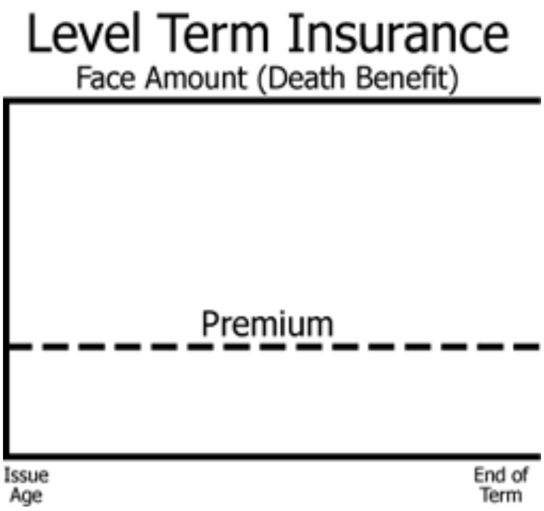
Know This! Term insurance has no cash value.

There are three basic types of term coverage available, based on **how the face amount (death benefit) changes** during the policy term:

- Level;
- Increasing; and
- Decreasing.

Regardless of the type of term insurance purchased, the premium is level throughout the term of the policy; only the amount of the death benefit may fluctuate, depending on the type of term insurance. Upon selling, renewing, or converting the term policy, the premium is figured at attained age (the insured's age at the time of transaction).

1. Level Term



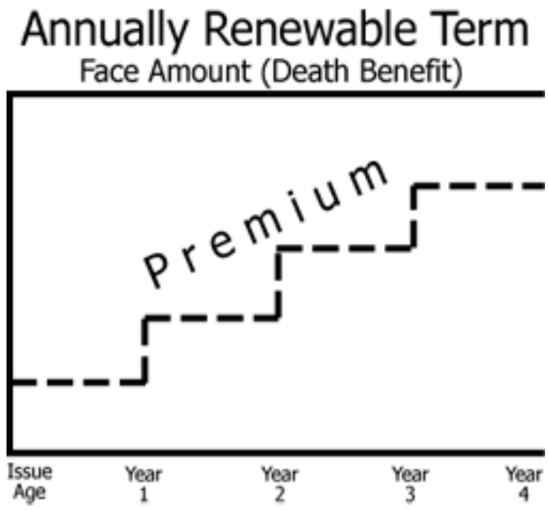
Level term insurance is the most common type of temporary protection purchased. The word *level* refers to the death benefit that does not change throughout the life of the policy.

Know This! "Level" in level term insurance refers to the death benefit, which does NOT change.

Level Premium Term

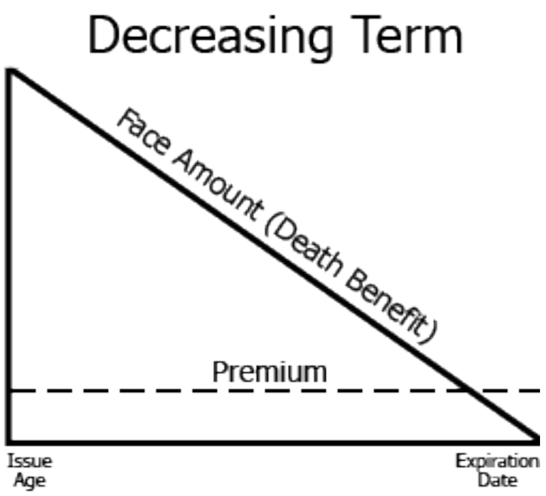
Level premium term, as the name implies, provides a level death benefit and a level premium during the policy term. *For example,* a $100,000 10-year level term policy will provide a $100,000 death benefit if the insured dies any time during the 10-year period. The premium will remain level during the entire 10-year period. If the policy is renewed at the end of the 10-year period, the premium will be based on the insured's attained age at the time of renewal.

