# TABLE OF CONTENTS

**LIFE INSURANCE** ................................................................................................................................. 9

**REASONS FOR BUYING LIFE INSURANCE - PERSONAL LOSS EXPOSURES** ........................................... 9

   *Death Benefits* .................................................................................................................................... 9

**PREMATURE DEATH** .......................................................................................................................... 10

**FINANCIAL CONSEQUENCES OF DYING** ............................................................................................. 10

**PURE PROTECTION** ............................................................................................................................. 11

**NON-INSURANCE ELEMENTS** ........................................................................................................... 11

**LIFE INSURANCE IS NOT JUST INSURANCE** ...................................................................................... 12

**FINANCIAL CONSEQUENCES OF LIVING** ............................................................................................ 12

**PERSONAL USES OF LIFE INSURANCE** ............................................................................................ 14

**THE HUMAN LIFE CYCLE** ................................................................................................................ 14

   *Singles* .................................................................................................................................................. 14

   *Single-Parent Families* ........................................................................................................................ 15

   *Two-income Families* .......................................................................................................................... 15

   *Traditional Families* .......................................................................................................................... 15

   *Blended Families* ............................................................................................................................... 16

   *Sandwiched Families* .......................................................................................................................... 16

   *Juveniles* .............................................................................................................................................. 16

**COLLEGE PLANNING** ......................................................................................................................... 16

**RETIREMENT PLANNING** .................................................................................................................... 17

**ESTATE PLANNING** ............................................................................................................................ 17

**BUSINESS USES OF LIFE INSURANCE** ............................................................................................ 18

**LIQUIDATION** ..................................................................................................................................... 19

**RETENTION** ....................................................................................................................................... 19

**BUY-SELL AGREEMENTS** ................................................................................................................. 20

**KEY PERSON INDEMNIFICATION** ...................................................................................................... 21

**DEFERRED COMPENSATION AND EXECUTIVE BONUSES** ............................................................... 22

**SPLIT DOLLAR PLANS** ....................................................................................................................... 22

**DETERMINING THE AMOUNT OF LIFE INSURANCE TO OWN** ....................................................... 23

**THE X FACTOR** .................................................................................................................................... 23

   *Tools for Analysis* ............................................................................................................................... 23

   *Insurance Amount: Gross Estimate* .................................................................................................... 24

   *Other Sources of Funds* .................................................................................................................... 24

   *Insurance Amount: Net Estimate* ...................................................................................................... 25

**THE HUMAN LIFE VALUE APPROACH** .............................................................................................. 26

   *Importance of Client Involvement* ..................................................................................................... 27

   *Importance of Assumptions* .............................................................................................................. 27

   *Best Prospects for the Human Life Value Approach* ..................................................................... 27

**THE NEEDS APPROACH** .................................................................................................................... 27

   *Need Categories* ............................................................................................................................... 28

      *Final Expense Needs* ...................................................................................................................... 28

      *Readjustment Income Needs* ........................................................................................................ 29

      *Dependency Period* ...................................................................................................................... 29

      *Blackout period* ............................................................................................................................ 29

      *Capital Needs* ............................................................................................................................... 30


© Copyright Sandi Kruise Insurance Training, Sandi Kruise Inc 2002-2015, all rights reserved
Types of Life Insurance Policies ................................................................. 32
  Group Life Insurance ............................................................................. 32
  Credit Life Insurance ........................................................................... 32
  Industrial Life Insurance ....................................................................... 32
  Individual or Ordinary Insurance ......................................................... 32

Term Life Insurance ................................................................................ 34
  Renewable Term ................................................................................... 34
    Annual Renewable Term .................................................................... 35
  Convertible Term ................................................................................. 35
  Reentry Term ......................................................................................... 36

Premium Considerations ......................................................................... 36
  Lowest Cost for Pure Protection ......................................................... 36
  Premium Components ........................................................................... 36
  Renewal Premium Increase .................................................................. 36

Term Policy Variations ........................................................................... 36
  Level Term ............................................................................................ 37
  Decreasing Term ................................................................................... 37
  Increasing Term .................................................................................... 38

Uses of Term Insurance .......................................................................... 39

Term vs. Whole Life ............................................................................... 40
  Forced vs. Voluntary Savings ................................................................. 40
  Rates of Return and Risks .................................................................... 41
  Advantages of Term Insurance ............................................................. 41
  Disadvantages of Term Insurance ........................................................ 42

Permanent Life Insurance ...................................................................... 43

Whole Life ............................................................................................... 44

Whole Life Products ............................................................................... 44
  General Characteristics of Whole Life Insurance ............................... 44
    Level Premiums ................................................................................... 44
    Permanent Protection ......................................................................... 45
  Cash Value ........................................................................................... 45
  Using Cash Value .................................................................................. 45
    Guaranteeing the Cash Value .............................................................. 45
  The General Account: The Foundation of Guaranteed Values ............. 45
  Guaranteed Nonforfeiture Values ........................................................ 46
  Guaranteed Rates ................................................................................. 46
  Level Face Amount .............................................................................. 46

Types of Whole Life Policies ............................................................... 47
  Methods of Payment .............................................................................. 47
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>POLICY LOANS</td>
<td>69</td>
</tr>
<tr>
<td>WITHDRAWAL OR PARTIAL SURRENDER</td>
<td>69</td>
</tr>
<tr>
<td>VARIABLES LIFE INSURANCE</td>
<td>71</td>
</tr>
<tr>
<td>THE REGULATION OF VARIABLE LIFE INSURANCE</td>
<td>72</td>
</tr>
<tr>
<td>Extra Risk Demands Extra Care</td>
<td>72</td>
</tr>
<tr>
<td>SUITABILITY OF VARIABLE CONTRACTS</td>
<td>73</td>
</tr>
<tr>
<td>Full Disclosure</td>
<td>73</td>
</tr>
<tr>
<td>HOW A VARIABLE LIFE INSURANCE CONTRACT WORKS</td>
<td>75</td>
</tr>
<tr>
<td>SCHEDULED PREMIUM VARIABLE LIFE</td>
<td>76</td>
</tr>
<tr>
<td>FLEXIBLE PREMIUM VARIABLE LIFE</td>
<td>76</td>
</tr>
<tr>
<td>Premium Payments</td>
<td>76</td>
</tr>
<tr>
<td>Charges and Expenses</td>
<td>76</td>
</tr>
<tr>
<td>Deductions from the Cash Value</td>
<td>77</td>
</tr>
<tr>
<td>Monthly Revaluation of the Cash Value</td>
<td>77</td>
</tr>
<tr>
<td>Guaranteed Minimum Death Benefit</td>
<td>77</td>
</tr>
<tr>
<td>Conversion (Exchange)</td>
<td>77</td>
</tr>
<tr>
<td>THE SEPARATE ACCOUNT: THE FOUNDATION OF VARIABLE CONTRACT VALUES</td>
<td>77</td>
</tr>
<tr>
<td>Shelter from Creditors</td>
<td>78</td>
</tr>
<tr>
<td>Buying Separate Account Units</td>
<td>78</td>
</tr>
<tr>
<td>Separate Account Performance and the Variable Death Benefit</td>
<td>78</td>
</tr>
<tr>
<td>Separate Account Performance and the Cash Value</td>
<td>79</td>
</tr>
<tr>
<td>Death Benefit Redetermination</td>
<td>79</td>
</tr>
<tr>
<td>VARIABLE LIFE POLICY LOANS</td>
<td>79</td>
</tr>
<tr>
<td>DESCRIPTION OF BENEFITS</td>
<td>80</td>
</tr>
<tr>
<td>INVESTMENT OBJECTIVES</td>
<td>80</td>
</tr>
<tr>
<td>VARIABLE UNIVERSAL LIFE</td>
<td>81</td>
</tr>
<tr>
<td>Guaranteed Death Benefit Rider</td>
<td>81</td>
</tr>
<tr>
<td>Death Benefit Amount Depends on Death Benefit Option</td>
<td>81</td>
</tr>
<tr>
<td>INDUSTRIAL LIFE &amp; CREDIT INSURANCE</td>
<td>83</td>
</tr>
<tr>
<td>INDUSTRIAL LIFE INSURANCE</td>
<td>83</td>
</tr>
<tr>
<td>Home Service Life Insurance</td>
<td>83</td>
</tr>
<tr>
<td>CREDIT LIFE INSURANCE</td>
<td>83</td>
</tr>
<tr>
<td>ENDOWMENTS</td>
<td>84</td>
</tr>
<tr>
<td>TYPES OF ENDOWMENTS</td>
<td>84</td>
</tr>
<tr>
<td>ADVANTAGES OF ENDOWMENTS</td>
<td>84</td>
</tr>
<tr>
<td>DISADVANTAGES OF ENDOWMENTS</td>
<td>85</td>
</tr>
<tr>
<td>LIFE INSURANCE POLICY PROVISIONS</td>
<td>86</td>
</tr>
<tr>
<td>INSURING CLAUSE</td>
<td>86</td>
</tr>
<tr>
<td>CONSIDERATION CLAUSE</td>
<td>86</td>
</tr>
<tr>
<td>PREMIUM CLAUSE</td>
<td>86</td>
</tr>
<tr>
<td>GRACE PERIOD</td>
<td>87</td>
</tr>
<tr>
<td>DEFAULT AND LAPSE OF POLICY</td>
<td>87</td>
</tr>
<tr>
<td>REINSTATEMENT</td>
<td>87</td>
</tr>
<tr>
<td>PREMIUM REFUND AT DEATH</td>
<td>88</td>
</tr>
<tr>
<td>OWNERSHIP RIGHTS</td>
<td>88</td>
</tr>
</tbody>
</table>

© Copyright Sandi Kruise Insurance Training, Sandi Kruise Inc 2002-2015, all rights reserved
INSURABLE INTEREST ............................................................................................................. 89
TRANSFER OR ASSIGNMENT OF OWNERSHIP ...................................................................... 89
POLICY LOAN PROVISIONS .................................................................................................. 90
INCONTESTABILITY ............................................................................................................. 91
ENTIRE CONTRACT AND REPRESENTATIONS ...................................................................... 91
POLICY DATES ..................................................................................................................... 91
COORDINATION OF POLICY .............................................................................................. 91
POLICY CHANGE (CONVERSION OPTION) .......................................................................... 92
MISSTATEMENT OF AGE OR SEX ......................................................................................... 92
FREE LOOK ............................................................................................................................ 92
MEDICAL EXAMINATIONS AND AUTOPSY ......................................................................... 92
BENEFICIARY PROVISIONS ................................................................................................. 92
Revocable vs. Irrevocable ................................................................................................. 93
Methods of Designating Beneficiaries .................................................................................. 93
Succession of Beneficiaries ................................................................................................ 94
Beneficiaries Must Be Clearly Named .............................................................................. 94
DESIGNATION OPTIONS ..................................................................................................... 94
Minor Child.......................................................................................................................... 94
Class Designations.............................................................................................................. 95
PER CAPITA ......................................................................................................................... 95
PER STIRPES ......................................................................................................................... 95
A Trust .................................................................................................................................. 95
Insured's Estate ................................................................................................................... 95
The Uniform Simultaneous Death Act ............................................................................... 96
Common Disaster Clause .................................................................................................... 96
Facility of Payment ............................................................................................................. 96
EXCLUSIONS & LIMITATIONS ............................................................................................. 97
SUICIDE .................................................................................................................................. 97
AVIATION RESTRICTIONS .................................................................................................. 97
HAZARDOUS OCCUPATIONS AND AVOCATIONS ............................................................. 97
WAR AND MILITARY SERVICE ............................................................................................ 97
PROHIBITED PROVISIONS .................................................................................................. 98
LIFE INSURANCE POLICY OPTIONS ............................................................................... 99
SETTLEMENT OPTIONS ...................................................................................................... 99
ELECTING AN OPTION ........................................................................................................ 99
Lump Sum (Default Mode) ................................................................................................. 99
Interest Only ......................................................................................................................... 100
Fixed-Period Installments ................................................................................................. 100
Fixed-Amount Installments .............................................................................................. 100
Life Income ......................................................................................................................... 101
Life Income With Period Certain ...................................................................................... 101
Joint and Survivor ............................................................................................................. 101
Other Methods .................................................................................................................. 102
PAYMENT OF SMALL AMOUNTS ...................................................................................... 102
TIME LIMITATIONS ............................................................................................................ 102
WITHDRAWAL PROVISIONS .............................................................................................. 102
OTHER SETTLEMENT OPTIONS ......................................................................................... 102
LIFE INSURANCE

Life insurance plays an important role in the financial security of many families. More than 80% of American households have purchased individual life insurance policies. Over the years, life insurance policies have evolved from contracts that only provided death benefits into complex contracts that often include numerous types of benefits and features. New products have frequently been introduced in response to changing economic conditions and consumer preferences, and that trend is expected to continue in the future.

