

Purpose Of Life And Health Insurance

A. Key Concepts / Definitions

1. Risk Management Key Terms

Insurance is the **transfer** of financial responsibility associated with a potential of a loss (**risk**) to an insurance company, which in turn spreads the costs of unexpected losses to many individuals. It is a contract in which one party agrees to indemnify the other against loss, damage or liability arising from an unknown event. In most situations only a small number of those insured will actually suffer a loss. Insurance redistributes the financial consequences of individual losses to all persons insured. If there were no insurance mechanism, the cost of a loss would have to be borne solely by the unfortunate individual who suffered the loss. With insurance, the cost of the loss up to the amount of the policy face amount will be covered by the insurance provider. However, the cost of the loss may exceed the limit of insurance.

Hazard

Hazards are conditions or situations that increase the probability of an insured loss occurring. Hazards are classified as physical hazards, moral hazards, or morale hazards. Conditions such as lifestyle and existing health, or activities such as scuba diving are hazards and may increase the chance of a loss occurring.

- **Physical** hazards are individual characteristics that increase the chances of the cause of loss. Physical hazards exist because of a physical condition, past medical history, or a condition at birth, such as blindness.
- **Moral** hazards are tendencies towards increased risk. Moral hazards involve evaluating the character and reputation of the proposed insured. Moral hazards refer to those applicants that may lie on an application for insurance, or in the past, have submitted fraudulent claims against an insurer.
- **Morale** hazards are similar to moral hazards, except that they arise from a state of mind that causes indifference to loss, such as carelessness. Actions taken without forethought may cause physical injuries. ("I'm not going to spend my money for a flu shot. If I get sick, my insurance will pay for my care.")

Risk

Risk is the uncertainty or chance of a loss occurring. The two types of risks are pure and speculative, only one of which is insurable. **Pure risk** refers to situations that can only result in a loss or no change. There is no opportunity for financial gain. Pure risk is the only type insurance companies are willing to accept. **Speculative risk** involves the opportunity for either loss or gain. An example of speculative risk is gambling. These types of risks are not insurable.

Exposure

Exposure is a unit of measure used to determine rates charged for insurance coverage. In life insurance, all of the following factors are considered in determining rates:

- The age of the insured;
- Medical history;
- Occupation; and
- Sex.

A large number of units having the same or similar exposure to loss is known as **homogeneous**. The basis of insurance is sharing risk among the members of a large homogeneous group with similar exposure to loss.

Peril

Perils are the **causes** of loss insured against in an insurance policy.

- *Life insurance* insures against the financial loss caused by the premature death of the insured;
- *Health insurance* insures against the medical expenses and/or loss of income caused by the insured's sickness or accidental injury;
- *Property insurance* insures against the loss of physical property or the loss of its income-producing abilities;
- *Casualty insurance* insures against the loss and/or damage of property and resulting liabilities.

Loss

Loss is defined as the reduction, decrease, or disappearance of value of the person or property insured in a policy, caused by a named peril. Insurance provides a means to transfer loss.

2. Elements of Insurable Risks

Though insurance may be one of the most effective ways to handle risks, not all risks are insurable. As noted earlier, insurers will insure only **pure risks**, or those that involve only the chance of loss with no chance of gain. However, not all pure risks are insurable. Certain characteristics or elements must be present before a pure risk can be insured.

The loss must be due to chance (accidental). In order to be insurable, a risk must involve the chance of loss that is outside the insured's control.

The loss must be definite and measurable. An insurable risk must involve a loss that is definite as to cause, time, place and amount. An insurer must be able to determine how much the benefit will be and when it becomes payable. Since insurance policies are legal contracts, it helps if the conditions are as exact as possible.

The loss must be statistically predictable. This enables insurers to estimate the average frequency and severity of future losses and to set appropriate premium rates. (In life and health insurance, the use of mortality tables and morbidity tables allows the insurer to project losses based on statistics.)

The loss cannot be catastrophic. Insurers typically will not insure risks that will expose them to catastrophic losses. Insurers need to be reasonably certain that the losses will not exceed certain limits. Typically, insurance policies exclude coverage for loss caused by wars or nuclear events because there is no statistical data that allows for the development of rates that would be necessary to cover these events should they occur.

The loss exposure to be insured must involve large homogenous exposure units. There must be a sufficiently large pool to be insured and those in the pool must be grouped into classes with similar risks so the insurer is able to predict losses based upon the **law of large numbers**. This enables insurers to properly predict the average frequency and severity of future losses and to set appropriate premium rates. (In life insurance, the use of mortality tables allows the insurer to project losses based on statistics.)

The insurance must not be mandatory. An insurer must not be required to issue a policy to each applicant applying for coverage. The insurer must have the ability to require that certain underwriting guidelines be met.

3. Adverse Selection

Adverse selection is the insuring of risks that are of a poorer class (more prone to losses) than the average risk. Poorer risks or less desirable insureds tend to seek or continue insurance to a greater extent than better risks. One of the functions of the underwriting department is to protect the insurer from adverse selection.

Underwriters protect the insurer against adverse selection by some of the following methods:

- Restriction of coverage;
- Acceptance only at a higher rate;
- Refusal to accept the risk.

4. Law of Large Numbers

The basis of insurance is sharing risk among a large pool of people with a similar exposure to loss (a homogeneous group). The **law of large numbers** states that the larger the number of people with a similar exposure to loss, the more predictable actual losses will be. This law forms the basis for statistical prediction of loss upon which insurance rates are calculated.

Example:

When an insurance company issues a policy on a 35-year-old male, the company really has no way of knowing or accurately predicting when he will die. However, the Law of Large Numbers looks at a large group of similar risks – 35-year-old males of similar lifestyles and health conditions – and makes some conclusions based on statistics of past losses. This allows the insurance company to have a general idea about the predicted time of death for this type of insured and to set the premiums accordingly.

Know This! As the number of people in a risk pool increases, future losses become more predictable.

5. Reinsurance

Reinsurance is a contract under which one insurance company (the reinsurer) indemnifies another insurance company for part or all of its liabilities. The purpose of reinsurance is to protect insurers against catastrophic losses. The originating company that procures insurance on itself from another insurer is called the *ceding insurer* (because it cedes, or gives, the risk to the reinsurer). The other insurer is called the *assuming insurer*, or reinsurer.

When reinsurance is purchased on a specific policy, it is classified as *facultative reinsurance*. When an insurer has an automatic reinsurance agreement between itself and the reinsurer in which the reinsurer is bound to accept all risks ceded to it, it is classified as a *reinsurance treaty*. Treaties are usually negotiated for a period of a year or longer.

B. Insurable Interest

To purchase insurance, the policyowner must face the possibility of losing money or something of value in the event of loss. This is called **insurable interest**. In life insurance, insurable interest must exist between the policyowner and the insured **at the time of application**; however, once a life insurance policy has been issued, the insurer must pay the policy benefit, whether or not an insurable interest exists.