Annually Renewable Term



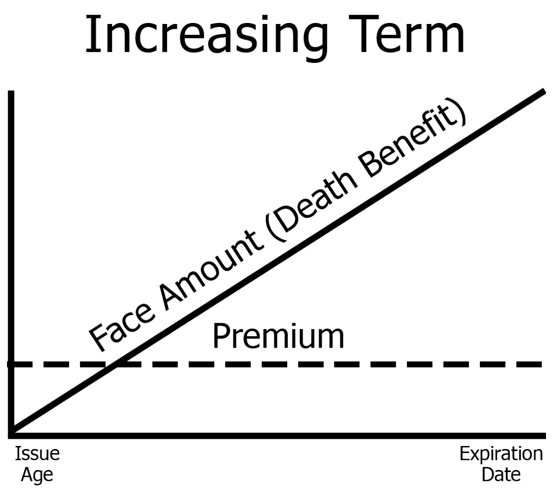
Annually renewable term (ART) is the purest form of term insurance. The death benefit remains level (in that sense, it's a level term policy), and the policy may be guaranteed to be renewable each year without proof of insurability, but the premium increases annually according to the attained age, as the probability of death increases.

2. Decreasing Term



Decreasing term policies feature a level premium and a death benefit that decreases each year over the duration of the policy term. Decreasing term is primarily used when the amount of needed protection is time sensitive, or decreases over time. Decreasing term coverage is commonly purchased to insure the payment of a **mortgage or other debts** if the insured dies prematurely. The amount of coverage thereby decreases as the outstanding loan balance decreases each year. A decreasing term policy is usually convertible; however, it is usually not renewable since the death benefit is $0 at the end of the policy term.

3. Increasing Term



Increasing term features level premiums and a death benefit that increases each year over the duration of the policy term. The amount of the increase in the death benefit is usually expressed as a specific amount or a percentage of the original amount. Increasing term is often used by insurance companies to fund certain riders that provide a *refund of premiums* or a gradual increase in total coverage, such as the cost of living or return of premium riders.

This type of policy would be ideal to handle inflation and the increasing cost of living. It is also often added to another policy as a rider, such as with return of premium policies.

4. Return of Premium

Return of premium (ROP) life insurance is an *increasing term* insurance policy that pays an additional death benefit to the beneficiary equal to the amount of the premiums paid. The return of premium is paid if the death occurs within a specified period of time or if the insured outlives the policy term.

ROP policies are structured to consider the low risk factor of a term policy but at a significant increase in premium cost, sometimes as much as 25% to 50% more. Traditional term policies offer a low-cost, simple-death benefit for a specified term but have no investment component or cash value. When the term is over, the policy expires, and the insured is without coverage. An ROP policy offers the pure protection of a term policy, but if the insured remains healthy and is still alive once the term limit expires, the insurance company guarantees a return of premium. However, since the amount returned equals the amount paid in, the returned premiums are not taxable.

Example:

A healthy 30-year-old insured pays $380 annually for a $250,000, 30-year term policy. At the end of the 30 years, the insured will have paid a total of $11,400 in premiums which will be returned if the insured is still alive. The insurance company has determined that $250 per year, or $7,500 over 30 years, will cover the actual cost of protection. The excess funds, which the insurer invests, provide the cash for the returned premiums.

5. Special Features: Renewable and Convertible

Most term insurance policies are renewable, convertible, or renewable and convertible (R&C).

The **renewable** provision allows the policyowner the right to renew the coverage at the expiration date *without evidence of insurability*. The premium for the new term policy will be based on the insured's current age. *For example*, a 10-year term policy that is renewable can be renewed at the end of the 10-year period for a subsequent 10-year period without evidence of insurability. However, the insured will have to pay the premium that is based on their attained age. If an individual purchases a 10-year term policy at age 35, they will pay a premium based on the age of 45 upon renewing the policy.

The **convertible** provision provides the policyowner with the right to convert the policy to a permanent insurance policy *without evidence of insurability*. The premium will be based on the insured's attained age at the time of conversion.

B. Whole Life Insurance

Permanent life insurance is a general term used to refer to various forms of life insurance policies that build cash value and remain in effect for the entire life of the insured (or until age 100) as long as the premium is paid. The most common type of permanent insurance is whole life.