This course will examine the field of life insurance, including the role of underwriting and rating, types of policies in the marketplace, life insurance riders, policy options, policy provisions, and some of the ways that life insurance is used in financial planning.

Reasons for Buying Life Insurance - Personal Loss Exposures

A personal loss exposure can be defined as any condition or situation that presents the possibility of a direct financial loss to a human being. Certain personal loss exposures can result in great financial difficulty for individuals and their family members. Important personal loss exposures include premature death, poor health, unemployment, and insufficient income during retirement. Personal loss exposures can be reduced or even eliminated by life and health insurance, disability income insurance, private and public retirement plans, and an effective saving and investing program.

When selling life insurance, agents should assist applicants in determining the types and amounts of coverage to purchase. While consumers are usually aware of a general need for life insurance, many of them may not be aware of the full range of their needs for coverage.

Death Benefits

Death benefits are the one thing that all types of life insurance contracts have in common. In the purest sense, life insurance is a contract that pays a death benefit to someone when an insured person dies. This concept is easily understood. We buy fire insurance to protect against the risk of fire damage, we buy flood insurance to protect against the risk of flood damage, and we buy life insurance to protect other family members against the financial risk of our premature death.

It is the risk of premature death that motivates most purchases of life insurance protection. Anyone who knew for certain that they would live to a very old age would be foolish to waste money on life insurance. If a long life was a certainty, and it would only be necessary to set aside a small sum for the eventual funeral.

However, none of us can be certain that we will live for a long time. There is always the possibility that a disease or accident will end our life. Any of us could become a victim of a natural disaster, an accident, or an act of violence. A long life cannot be guaranteed, even for those whose ancestors have a record of longevity and those who follow a healthy lifestyle.

The risk of an early death is evident to most of us, particularly when we have family obligations, dependent minor children to provide for, and unpaid debts.
The death benefit is the primary purpose for buying life insurance.

**Premature Death**

Premature death can be defined as the death of a working person with outstanding or unfulfilled financial obligations, such as family members to support, children to educate, and a mortgage to pay off. The costs of premature death include the loss of income to the family, additional family expenses, possible decline in the family's standard of living, and noneconomic costs, such as grief and the loss of a role model for the children.

The ownership of life insurance is economically justified on a family member who earns an income that others are dependent on for part or all of their financial support. The financial impact of premature death is not uniform for all families and varies depending on the family structure.

If a single person with no dependents dies or a spouse in a two-income family with no children dies, that death is not likely to cause a serious financial problem for others. In contrast, premature death can cause great financial insecurity in a single-parent family, in a family with children in which both spouses work, and in a traditional, blended, or sandwiched family. The needs can be used to estimate the amount of life insurance these families need.

When premature death occurs, the family's share of the deceased person's future earnings is lost forever. If replacement income from other sources is insufficient to meet the family's needs, or if present savings and financial assets are limited, the surviving family members might experience considerable financial hardship.

**Financial Consequences of Dying**

The expenses and loss of income associated with premature death are the main reason for buying life insurance as well as the major factors in determining the overall need for life insurance.

The needs that may arise due to premature death depend upon the prospective insured's individual situation, such as family structure, marital status, and financial obligations. These needs may include one-time expenses (such as funeral costs), as well as a variety of continuing expenses and income needs. Some needs may be immediate and some may be in the future.

In order to help applicants plan for all possible contingencies, agents should be familiar with the wide range of costs and financial needs that may arise. Consumers may overlook some contingencies, and do not always realize that multiple contingencies could occur. They may not be aware of the large amounts that these needs represent. Potential costs and needs create opportunities during sales presentations for agents to stimulate thought, and to expand the applicants understanding of the need for life insurance.

The most important family needs include the following:

**Final expenses** - Expenses before death, including health care and funeral expenses

- Doctor and hospital bills from a final illness
- Funeral expenses
- Probate and estate settlement costs
- Estate taxes
- Federal and state taxes for large estates
- Mortgage
- Loans, credit cards, and other debts
- Bequests to individuals or charitable organizations

Readjustment income - An amount provided to survivors to allow a transition from the current income level to a reduced income level

- Cash for emergencies
- Preventing a reduction in the family's standard of living, due to insufficient income.
- Child-care expenses for young dependent children

Dependency income needs - Income required while children are dependent

- Continuing family income
- Funding children's education
- Retirement income for a spouse

Pure Protection

All life insurance contracts include the pure protection against the risk of a premature death. It is the loss of life that triggers payment of the benefit.

Life insurance may be used to fulfill a number of personal and family needs. With life insurance, the death of the insured creates an immediate estate for the benefit of the insured's family.

Non-insurance Elements

Many life insurance policies include non-insurance elements. Perhaps the most common of these is cash value. It may be closely associated with the concept of life insurance in consumers' minds, but it is not insurance at all - it is simply a low-yielding savings account. Periodic contributions are made, and the funds earn a fixed rate of interest. Cash value accumulation has nothing to do with mortality or the general insurance concepts of risk of loss and the pooling of large numbers.

A variation of the cash value element is the investment account or the variable account in policies that make use of variable returns or equity investments instead of fixed-return cash values. This is a separate savings or investment element that has nothing to do with the insurance element in the contract. This could also be accomplished through other investments such as mutual funds.

Some policies, known as participating policies, pay periodic dividends which may be taken in cash or used to accumulate additional amounts of death benefit and/or cash value. Dividends are not insurance. Premiums for participating policies are generally higher than for non-participating policies, and dividends are considered to be a return of the excess premium
charge. But dividends have often been used as a successful sales tool, because some people like the idea of getting something extra back, even though they pay more initially.

Tax-advantaged growth makes permanent life insurance an attractive wealth accumulation vehicle as well as sources of financial protection. Conventional life insurance is appropriate when the need is primarily or exclusively for the financial protection element. The assurances offered through the contracts’ guarantees are of paramount importance.

If wealth accumulation is part of the product's intended purpose, variable contracts offer advantages over their traditional counterparts. Potential for above-average returns make variable contracts suitable for investors with long-term investment horizons.

**Life Insurance Is Not Just Insurance**

The need to cover expenses and replace lost family income due to early death is the main reason that people purchase life insurance protection, but it is not the only reason to purchase life insurance products. Originally, life insurance contracts only provided death benefits. That has changed. Today, many forms of life insurance include other types of benefits. Most people also buy life insurance to protect against the risk of living for a long time, or outliving their financial resources. Life insurance is usually associated with death, however life insurance may be used to treat two exposures: dying too soon and living too long.

Some policies have cash value or other savings or investment features. Life insurance products may also be used to protect against some of the risks of not dying at an early age. This could also be accomplished through other investment vehicles, such as stocks, bonds, and mutual funds.

Each insured faces one of two possibilities: dying too soon or living too long. Unfortunately, most people save and invest too little.

**Financial Consequences of Living**

The risk of living to a ripe old age creates additional needs and must also be considered in the planning process. People set financial goals in life, but without a plan to reach those goals, they may never be achieved. Life insurance products and investments such as stocks, bonds, and mutual funds often play a role in helping people reach the goals associated with living. Some of the possible financial needs that may arise as a consequence of living include:

- Funding children's education
- Providing retirement income for an insured
- Providing retirement income for an insured’s spouse
- Providing a contingency fund for emergencies
- Building an estate value

Some of the financial needs associated with living overlap with those associated with dying, such as the need to fund education for children. If a parent dies prematurely, a life insurance
death benefit can cover this need, and if the parent lives, the cash value in the policy will provide funds for this purpose.

Providing retirement income for a spouse is another area where the needs associated with living or dying overlap. The need to provide the insured's own retirement income arises only out of the risk of living, but it is one of the major reasons why people buy cash value life insurance.

Although many people think that the greatest threat to family security would be dying too soon, particularly if death occurs while there are young children involved and before the mortgage is paid, however living too long can create particular financial problems. Inflation may erode financial resources if retirement income benefits fail to keep up with increases in the cost of living. If a person requires medical care or assistance with daily chores and these expenses are not covered by some form of insurance, assets that were accumulated over a lifetime may have to be used to pay the bills. Life insurance can build a contingency fund for emergencies in addition to a fund to provide retirement income.
PERSONAL USES OF LIFE INSURANCE

Life insurance can solve a wide range of financial protection and wealth accumulation needs. Here we look at the additional advantages gained through the use of life insurance.

People need to pay the high cost of dying, if they are not to leave their families with this expense. Families need to be able to pay off the mortgage or provide rent and children’s education must be provided for. The family must have income, whether or not the breadwinner lives to provide it.

Of course, not everyone has the same needs, but as the lives most of people and their needs are similar. Life insurance has features which enable it to meet the needs of widely varying life styles.

During a lifetime, individuals find themselves in various economic circumstances that directly affect their need for financial products. These changing financial situations, along with the uncertainty about how long an individual will live, form the basis of life insurance planning.

The Human Life Cycle

The human life cycle can be described in terms of three economic phases. Most people are "consumers" from birth to age twenty-two, during the growth and education phases of their lives. The work, or "savings" phase runs from the end of the education phase until retirement. (If a couple has children, then the "savings" phase continues until the children finish their "education" phase.) At retirement, people become “consumers” again. If they wish to have an adequate amount to “consume” during retirement, people need to build surplus during the working phase. They must consume less than they earn. Some people also want to build large enough estates to pass on assets to their heirs, or to a charity. Others only want to build an estate big enough to live on until they die.

Singles

The number of single people in the United States has increased over time. Many younger people are delaying marriage, many adults are single because of divorce, and others because of the death of their spouse.

If a single person dies leaving no dependents or outstanding financial obligations, that death is not likely to create a financial problem for others. Such a person needs only a modest amount of life insurance to cover funeral expenses and uninsured medical bills. However, single persons should realize that their insurance needs could change in the future, and they might be wise to purchase life insurance early in life. Premiums will be lower and insurance might be more easily available than later in life when the need might be greater.

For single adults a life policy will enable them to provide:

1. An immediate estate to pay their last expenses and any debts, including particularly for young adults; the cost of repaying college loans.

2. Guaranteed future insurability. While the single adult may not be able to keep healthy, he or she can remain insurable once covered.
3. Tax-deferred growth of cash values that may be used during retirement.

**Single-Parent Families**

The number of single-parent families with children under age eighteen has increased substantially in recent years. This increase is primarily due to the large numbers of children born outside of marriage, widespread divorce and separation, and the incarceration or death of a parent. In most cases, single-parent families are headed by women.

Premature death of an income earner in a single-parent family can result in financial devastation for the surviving dependent children despite the possibility of receiving Social Security survivor benefits. Thus, the need for life insurance is great. Since death means no one remains to raise the children, single parents need to provide money for someone else to raise the children in their place. And they need to provide money to pay off debts and last expenses. Unfortunately, many single-parent families have low incomes, and their ability to purchase large amounts of life insurance is limited.

**Two-income Families**

In many families today, both spouses work. The proportion of women in the labor force has increased dramatically over time, especially married women with children.

Marriages in which both husband and wife work outside the home are the fastest growing segment of the population. The reasons for two-income families range from the desire for a career, or the wish to sustain a higher standard of living, or perhaps a major purchase such as a home. In the case of married couples with children, the extra cost of raising a family, including the cost of education, is reason enough for two incomes.

In two-income families with children, premature death of either spouse can cause financial insecurity for the surviving family members because both incomes are usually needed to maintain the family’s customary standard of living. The need for life insurance on both spouses is great to replace the lost earnings, so the family can maintain its previous standard of living.

In the case of a married working couple without children, premature death of one spouse might not create severe financial problems for the surviving spouse. The surviving spouse is already in the labor force, childcare costs, and the cost of a college education for children is not a factor. However, other concerns, such as indebtedness and current or future financial support of parents or other relatives, might prompt the need for life insurance.

**Traditional Families**

"Traditional families" are those in which only one parent (traditionally the father) is in the labor force, and the other parent (traditionally the mother) stays at home and takes care of the dependent children, and possibly dependent elders as well. Traditional families have declined in relative number over the last few decades. Premature death of the parent in the labor force can cause great financial loss for a traditional family. The need for life insurance for breadwinners is well established. Although the surviving family members might be eligible for Social Security survivor benefits, the benefits will probably be inadequate to meet the family's
needs. If the amount of life insurance on the deceased parent is insufficient, the family's standard of living is likely to decline.

What most people don’t realize is that the need for life insurance on the spouse staying at home can be equally important. The death of this spouse can result in significant expenses, such as child-care and housekeeping. Although the life insurance amounts needed might not be as high as those for the working spouse, the lack of insurance can have a negative effect on the surviving family's standard of living.

**Blended Families**

A "blended family" is one in which a divorced person with children marries someone who also has children. Premature death of a working spouse in a blended family can cause great financial difficulty for the surviving family members, and the need for life insurance is great. Both spouses might be in the labor force, and two incomes are needed to support the blended family. The premature death of one spouse may result in a reduction in the family’s standard of living. In addition to children present from the previous marriages, additional children may be born in the new marriage. As a result, child-care costs may be incurred over a longer period, and funds for the parents’ retirement and children's college education may have to compete for limited funds. Financial planning regarding estate distribution may also be especially important for these families.