Three factors that may determine insurable interest for the policyowner are

1. Insuring one's own life;
2. Insuring the life of a family member (relative or spouse); and
3. Insuring the life of a business partner, key employee, or someone who has a financial obligation to them.

C. Types Of Insurers

Insurance companies can be categorized according to how they are organized and operated. The following are the leading types of insurers.

Stock companies are owned by the stockholders who provide the capital necessary to establish and operate the insurance company and who share in any profits or losses. Officers are elected by the stockholders and manage stock insurance companies. Traditionally, stock companies issue **nonparticipating** policies, in which policyowners do not share in profits or losses.

A nonparticipating (stock) policy does not pay dividends to policyowners; however, taxable dividends are paid to stockholders.

Mutual companies are owned by the policyowners and issue **participating** policies. With participating policies, policyowners are entitled to dividends, which, in the case of mutual companies, are a return of excess premiums and are therefore **nontaxable**. Dividends are generated when the premiums and the earnings combined exceed the actual costs of providing coverage, creating a surplus. Dividends are not guaranteed.

Before insurers may transact business in a specific state, they must apply for and be granted a license or **Certificate of Authority** from the state department of insurance and meet any financial (capital and surplus) requirements set by the state. Insurers who meet the state's financial requirements and are approved to transact business in the state are considered **authorized or admitted** into the state as a legal insurer. Those insurers who have not been approved to do business in the state are considered **unauthorized or nonadmitted**. Most states have laws that prohibit unauthorized insurers from conducting business in the state, except through licensed excess and surplus lines brokers.

Know This! Insurers must obtain a Certificate of Authority prior to transacting business in this state.

Domicile of Insurer: Insurers can also be defined by their location of incorporation and whether or not they are authorized to write business in a state. The insurer's domicile, or location of incorporation, will determine whether an insurance company is considered domestic, foreign or alien. In the state they are incorporated in, they are considered a **domestic** insurer. If the insurer is operating in a state other than the one they are incorporated in, they are called a **foreign** insurer. If the insurer is incorporated outside the United States, they are considered an **alien** insurer.

D. Warranties, Representations, And Misrepresentations

A **warranty** is an absolutely true statement upon which the validity of the insurance policy depends. Breach of warranties can be considered grounds for voiding the policy. Because of such strict definition, statements made by applicants for life and health insurance policies are usually not considered warranties, except in cases of fraud.

Representations are statements believed to be true to the best of one's knowledge, but they are not guaranteed to be true. For insurance purposes, representations are the answers the insured gives to the questions on the insurance application.

Untrue statements on the application are considered **misrepresentations** and could void the contract. A **material misrepresentation** is a statement that, if discovered, would alter the underwriting decision of the insurance company. Furthermore, if material misrepresentations are **intentional**, they would be considered fraud.

Life Insurance Policies

Life insurance policies fall into two main categories: temporary or permanent protection. It is important to note that the purpose of life insurance is to provide financial protection in the event of the insured's death. As such, all life insurance offers a tax advantage: no income tax is payable on a lump-sum payment of the death benefit.

A. Term Life Insurance

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.

Although term insurance may be purchased for several different reasons, it is most generally purchased to provide temporary coverage, a large amount of coverage for a relatively small premium, or both. It would make little sense to purchase permanent insurance to insure a short-term debt if that is all the coverage is needed for.

Even from the perspective of a long-term need for insurance, term insurance can provide a significant amount of coverage for a relatively small outlay of premium, when compared to the premium that is charged for a permanent form of insurance. Term insurance has been instrumental in introducing young people to the habit of obtaining life insurance in order to provide various forms of protection, mainly because of its affordability. Young professionals who are just starting their practices and have not reached their earnings potential may still have a need for a large amount of coverage. For them, term insurance provides protection in the early years of their careers, until they can afford to purchase some form of permanent insurance.

1. Special Features

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

Renewable

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.

Convertible

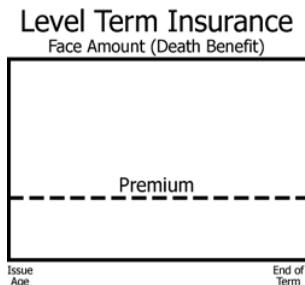
The **convertible** provision provides the policyowner with the right to convert the policy to a permanent insurance policy *without evidence of insurability*. The premium will be based on the insured's attained age at the time of conversion.

2. Level, Decreasing, and Increasing Term

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

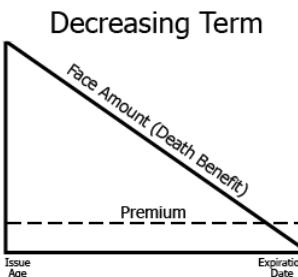
- Level;
- Increasing; and
- Decreasing.

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).

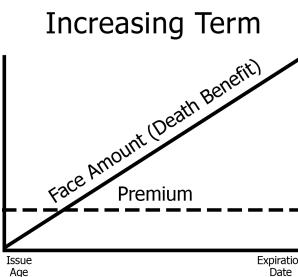


Level term insurance is the most common type of temporary protection purchased. The word *level* refers to the death benefit that does not change throughout the life of the policy.

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



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.



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.

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 policies also build **cash value** (living benefits), which the policyowner can borrow against, or to which he or she is entitled, in the event the policy is surrendered. The cash value, called **nonforfeiture value**, does not usually accumulate until the third policy year and it grows tax deferred. The policyowner may also borrow against the cash value of a whole life policy. However, the amount of any outstanding loan and interest will be deducted from the policy face amount upon the insured's death. Additionally, the insurer may defer payment of any loan request for up to 6 months.

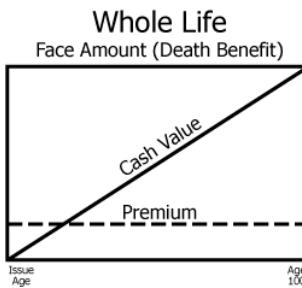
Whole life insurance provides lifetime protection, and includes a savings element (or cash value). Whole life policies endow at the insured's **age 100**, which means the cash value created by the accumulation of premium is scheduled to equal the face amount of the policy at age 100. The policy premium 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 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.

PERMANENT LIFE FEATURES TAX TREATMENT

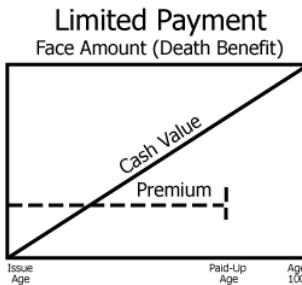
Premiums	Not tax deductible
Cash value exceeding premiums paid	Taxable at surrender
Policy loans	Not income taxable
Policy dividends	Not taxable
Dividend interest	Taxable in the year earned
Lump-sum death benefit	Not income taxable

1. Ordinary (Straight) Life



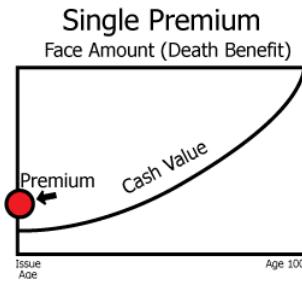
Straight life (also referred to as *ordinary life* or *continuous premium whole life*) is the basic whole life policy (illustrated above). The policyowner pays the premium from the time the policy is issued until the insured's death or age 100 (whichever occurs first). Of the common whole life policies,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

2. Limited-pay Life and Single Premium Life



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.