Whole life insurance provides lifetime protection, and includes a savings element (or cash value). Whole life policies endow at the insured's **age 100**, which means the cash value created by the accumulation of premium is scheduled to equal the face amount of the policy at age 100. The policy premium is calculated assuming that the policyowner will be paying the premium until that age. Premiums for whole life policies usually are higher than for term insurance.

The following are key characteristics of whole life insurance.

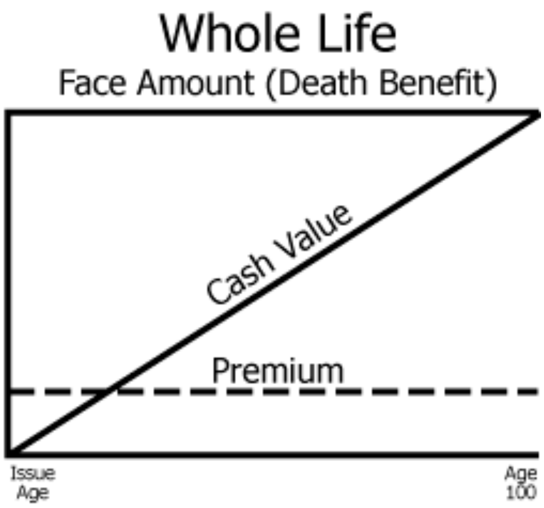
- **Level premium** — the premium for whole life policies is based on the issue age; therefore, it remains the same throughout the life of the policy.
- **Death benefit** — the death benefit is guaranteed and also remains level for life.
- **Cash value** — the cash value, created by the accumulation of premium, is scheduled to equal the face amount of the policy when the insured reaches age 100 (the policy maturity date), and is paid out to the policyowner. (Remember: the insured and the policyowner do not have to be the same person.) Cash values are credited to the policy on a regular basis and have a guaranteed interest rate.
- **Living benefits** — the policyowner can borrow against the cash value while the policy is in effect, or can receive the cash value when the policy is surrendered. The cash value, also called nonforfeiture value, does not usually

accumulate until the third policy year and it grows tax deferred.

Know This! Whole life insurance provides lifetime (permanent) protection and accumulates cash value.

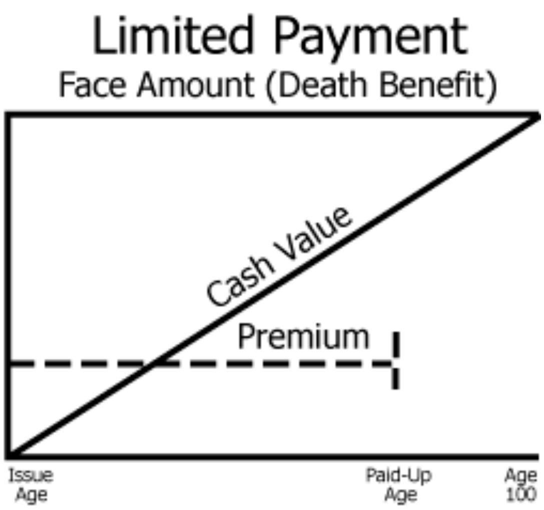
The three basic forms of whole life insurance are straight whole life, limited-pay whole life and single premium whole life; however, other forms and combination plans may also be available.

1. Continuous Premium (Straight Life)



Straight life (also referred to as *ordinary life* or *continuous premium whole life*) is the basic whole life policy (illustrated above). The policyowner pays the premium from the time the policy is issued until the insured's death or age 100 (whichever occurs first). Of the common whole life policies, straight life will have the lowest annual premium.