**Sandwiched Families**

The increase in life expectancy over the last few decades has proportionately increased the number of older people in the total population. Often, an aged parent receives financial assistance or other assistance from a son or daughter. A "sandwiched family" is one in which a son or daughter with children provides financial support or other types of assistance, such as physical care, to one or both parents, leaving them "sandwiched" between the older and younger generations. Premature death of an income earner in a sandwiched family can cause enormous financial hardship to the surviving family members. Death of a caregiver can also be devastating and result in the need for thousands of dollars per year to pay for substitute care.

**Juveniles**

An obvious advantage of a juvenile policy is coverage to pay the child's last expenses in the event of premature death. For many parents, this is a hard sell since the death of a child is not something they wish to contemplate.

However, a life insurance policy on the life of a child can also protect insurability, and also offers a unique opportunity for cash value accumulation. Since the cost of insurance is lower in a child's early years, most of the premiums paid go into cash value which grows with interest. When a child reaches college age this accumulated cash value may be used to pay the cost of education. And eventually the cash value may be used to purchase a home or start a business. Parents may be more receptive to insuring children when these reasons are discussed.

**College Planning**

Life insurance purchased on a parent's life for the purpose of funding a child's college education offers several advantages over other forms of saving. Only life insurance can guarantee to
complete a college saving plan in the event of the family breadwinner’s death. Fortunately, it is more likely that parents will live to see their children attend college than die prematurely, in which case the policy’s cash value can be borrowed or withdrawn to help cover college expenses. Tax-advantaged borrowing makes permanent life insurance a popular source of college funding. If the policy was purchased on the child’s life, ownership can be assigned to the child as a gift upon graduation.

Retirement Planning

The possibility of insufficient income during retirement is another important loss exposure. Most workers retire voluntarily by age sixty-five. The major financial problem for retired workers is insufficient income. When workers retire, they lose their regular earnings. If replacement income from Social Security, private retirement plans, and personal savings is inadequate, the retired worker’s previous standard of living may be reduced. The problem of insufficient income is aggravated if the retired worker lives unusually long, incurs catastrophic medical expenses or needs long-term care in a nursing facility.

Saving for retirement has assumed greater prominence in recent years, fueled largely by the realization by the immense baby boomer generation of the need to save for what was once a remote concern.

Life insurance plays a well-established role in many people’s retirement plans. Life insurance will complete a survivor’s retirement plan in the event of the insured’s premature death, while insureds who live to retirement find life insurance cash values to be an important source of retirement income.

Estate Planning

Estate planning usually has two primary goals: (1) to reduce the size a one’s taxable estate and (2) to pass on as much of the deceased’s estate as possible to heirs. These goals can be accomplished through property transfers and use of the unlimited marital deduction. If a family’s estate is sufficiently large, however, estate taxes become unavoidable. Since the unlimited marital deduction can put off the tax liability until the death of a surviving spouse, “second-to-die” life insurance is a popular estate planning tool.
BUSINESS USES OF LIFE INSURANCE

Various types of life insurance policies may be used for business purposes. Many businesses buy Key Person life insurance covering the lives of owners, executives or managers. Employers frequently include Group Term life insurance in their employee benefit packages. Businesses often plan for continuation of the business following the death of an owner, partner or stockholder, by executing buy-sell agreements which are funded by life insurance.

Life insurance may also be used to fill a variety of special business needs. Businesses needs to protect against premature death of principals, and other key employees, and need cash to dispose of business interests upon their death.

The three most common types of business with which you will be concerned are the:

- Sole Proprietorship,
- Close Corporation, and
- Partnership.

A sole proprietorship is an unincorporated form of business owned and managed by an individual. The sole proprietor has unlimited liability with regard to the business operation. Creditors can claim both the sole proprietor's business assets and personal assets. When the sole proprietor dies, the business becomes part of the deceased's estate and is commingled with other personal assets subject to taxation, the payment of debts and claims of creditors. Life insurance can be used to fund a business continuation agreement by providing necessary cash with which to keep the business doors open until the business can be sold at its fair market value for the benefit of the family, or the business can be continued by a family member.

A partnership is a legal, non-incorporated business relationship involving two or more individuals who each contribute their unique skills, talents and capital for the purpose of owning and operating a business enterprise. When a partner dies, the surviving partner(s) usually becomes a liquidating trustee, dissolving the business in order to settle the deceased's estate. Life insurance may be used to fund a buy-sell agreement or a cross purchase plan so that surviving partners purchase the deceased partner's interest.

Regardless of the type of business organization, there are three risks which must be faced by the owner of a business interest. He or she will either:

- Die, or
- Become disabled, or
- Retire

When any of these three eventualities occurs, one of three things must happen to the business. It will either be:

- Sold
- Continued, kept in operation by the family or former employees
- Liquidated, or sold
Various agreements backed by life insurance may be used to provide for temporary continuation and eventual sale of a business upon the death of a sole proprietor, purchase of a business by surviving partners, or the purchase of stock in a corporation when a major stockholder dies.

**Liquidation**

In the case of a sole proprietor, death of the owner could result in an abrupt end of income for family members and the forced liquidation of business assets at a fraction of their value. Life insurance proceeds may be used to pay a competent employee or manager to keep the business running until it can be sold at its fair market value.

Many proprietors have very specific ideas of what they would like to see done with his or her business at death. Sometimes the business is the sole means of livelihood of a number of partners or stockholders. In these cases, the liquidation alternative is not acceptable if it can be avoided. But sometimes liquidation, even at a loss of as much as 50% of the business value, is the only practical alternative, since a substantial amount of cash is needed at the owner’s death. A life insurance policy on the owner can often prevent liquidation and preserve the value of the business to be sold or passed on to heirs or dependents.

**Retention**

If the family wishes to continue the sole proprietorship after the death of the owner, life insurance on the life of the sole proprietor may be purchased in an amount sufficient to meet estate settlement costs and to provide a financial "cushion" during the often difficult transition from the founder of the business to his or her successor.

Reorganization of a partnership is greatly facilitated if all the partners execute a buy-sell agreement and fund it with life insurance. In this manner, at the death of any partner, life insurance will furnish the surviving partners the cash needed to purchase the deceased partner's interest from his or her estate. The surviving partners may then proceed with reorganization according to their own wishes.

The family interest in a close corporation may be retained through a partial stock redemption. Section 303 of the Internal Revenue Code allows a corporation itself to redeem (or purchase) enough of its stock from the owner's estate to pay death taxes, funeral costs, and administration expenses. Since this is only a partial redemption, the family retains ownership in the business.

Typically, a Section 303 redemption, integrated into an overall estate plan, operates like this: The close corporation purchases and retains all ownership rights to a life insurance policy on the life of the owner of the stock in the close corporation. The close corporation pays all premiums to keep the policy in force.

When the insured dies, the life insurance company pays the proceeds of the policy to the close corporation. The corporation then uses this money to redeem (purchase) shares of the corporate stock from the insured’s estate. Only enough shares are purchased to death taxes, funeral costs and estate administration expenses, while the remainder of the shares (the remaining interest in the business) passes via the insured’s will to his son or daughter or other family member. The term "partial redemption" comes from the fact that only part of the shares are redeemed to pay expenses.
The end result of a Section 303 redemption is that the family now owns the business outright and can carry on just as they wish.

To assure the smooth continuation of a business during times of changing economic conditions or during periods of rapid growth of a business, it could become necessary to make fairly frequent changes in the amount of insurance on the lives of sole proprietors, or partners, or close corporation stockholders.

### Buy-Sell Agreements

Life insurance may also be used to fund various types of buy-sell agreements which enable businesses to continue after the death of an owner.

Selling a business interest involves a substantial amount of planning. Such planning includes finding a willing buyer, preferably among surviving partners or stockholders, or perhaps employees of the business. In any type of arrangement, an important ingredient is an agreement by the buyer and the seller that, in the event of death, the deceased's business interest will be sold at a predetermined price. Such an agreement is called a buy-sell agreement. An essential provision in such an agreement is the funding provision, since without funds to buy, even the most carefully prepared buy-sell agreement isn't worth the paper it's typed on.

Funding is where life insurance plays a vital part. The needed funds are available at exactly the time needed: at the death of the owner of the business interest. Insurance on the life of the owner of a business interest, payable to the beneficiary who is the buyer of the business interest, can fund the buy-sell agreement with precisely the amount needed, at precisely the right time.

There are two general types of buy-sell agreements:

1. The entity-purchase buy-sell, and
2. The cross-purchase buy-sell.

The major difference between the two is the identity of the buyer (and beneficiary) of the insurance to fund the agreement. In an entity-purchase buy-sell plan, the business entity, usually a partnership or corporation, buys the insurance on the life of each principal that will provide the cash the business entity will need to purchase the deceased principal's interest in the business.

In a cross-purchase buy-sell plan, the principals in the business, the partners or stockholders, each buy insurance on each other to provide the cash each will need to purchase a share of the deceased's interest in the business. Under a cross-purchase plan, in a partnership having six equal partners, 30 policies must be issued if each of the six partners buys life insurance on the other five partners.

Regardless of the type of buy-sell plan, any buy-sell agreement should provide:

1. That the business interest will be sold at a predetermined price, and
2. That the business interest will be purchased at a predetermined price, and

3. A funding mechanism for the agreement.

Some buy-sell agreements provide for a fixed-value agreement which arranges for periodic fixed increases as the value of the business increases. Other types of buy-sell agreements provide for evaluation of the business by applying an appraisal formula. In either situation, the amount of coverage kept current to match the current business valuation, however established. The plan must be re-evaluated from time to time.

In the case of a partnership, the business must be dissolved upon the death of any partner. Partners may plan for reorganization and continuation of the business by executing a buy-sell agreement in advance, under which each surviving partner would purchase a share of any deceased partner's interest. Each partner may take out life insurance on the life of every other partner, or policies covering each partner may be payable to the partnership, to provide the funds for the purchase.

Buy-sell agreements in the form of stock purchase plans or stock redemption plans backed by life insurance are also used by corporations which have a few stockholders, or a few major stockholders, when ownership and control of the business is an important issue. The surviving spouse of a deceased major stockholder may not have the knowledge and experience to make sound business decisions, and remaining stockholders may not want an inexperienced stockholder voting on major policy issues. To avoid this problem, major shareholders may execute a stock purchase plan in advance, under which each agrees to purchase a proportionate share of any deceased shareholder's stock. To fund the purchase, each shareholder would become the beneficiary under life insurance contracts on the lives of the other major shareholders.

Life insurance is widely recognized as a logical means of funding partnership buy-sell agreements and corporate stock redemption plans. The death benefit amount is of critical importance, since it is usually targeted to the agreement's funding requirement. But, whether the policy is owned by an individual (in a cross-purchase arrangement) or by the corporation itself (in an entity-purchase arrangement), the policy's cash value is still a valuable asset.

**Key Person Indemnification**

Many corporations recognize that certain employees play an exceptionally important role in the company's success. The company is often dependent on their vision, creativity, or skill. The death of a key person may have serious consequences for a business, ranging from a loss of customers and income to the expense of finding and hiring a replacement. Many companies protect their financial interest in these key employees with life insurance called Key-Person life insurance. Coverage is frequently in the form of annual renewable term, or perhaps 5-year or 10-year level renewable term, and the proceeds are payable to the business. If it's permanent life insurance, the cash value represents an asset of the company. The key employee is the insured party, but the company is the policyowner and beneficiary.

Life insurance enjoys the same tax-favored treatment when used in meeting a key person need as it does when used with any personal need. Because the company owns the policy, it may use the cash values to meet any financial need encountered.
Deferred compensation and executive bonuses

Some companies set up benefit plans for executives which allow highly-paid officers to defer current income or bonuses and to receive the funds at a later date (such as after retirement) when they might be in a lower tax bracket.

Life insurance is often used to informally fund a nonqualified deferred compensation plan. As an asset of the corporation, it enables the company to promise a preretirement death benefit in addition to retirement benefits. At retirement, the corporation is obligated to pay the employee the deferred compensation, which is usually equal to the policy's cash value.

Split dollar plans

These plans allow employees and employers to share premium payments and benefits. This arrangement often allows a key employee to have additional life insurance at a reasonable cost, and the employer to eventually recapture its investment in premiums.
DETERMINING THE AMOUNT OF LIFE INSURANCE TO OWN

In most cases, an agent must first determine how much coverage is needed before even considering the types of insurance to recommend. Making that determination requires a detailed analysis of the level of security the prospect needs and wants.

The limit of liability is the maximum amount the insurer will pay for a specified insured contingency. Life insurance policies usually use the term face amount to refer to the maximum liability of a death claim. Most American families are underinsured. The average amount of life insurance in force per household in the United States is only $150,100.