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 it generates immediate cash. Most companies require a minimum premium for a single premium policy.

3. Joint Life

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.

4. Survivorship Life

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.

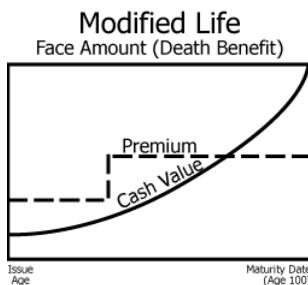
Know This! Joint life = first to die; survivorship life = second to die (last survivor).

5. Interest Sensitive Whole Life

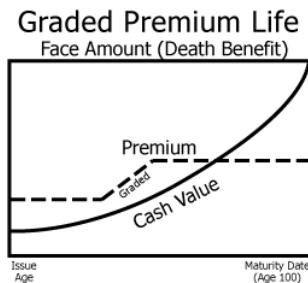
Interest-sensitive whole life, also referred to as **current assumption life**, is a whole life policy that provides a guaranteed death benefit to age 100. The insurer sets the initial premium based on current assumptions about risk, interest and expense. If the actual values change, the company will lower or raise the premium at designated intervals. In addition, interest-sensitive whole life policies credit the cash value with the current interest rate that is usually comparable to money market rates, and can be higher than the guaranteed levels. The policy also provides for a minimum guaranteed rate of interest.

Interest-sensitive whole life provides the same benefits as other traditional whole life policies with the added benefit of current interest rates, which may allow for either greater cash value accumulation or a shorter premium-paying period.

6. Modified and Graded Premium Whole Life



Modified life is a type of whole life policy that charges a lower premium (similar to term rates) in the first few policy years, usually the first 3 to 5 years, and then a higher level premium for the remainder of the insured's life. The higher subsequent premium is typically higher than a straight life premium would be for the same age and amount of coverage. These policies were developed to make the purchase of whole life insurance more attractive for individuals who, for example, are just starting out and have limited financial resources, but will be able to afford the higher premiums in the future as their income grows.



Graded-premium whole life is somewhat similar to modified life in that premiums start out relatively low and then level off at a point in the future. A graded premium whole life policy typically starts with a premium that is approximately 50% or lower than the premium of a straight life policy. The premium then gradually increases each year for a period of usually 5 or 10 years, and then remains level thereafter.

Modified Life and Graded-Premium Life policies are useful as a compromise between straight life and convertible term insurance since the premium is less than straight life in the early years, but some cash value is being accumulated. The actual premiums paid over the life of the contract for a modified or graded premium policy are actually the same as paying for a straight life policy to age 100.

7. Adjustable Life

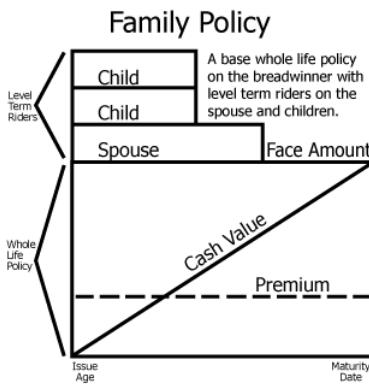
Adjustable life was developed in an effort to provide the policyowner with the best of both worlds (term and permanent coverage). An adjustable life policy can assume the form of either term insurance or permanent insurance. The insured typically determines how much coverage is needed and the affordable 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.

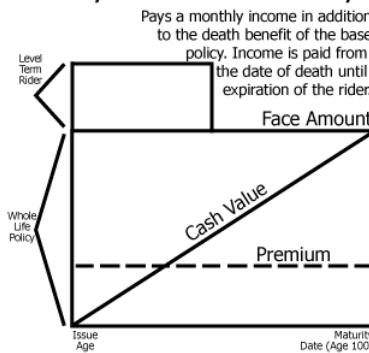
8. Family Policy



A family policy (family protection) combines **whole life** with **term insurance** to cover family members in a single policy, providing coverage on every member of a family. The family policy typically provides whole life insurance on the breadwinner of the family and convertible term insurance on the other family members. The spouse has the opportunity to convert his or her term coverage to permanent coverage up until age 65. Children are automatically covered after birth for a specified period of time, usually 30 or 31 days. To continue coverage for the newborn after the initial period, the parents must inform the insurer of the birth within that time period. The children may convert their term coverage to permanent coverage when they turn the age of 21, or the maximum age for coverage as a dependent that is stated in the policy, without evidence of insurability.

9. Family Maintenance Policy

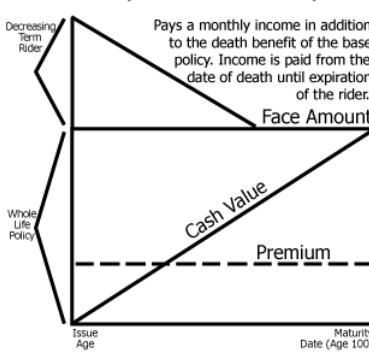
Family Maintenance Policy



A family maintenance policy is life insurance based on a family income policy which combines **whole life** with **level term** insurance to provide a beneficiary with income over a specified period of time (e.g. 15 years or 20 years) if the insured dies during that period of time. If the insured dies within the time period, the level term insurance is sufficient to pay the monthly income portion of the contract. Also the policy contains permanent life insurance protection to be paid upon the death of the insured. Should the insured survive the specified time period, then the term portion expires without value and the contract is left with only the permanent life protection.

10. Family Income Policy

Family Income Policy



The Family Income Policy is a combination of **decreasing term** insurance and **whole life insurance** on the breadwinner of the family. The policy is designed to provide an income period which begins from the effective date of the policy and commonly runs for twenty years, but it is also issued for ten years or even to age 65. This income period is funded with decreasing term insurance. If the insured should die any time during the income period, the term coverage will provide the surviving family with a monthly income for the remainder of the income period. At the end of the income period, the face amount of the whole life coverage is paid to the beneficiary. If the insured dies after the income period, only the whole life portion will be paid to the beneficiary. This type of policy provides a family with a monthly income upon the death of the insured while maintaining permanent coverage until the end of the income payments.

For example, if one purchases a 20-year family income policy and dies five years after the policy is issued, the decreasing term portion of the plan would provide his or her surviving family with a monthly income for 15 years. At the end of the 15-year period, the whole life death benefit would then be paid to the family.

11. 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.