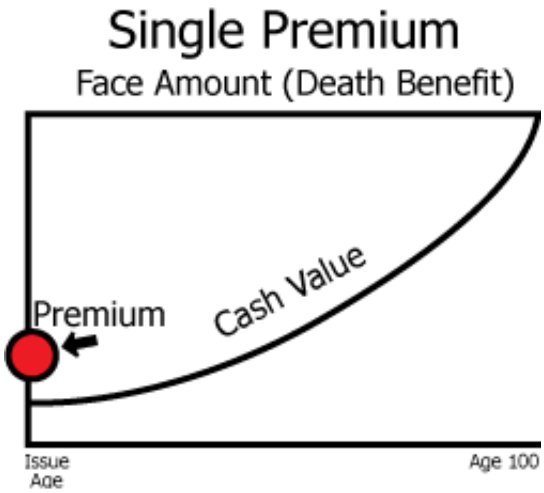
2. Limited Payment



Unlike straight life, limited-pay whole life is designed so that the premiums for coverage will be completely paid-up well before age 100. Some of the more common versions of limited-pay life are 20-pay life whereby coverage is completely paid for in 20 years, and life paid-up at 65 (LP-65) whereby the coverage is completely paid up for by the insured's age 65. All other factors being equal, this type of policy has a shorter premium-paying period than straight life insurance, so the annual premium will be higher. Cash value builds up faster for the limited-pay policies.

Limited-pay policies are well suited for those insureds who do not want to be paying premiums beyond a certain point in time. *For example*, an individual may need some protection after retirement, but does not want to be paying premiums at that time. A limited-pay (paid-up at 65) policy purchased during the person's working years will accomplish that objective.

3. Single Premium



Single premium whole life (SPWL) is designed to provide a level death benefit to the insured's age 100 for a one-time, lump-sum payment. The policy is completely paid-up after one premium and generates immediate cash.

	TERM LIFE	**WHOLE LIFE**
Type of protection	Temporary	Permanent until age 100
Premium	Level	Level
Death benefit	• Level • Increasing • Decreasing	Level
Living benefits	Not available	• Cash values • Policy loans • Nonforfeiture values

C. Flexible Premium Policies

There are several other types of whole life policies. While they all have the same key characteristics, they may also offer unique features based on how the policyowner pays the premium or how the premium is invested. Flexible premium policies allow the policyowner to pay more or less than the planned premium.

1. Adjustable Life

Adjustable life was developed in an effort to provide the policyowner with the best of both worlds (term and permanent coverage). An adjustable life policy can assume the form of either term insurance or permanent insurance. The insured typically determines how much coverage is needed and the affordable amount of premium. The insurer will then determine the appropriate type of insurance to meet the insured's needs. As the insured's needs change, the policyowner can make adjustments in his or her policy. Typically, the policyowner has the following options:

- Increase or decrease the premium or the premium-paying period;
- Increase or decrease the face amount; or
- Change the period of protection.

The policyowner also has the option of **converting** from term to whole life or vice versa. However, increases in the death benefit or changing to a lower premium type of policy will usually require proof of insurability. In the case of converting from a whole life policy to a term policy, the insurer may adjust the death benefit. The policyowner may also pay additional premiums above and beyond what is required under the permanent form in order to accumulate greater cash value or to shorten the premium-paying period.

Although adjustable life policies contain most of the common features of other whole life policies, the **cash value** of an adjustable life policy only develops when the premiums paid are more than the cost of the policy.

2. Universal Life

Universal life insurance is also known by the generic name of *flexible premium adjustable life*. That implies that the policyowner has the flexibility to increase the amount of premium paid into the policy and to later decrease it again. In fact, the policyowner may even skip paying a premium and the policy will not lapse as long as there is sufficient cash value at the time to cover the monthly deductions for cost of insurance. If the cash value is too small, the policy will expire.

Since the premium can be adjusted, the insurance companies may give the policyowner a choice to pay either of the two types of premiums:

- The **minimum premium** is the amount needed to keep the policy in force for the current year. Paying the minimum premium will make the policy perform as an annually renewable term product.
- The **target premium** is a recommended amount that should be paid on a policy in order to cover the cost of insurance protection and to keep the policy in force throughout its lifetime.