Conducting a needs analysis is not an exact science. Each prospect has different needs, priorities and resources. Many variables need to be considered and no set formula can produce the "correct" answer for all prospects. This is why it is important for an agent to be familiar with the concept of analyzing needs. Even if tables or computers are used to manipulate the numbers and generate proposals, an agent still needs to rely on personal judgment when gathering data. The agent also needs to understand that the process is very interactive and that close attention must be given to the needs being expressed by a prospect when answering questions.

The X Factor

Some life insurers use certain arbitrary rules for determining the amount of life insurance to own, such as six to ten times annual earnings. These rules, however, are imprecise and might not reflect a particular family's needs.

As a starting point, agents can use an "X factor," where "X" is a number representing multiples of the proposed insured's annual income. Based largely on the agent's judgment and experience, the factor actually used might be adjusted based on a person's economic status. A factor of 10 might be used for people with lower incomes, a factor of 15 for those with middle incomes, and a factor of 20 for those with high incomes. The rationale is that people with higher incomes tend to accumulate more assets and larger estates, and thus have a proportionally greater need for life insurance.

The amount produced by the "X factor" however, is only a starting point. It should be adjusted for any specific needs, such as large debt obligations, or an above-average number of children in the household. Even with these adjustments there are many limitations to using an "X factor." It is basically an estimate and cannot account for the many unique variables that actually shape an individual's need for insurance. Most significantly, it cannot account for a person's goals, desires and priorities, which have a great influence on insurance needs.

Tools for Analysis

It is generally recognized that a more, formal approach to needs analysis is desirable. Many companies provide their agents with formulas, checklists and charts to help in estimating amounts of insurance to recommend. Some of these tools may be used to project the time value of money, and to convert monthly income needs for a specified, period into an aggregate
amount of coverage. Checklist items help to identify specific needs which might otherwise be overlooked. Computer software programs may be available to analyze overall needs once all the key questions about desired income and benefit levels have been answered.

**Insurance Amount: Gross Estimate**

Usually, each of the separate needs is considered and an amount of insurance is then established for each. However, the amount of insurance needed is not always clear cut. Judgment often enters the picture. In some areas it may be necessary to estimate a sum that might be appropriate.

The items identified during a needs analysis are used to develop an estimate for an overall amount of insurance needed. Think of this as a gross estimate, because other sources of funds and benefits must be taken into consideration before an actual recommendation can be made.

The appropriate amount of insurance for certain needs will be easier to establish than for others. The current unpaid balance of a mortgage and any other loans might be appropriate to cover with decreasing term insurance.

In some areas, particularly when it comes to continuing income needs for survivors or retirees, there are many variables to consider. Interaction with the prospect is a vital part of this process. As part of the information gathering process, an agent should raise some very relevant questions regarding the prospect's wishes. What is the particular lifestyle and level of income that the insured wants to preserve? Is the spouse also working, or would the spouse plan to go to work if the insured dies?

Time factors need to be considered. The number of years this income will be needed. Until the children grow up? Until retirement income for the spouse begins?

If funds for children's education are an identified need, the agent needs to determine how many children there are, how old they are now, when the funds will be needed, and what average college costs might be at that time.

Inflation should be considered if particular needs lie far in the future. Otherwise, the fund being accumulated may be inadequate. The goal of the plan should be to provide a fund large enough to produce the desired income for the required number of years.

In cases where lifetime incomes are being contemplated, insurance company benefit schedules may be helpful to determine appropriate amounts. Each company provides settlement option tables that show the dollar amount of monthly benefit payable per $1,000 of insurance proceeds. These figures indicate how much cash value would be needed to provide a lifetime income for a recipient of a particular age.

**Other Sources of Funds**

Once gross estimates are made for the various life insurance needs, other sources of funds that may reduce or eliminate those needs should be considered. An overall gross estimate may be considerable (hundreds of thousands of dollars or, perhaps, over a million), but other sources of funds and benefits may reduce it significantly.
Regardless of the approach taken when determining insurance needs, other sources of funds should be considered when calculating the need for additional life insurance, such as:

- **Other insurance**
  - Existing medical insurance (may cover cost of last illness)
  - Existing life insurance (individual and group)
  - Credit insurance (may cover debts and mortgages)
- **Social Security** (may provide survivor's benefits and/or retirement income)

**Medicare**
- Medicaid

**Vested pension benefits** (death benefits, retirement income)
  - Group retirement plans

**Personal savings, assets and investments** (IRAS, etc.)
  - Savings

**Investments**
  - Other income (rental property income, etc.)
  - Annuities

These other assets will help in determining the amount and kind of insurance necessary to meet the applicant's current and future needs. When estimating the potential contribution of Social Security benefits to survivors' income, agents should be aware of something known as the blackout period. This is the period of time after the youngest child is 16 years old and before the surviving spouse becomes eligible for retirement benefits. During this period, no benefits will be paid by Social Security to a surviving spouse.

Offsetting benefits may reduce or even eliminate some of the items in the needs list. If existing medical insurance has a large lifetime benefit, any uninsured exposure related to a last illness may be limited to the deductibles and coinsurance, if any. Existing life insurance may substantially reduce a number of needs. Group life insurance will not provide a retirement income, but it will reduce the need for insurance by a working parent working with minor children in the family. An unpaid mortgage may already be fully insured by a credit life policy. Social Security and other available benefits might cut the remaining need for retirement income considerably.

**Insurance Amount: Net Estimate**

By considering all offsetting resources and benefits, the aggregate need for insurance can be trimmed to the unmet need for insurance - the gap to be filled in order to satisfy the established
goals. This net estimate may be used as the basis for a specific sales proposal. The nature of the unmet needs might also suggest the amounts and combination of types of insurance to recommend, such as a specified amount of whole life or other form of level coverage and a specified amount of decreasing term coverage.

There are two basic methods for measuring life insurance needs: the human life value approach and the needs approach. Each approach is a tool to help determine the amount of life insurance needed by an individual or family.

**The Human Life Value Approach**

The Human Life Value approach uses mathematical computation to determine how much life insurance is needed by valuing a human life. The Human Life Value approach considers the human being to be an "income-producing machine." It is a device that mathematically converts the output of the prospect into an amount of cash; the client’s expected income until retirement. The human life value approach determines the value today of cash that is flowing from the prospect in the future.

This method focuses on an individual's future stream of income. It considers such things as annual salary and expenses, years remaining until retirement, and the future value of current dollars, and translates this into an amount of insurance needed to replace the income stream in the event of premature death.

In the human life value approach, the first step is to find the amount of annual income that is surplus to the individual. The surplus is the amount above what the insured would consume himself; which provides the overall standard of living for the individual and the family. The surplus includes amounts spent on education for children, automobiles, vacations, clothing, and food for everyone in the family except him. The items to include in costs of self-maintenance are any money spent on his portion of housing, his clothing, food, the portion of his salary that goes for FICA, federal, state, and local taxes, and all other expenses to maintain the insured as a productive asset.

The next part of the human life value approach involves plugging the given information into the mathematical model and calculating the answer. To determine the surplus, subtract the self-maintenance expenses from the average income.
The amount of any current life insurance is deducted along with the Social Security benefits, any savings accounts and investments, together with the present value of income that would continue if he dies (such as trust funds, or rental income). Subtracting these amounts from the human life value reveals the amount of life insurance needed.

When using this approach, the producer should keep in mind the importance of involving the client in the process, as well as the importance of the assumptions on which the calculation is based, and the potential for change.

Like any tool, its effectiveness depends on how it is used and the validity of the information used, such as:

- Average expected income during the working period
- The time horizon, or expected working life
- Costs of "self-maintenance"
- An interest rate that could be earned, on average, over a long period of time

Importance of Client Involvement

In determining a prospect's life insurance needs, the producer should involve the prospect in constructing the plan as much as possible. This way, the client feels more like the plan is his or her own. As a result, the client is more likely to accept the amount of insurance that is finally determined. If the producer fails to involve the prospect, the plan is easier for the client to reject.

Importance of Assumptions

Mistakes or changes in assumptions can significantly change the results of the human life value calculations. If the estimate of the interest rate is incorrect, the figures change substantially. The projected retirement age also affects the human life value calculation.

Because each of the underlying assumptions used in this technique is variable over time, the human life value approach requires regular review and updates. "Financial checkups" are a valuable service producers can provide to clients. Financial plans must be flexible since the client's needs and circumstances often change greatly over a period of time.

Best Prospects for the Human Life Value Approach

The human life value approach appeals to prospects who are mathematically oriented. Agents should use the human life value approach with prospects most likely to acknowledge its validity: engineers, accountants, architects, and others familiar with, and comfortable with, mathematical models.

The Needs Approach

The needs approach is a method used to determine an adequate amount of life insurance based on the survivors' needs and the amount of existing life insurance, financial assets, and expected Social Security benefits.
This technique focuses on the needs of survivors, instead of the value of the insured’s earnings that will be lost. It considers such things as funeral expenses, possible last illness, continuing family income needs, children’s education, and spousal retirement income, and translates these into an amount of insurance to provide for the survivors.

The purpose of a needs analysis is to determine the overall need for insurance, contributing sources of benefits, the net amount of additional insurance needed, and the most appropriate types of insurance to meet the prospect's goals.

The needs approach is widely used to determine the amount of life insurance to purchase. Under the needs approach, a family’s financial needs are estimated after taking into account any Social Security survivor benefits or other benefits that might be available. The amount of existing life insurance and financial assets is then subtracted from the family's financial needs to determine the additional amount of life insurance required, if any, to meet these needs.

A full needs analysis includes consideration of the possibility of living as well as that of dying. Although a big part of the reason for identifying needs is to help determine an amount of insurance, the nature of the needs revealed will also suggest the types of life insurance which may be appropriate for satisfying these needs. Term insurance can be used to cover the needs associated with premature death, but in order to accumulate funds for retirement income, education or emergencies, a person needs a policy which includes savings and investments.

Although the human life value approach and the needs approach generally give the same results for any given situation, the needs approach is less mathematically complicated and can help policy limits to be more accurately matched with a client's perceived needs. The needs approach is still based on accurate financial information and must be coordinated with all of the prospect's financial resources such as OASDHI and group insurance. It focuses on what the prospect would like to have happen to the family after his or her death and on the very real possibility that the prospect will live on into retirement. It is much easier for most people to understand than the human life value approach.

**Need Categories**

Many categories of needs should be considered:

- Needs created by final expenses
- Needs for readjustment income
- Needs for income during dependency
- Needs for capital
- Needs for income during retirement

The prospect gives the producer an estimate of the amount of money he or she will need to meet the expenses in each category. Those estimates are then matched with the prospect’s resources. Any deficiency in existing resources can be made up with a life insurance product.

**Final Expense Needs**

The first category in the needs approach is final expenses. The goal is to free the family of all short-term debts.
Cash would be needed immediately in an estate clearance fund for funeral expenses, uninsured medical bills, car loans and installment debts, and estate administration expenses.

Estimating the size of the final expense need is not easy. The cost of a funeral is probably the easiest to predict. A producer could contact a funeral director to determine current average costs of a funeral and how they might increase. The amount of money needed to pay off consumer debts may also be reasonably easy to estimate. Final illness expenses are the most difficult to estimate. The prospect cannot possibly know the length of the final illness. A prolonged illness would be more expensive than an accidental death or sudden death. In any event, it is probably a good idea to encourage the prospect to overestimate. Any money left over could be used as an emergency fund for unexpected expenses.

Federal and state inheritance or estate taxes are due in cash shortly after the time of death. The federal estate tax form must be filed within nine months of death. Although a credit shields estates under a certain amount from federal estate tax liability, the tax rate thereafter is sharply progressive. Marriage and charity deductions can reduce the impact of the taxes on the estate, but the wealthier the individual is, and the greater the amount of wealth tied up in illiquid assets, like real estate, the more important it is to have cash from life insurance to pay death taxes.

Life insurance is valuable as a source of cash even when the estate possesses assets that can be sold to raise the money to pay the death taxes. It is common for a forced sale of an asset to bring a low price. As a general rule, wealthy people who want to leave property to heirs face a growing and permanent need for substantial life insurance to make sure their goals can be achieved. This need falls into the final expense need category. The more successful the prospect, the more likely there will be a need for ready cash at the time of death to pay federal estate and state inheritance taxes.

Readjustment Income Needs

Readjustment income is equal to the prospect's current take-home pay for a period of time sufficient for the family to adjust to the absence of the deceased's income. It is designed to allow a transition from the current income level to a reduced income level. This period of time typically runs from one to five years. The readjustment period should be long enough to allow as normal a home life as possible. An abrupt downward change in the family's lifestyle, on top of the death of a loved one, can be devastating, especially to children.