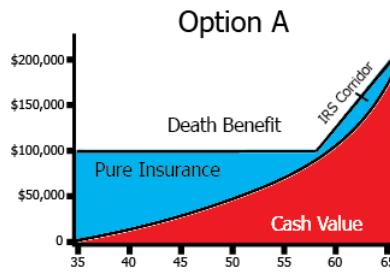
Know This! If an insured skips a premium payment on a universal life policy, the missing premium may be deducted from the policy's cash value. The policy will NOT lapse.

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**.

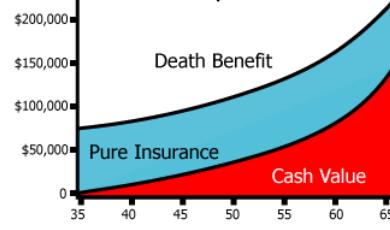
Universal life policies allow the **partial withdrawal** (partial **surrender**) of the policy cash value. However, there may be a charge for each withdrawal and there are usually limits as to how much and how often a withdrawal may be made. During the withdrawal, the interest earned on the withdrawn cash value may be subject to taxation, depending upon the plan. The death benefit will be reduced by the amount of any partial surrender. Note, however, that a partial surrender from a universal life policy is not the same as a policy loan.

At the time that an individual applies for a universal life policy, he or she selects the level of premium, cash value, death benefit and premium-paying period that is desired. If the policyowner wishes to accumulate a certain amount of cash value by a certain period of time, say 20 years, the cash value can be targeted to accumulate to that amount by the 20th year and the amount of premium required to accomplish that objective will be calculated. If no cash value is ever factored into the premium, or, in other words, zero cash value is targeted for age 100, the policy will look and function just like a level term policy to age 100. If the minimum premium is paid each year, then the policy will function just like an annually renewable term policy.

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).

12. Variable Life

Variable life insurance is much like traditional whole life insurance. It is a fixed-premium policy with the addition of an underlying investment account. However, it does not contain the same guarantees of principal and interest that are found in traditional whole life policies. The major distinction is that the policyowner may allocate the premium, after certain deductions for expense loads, into a sub-account that is held by the insurance company, called the **separate account**. This differs from the other forms of permanent insurance, in which the monies are held in the general account. The types of sub-accounts that are

available include bond accounts, growth stock accounts, money market accounts, real estate accounts, and a balanced fund account. The insurance company is required to maintain a separate account for purposes of the sub-accounts that are available to the policyowner. This is largely due to the fact that insurance companies are somewhat restricted as to the types of investments that they may hold in the general account.

Another factor that distinguishes variable life from traditional whole life is that the death benefit and cash value are not guaranteed under variable life. 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. The premium is fixed and will not change over the life of the policy.

Variable life was designed primarily to serve as a *hedge against inflation*. However, in return for the potential of investment growth, the policyowner assumes the downside risk of unfavorable investment performance of the underlying sub-account, which in turn may result in a death benefit that falls short of the policyowner's needs. Because this type of policy involves investment accounts, an individual must hold a **securities license** in addition to a **life insurance license** in order to sell variable life. In addition, the sale of a variable life policy must be preceded or accompanied by a prospectus that is filed with the SEC.

13. 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.

14. Flexible Premium Policies Comparison

POLICIES COMPARED

Adjustable Life	<ul style="list-style-type: none">Key Features: Can be Term or Whole Life; can convert from one to the otherPremium: Can be increased or decreased by policyownersFace Amount: Flexible; set by policyowner with proof of insurabilityCash Value: Fixed rate of return; general accountPolicy Loans: Can borrow cash value
Universal Life	<ul style="list-style-type: none">Key Features: Permanent insurance with renewable term protection componentPremium: Flexible; minimum or targetFace Amount: Flexible; set by policyowner with proof of insurabilityCash Value: Guaranteed at a minimum level; general accountPolicy Loans: Can borrow cash value
Variable Life	<ul style="list-style-type: none">Key Features: Permanent insurancePremium: Fixed (if Whole Life); flexible (if Universal Life)Face Amount: Can increase or decrease to a stated minimumCash Value: Not guaranteed; separate accountPolicy Loans: Can borrow cash value

C. Endowment

Following the elimination of many traditional tax shelters by the Tax Reform Act of 1984, single premium life insurance remained as one of the few financial products offering significant tax advantages. Consequently, many of these types of policies were purchased solely for purposes of setting aside large sums of money for the tax-deferred growth as well as tax-free cash flow available via policy loans and partial surrenders.

To curtail this activity, and to determine if an insurance policy is overfunded, the Internal Revenue Service (IRS) established what is known as the **7-pay Test**. Any life insurance policy that fails a 7-pay test is classified as a **Modified Endowment Contract (MEC)**, and loses the standard tax benefits of a life insurance contract. In a MEC, the cumulative premiums paid during the first 7 years of the policy exceed the total amount of net level premiums that would be required to pay the policy up using guaranteed mortality costs and interest.

Once a policy fails the 7-pay test and becomes a MEC, it remains a MEC.

Know This! A MEC is an overfunded life insurance policy = failed the 7-pay test.

Know This! Once a MEC, always a MEC!

Life Insurance Policy Provisions, Options And Riders

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.

2. Insuring Clause

The insuring agreement provision 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 agreement usually is located on the policy face page, and also defines who the parties to the contract are, the premium to be paid, how long coverage is in force, and the amount of the death benefit.

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.

4. Consideration

Both parties to a contract must provide some value, or **consideration**, in order for the contract to be valid. The consideration provision states that the consideration (value) offered by the insured is the premium and statements made in the application. The consideration given by the insurer is the promise to pay in accordance with the terms of the contract. The consideration clause is not always a separate provision, but is often included in the entire contract provision. A separate provision concerning the payment of policy premiums is usually also found in the policy.

5. 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.

6. 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 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.

7. Third-party Ownership

Most insurance policies are written where the insured and owner of the policy are the same person. However, there are situations in which the contract may be owned by someone other than the insured. These types of contracts are known as third-party ownership. Most policies involving **third-party ownership** are written in business situations or for minors in which the parent owns the policy. **Third-party owner** is a legal term used to identify an individual or entity that is not an insured under the contract, but that has a legally enforceable right under it.

8. Assignments

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.

9. Reinstatement

The reinstatement provision allows a lapsed policy to be put back in force. The maximum time limit for reinstatement is usually **3 years** after the policy has lapsed. If the policyowner elects to reinstate the policy, he/she will have to provide evidence of insurability. The policyowner is required to pay all back premiums plus interest, and may be required to repay any outstanding loans and 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.

10. 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.

11. Misstatement of Age

Because the age of an insured affects the premium that will be charged for a life insurance policy, if the applicant has misstated his or her age on the application, in the event of a claim, the insurer has the right to adjust the benefit to an amount that the premium would have purchased at the correct age of the insured.

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

12. 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).

13. Automatic Premium Loan

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.

14. 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).

15. Suicide

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 commits 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 commits 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.