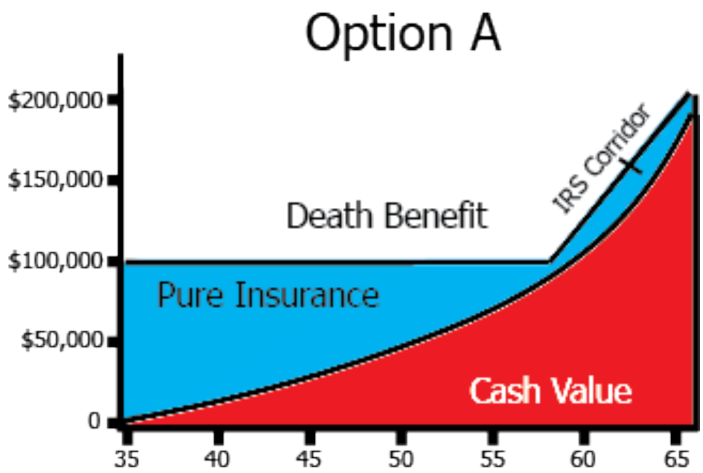
Know This! If an insured skips a premium payment on a universal life policy, the missing premium may be deducted from the policy's cash value. The policy will NOT lapse.

As well as being a flexible premium policy, universal life is also an interest-sensitive policy. Although the insurer guarantees a **contract interest rate** (usually 3 to 6%), there is also potential for the policyowner to get a **current interest rate**, which is not guaranteed in the contract but may be higher because of current market conditions.

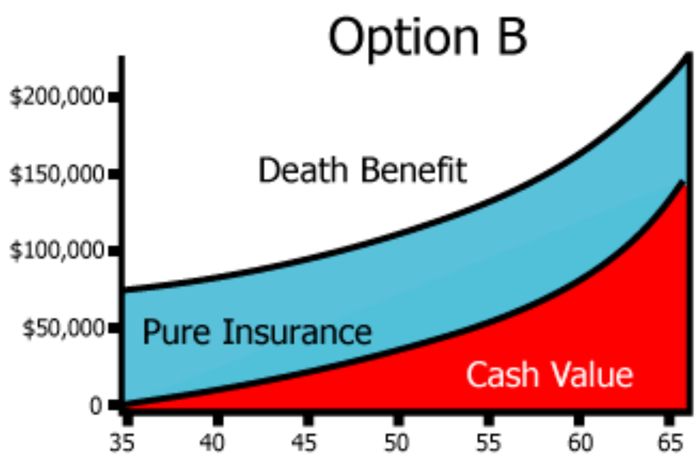
A universal life policy has two components: an **insurance component** and a

cash account. The insurance component of a universal life policy is always **annually renewable term insurance**.

Universal life offers one of two death benefit options to the policyowner. **Option A** is the *level death benefit* option, and **Option B** is the *increasing death benefit* option.



Under **Option A (Level Death Benefit option)**, the death benefit remains level while the cash value gradually increases, thereby lowering the *pure insurance* with the insurer in the later years. Notice that the pure insurance is actually decreasing as time passes, lowering the expenses, and allowing for greater cash value in the older years. The reason that the illustration shows an increase in the death benefit at a later point in time is so that the policy will comply with the "statutory definition of life insurance" that was established by the IRS and applies to all life insurance contracts issued after December 31, 1984. According to this definition, there must be a specified "corridor" or gap maintained between the cash value and the death benefit in a life insurance policy. The percentages that apply to the corridor are established in a table published by the IRS and vary as to the age of the insured and the amount of coverage. If this corridor is not maintained, the policy is no longer defined as life insurance for tax purposes and consequently loses most of the tax advantages that have been associated with life insurance.



Under **Option B (Increasing Death Benefit option)**, the death benefit includes the annual increase in cash value so that the death benefit gradually increases each year by the amount that the cash value increases. At any point in time, the total death benefit will always be equal to the face amount of the policy plus the current amount of cash value. Since the *pure insurance* with the insurer remains level for life, the expenses of this option are much greater than those for Option A, thereby causing the cash value to be lower in the older years (all else being equal).