Dependency Period

The dependency income needs include income required while children are dependent. More income is needed while the children are dependent than after they become self-supporting. If the surviving spouse will not be going to work at all, the dependency period runs until when the insured would retire. If, however, the surviving spouse has a viable career, the dependency period ends when the youngest child reaches age eighteen or twenty-two, when children usually either go to work, or until the youngest child graduates from college. The producer should inform the prospect of these various time periods so that he or she can more accurately estimate the needs in this category.

Blackout period

The blackout period refers to the period during which Social Security survivor benefits to a surviving spouse are temporarily terminated. Under current law, Social Security survivor
benefits will be paid to a surviving spouse with eligible children under age sixteen. The benefits paid to the surviving spouse terminate when the youngest child reaches age sixteen and do not resume again until the spouse reaches age sixty. The children's benefits, however, continue until the youngest child reaches age eighteen.

**Capital Needs**

Capital needs is a broad term encompassing many types of financial needs that must be met with cash. An emergency fund is one kind of capital need. It is cash that is available to pay for unexpected events. Mortgage payments are another kind of capital need. Here, the amount is known and can be planned for by setting aside a lump sum to pay the full amount of the mortgage, by investing a lump sum that can generate enough money to make monthly mortgage payments.

A capital needs fund can be used for any long-term financial obligation. The capital fund can provide for the payment of loans on a car, boat, or vacation home. Some people have even included in this fund $500 a year for twenty years for holiday and birthday gifts.

**Retirement Needs**

Retirement needs are financial needs that must be met after the prospect stops working. A retirement fund can be created by the cash values of a permanent life insurance policy. The retirement fund can be a lump sum of money to supplement retirement payments from OASDHI, private retirement plans, IRAs, and other savings. The key fact to present to the prospect is that the retirement fund should be enough to allow the prospect to enjoy retirement. Retirement income for a surviving spouse is another important need to consider.

To calculate retirement needs, anticipated savings, investments, and retirement income (private and/or retirement benefits of OASDHI) available at retirement are subtracted from the lump sum retirement need. The result represents the amount of cash values to be accumulated through permanent life insurance.

Retirement income should not be added to the other needs since retirement income will only be needed if the prospect lives on into retirement, whereas other needs are created only upon the death of the insured.

The prospect's involvement in the assumptions and calculations used in the sales process is crucial. Participation by the prospect makes him feel that he has built his own plan and has made his own financial decisions. This personal contribution and control makes it more likely that the prospect will be committed to his financial goals. It is very difficult for the prospect to reject an amount of insurance recommended. It also conveys to the prospect that the plan is personal and is the prospect's responsibility.

**Producer Use of the Needs Approach**

The primary purpose of every life insurance policy is to provide funds upon the death of the insured. Also important is the accumulation of cash value that is available while the insured is alive. This cash value can be used to supplement the insured's other retirement funds if needed.
Life insurance should never be sold primarily as a retirement plan or an investment. Low cash values in the early years of the policy and the possibility of fluctuating interest rates can leave an insured with far less cash in the policy than expected at retirement. Those circumstances could also cause the premium to increase, and can even result in the policy lapsing due to insufficient premium and interest earnings.

When life insurance is sold to protect the insured's family or estate, it serves its primary purpose. The cash value aspect of permanent life serves a great need, but true retirement plans (IRAs, annuities, etc.) are the products designed primarily this purpose. Producers can avoid E&O claims by selling the proper product for the specific need.

After the needs analysis is complete, the agent should then make recommendations as to the amount and type of insurance needed by the individual.
TYPES OF LIFE INSURANCE POLICIES

Essentially there are only two basic types of life insurance policies: term and permanent. All life insurance is a variation or combination of these two basic types. To match a product to a need requires an understanding of the basic form, its strengths, and weaknesses.

Term life policies cover a limited time period and are pure insurance plans. If death does not occur within the policy period, the policy does not pay.

Permanent policies pay no matter when death occurs, by combining pure insurance with a financial plan. They act as insurance plans if the insured dies prior to completing a financial plan. However, the insured will accumulate savings if the insured does not die.

Life insurance policies fall into four basic classes:

- Group life insurance
- Credit life insurance
- Industrial or home service life insurance
- Individual or ordinary life insurance

**Group Life Insurance**

A specialized type of policy is group life insurance which covers the lives of employees or other group members. The group policy is issued to the employer, association, or labor union, and individual certificates of insurance are issued to each covered person. Benefits are payable to the insured person's designated beneficiary or estate. Group life insurance is usually issued in the form of annual renewable term coverage. Group term rates are based on the overall experience of the insured group and not on the ages or health of the individual group members.

**Credit Life Insurance**

Credit life insurance may be issued on an individual or group basis to cover the lives of debtors for the benefit of creditors. It is written specifically to protect the balance of an unpaid loan if the debtor should the prior to paying the indebtedness.

**Industrial Life Insurance**

This form of life insurance is usually written for small amounts and is characterized by frequent premium payments (monthly or weekly) which are collected by the agent. Home service policies are a variation of this concept, which are sold on a debit payment plan, such as automatic bank drafts. The term industrial life insurance is considered interchangeable with debit or home service insurance.

**Individual or Ordinary Insurance**
Most often, agents will be recommending some form of ordinary, or individual, life insurance to prospects. The term "ordinary insurance" is sometimes used to describe individually-owned life insurance. Some ordinary life policies are issued on a participating basis, which means they pay dividends. Others are issued on a nonparticipating basis, and do not pay any policy dividends.

The category known as ordinary life insurance generally consists of three types of policies and their variations:

- Term insurance
- Whole life insurance
- Endowments

We will explore each of these, as well as some of their variations, in detail in the following sections.
TERM LIFE INSURANCE

Term insurance, a form of temporary life insurance coverage, may be appropriate for many families that foresee decreasing insurance needs during their lifetimes.

Term life insurance policies provide pure protection. These contracts cover a person's mortality risk and pay a death benefit only if the insured dies during the specified term. The term may be specified as a period of time from the inception date (such as one year, five years, 10 years, 20 years, or 30 years), or as a period of time ending at a specific age (such as age 65). If the insured lives beyond the term period, the policy expires and no benefits are payable.

Term insurance has many practical applications for covering insurance needs and it may be combined with other elements of a person's overall financial plan.

Since term insurance is temporary life insurance, the use of term insurance should be related to needs that are also temporary. The basic guideline is to cover temporary needs with term life insurance and permanent needs with permanent life insurance. If the prospect cannot afford sufficient permanent insurance, agents should temporarily cover the permanent need with term insurance rather than leave it unaddressed. The prospect may wish to convert the insurance to a permanent form when finances allow.

Term insurance has four basic characteristics:

- Term insurance provides temporary protection for a specified period, such as one, five, or ten years, or until the insured reaches a specified age, such as age sixty-five or seventy.

- Term insurance policies have no cash value or savings element. The insurance provides protection but no investment, and cash values do not accumulate.

- Most term insurance policies are renewable and convertible. Insurers typically do not allow renewal after a certain age, such as sixty-five, seventy, or seventy-five.

- Term insurance premiums increase with the insured's age and are based on mortality rates. Because mortality rates increase with age, term insurance premiums must also increase.

Mortality rates are the probabilities of death at specific ages. Life insurers have been able to predict mortality rates with a high degree of accuracy for large groups of people.

Term insurance policies may be characterized according to their renewability and convertibility provisions. Term insurance policies may be renewable, or convertible, or both, for a specified number of years without requiring evidence of insurability.

### Renewable Term

Renewable means that a term insurance policy can be renewed for additional periods without evidence of insurability.
Evidence of insurability is a requirement by a life insurer that the insured demonstrate that he or she still meets the insurer's underwriting standards by submitting a medical questionnaire or having a physical examination.

Renewable term policies may be limited as to the number of renewals, or to a specified age beyond which renewals will not be available. When a term policy is renewed, the premium for the renewal policy will be based on the insured's age at the time of renewal.

A term policy is renewable only if the contract includes a renewal clause. When a policy does not include a clause specifically granting the right of renewal, it is a nonrenewable term policy.

A nonrenewable term policy is issued for a specified term and may not be renewed. An insured may always apply for a new policy at the end of the term, but there are no guarantees and the risk may be accepted or rejected based on current underwriting standards.

**Annual Renewable Term**

Annual renewable term policies are term insurance contracts issued for one year at a time. In each year, the premium must cover the current mortality cost plus policy expenses. With this type of policy, the policyowner has the right to renew for successive one-year periods.

Each year the coverage is renewed, the premium for the same face amount increases because of the increase in the insured's age and probability of death.

Yearly renewable term insurance is the most common type of group life insurance used today. Large employee groups tend to be relatively stable, because each year some individuals retire or terminate for other reasons and younger individuals enter the group as new employees. If the overall mix remains similar, changes in group membership do not have much impact on premiums.

Annual renewable term insurance has limited applications for individual insureds, largely due to the fact that the premium rises rapidly at advanced ages. It is usually appropriate only when there is an immediate short-term need for insurance protection. For most individuals, longer term contracts are usually more practical.

**Convertible Term**

Term policies may also be convertible, which means the insured may convert to a permanent type of contract (such as whole life) without providing evidence of insurability. The right to convert may be limited to a number of years or to a specified age. Conversion is often exercised by someone who initially purchases term insurance to maximize protection at a minimal cost, and who later decides to change to a type of policy which the insured could not initially afford. The premium for any converted policy will be based on the insured's age at the time of conversion.

The conversion privilege is valuable. Conversion allows the insured to retain insurance coverage at higher permanent rates if they become uninsurable. However, once the right of renewal or conversion has expired, the insured is no longer protected against loss of insurability.
Reentry Term

A reentry term policy gives the insured the opportunity to provide evidence of insurability at the end of the term and qualify for reduced premium rates (lower than the guaranteed rate which is available for a renewable term policy). The premiums for this type of policy are substantially increased if the insured cannot provide satisfactory evidence of insurability.

PREMIUM CONSIDERATIONS

Lowest Cost for Pure Protection

Because term insurance provides pure protection only, it has the lowest premium cost per unit of protection. For any amount of insurance at a specified age, term insurance would have the lowest premium. For any amount of premium dollars at a specified age, term insurance would provide the greatest amount of coverage. Term insurance may be used to provide coverage when there is an immediate need for a large amount of protection, and a small income to pay the premium.

Premium Components

Term insurance premiums are based almost entirely on the mortality cost for the insurance. Since term insurance is pure insurance, and provides pure protection, the mortality cost is the greatest component of the premium. The premium also includes a loading for expenses to cover acquisition costs, commissions, and overhead expenses.

Renewal Premium Increase

If a term policy is renewed, the new premium charge will be based on the insured's attained age. This means that premiums increase at each renewal due to the rising mortality cost. As an insured gets older, the rate of increase at each renewal will become steeper.

TERM POLICY VARIATIONS

Term life insurance policies can be designed for almost any length of time. There are yearly term policies, five-year term policies, ten-year term policies, and twenty-year term policies. There are also term policies to age sixty-five.

The types of term insurance policies may be defined by the way the face amount of the policy changes, or doesn't change, throughout the term of the policy. The face amount of the policy is the amount of money payable as a death benefit. Generally, they fall into three categories:

- Level,
- Increasing, or
- Decreasing
**Level Term**

Level term insurance provides a level death benefit during the policy term, and is most appropriate where there is a known fixed obligation or contingency.

Level term policies may be used to provide a benefit of a specified size for final expenses, funeral costs, fixed obligations and a general transition period for survivors. Decreasing term policies are ideal for insuring a number of time sensitive obligations, such as paying off long-term debts and providing income for dependent children. Due to its lower cost, it might be preferred over whole life insurance when maximum protection is the current priority, especially when premium cost is an issue. In many cases, an individual's insurance portfolio should consist of some level coverage and some decreasing coverage.

Frequently, level term policies are issued as five-year, 10-year or 20-year policies. In these cases, the annual mortality costs are balanced out and the annual premium, as well as the face amount, remains level for the entire policy term.

Level term policies are often issued as renewable and convertible policies. At expiration of a level term policy, all coverage ceases if it is not renewed. If it is renewed, a new term period would start and the premium would be based on the insured's higher age at that time.

**Decreasing Term**

Decreasing term policies also provide temporary protection for a specified period of time, but the death benefit (face amount) decreases during the policy term until it reaches zero at expiration of the policy.

Many life insurance needs are time-sensitive - they decline as time passes. Decreasing term insurance is ideal for meeting many kinds of time-sensitive needs. One of the most common types of time sensitive needs is a long-term debt obligation, such as a mortgage, or other loan. Income needs may also be time-sensitive. This is particularly true in the case of providing for minor children who will not always be dependent upon the insured.

The need to provide income for a surviving spouse may also be time-sensitive to a degree. There is a time factor to consider between when death might occur and how long income may be needed. There may be a time factor between when supplemental income might be needed and when other future benefits may begin. However, supplemental income benefits may be needed for an indefinite period because other benefits may not exist or may be inadequate, and there is no way of knowing how long a surviving spouse will live.