B. Policy Riders

Policy **riders** are added to the basic life insurance policy in order to add, modify or delete policy provisions. Riders have value and meaning only when attached to the policy, they have no independent value. They are used primarily as a means for individuals to customize their policies to meet their individual needs. However, insurers can also attach riders to the policy in order to delete coverage. Riders that delete coverage are called **exclusions**. Exclusions are sometimes used as a means of

insuring an otherwise ineligible risk. *For example*, an insured who races cars as a hobby may be insurable only if the policy excludes death while the insured is engaged in auto racing. Generally, riders must be agreed upon and selected at the time of the policy application. However, a policy rider may be added by endorsement after policy issue. If the additional rider increases the risk to the insurer, proof of insurability will generally be required. Most riders also require the payment of an additional premium. Some riders, however, are often included in the policy for free, such as terminal illness (living need) rider, the automatic premium loan, and exclusions.

1. 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.

2. 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.

In order for an insured to qualify for this benefit, the insured must meet the policy's definition of **total disability**. Although this definition will differ from one policy to another, it is generally defined as the inability to engage in any work. More specifically, total disability refers to the insured's inability to perform the duties of his/her own occupation for the first 2 years; then any gainful employment for which the insured is reasonably suited by education, training and experience. No benefits are payable for partial disability.

Policy cash values will continue to accumulate at their normal pace during the period of time that premiums are waived. In addition, if the policy is participating, the policyowner will continue to receive dividends as they are declared. (Note: this may not be true of all Universal life insurance policies; some UL policies offer "waiver of premium" or "cost of insurance deduction rider" for the mortality charges only.)

3. Payor Benefit

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.

4. Accidental Death and/or Accidental Death and Dismemberment

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.

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.

5. Accelerated Death Benefits - Living Benefits

The **Accelerated Benefit** or **Living Needs Rider** provides for an early 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, or has other qualifying conditions. It does not cover disability. 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.

6. Return of Premium

The **return of premium** rider is implemented by using increasing term insurance. When added to a whole life policy, it provides that at death prior to a given age, not only is the original face amount payable, but an amount equal to all premiums previously paid is also payable to the beneficiary. The return of premium rider usually expires at a specified age such as age 60.

7. 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.

8. Other Insureds

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).

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.

Other riders are also available to insure somebody who is not a member of the insured's family - **nonfamily insureds**. The **substitute insured** or **change of insured** rider does not permit an additional insured, but instead allows for the change of insureds, subject to insurability. It is most commonly used with Key Person insurance when the key person or employee retires or terminates employment. The rider permits the policyowner, owner or employer, to change the insured to another key employee, subject to insurability.

This rider is often used by businesses that have a joint life policy that covers multiple key persons. Assume that the business has a joint life insurance policy covering key employees Jack and Jake. Jake retires and Jim is hired to replace him. Now the business would like a joint policy covering Jack and Jim, but Jack would no longer meet the underwriting requirements for a new policy because of changes in his health. If the policy covering Jack and Jake had a "Change of Insured Rider", the same policy could be maintained preserving Jack's insurability and Jim could be substituted for Jake as an insured, with only Jim needing to prove insurability.

C. Policy 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.

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.

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.

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.

Application to Reduce Premiums

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.

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.

Paid-up Option

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 Option

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.

Acceleration of Endowment

The acceleration of endowment option also requires the insurer to first accumulate the dividends at interest and then the accumulated amount is used to either shorten the endowment period in the case of an endowment policy, or convert a whole life policy into an endowment.

Life Insurance 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.

A. Who Can Be A Beneficiary

1. 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.

2. Minors

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.

3. 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.

4. 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.

5. Prohibited Designations

An insurance producer may not:

- Be named as owner or beneficiary of a life insurance policy or annuity of an insurance customer (transactions that involve interim ownership immediately before transferring ownership to a trust are allowed.)
- Be named as a beneficiary in a will of an insurance customer who is not a relative;
- Obtain a personal loan or monetary gift from an insurance customer who is not a relative;
- Execute a transaction for an insurance customer without authorization by the customer to do so; or
- Commit any act which shows that the producer has taken advantage of the producer-customer relationship and exerted undue influence over a person.

B. Types Of Beneficiary Designations

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.

1. Primary

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.

2. Secondary (Contingent)

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.

3. Tertiary

The **tertiary beneficiary** is third in line for the death benefits in the event that both the primary and contingent beneficiaries predecease the insured.

4. Per Capita / Per Stirpes

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.

5. Revocable vs. 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*.

C. Special Situations

1. 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.

2. Spendthrift Clause

The spendthrift clause is designed to protect the proceeds from creditors of the beneficiary. When an insured's beneficiary receives policy proceeds, the spendthrift clause protects the beneficiary from losing those proceeds before collected. When a life insurance policy contains a spendthrift provision, all rights of the beneficiary to commute, change time of payment or amount of installments, surrender for cash, borrow against, or assign for any purpose, are withdrawn and those parts of the policy that may give the beneficiary such rights are declared inoperative and void.

3. Facility of Payment Clause

If the facility of payment provision is in the policy, it allows the insurer to pay a portion of the proceeds to any relative or person who has possession of the policy and appears equitably entitled to the payment. This provision is designed to facilitate payment when some doubt may exist as to who the beneficiary is and save legal expenses. It is mostly commonly found in group life, industrial, or fraternal insurance contracts.

The situations in which the facility of payment provision might be used include the following:

- The named beneficiary is a minor;
- The named beneficiary is deceased;
- The insurer did not receive death benefits claims within a specified period of time;
- Costs for the deceased insured's final medical or funeral expenses were incurred by another party, and not the beneficiary.

Life Insurance Premiums And Proceeds

A. Primary Factors In Premium Calculations

1. Mortality Table

Mortality tables indicate the number of individuals within a specified group (e.g. males, females, smokers, nonsmokers) starting at a certain age, who are expected to be alive at a succeeding age. These tables indicate to a life insurance company the *natural premium* for an individual applying for life insurance. *Natural premium* is the amount of premium that must be collected from each member of a group composed of the same age, sex and risk in order to pay \$1,000 for each death that will occur in the group each year.

2. Interest

Since premiums are paid before claims are incurred, insurance companies invest the premiums in an effort to earn interest on these funds (invested in bonds, stocks, mortgages, etc.). This interest is a primary factor in lowering the premium rate.

3. Expense Factor

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

Gross annual premium is the one year cost for mortality, plus expense loading. Loading includes commissions, taxes, advertising, and while not an expense, includes the amount added to a pure or basic rate to provide for a profit margin to the insurer.

$$\text{Gross Annual Premium} = \text{cost of 1 year of mortality} + (\text{commissions} + \text{taxes} + \text{advertising} + \text{profit margin})$$

B. Premium Payment

1. 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.

2. 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.

C. Taxation Of Premiums

Generally speaking, the following taxation rules apply to life insurance policies:

- **Premiums** are not tax deductible; and
- **Death benefit:**
 - Tax free if taken as a lump-sum distribution to a named beneficiary; and
 - Principal is tax free; interest is taxable if paid in installments (other than lump sum).