3. Indexed Life

The main feature of **indexed whole life** (or equity index whole life) insurance is that the cash value is dependent upon the performance of the equity index, such as S&P 500 although there is a guaranteed minimum interest rate. The policy's face amount increases annually to keep pace with inflation (as the Consumer Price Index increases) without requiring evidence of insurability. Indexed whole life policies are classified depending on whether the policyowner or the insurer assumes the inflation risk. If the policyowner assumes the risk, the policy premiums increase with the increases in the face amount. If the insurer assumes the risk, the premium remains level.

D. Variable Life

Variable life insurance (sometimes referred to as *variable whole life insurance*) is a level, fixed premium, investment-based product. Like traditional forms of life insurance, these policies have fixed premiums and a guaranteed minimum death benefit. The cash value of the policy, however, is not guaranteed and fluctuates with the performance of the portfolio in which the premiums have been invested by the insurer. The policyowner bears the investment risk in variable contracts.

Know This! In variable contracts, the policyowner bears the investment risk (assets in a separate account).

Because the insurance company is not sustaining the investment risk of the contract, the underlying assets of the contract cannot be kept in the insurance company’s general account. These assets must be held in a **separate account**, which invests in stocks, bonds, and other securities investment options. Any domestic insurer issuing variable contracts must establish one or more separate accounts. Each separate account must maintain assets with a value at least equal to the reserves and other contract liabilities. Assets in the separate account cannot be commingled with assets in the general account.

1. Variable Universal Life

Variable universal life is a combination of universal life and variable life. Like universal life, it provides the policyowner with flexible premiums and an adjustable death benefit. Like variable life, the policyowner rather than the insurer, decides where the net premiums (cash value) will be invested. Also, like variable life, the cash values are not guaranteed, and the death benefit is not fixed. The cash value and/or death benefit may increase or decrease over the life of the policy depending on the investment performance of the underlying sub-account. The death benefit, however, generally cannot decrease below the initial face amount of the policy. A producer must also be **licensed for both securities and life insurance** in order to sell variable universal life.

2. Regulation of Variable Products (SEC, FINRA and Pennsylvania)

Variable life insurance products are **dually regulated** by the State and Federal Government. Due to the element of investment risk, the federal government has declared that variable contracts are **securities**, and are thus regulated by the Securities and Exchange Commission (SEC), and the Financial Industry Regulatory Authority (FINRA). Variable life insurance is also regulated by the Insurance Department as an insurance product.

Agents selling variable life insurance products must:

- Be registered with FINRA;
- Be licensed by the state to sell life insurance; and
- Have received a securities license.

If specific regulations of the place of domicile of **foreign or alien insurers** prevent them from being compliant with any of the Pennsylvania regulations, the Pennsylvania Department of Insurance must be notified in writing. The Department will then determine the degree of compliance and acceptability for sure foreign or alien insurer.

The Commissioner has the authority to conduct frequent **reviews** to assess the insurer's compliance with the investment requirements for variable annuities. Insurers who are in violation of those requirements cannot claim value to any asset that was improperly invested.

POLICIES COMPARED

Adjustable Life

- ***Key Features:*** Can be Term or Whole Life; can convert from one to the other
- ***Premium:*** Can be increased or decreased by policyowners
- ***Face Amount:*** Flexible; set by policyowner with proof of insurability
- ***Cash Value:*** Fixed rate of return; general account
- ***Policy Loans:*** Can borrow cash value

Universal Life

- ***Key Features:*** Permanent insurance with renewable term protection component
- ***Premium:*** Flexible; minimum or target
- ***Face Amount:*** Flexible; set by policyowner with proof of insurability
- ***Cash Value:*** Guaranteed at a minimum level; general account
- ***Policy Loans:*** Can borrow cash value

Variable Life

- ***Key Features:*** Permanent insurance
- ***Premium:*** Fixed (if Whole Life); flexible (if Universal Life)
- ***Face Amount:*** Can increase or decrease to a stated minimum
- ***Cash Value:*** Not guaranteed; separate account
- ***Policy Loans:*** Can borrow cash value

E. Specialized Policies

1. Joint Life (First-to-die)

Joint life is a single policy that is designed to insure two or more lives. Joint life policies can be in the form of term insurance or permanent insurance. The premium for joint life would be less than for the same type and amount of coverage on the same individuals. It is more commonly found as *joint whole life*, which functions similarly to an individual whole life policy with two major exceptions:

- The premium is based on a **joint average age** that is between the ages of the insureds; and
- The death benefit is paid upon the **first death only**.