The annual premiums for a decreasing term policy remain level throughout the policy term. Although the insured's mortality cost increases each year, the amount of coverage being provided is reduced, so the same premium dollars do not have to purchase as much coverage.

Although decreasing term policies are generally not renewable, they often permit the policyowner to convert the amount of remaining coverage into permanent insurance. The premium for the converted policy will be based on the insured's attained age at the time of conversion.
The longer one lives, the less need there is for life insurance to cover specific exposures related to debt obligations and temporary income for survivors. Additionally, as many people mature they accumulate assets - home equity, vested employee benefits, and personal savings and investments. Later in life there may be more assets available for family security, which reduces the gap that needs to be covered by life insurance.

**Increasing Term**

Another type of term insurance which is available is increasing term insurance. With this contract the premium remains level but the death benefit starts small and increases over the term of the policy. The structure of an increasing term policy is the opposite of decreasing term policy.

Increasing term insurance has fewer practical applications than other forms, and is used mostly as a sales tool to attach additional benefits to other types of policies.

There may also be some offsetting forces which can increase the need for insurance as a family ages. When a young couple has additional children, the need for protection may increase. As working people increase their income and accumulate assets, the standard of living rises and the perceived need for aggregate life insurance protection may grow. If an insured accumulates a large estate, the assets above exempt amounts are subject to estate taxes, which reach a maximum tax rate from 30% to 60% for very large estates. Additional life insurance may be needed to protect the value of a large estate by providing funds for estate taxes. These are some of the reasons why an insured's changing insurance needs should be reviewed every few years by an agent.

Increasing term insurance is usually sold as a rider to other types of policies, usually whole life products. These riders are often called “return of premium riders” or “cost of living adjustment riders”. In both cases increasing term insurance is used to purchase additional amounts of protection which would be paid as an additional death benefit.
USES OF TERM INSURANCE

Term insurance has a variety of useful applications and is appropriate in three general situations:

- When income is limited and substantial amounts of life insurance are needed. Substantial amounts of term insurance can be purchased with relatively modest annual premiums. Since term insurance provides pure protection, it allows a person with a limited income to purchase more coverage than might otherwise be affordable.

- To meet a temporary need, such as the need for income during the readjustment, dependency, and blackout periods. Decreasing term can be used to pay off a mortgage or a loan if the insured should die while a balance remains.

- To protect insurability and provide a person with options for the future. The insured might wish to buy permanent insurance but might currently be unable to pay the higher premiums. He or she can purchase term insurance and convert it later into a permanent policy without evidence of insurability.

Adequate protection should be the first priority for most families. It might better serve the prospect's needs to sell the needed level of protection first, and then convert to permanent insurance or savings plans in the future.

Although term insurance can play a valuable role in an insurance program, two major limitations exist. First, term insurance premiums gradually increase with age and eventually reach prohibitive levels at older ages. Term insurance is not suitable for lifetime protection. Second, term insurance policies typically do not develop cash values. Term insurance cannot be used to save money, such as saving for retirement or accumulating a fund for the children's college education. Another savings program must be set up to provide these funds.

Once an agent has completed a needs analysis and determined an estimate, the unmet need for protection and/or savings, one or more proposals may be made using life insurance products to satisfy these needs. An agent will usually find that there are many opportunities to include term insurance products into a financial plan.

Individual financial planning almost always encompasses both insurance protection and savings or investment. Using term insurance in a financial plan allows an individual to separate these elements into two distinct parts of the plan. By treating them separately, some potential conflicts between the two goals can be eliminated and a better allocation of financial resources may be possible.

There are several advantages to using term insurance to deal with the need for insurance protection as a separate element in the financial plan. Doing so helps to clarify the amount of protection that is actually needed. It also helps to minimize the chance that excessive or inadequate amounts of the wrong type of coverage may be sold because of a preoccupation with cash value.

Because term insurance protection is available at the lowest cost, it will always leave more dollars for investment.
Eliminating possible overinsurance or underinsurance in the financial plan results in a better use of financial resources.

Fixed-return cash value policies provide a low return on savings and many alternative investments (such as stocks, bonds, and mutual funds) have performed better over long periods of time.

Many consumers are quite capable of managing the savings/investment side of their own financial plans. Using term insurance often makes it possible to maximize the dollars available for investment. While some consumers need to be “forced” to save at low fixed rates of return, knowing that more dollars are being made available for savings and that higher returns are possible may motivate many consumers to keep their savings and investment plan on track.

**TERM VS. WHOLE LIFE**

Whether term policies should be used in conjunction with or instead of permanent policies depends upon the situation. Some proponents of term insurance products argue that they should be used almost exclusively to satisfy insurance needs. Some proponents of whole life products insist that permanent insurance must be used as the foundation of every financial plan.

There is no reason why term coverage cannot be used as a valid alternative to whole life to satisfy many life insurance needs. What distinguishes whole life policies from term policies is that whole life products accumulate cash value. This is a savings account, and savings are important in anyone's long-range financial planning, but savings are not "insurance." Term policies may also be used in conjunction with savings or investments to accomplish similar or superior results.

<table>
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<tr>
<th>Forced vs. Voluntary Savings</th>
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Some agents argue that people need to buy whole life insurance because it forces them to save for retirement, and that otherwise many people simply would not save. Whole life policies represent a form of semi-compulsory savings. Since term coverage can be purchased at a lower premium cost, term insurance could, however, free up dollars which could be used for voluntary savings.

Some consumers need compulsory savings, and some don't -- it depends upon that person's propensity to save. One of the problems with buying term insurance instead of whole life and attempting to invest the difference, in the hope of a greater return, is that some people have difficulty saving. Some people are more committed to their financial goals than others. A person who understands the concepts of insurance and savings and who is committed to the separate goals, will succeed at buying term and investing the difference.

For many there may be a greater psychological commitment to making a whole life premium payment than to making a voluntary savings contribution or investment. People tend to pay their insurance premiums, but often delay or skip voluntary contributions to a separate savings plan. Proper guidance, such as the establishment of a systematic bank draft or payroll deduction for voluntary savings, may alleviate this problem.
Rates of Return and Risks

The concept of buying term and investing the difference is viable and has merit. Clients buy term insurance rather than whole life, and save or invest the savings in premium in the hope for a better return.

Historically, the interest rates guaranteed by whole life policies have been low (3%-to-4%). These policies offer an extremely high level of safety for consumers, since the principal is fully protected and the interest rates and future cash values are guaranteed by the insurance company. This reflects a fundamental principal of risk and investment the lower the risk, the lower the return; the greater the potential return, the greater the risk.

Insurance companies can guarantee the rate of interest paid to policyholders because they expect to earn more on the use of the money. Cash holdings are invested and yield returns. Policyholders do not have to worry about safety, but they do not share in the investment gains either.

When life insurance is purchased as an investment, it is generally held for a long period of time (up to 30 or 40 years in many cases). Over a long-term, a few percentage points of difference in the return can make a great deal of difference in the principal.

$2,000 Investment Over 30 Years at Various Interest Rates

<table>
<thead>
<tr>
<th>Interest Rate</th>
<th>Years</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>3%</td>
<td>30</td>
<td>$ 4,855</td>
</tr>
<tr>
<td>6%</td>
<td>30</td>
<td>$11,487</td>
</tr>
<tr>
<td>9%</td>
<td>30</td>
<td>$26,535</td>
</tr>
<tr>
<td>12%</td>
<td>30</td>
<td>$59,920</td>
</tr>
</tbody>
</table>

In recent decades, we have seen rising and falling interest rates, rising and falling inflation, and rising and falling stock prices. Many mutual funds and common stocks have shown impressive long-term rates of return, but these are subject to wide fluctuations in value. While these investments may offer higher returns at times, they expose the investment to more risk.

What is best for any given policyowner depends upon the desired rates of return and the degree of risk the policyowner is willing to assume. In order to choose an approach, an individual would first have to make decisions about the degree of safety versus the degree of risk, preferences for fixed returns or variable returns, an understanding of how inflation impacts fixed returns, and whether or not the person would be comfortable managing long-term savings rather than having an insurance company do it.

During periods of inflation, and over long periods of time, equity-type investments have tended to keep pace with inflation and perform better than many fixed-return investments. Many people choose to combine both approaches by purchasing an amount of cash value insurance and then supplementing it with a larger amount of term coverage.

Advantages of Term Insurance

Proponents of term life insurance cite the following advantages:

- It provides the maximum amount of protection for the lowest premium cost
- It allows people with low incomes to purchase an adequate amount of immediate protection
- It is ideal for covering many temporary obligations, such as the outstanding balance on long-term debts
- It may be used as a low-cost option to protect future insurability for an insured whose future need for insurance may change
- It may be used to cover the need for pure insurance protection at a lower cost while releasing funds that may be used for alternative savings or investments

**Disadvantages of Term Insurance**

Some of the potential disadvantages of term insurance are:

- It is temporary protection only
- It could leave an insured who has become uninsurable without protection if the option to renew or convert to another type of policy is limited to a specified age
- If term insurance is renewable, the renewal premiums advance with age and could become prohibitively expensive at higher ages
- It provides a death benefit only and nothing is returned if an insured lives beyond the insured term

Term insurance contracts have many potential applications when used in lieu of or as a supplement to other policy forms. They may be used to provide temporary protection or to protect insurability when a person is young and insurance needs may change over time. When used as part of a long-range financial plan an insured should supplement the term insurance with some form of savings or investment. Term insurance alone cannot be used to accumulate assets.
PERMANENT LIFE INSURANCE

Permanent life insurance should be used for permanent needs. If a business wants to permanently retain a key employee, a whole life insurance contract is an appropriate employee benefit. If the owner of a business is also a key employee, permanent life insurance is appropriate to cover the eventual loss of that employee-owner. Permanent life insurance would be inappropriate for covering a short-term loan, which is a temporary need.

As with term life insurance, a portion of the premium is used to fund the contract if the insured dies prematurely. A second portion of the premium establishes a fund that will provide a specific benefit whether or not the insured dies.

This second portion of the permanent life insurance premium makes up the policy's cash value. Premiums in the early years of term policies are significantly lower than premiums in the same years of permanent policies. Permanent policies have a cash value, which comes from the difference between the cost of the insurance (what is paid for term) and the amount of premium paid for the permanent policy.

Accumulated values are protected and may not be forfeited. A policy may be surrendered for its cash value, or the cash value may be used to purchase another form of insurance. Policy loans are also available once a policy has accumulated cash value (but face value decreases when policy loans are made).

Because of that initial difference in premium, many clients choose term insurance. But the premium for term insurance will increase as the client grows older, due to the increased likelihood of dying.

Permanent policies, on the other hand, are more expensive than term policies in the early years of the policy, but in the long run the annual premium of term insurance will usually exceed that of permanent insurance.

An agent should show the client the total long-term premium (twenty years, thirty years, or longer) for both term and permanent policies, to assist them in making their decision.
WHOLE LIFE

Whole life insurance provides level premiums and lifetime protection. Two basic types of whole life insurance are straight life and limited-payment life insurance. Straight life insurance provides lifetime protection to age 100 with level premiums paid periodically until the insured dies or reaches age 100. Limited-payment life insurance requires level premium payments for only a specified number of years, although the protection is for a lifetime. All whole life policies have cash values.

Whole life insurance combines insurance protection and savings in a permanent contract that remains in effect for an insured's whole life. It provides a level face amount payable as a death benefit, which consists of the combined value of the declining net insurance protection and accumulating cash value. The policy is designed to mature when the insured reaches age 100, at which time the cash value would equal the face value and become payable as a living benefit.

All whole life policies follow the level premium concept. Under continuous payment straight life policies, premiums are payable until age 100. A whole life policy may also be purchased with a single premium, or according to a limited premium payment schedule which permits the policy to become fully paid-up after a specified number of years.

Whole life insurance is widely used to provide family security because it combines insurance protection and savings, which are the two major elements in the financial plans of most individuals. Term insurance may be used as the "pure protection" underlying an investment plan, or when there is a need for additional protection, and annuities or other investments such as stocks, bonds, or mutual funds may be used when there is a need for greater accumulation of assets.

WHOLE LIFE PRODUCTS

The insurance element of a whole life policy is virtually identical to the insurance provided by a decreasing term policy. The concepts of "level protection" and "permanent insurance" are misleading, because every whole life policy is a combination of a savings plan and an amount of insurance, which is decreasing over time.

Because whole life policies include both insurance and savings, they are often part of a long-range financial plan. They provide a level of safety, since the face value, cash value, and the rate of interest earned on cash value are all guaranteed by the insurance company. In some cases, whole life insurance can be used to provide both life insurance protection and savings for retirement or other purposes. In other cases, it is used as a base, to provide guaranteed security supplemented by other forms of protection and/or savings and investment.

GENERAL CHARACTERISTICS OF WHOLE LIFE INSURANCE

Whole life contracts may be characterized by a number of policy features relating to premiums, death benefits, and other policy values.