D. Policy Proceeds

1. Settlement Options

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.

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.

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.

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 1/2 survivor" or "joint and 2/3 survivor," in which the surviving beneficiary receives 1/2 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.

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.

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.

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.

2. Living Benefits

Viatical Settlements

Viatical Settlements allow someone living with a life-threatening condition to sell their existing life insurance policy and use the proceeds when they are most needed, before their death. Viators (or the owners of the original insurance policy) usually receive **a percentage** of the policy's face value from a third party who purchases the policy. The new owner continues to maintain premium payments and will eventually collect the entire death benefit.

Know This! In a viatical settlement, the owner receives a *percentage* of the policy's cash value.

3. Taxation of Proceeds

Individual Life

Premiums—The premiums that an individual pays for his or her own personal life insurance are considered to be a personal expense and are not tax deductible by the individual.

Death Benefit/Policy Proceeds — The life insurance policy death benefit is not subject to income tax even if it exceeds the premiums paid.

Cash Value — The policyowner is not taxed on the annual increase in cash value as this accumulates on a tax-deferred basis.

If the policyowner withdraws any of the cash value or surrenders the policy for the cash value, the amount of cash value that exceeds the sum of the total premiums paid will be taxed to the policyowner as ordinary income (referred to as the **Cost Recovery Rule**). *For example*, a life insurance policy has a cash value of \$5,000, and the policyowner has paid premiums of \$3,000. The taxable portion would be as follows:

Total Cash Value
\$5,000

Total Premiums Paid-\$3,000
Taxable Portion
\$2,000

Policy Loans — A loan from the cash value of a life insurance policy is not taxable to the policyowner. An individual cannot receive a tax deduction for interest paid on a life insurance policy loan.

Estate Taxation — The death benefit of a life insurance policy may be included in the insured's taxable estate at death and can be subject to the federal estate tax.

Group Life

The **premiums** that an employer pays for life insurance on an employee, whereby the policy is for the employee's benefit, **are tax deductible to the employer** as a business expense. If the group life policy coverage is \$50,000 or less, the employee does not have to report the premium paid by the employer as income (not taxable to the employee).

Any time a business is the named beneficiary of a life insurance policy, or has a beneficial interest in the policy, any premiums that the business pays for such insurance are not tax deductible. Therefore, when a business pays the premiums for any of the following arrangements, the premiums are not deductible:

- Key-employee (key-person) insurance;
- Stock redemption or entity purchase agreement; and
- Split-dollar insurance.

The **cash value** of a business owned life insurance policy or an employer provided policy accumulates on a tax-deferred basis and is taxed in the same manner as an individually owned policy.

Policy loans are not taxable to a business. Unlike an individual taxpayer, a corporation may deduct interest on a life insurance policy loan for loans up to \$50,000.

Policy death benefits paid under a business owned or an employer provided life insurance policy are received income tax free by the beneficiary (in the same manner as in individually owned policies).

Modified Endowment Contracts (MECs)

The following are taxation rules that apply to MEC's cash value:

- Tax-deferred accumulations;
- Any distributions are taxable, including withdrawals and policy loans;
- Distributions are taxed on LIFO basis (Last In, First Out) — known as "interest-first" rule; and
- Distributions before age 59 ½ are subject to a 10% penalty.

TAX CONSIDERATIONS FOR LIFE INSURANCE AND ANNUITIES

Premiums

Not deductible (personal expense)

Death Benefit Not income taxable (except for interest)

Cash Value Increases Not taxable (as long as policy in force)

Cash Value Gains Taxed at surrender

Dividends Not taxable (return of unused premium; however, interest is taxable)

Accumulations Interest taxable

Policy Loans Not income taxable

Surrenders Surrender value - past premium = amount taxable

Partial Surrenders

First In, First Out (FIFO)*

Settlement Options - death benefit spread evenly over income period (averaged).

Interest payments in excess of death benefit portion are taxable.

Estate Tax - If the insured owns the policy, it will be included for estate tax purposes. If the policy is given away (possibly to a trust) and the insured dies within 3 years of the gift, the death benefit will be included in the estate.

**FIFO method applies to Life insurance only. The policyowner will receive their investment in the contract first before receiving any gains in the policy (or being taxed on those gains). Annuities follow a LIFO format.*

1035 Exchange

In accordance with Section 1035 of the Internal Revenue Code, certain exchanges of life insurance policies and annuities may occur as nontaxable exchanges. When a policyowner exchanges a cash value life insurance policy for another cash value life insurance policy, or a cash value life policy for an annuity, or an annuity for an annuity, the policies or annuities **must be on the same life**. There will be no income tax on these transactions.

The following are allowable exchanges:

- A life insurance policy for another life insurance policy, an endowment contract, or an annuity contract;
- An endowment contract for another endowment contract or an annuity contract; or
- An annuity contract for another annuity contract.

Note that a policyowner may not exchange funds from an annuity into a cash value life policy. Nor would term life be used in a 1035 Exchange since it has no cash value. The key is that the exchange may not be from a less tax-advantaged contract to a more tax-advantaged contract. "*Same to same*" is acceptable.

Know This! A 1035 exchange is a nontaxable exchange of cash value life insurance or an annuity on the same life.

Life Insurance Underwriting And Policy Issue

A. Completing The Application

It is the agent's responsibility to make certain that the application is filled out completely, correctly, and to the best of the applicant's knowledge. The agent must probe beyond the stated questions in the application if he or she has any reason to believe the applicant is misrepresenting or concealing information, or does not understand the specific questions asked. Any information that is misleading, inaccurate or illegible may delay the issuance of the policy. If the agent feels that there could be some misrepresentation, he/she must inform the insurance company. Some insurers require that the applicant complete the application under the agent's watchful eye, while other insurers require that the agent complete the application in order to help avoid mistakes and unanswered questions.

Underwriting is the risk selection and classification process. It involves a careful analysis of many different factors to determine the acceptability of applicants for insurance. In other words, underwriting is the process in which an insurance company determines whether or not a particular applicant is insurable, and if so, what premium to charge.

The agent is the company's front line, and is referred to as a **field underwriter** because the agent is usually the one who has solicited the potential insured. As a field underwriter, the agent has many important responsibilities, including the following:

- Helping prevent adverse selection;
- The proper solicitation of applicants;
- Completing the application;
- Obtaining the required signatures;
- Collecting the initial premium and issuing the receipt, if applicable; and
- Delivering the policy.

Know This! A life insurance producer is the company's *field underwriter*.

The Application is the starting point and basic source of information used by the company in the risk selection process. Although applications are not uniform and may vary from one insurer to another, they all have the same basic components: Part 1 - General Information and Part 2 - Medical Information.

Part 1 - General Information of the application includes the general questions about the applicant, such as name, age, address, birth date, gender, income, marital status, and occupation. It will also inquire about the existing policies and if the proposed insurance will replace them. Part 1 identifies the type of policy

applied for and the amount of coverage, and usually contains information concerning the beneficiary.