A premium based on joint age is less than the sum of 2 premiums based on individual age, so it is common to find joint life policies issued on spouses. This is particularly so if the need for insurance is such that it does not extend beyond the first death. Joint life policies are used when there is a need for two or more persons to be protected; however, the need for the insurance is no longer present after the first of the insureds dies.

For example, a married couple purchasing a house may use a Joint Life policy for mortgage protection if both spouses work and earn close to the same amount of income. If one spouse dies, the insurance pays the mortgage for the surviving spouse.

Joint Life is also used to insure the lives of business partners in the funding of a buy-sell agreement and other business life needs. A buy-sell is a business continuation agreement that determines what will be done with the business in the event that an owner dies or becomes disabled.

Know This! Premium rates on a joint life policy are determined by averaging the ages of both insureds.

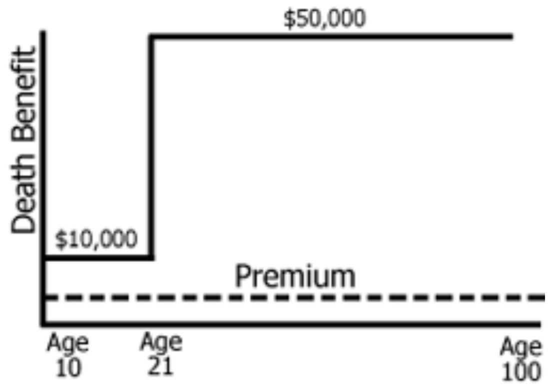
2. Survivorship Life (Second-to-die)

Survivorship life (also referred to as "second-to-die" or "last survivor" policy) is much the same as joint life in that it insures two or more lives for a **premium that is based on a joint age**. The major difference is that survivorship life **pays on the last death** rather than upon the first death. Since the death benefit is not paid until the last death, the joint life expectancy in a sense is extended, resulting in a lower premium than that which is typically charged for joint life, which pays upon the first death. This type of policy is often used to **offset the liability of the estate tax** upon the death of the last insured.

Know This! Joint life = first to die; survivorship life = second to die (last survivor).

3. Juvenile Life

Jumping Juvenile



Juvenile life insurance is, as the name implies, any life insurance written on the life of a minor. A common juvenile policy is known as the "jumping juvenile" policy because the face amount increases at a predetermined age, often age 21. The face amount jumps, but the premium remains level.

F. Group Life Insurance

In contrast to individual life insurance, which is written on a single life, and in which the rate and coverage is based upon the underwriting of that individual, **group life insurance** is issued to the sponsoring organization, and covers the lives of **more than one individual** member of that group. Group insurance is usually written for employee-employer groups, but other types of groups are also eligible for coverage. It is usually written as **annually renewable term** insurance. Two features that distinguish group insurance from individual insurance are

- Evidence of insurability is usually not required (unless an applicant is enrolling for coverage outside the normal enrollment period); and
- Participants (insureds) under the plan do not receive a policy because they do not own or control the policy.

Instead, each insured participant under the group plan is issued a **certificate of insurance** evidencing that they have coverage. The actual policy, or **master policy/contract**, is issued to the sponsor of the group, which is often an employer. The group sponsor is the policyholder and is the one that exercises control over the policy.

Know This! Group insurance is written as annually renewable term insurance.

Know This! In group insurance, the master contract is for the employer, and certificates of insurance are for individual insureds.

1. Characteristics of Group Plans

Group underwriting differs from that of individual insurance, and is based on the group characteristics and makeup. Some of the characteristics of concern to a group underwriter include the following:

- **Purpose or nature of the group** — The group must be created for a purpose other than to obtain group insurance.