Level Premiums
Premiums for whole life policies are level and guaranteed for the life of the contract. Level premiums are achieved by charging more than the actual mortality cost during the early years of the contract, and using these extra premium funds, interest earned on them to compensate for the increasing mortality costs during the later years. The policyholder will pay the same annual premiums for as long as the policy remains in effect. If the insured is still alive at age 100, the face amount of insurance is paid to the policyowner at that time (the policy is said to endow).

**Permanent Protection**

Whole life insurance is often called "permanent insurance" because the death benefit remains the same throughout a person's life. In reality, many consumers who purchase whole life insurance use the cash value for retirement income or some other purpose prior to death or policy maturity.

A whole life policy actually consists of a combination of a savings element (the increasing cash value) and a decreasing amount of insurance protection (the difference between the cash value and the face amount). If a whole life policy actually reaches its maturity date, the cash value equals the face amount and the net insurance protection would have declined to zero.

**Cash Value**

Whole life policies include a cash value, or savings, element in addition to the element of pure insurance protection. This value increases during the life of the contract until, if it is held long enough (usually age 100), it equals the face value and the policy matures (in which case, the cash value becomes payable as a living benefit). A policy may also be surrendered for its cash value, or all or a portion of the cash value may be borrowed, at any time prior to the maturity date. Interest charges are assessed on any policy loans, and unpaid loans are deducted from the death benefit.

A cash value is a fund that accumulates in a whole life insurance policy, which the policyowner can access in several ways while still alive. While the cash value is an integral part of the policy's funding, it is also a nonforfeitable asset of the policyowner. If and when a whole life policy is canceled or surrendered, the owner is entitled to receive the cash value by one of three nonforfeiture options.

**Using Cash Value**

There are many situations in which a ready source of cash is needed. The life contract could be used to store funds at competitive current interest rates until a need arises. If the need never arises, the accumulated cash could be used to fund growth opportunities, or even retirement. Life insurance may be used as a means of providing funds for the purpose of buying out an interest in a partnership or close corporation, or to allow a sole proprietor to retire while the business is operated by an heir.

**Guaranteeing the Cash Value**

**The General Account: The Foundation of Guaranteed Values**

For fully guaranteed contracts (such as whole life insurance), an insurer maintains a general account which consists primarily of safe and conservative investments (such as high grade
bonds, real estate, and certificates of deposit). The safety of these investments makes it possible for the insurer to guarantee its policies.

Whole life policies require insurers to operate with a conservative investment perspective. Assets used to support their contractual obligations are held in the insurers' general accounts. These accounts are comprised of investments that are carefully selected to match the liabilities and guarantees of the contracts they back. These accounts represent the general assets of the company; though they are the foundation of the insurer's policy reserves, they are also subject to the claims of creditors. If an insurer's general account assets ever fail to support its reserve liability, the company is said to be "insolvent" and the assets become subject to the claims of the company's creditors—including its policyowners. To reduce the likelihood of this occurring, insurers typically invest their general account assets in conservative instruments; U.S. Government securities, investment-grade bonds and preferred stock are common.

Whole life insurance contracts guarantee more than just the pure insurance protection. The entire death benefit is guaranteed—including the cash value element. In order to guarantee payment of the entire death benefit under a fixed insurance contract, the policy's cash value is guaranteed to meet contractual expectations. This requires conservative investing by the insurer. This applies to all factors that comprise the policy's funding, including the expected return on investments.

<table>
<thead>
<tr>
<th>Guaranteed Nonforfeiture Values</th>
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During the life of the policy, the cash value continues to accumulate, and is guaranteed to have specific values at the end of each year the policy is in force. These specific, guaranteed values are listed in a table which is a part of the policy.

Usually a whole life policy does not have any cash value at the end of the first or second policy year, due to front-end expenses. After that time, cash value begins to accumulate and it is fully protected. Once an insured has accumulated cash value, it cannot be forfeited. An insured may cash in a policy at any time, by surrendering it in exchange for its cash value.

Upon surrender guaranteed cash values may be taken in cash, may be used to purchase a lesser amount of fully paid-up whole life insurance, or may be used to purchase extended term insurance with the same face value of the whole life policy being surrendered. These options are required by law and are designed to protect the equity that an insured accumulates in a whole life contract.

<table>
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<tr>
<th>Guaranteed Rates</th>
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The "guaranteed" rates are contractually guaranteed. Because of their long-term nature, they are characteristically low—perhaps 3 to 5 percent compounded annually. Traditional whole life policies rely exclusively on these rates and credit their cash values with the contractually guaranteed rate.

<table>
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<tr>
<th>Level Face Amount</th>
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The whole life policy provides a fixed amount of protection. The face amount of the policy (the amount payable upon death at any age) is fixed and will not change while the policy remains in effect. As the following diagram shows, an individual who pays premiums every year on the
policy is guaranteed $100,000 when the policy matures at age 100. If the insured dies before age 100, the beneficiary will receive $100,000.

<table>
<thead>
<tr>
<th>INSURANCE PROTECTION</th>
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<tbody>
<tr>
<td>Age 35</td>
</tr>
<tr>
<td>$100,000</td>
</tr>
<tr>
<td>65</td>
</tr>
<tr>
<td>$100,000</td>
</tr>
<tr>
<td>AGE 100</td>
</tr>
<tr>
<td>$100,000</td>
</tr>
</tbody>
</table>

The face value of a whole life policy remains level throughout the insured's lifetime. However, a level face value does not mean level insurance protection. The death benefit is level, but the net amount of true insurance is not. The face amount is a combination of the insurance element (pure protection at risk for the insurance company) and the savings element (the cash value). As the cash value increases, the net protection provided by the contract declines proportionately. The basic structure of a whole life policy consists of an element of decreasing term insurance and an increasing savings account.

The idea of a "level" benefit is something consumers readily understand. Unfortunately, some consumers get confused about the differences between "face amount" and "cash value" - it is not always understood that the death benefit includes the cash value. Many people erroneously believe that both the death benefit and cash value will be paid to the beneficiary.

Since the insurance and savings elements of the contract are, in fact, distinct and mutually exclusive elements, it would be more correct to say that whole life insurance is a "permanent contract" providing a "level face amount" as a death benefit.

**TYPES OF WHOLE LIFE POLICIES**

Most whole life policies have essentially the same characteristics (maturity at age 100, level face amount, and cash value). Differences in whole life policies usually focus on the different approaches with respect to premium payments.

**Methods of Payment**

There are a number of variations available in the options for whole life premium payments. Under any of these options the whole life policy will still mature at age 100, but in some cases the premium payment period will be shorter.

Life "paid-up at 65" policies require premium payments to stop at age sixty-five. Single premium life insurance has one premium payment and lifelong coverage. In some policies, premium levels may change. Initial premiums are set at a low level and gradually increase for several years until they reach a maximum and then continue at a level amount.

**Continuous Premium Whole Life**

The most common method of payment is the continuous premium whole life policy, which is also known as a straight life policy. This is the standard whole life contract. It has all of the
general characteristics of any whole life policy (level premium, level face amount, cash value, etc.), and its distinguishing feature is that premium payments are required throughout the entire life of the policy.

This type of policy is often referred to as straight life insurance, because it does not deviate in any way from the whole life concept.

**Single Premium Whole Life**

This is simply a whole life policy with one premium payment (a lump sum amount which, together with the interest it will earn, will be sufficient to cover all future premium payments). The entire cost of this policy is paid up at the time of purchase.

Except for the premium payment, a single premium whole life policy has all of the same characteristics as all other whole life policies.

**Limited Payment Whole Life**

Limited-payment life insurance is a form of whole life insurance in which the premiums are level but are paid only for a certain number of years, after which time the policy is paid-up. These policies allow the policyowner to pay for the entire policy in a shorter period of time than under a straight life contract. Common forms of limited payment whole life are 20-payment life (meaning payments spread out over 20 years), 30-payment life, and life paid-up at age 65. These contracts offer the policyowner the opportunity to complete all required premium payments during the income-earning years. Although the policy is fully paid up at the end of this period, it will continue to provide protection and will accumulate cash value until the scheduled maturity date at age 100.

In contrast to a continuous payment straight life policy, a limited payment policy will have relatively higher annual premiums, because premium payments will be made for a shorter time. The shorter the premium payment period, the higher the required premium will be. Limited payment policies will also have a relatively higher initial cash value and a more rapid cash value accumulation for the same reasons.

**Indeterminate Premium Whole Life**

These policies are nonparticipating contracts which were developed to compete with participating policies. These policies employ a dual premium concept - a maximum premium and discounts which may reduce the premium. The discounts will vary with insurance company investment performance, but the actual premium charged will never be more than the maximum premium specified in the contract.

**Current Assumption Whole Life**

Current assumption whole life insurance (also called interest-sensitive life insurance) is a generic name for a whole life policy in which the cash values and premiums are determined by the insurer's current investment and loss experience. The standard whole life policy with the level premium is modified to reflect changes in interest rates. Annual premium payments are still required until policy maturity.
The insurance company reserves the right to increase or decrease the premium within a certain range depending on interest rate fluctuations. Premiums might be reduced during periods of relatively high interest rates, and premiums might be increased during periods of low interest rates. These premium adjustments are usually made on an annual basis.

The premium and cash value amounts may change based on the insurer's experience, however there is a minimum guaranteed cash value based on a minimum guaranteed rate of return. The insurer guarantees a maximum annual premium on the policy, but may charge less if the current return on the policy so warrants. The excess interest earned above the guaranteed rate may either lower the premium or increase the cash value accumulation.

**Economatic Contracts**

These policies combine a participating whole life policy with a term rider, and then use dividends to purchase additional paid-up insurance which gradually reduces the term coverage. This allows an individual to purchase a specified amount of total coverage for a lower cost than the premium for the equivalent amount of whole life coverage.

**USES OF WHOLE LIFE INSURANCE**

Whole life insurance has practical applications as a component in individual and family financial planning. Since it includes protection and savings, it addresses the two major components of most people's long-range goals for protection against the financial risk of premature death and providing supplemental funds for retirement income.

A person may choose to use whole life insurance as a part of a financial plan and to supplement it with an additional amount of term coverage. In fact, many whole life policies are issued with term insurance riders.

When the protection portion of the financial plan is adequate, a need to supplement the cash accumulation side of a person's financial plan may also be satisfied with other products, such as an annuity, or alternative savings and investments. These may include certificates of deposit, stocks and bonds, mutual funds and other forms of investment. An individual's needs, resources and willingness to take risks often dictate which tools are appropriate for use in their financial plan.

A whole life policy guarantees that funds will be available whether an insured lives or dies. As soon as a policy is purchased, the death benefit is guaranteed. This provides the security of having time to pursue other goals. If an insured has other long-range financial objectives, such as accumulating assets in real estate or a separate investment portfolio, the immediate security of the death benefit offers peace of mind while these objectives are being pursued. The policy will also accumulate cash value, which can be applied toward these other objectives.

Whole life insurance may also be used to protect estate assets which have been accumulated during life. If an estate is large enough, it may be subject to substantial amounts of estate taxes when the insured dies. Not only does this take away from value of the estate which may be passed on to heirs, it may even force the liquidation of assets in order to pay the required estate taxes. The estate tax and liquidation of assets could mean that much less will be left for survivors. It is quite common for a successful person to purchase a large amount of life insurance later in life specifically to pay estate taxes and to preserve the total size of the estate.
Advantages of Whole Life Insurance

Proponents of whole life insurance point to the following advantages:

- It is a permanent contract that provides a level face amount as a death benefit for the whole life of the insured
- It has level premiums so the policyowner always knows exactly what the cost of insurance will be and never has to worry about premium increases
- It includes protection against premature death and cash value savings which may be used to supplement retirement income or other purposes
- Its accumulated cash value is protected and cannot be forfeited if the policy lapses or is surrendered
- It provides flexibility because the cash value may be borrowed as a policy loan during emergencies, or may be converted into paid-up whole life insurance or extended term insurance
- As an investment, it provides a high level of safety because policy values are guaranteed by the insurance company

The principal advantage of whole life is that it is permanent insurance and can be used to satisfy permanent needs such as the cost of the final illness and burial expenses. The level premium allows the policyowner to always know exactly what the cost of insurance will be, and it offers a form of forced savings. Whole life builds a living benefit through its guaranteed cash value. The cash value can be used as an emergency fund, or cash can be accumulated for specific purposes, such as the children’s college education or additional retirement income to the insured.