Part 2 - Medical Information of the application includes information on the prospective insured's medical background, present health, any medical visits in recent years, medical status of living relatives, and causes of death of deceased relatives. If the amount of insurance is relatively small, the agent and the proposed insured will complete all of the medical information. That would be considered a *nonmedical* application. For larger amounts, the insurer will usually require some sort of medical examination by a professional.

As a field underwriter, the agent (or producer) can be considered the most important source of information available to the company underwriters. The **agent's (producer's) report** provides the agent's personal observations concerning the proposed insured. The insurer may inquire whether the agent knows of any adverse information about the applicant, or ask the agent to express an opinion about the applicant's character, financial standing, and environment. The agent's report does not become a part of the entire contract, although it is a part of the application process.

1. Required Signatures

Both the agent and the proposed insured (usually the applicant) must sign the application. If the proposed insured and the policyowner are not the same person, such as a business purchasing insurance on an employee, then the policyowner must also sign the application. An exception to the proposed insured signing the application would be in the case of an adult, such as a parent or guardian, applying for insurance on a minor child.

2. Changes in the Application

When an answer to a question on the application needs to be corrected, agents have the option, depending on which insurer they represent, of correcting the information and having the applicant initial the change, or completing a new application. An agent should never erase or white out any information on an application for insurance.

3. Consequences of Incomplete Applications

Before a policy is issued, all of the questions on the application must be answered. If the insurer receives an incomplete application, the insurer must return it to the applicant for completion. If a policy is issued with questions left unanswered, the contract will be interpreted as if the insurer waived its right to have an answer to the question. The insurer will not have the right to deny coverage based on any information that the unanswered question might have contained.

4. Collecting the Initial Premium and Issuing the Receipt

Most agents attempt to collect the initial premium and submit it along with the application to the insurer. In addition, collecting the initial premium at the time of the application increases the chance that the applicant will accept the policy once

it is issued. Whenever the agent collects premiums, the agent must issue a **premium receipt**. The type of receipt issued will determine when coverage will be effective.

The most common type of receipt is a **conditional receipt**, which is used only when the applicant submits a prepaid application. The conditional receipt says that coverage will be *effective either on the date of the application or the date of the medical exam*, whichever occurs last, as long as the applicant is found to be insurable as a standard risk, and policy is issued exactly as applied for. This rule will not apply if a policy is declined, rated, or issued with riders excluding specific coverages.

Example:

If an agent collects the initial premium from an applicant and gives the applicant a conditional receipt, and the applicant dies the next day, the underwriting process will proceed as though the applicant were still alive. If the insurer ends up approving the coverage, then the applicant's beneficiary will receive the death benefit of the policy. If, on the other hand, the insurer determines that the applicant was not an acceptable risk and declines the coverage, the premium will be refunded to the beneficiary, and the insurer is not required to pay the death benefit.

Know This! Conditional receipt means the applicant may be covered as early as the date of the application.

B. Underwriting

Underwriting is the risk selection process. The underwriter's responsibilities include selecting only those risks that are considered insurable and meet the insurer's underwriting standards. The purpose of underwriting is to protect the insurer against **adverse selection** (risks which are more likely to suffer a loss).

The primary criteria an underwriter will use in assessing the desirability of a particular candidate for life insurance includes the applicant's health (current and past), occupation, lifestyle, and hobbies or habits. The underwriter will use many different sources of information in determining the insurability of the individual risk. The specific underwriting requirements will also differ by insurers.

1. Medical Information and Consumer Reports

For policies with higher amounts of coverage or if the application raised additional questions concerning the prospective insured's health, the underwriter may require a medical examination of the insured. There are two options, depending on the reason for the medical examination:

1. The insurer may only request a **paramedical report** which is completed by a paramedic or a registered nurse; and
2. The underwriter may require an **Attending Physician's Statement (APS)** from a medical practitioner who treated the applicant for a prior medical problem.

In addition to an attending physician's report, the underwriter will usually request a **Medical Information Bureau (MIB)** report.

The MIB is a membership corporation owned by member insurance companies. It is a **nonprofit trade organization** which receives adverse medical information from insurance companies and maintains confidential medical impairment information on individuals. It is a systematic method for companies to compare the information they have collected on a potential insured with information other insurers may have discovered. The MIB can be used only as an aid in helping insurers know what areas of impairment they might need to investigate further. An applicant cannot be refused simply because of some adverse information discovered through the MIB.

Know This! Insurers cannot refuse coverage solely on the basis of adverse information on an MIB report.

To supplement the information on the application, the underwriter may order an inspection report on the applicant from an independent investigating firm or credit agency, which covers financial and moral information. They are general reports of the applicant's finances, character, work, hobbies, and habits. Companies that use inspection reports are subject to the rules and regulations outlined in the Fair Credit Reporting Act.

2. Fair Credit Reporting Act

The **Fair Credit Reporting Act** became law on April 25, 1971, and is administered and enforced by the Federal Trade Commission. The act established procedures that consumer-reporting agencies must follow in order to ensure that records are confidential, accurate, relevant, and properly used. The law also protects consumers against the circulation of inaccurate or obsolete information.

The acceptability of a risk is determined by checking the individual risk against many factors directly related to the risk's potential for loss. Besides these factors, an underwriter will sometimes request additional information about a particular risk from an outside source. These reports generally fall into 2 categories: Consumer Reports and Investigative Consumer Reports. Both consumer reports and investigative reports can only be used by someone with a legitimate business purpose, including insurance underwriting, employment screening, and credit transactions.

Consumer Reports include written and/or oral information regarding a consumer's credit, character, reputation, or habits collected by a reporting agency from employment records, credit reports, and other public sources.

Investigative Consumer Reports are similar to consumer reports in that they also provide information on the consumer's character, reputation, and habits. The primary *difference* is that the information is obtained through an investigation and interviews with associates, friends and neighbors of the consumer. Unlike consumer reports, these reports cannot be made unless the consumer is advised in writing about the report within **3 days** of the date the report was requested. The consumers must be advised that they have a right to request additional

information concerning the report, and the insurer or reporting agency has **5 days** to provide the consumer with the additional information.

Know This! Insurance applicants must be notified in writing whenever insurers request investigative consumer reports.

The reporting agency and users of the information are subject to civil action for failure to comply with the provisions of the Fair Credit Reporting Act. Consumers can collect for damages between \$100 and \$1,000 if the reporting agency or users of the information engage in negligent use of the reports. Any individual who knowingly obtains a consumer report under false pretenses or without a permissible purpose may be liable for damages sustained by the consumer, or \$1,000, whichever is greater. A person who knowingly and willfully obtains information on a consumer from a consumer reporting agency under false pretenses may also be imprisoned for up to 2 years.

An individual who **unknowingly** violates the Fair Credit Reporting Act is liable in the amount equal to the loss to the consumer, as well as any reasonable attorney fees incurred in the process.