- **Size of the group** — The larger the number of people in the group, the more accurate the projections of future loss experience will be. This is based on the Law of Large Numbers of similar risks.
- **Turnover of the group** — From the underwriting perspective, a group should have a steady turnover: younger, lower-risk employees enter the group, and older, higher-risk employees leave.
- **Financial strength of the group** — Because group insurance is costly to administer, the underwriter should consider whether or not the group has the financial resources to pay the policy premiums, and whether or not it will be able to renew the coverage.

Another unique aspect of group underwriting is that the cost of the coverage is based on the average age of the group and the ratio of men to women. In addition, in order to reduce adverse selection, the insurer will require a minimum number of participants in the group, depending on whether the employer or employees pay the premium.

2. Eligible Groups

Group life insurance plans may be sponsored by employers, debtor groups, labor unions, credit unions, associations, and other organizations formed for a reason other than purchasing insurance. Insurance companies may establish a required minimum number of persons to be insured under a group plan.

3. Conversion to Individual Policy

Another characteristic of group insurance is the conversion privilege. If an employee terminates membership in the insured group, the employee has the right to convert to an individual policy ***without proving insurability*** at a standard rate, based on the individual's attained age. The group life policy can convert to any form of insurance issued by the insurer (usually whole life), *except* for term insurance. The face amount or death benefit will be equal to the group term face amount, but the premium will be higher. The employee usually has a period of **31 days after terminating** from the group in order to exercise the conversion option. During this time, the employee is still covered under the original group policy.

Other rules that apply to conversion involve the death or disability of the insured, and termination of the master policy. If the insured dies during the conversion period, a death benefit equal to the maximum amount of individual insurance which would have been issued must be paid by the group policy, whether or not the application for an individual policy was completed. If the master contract is terminated, every individual who has been on the plan for at least 5 years will be allowed to convert to individual permanent insurance of the same coverage.

Know This! When converting from group life to individual life insurance, evidence of insurability is not required.

In Pennsylvania, if an insured is not given notice of his or her conversion privileges **15 days** prior to the policy's expiration date, the insured will have additional **15 days** within which to convert. In no case will such an additional period extend beyond **60 days**.

G. Chapter Recap

This chapter was full of information about different types of life insurance policies. Make sure you know all of the types of policies discussed in this chapter, can recognize their major characteristics, and can compare and contrast different types of policies. Let's recap all of these concepts.

TERM LIFE	
General Characteristics	• Pure protection • Lasts for specific term • No cash value
Level Premium Term	Level death benefit and level premium
Annually Renewable Term	• Renews each year without proof of insurability • Premiums increase due to attained age
Decreasing Term	Coverage decreases at predetermined times gradually; best used when the need for protection declines from year to year
WHOLE LIFE	
General Characteristics	• Permanent protection • Guaranteed elements (face amount, premium, and cash value) until death or age 100 • Level premium • Cash value and other living benefits
Straight Life (Continuous Premium)	• Basic policy • Level death benefit • Insured pays premiums for life or until age 100
Limited Payment	Premiums are paid until a certain age or time; coverage in effect to age 100
Single Payment	Premiums paid in one lump sum and coverage continues to age 100
FLEXIBLE PREMIUM	
General Characteristics	• Types of whole life insurance • Flexible premium
Adjustable Life	• Policyowner may adjust the premium and premium-paying period, the face amount, and the period of protection. • Can be converted from term to whole life and vice versa • Cash value only develops if the premiums paid are more than the cost of the policy
Universal Life	• Has an insurance component in the form of annually renewable term • 2 death benefit options: Option A - level death benefit, and Option B - increasing death benefit • Can make partial surrender/cash withdrawal • Flexibility through unbundling (separating)
OTHER TYPES OF POLICIES	
Variable Life	• Fixed premium, minimum death benefit • Cash value and the actual amount of death benefit are not guaranteed • Assets in separate accounts • Agents must be dually licensed in insurance and in securities
Group Life	• Master Contract goes to the sponsor, usually employer • Certificate of Insurance goes to member • Underwritten as a group • If coverage after open enrollment-proof of insurability is required • Conversion to individual policy in 31 days - same face amount but higher premiums due to attained age