An individual who **willfully** violates this Act enough to constitute a general pattern or business practice will be subject to a penalty of up to **\$2,500** per violation.

Under the Fair Credit Reporting Act, if a policy of insurance is declined or modified because of information contained in either a consumer or investigative report, the consumer must be advised and provided with the name and address of the reporting agency. **The consumer has the right to know what was in the report.** The consumer also has a right to know the identity of anyone who has received a copy of the report during the past year. If the consumer challenges any of the information in the report, the reporting agency is required to reinvestigate and amend the report, if warranted. If a report is found to be inaccurate and is corrected, the agency must send the corrected information to all parties to which they had reported the inaccurate information within the last 2 years.

Before any adverse action can be taken against a consumer based on the report, the consumer must be provided a copy of the report and a description in writing of the consumer's rights.

Consumer reports cannot contain certain types of information if the report is requested in connection with a life insurance policy or credit transaction of **less than \$150,000**. The **prohibited information** includes bankruptcies more than 10 years old, civil suits, records of arrest or convictions of crimes, or any other negative information that is more than 7 years old.

3. Risk Classification

In classifying a risk, the Home Office underwriting department will look at the applicant's past medical history, present physical condition, occupation, habits and morals. If the applicant is acceptable, the underwriter must then determine the risk or **rating classification** to be used in deciding whether or not the applicant should pay a higher or lower premium. A prospective insured may be rated as one of the three classifications: **standard, substandard, or preferred**.

Know This! The higher the risk, the higher the premium.

Standard risks are persons who, according to a company's underwriting standards, are entitled to insurance protection without extra rating or special restrictions. Standard risks are representative of the majority of people at their age and with similar lifestyles. They are the average risk.

Substandard (High Exposure) risk applicants are not acceptable at standard rates because of physical condition, personal or family history of disease, occupation, or dangerous habits. These policies are also referred to as "rated" because they could be issued with the **premium rated-up**, resulting in a higher premium.

Preferred risks are those individuals who meet certain requirements and qualify for lower premiums than the standard risk. These applicants have a superior physical condition, lifestyle, and habits.

C. Delivering The Policy

Once the underwriting process has been completed and the company issues the policy, the agent will deliver it to the insured. Although personal delivery of the insurance policy is the best method of finalizing the insurance transaction, mailing the policy directly to the policyowner is acceptable. When the insurer relinquishes control of the policy by mailing it to the policyowner, policy is considered legally delivered. However, it is advisable to obtain a signed **delivery receipt**.

1. When Coverage Begins

If the initial premium is not paid with the application, the agent will be required to collect the premium at the time of policy delivery. In this case, the policy does not go into effect until the premium has been collected. The agent may also be required to get a **statement of good health** from the insured. This statement must be signed by the insured, and verifies that the insured has not suffered injury or illness since the application date.

If the full premium was submitted with the application and the policy was issued as requested, the policy coverage would generally coincide with the date of application if no medical exam is required. If a medical exam is required, the date of the coverage will coincide with the date of the exam.

Know This! NO premium, NO coverage.

2. Explaining the Policy and its Provisions, Riders, Exclusions, and Ratings to the Client

Personal delivery of the policy allows the agent an opportunity to make sure that the insured understands all aspects of the contract. Review of the contract with the insured involves pointing out provisions or riders that may be different than anticipated, and explaining what effect they have on the contract. In addition, the agent should explain the rating procedure to the client, especially if the policy is **rated differently** than applied for, or has been modified or amended in any other way. The agent should also explain any other choices and provisions available to the policyowner that may become active at this time.

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.

A. 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.

B. 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.

C. Group Underwriting Requirements

Group life insurance is underwritten on a group basis as opposed to an individual basis. Each participant completes a short application that clearly identifies the insured and the insured's beneficiary. Generally, if the group is large enough, there are **no medical questions** since the plan will be issued based upon the nature of the group and the group's past claims experience.

1. Experience vs. Community Rating

When dealing with group plans, insurance companies use two types of rating to determine the rates to be charged. The **experience rating** is based on the overall experience of the group in terms of insurance claims. The **community rating** is usually used for pricing products for smaller employers and individuals, and it involves a pooling of the experience of all groups in all areas and then the setting of an average rate that will be sufficient to support this experience.

2. Contributory vs. Non-Contributory

The employer or other group sponsor may pay all of the premiums or share premiums with the employees. When an employer pays all of the premiums, the plan is referred to as a **noncontributory plan**. Under a noncontributory plan, an insurer will require that 100% of the eligible employees be included in the plan. When the premiums for group insurance are shared between the employer and employees, the plan is referred to as a **contributory plan**. Under a contributory plan, an insurer will require that 75% of eligible employees be included in the plan.

D. 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.

E. Other Forms Of Group Life Coverage

1. Franchise Life Insurance

Franchise life insurance provides coverage for small groups of employees; however, each participant is issued an individual policy instead of a master contract. This type of insurance requires individual underwriting and each participant could be charged a different premium rate. The policy remains in force for each individual as long as he or she maintains a valid relationship with the employer and pays the required premiums.

2. Credit Life

Credit insurance is a special type of coverage written to insure the life of the debtor and pay off the balance of a loan in the event of the death of the debtor. Credit life is usually written as **decreasing term insurance**, and it may be written as an individual policy or as a group plan. When written as a group policy, the creditor is the owner of the master policy, and each debtor receives a certificate of insurance.

The creditor is the owner and the beneficiary of the policy although the premiums are generally paid by the borrower (or the debtor). **Credit life insurance cannot pay out more than the balance of the debt**, so that there is no financial incentive for the death of the insured. The creditors may require the debtor to have life insurance; they cannot, however, require that the debtor buys insurance from a specific insurer.

Know This! Credit life insurance cannot pay out more than the balance of the debt.

3. Blanket Insurance

A **blanket** life policy would cover a group of people that are exposed to the same hazard. It differs from traditional group insurance in that it doesn't name individual insureds and doesn't issue certificates of insurance. The coverage under a blanket policy is temporary and only for the time the group is exposed to the hazards specified in the policy. Typical examples of blanket insurance would include airlines covering passengers while in flight, or schools covering students and teachers during the school hours.

4. Multiple Employer Trusts

A **Multiple-Employer Trust (MET)** is made up of two or more employers in *similar or related businesses* who do not qualify for group insurance on their own. Before HIPAA defined small employers, many small companies were unable to get health insurance at a reasonable cost due to the fact that there weren't enough people in the company to insure. In situations like this, several small companies banded together to create a large pool of people so that the insurance company will provide coverage. This group of employers jointly purchase a single benefits plan to cover employees of each separate employer.

A noninsured plan may operate without the services and funds of an insurance company. Once the trust fund is established, it can pay for employees' health care expenses directly (self-funding). The trustee has charge of the funds and all financial activities occur through it. As with any self-funded program, the employer assumes legal responsibility for providing coverage, and the employee has no conversion right upon leaving the group coverage.