Disadvantages of Whole Life Insurance

Some of the potential disadvantages of whole life insurance are:

- The premium paying period may last longer than the insured's income-producing years
- The maturity date is not practical, because few people live for 100 years
- The cash value at retirement age may be much less than the face value of the contract
- As an investment it is very conservative, because the guaranteed interest rate is low in comparison to the historical returns on other investments
- It does not provide as much protection per dollar of premium as term insurance

The major disadvantage of ordinary life insurance is that the policyowner might be substantially underinsured after purchasing the policy because ordinary life insurance premiums are
generally higher than term insurance until the insured reaches a certain age. Attracted by the savings feature, some policyowners might purchase an ordinary life insurance policy and, as a result, have an insufficient amount of insurance protection.
SPECIALIZED POLICY FORMS

Most life insurance policies may be modified by rider or endorsement to attach additional benefits, however, a number of specialized life insurance policies have been designed to apply to some of the more common situations. Many companies sell policies which package different types of coverage in a single contract.

Several life insurance products are based on combinations of the two basic types of life insurance – term and whole life. Most address a specific coverage need, but some are used as marketing tools with little or no relation to a need. The key marketing consideration for the producer in selling life insurance is to match the prospect's need with the right combination of life insurance coverage.

Some specialized policy forms are designed to modify the premium structure rather than the benefit structure. Instead of blending different types of coverage, plans which modify premiums are generally designed for marketing purposes to make life insurance initially more affordable to the buyer.

In a few specialized forms the unique features of the contract are found elsewhere in the policy, such as policies that provide a single amount of insurance that applies to two or more lives.

The names used by different insurance companies for similar types of policies may vary. Individual companies may sell some or all of the policies described in this section, or may include some completely different combinations of coverage in their portfolio of policy forms.

Some specialized life insurance policies are available to meet insurance needs of families with children. Family income and family maintenance policies provide whole life insurance coverage plus an additional amount of term insurance on the life of the head of a household. The term insurance is designed to provide periodic income payments to survivors if the insured dies during the term period. These forms are generally used to provide extra protection during the dependency period.

FAMILY INCOME POLICIES

One popular combination policy form is the family income policy. It combines whole life insurance with decreasing term coverage. Both portions of the insurance coverage apply to the head of the household. The permanent whole life portion of the policy is usually used to provide a lump sum payment at death, while the term portion of the policy is used to provide monthly income benefits for the surviving family.

Since two types of insurance are combined in the same contract, two time periods affect the benefits. The family income portion of the policy depends upon the decreasing term time period. The term insurance is designed only to provide family income payments from the date of death to the end of the term period. Death must occur during the term period in order for income benefits to begin. Income benefits are usually set as a dollar amount per $1,000 of whole life insurance face value.

Since the base part of the family income policy is provided by whole life insurance, it is permanent insurance and protection is provided for the whole of life (to age 100). If the insured...
outlives the specified term period for family income coverage, the decreasing term insurance expires, and only the whole life coverage remains until death or maturity, whichever comes first. As with any whole life policy, the insured may elect to surrender the policy for its cash value or begin taking payments under a settlement option at retirement or at any other time.

The family income policy is often used to fulfill the need for higher amounts of insurance coverage while children remain dependent upon the insured. The reason decreasing term insurance is used, is that every year the children are one year closer to independence, the need for insurance protection is reduced. Once the children have grown and become self-supporting, the need for the additional protection for dependent children no longer exists.

**FAMILY MAINTENANCE POLICIES**

This policy, which is also usually written on the life of a breadwinner, combines whole life insurance with level term coverage.

The family maintenance policy has many of the same features as the family income policy. It is designed to provide a lump sum at death and family income benefits, and pays income benefits if the insured dies before the end of a specified term period. However, the benefit structure is slightly different. It is designed to provide income benefits for a fixed period of time beginning with the date of death provided that the insured dies within the term period.

The primary difference between the family income policy and the family maintenance policy is the length of the income benefit period. Under the family maintenance policy, level term coverage is used to provide a fixed number of installments if the insured dies at any time during the term. Income benefits under this policy are also set as a specified dollar amount per $1,000 of whole life coverage.

There are obvious differences in the benefit structures of the family income and family maintenance policies. Whether one or the other is more appropriate for a particular family's needs may depend more on the insured's priorities, assumptions, and perception of need than on the actual economics of the situation.

One applicant may perceive a need for additional protection only until children become independent. They may assume that after the children are grown, the spouse can return to work full-time and the base life insurance proceeds will provide a sufficient death benefit. This applicant might select a family income policy.

Another applicant with children may feel that the spouse may have difficulty returning to the workforce, and more time will be needed for making transitions and adjustments. This applicant might select a family maintenance policy.

**FAMILY PROTECTION POLICY**

Many life insurance companies offer a package of life insurance benefits designed to provide coverage for all members of a family under one contract. This type of policy is frequently called a "family policy," "family protection policy" or "family plan". Its purpose is to provide minimal amounts of coverage on each member of the family.
Family protection policies provide whole life coverage on the life of the head of a household, with additional amounts of term coverage on the lives of other family members. Since the amounts of coverage are small, benefits usually cover little more than final expenses and funeral costs. It was originally designed for the stereotyped traditional family of the 1950's (where the father was the "breadwinner," the mother stayed at home and raised the children, and greater economic emphasis was placed on the father's life).

The coverage for children begins automatically, usually when they are a few days old, and continues up to a stated age, such as 18 or 21 years.

This form has become somewhat obsolete for families where both parents are working outside of the home. In recent years, there has been an increased awareness of the true economic role played by a "homemaker" (a few thousand dollars of term insurance will not even come close to covering the cost of replacement services, such as child care, house cleaning, preparing meals, etc.). Additionally, for the growing number of families in which both parents are working due to economic necessity, the financial contribution of each parent takes on equal importance. Each working parent usually needs separate life insurance coverage to provide adequately for final expenses, funeral costs, and income security for surviving family members.

The concept of either parent adding a term life insurance rider coverage for dependent children to their policies is still common. As tragic as the loss of a child is, dependent children generally do not contribute to family finances. Final expenses and funeral costs are the primary economic consequences when death of a child occurs, and there is little or no impact on family income. For these reasons, a few thousand dollars of term insurance for dependent children is usually adequate for many families.

**RETIREMENT INCOME POLICY**

A retirement income policy accumulates a sum of money specifically for retirement, while providing a death benefit if the insured should die prior to that time. Upon retirement, the policy pays an income such as $10 per $1,000 of life insurance for the insured's lifetime or for a specified period.

These policies are expensive, because of the rapid cash value accumulation required in order to fund the retirement benefits. This makes them more like endowment contracts than whole life insurance.

**JOINT LIFE POLICIES**

Joint life policies are variations of whole life contracts which are written with two or more persons as named insureds. Most commonly, the policy is issued on two lives with the insured amount payable upon the death of the first insured only. However, policies may be found that pay benefits upon each death, in which case the benefit amount for the first death may be reduced. There are even some policies available (usually written for business insurance purposes) that pay a benefit upon the first death and then increase the amount of coverage on the remaining insured or insureds so that the total face value coverage remains the same.

A popular variation of the joint life policy is the last survivor policy. It pays the insured amount upon the death of the last surviving insured. These policies are often used to provide cash to pay estate taxes and other costs after the death of the second spouse.
Joint life policies commonly provide a conversion or exchange privilege for the surviving insured, under which that person has the option to convert to a form of permanent coverage on his or her life following the death of the first insured.

**JUVENILE POLICIES**

The term “juvenile life insurance” is used to refer to any of the specialized policy forms which are specifically designed to cover lives of minors. One type of policy is commonly called a “jumping juvenile” policy because it automatically increases in face value at a given age, usually 21, but the premium remains level. The usual “jump” is from $1,000 to $5,000.

The owner of a juvenile policy is the person who applies for the insurance and is responsible for paying the premiums. Usually, the owner is a parent or grandparent of the insured child. For an extra premium, a payer benefit provision may be added to a juvenile policy under which the premiums for the child's insurance will be waived if the policyowner dies or becomes disabled before the child attains a stated age (usually age 21). The payer benefit is simply a variation of the waiver of premium benefit which may also be attached to the parent's own insurance policy.

**MINIMUM DEPOSIT POLICY**

This is a whole life type policy with a high cash and loan value, usually available immediately upon payment of the first premium. The initial premium is higher than the premium for traditional whole life insurance, because in addition to covering the mortality cost and expenses, dollars must be immediately allocated to cash value. Such policies were devised in the late 1950s to take advantage of the fact that, at the time, the Internal Revenue Service allowed the interest paid on a policy loan to be deducted in full for income tax purposes.

A prospect could buy such a policy and immediately borrow back the loan value and take a tax deduction so that, in effect, the initial net premium outlay was actually very small. Since that time, however, the IRS has placed restrictions on the interest deduction when a policy loan is made to finance insurance, and the popularity of this form has diminished.

**MODIFIED LIFE**

Generally, this type of policy is sold to an individual who desires whole life insurance but who cannot afford to pay the whole life premium during the initial years. By altering the policy structure, the individual is given the opportunity to purchase a whole life contract with a reduced premium for the initial three-to-five years of the policy.

Modified life is typically a whole life product which is purchased at a very low premium for a short period of time (three to five years) followed by a higher than average premium for the remaining term of the policy. The policy may be a combination of term insurance for the "modified" period automatically converting to whole life insurance at the later date. The face value remains constant and is not affected by the premium change. The policy does not begin to accumulate cash value until after it converts to a whole life form, because initially the coverage is provided by term insurance.

**GRADED PREMIUM**
Graded premium policies are designed to allow the policyowner to purchase a version of whole life without the initial cost of whole life insurance. These contracts are aimed at the young individual just beginning a job or career and whose income is expected to increase in future years.

Graded premium whole life is similar to modified whole life in the sense that initially the premium is very low. Unlike modified life, which has only one increase to a higher level premium for the remaining term of the contract, graded premium policies provide for a series of annual premium increases, usually during the first 5-to-10 years of the policy. At the end of this "step-rated" premium period, the premium remains level for the life of the policy.

Graded premium policies do build cash value, but the amount of the cash value is usually less because of the smaller outlay of premium. Most of the initial premium dollars are allocated to cover the mortality cost of the insurance. The cash value accumulation begins later and has a slower start than under traditional policies. A graded premium policy typically will have very little, if any, cash value during the graded premium period.

**GRADED BENEFIT POLICY**

A graded benefit policy has a level premium but an adjustment in the benefit structure at some later date. Unlike some of the other policies which provide for an adjustment in the premium and/or benefits primarily as a sales tool (offering some attractive feature to the insurance buyer), graded benefits are primarily used as an underwriting tool. When a risk is substandard but the negative risk factors are not great enough to justify rejection, a policy may be issued if the insurance company collects some additional premium dollars to cover the higher risk of mortality. There are two ways to do this - charging more than the coverage being provided, or providing less coverage than the premium charge would otherwise indicate.

One technique is to issue a "rated up" policy, where the premium charge is based on an age higher than the insured's actual attained age. An alternative technique is to issue a "graded benefit" policy, under which a premium is charged for a higher face amount, while the death benefit payable is actually lower during the first five policy years. In this manner, the dollars actually collected are greater than what is needed to cover the amount actually at risk during the early years, and these extra dollars may be set aside to offset the slightly higher risk of mortality.

**SPLIT-LIFE POLICY**

A split-life policy is a combination of a whole life or a term life insurance contract and an annuity contract. The life insurance has a very low cost, but is available only in combination with the purchase of the annuity. The contract gets its name, "split life," because the insurance may be issued to cover the life of one individual and the annuity may be provided on the life of another (perhaps the beneficiary of the life insurance).

**MORTGAGE REDEMPTION POLICY**

The mortgage redemption policy or rider is simply decreasing term insurance. The benefit amount of the term coverage is designed to be equal to the unpaid balance of the mortgage loan at any point in time. These policies may be issued independently of the loan, but
frequently arrangements for such coverage are made in conjunction with the loan transaction to protect the lender against default. It is often convenient for the purchaser to pay their insurance premium along with their mortgage payment.

**MULTIPLE PROTECTION POLICY**

Multiple protection policies are combinations of whole life and term whereby the amount of protection is higher in the early years of the policy and less in the later years. For example, the current death benefit may be equal to two times the amount of the benefit at age 65 (double protection). The death benefit payable prior to age 65 is simply reduced to half of its former amount when the insured reaches that age. The additional death benefit prior to age 65 is term insurance.

**DEPOSIT TERM INSURANCE**

Deposit term insurance is a level term insurance policy that has a much higher premium for the first year than for subsequent years. The initial premium is significantly higher than the average premium needed to cover the cost of mortality during the term period. The excess front end premium (the deposit) is then set aside to earn interest, and these dollars (deposit plus interest) will be applied to reduce the premium payments required in the following years. The premium levels are set so that the entire deposit will be exhausted when the final annual premium is paid. This arrangement provides a method of paying a portion of the premium in advance. The initial deposit and interest are used to make up the difference in premium.

**INDEX-LINKED POLICIES**

Some companies offer policies with face amounts that increase with inflationary trends. The death benefit is usually linked to the Consumer Price Index. Naturally, an additional premium must be charged for the increased amount of protection, and it may be obtained in one of two ways: the insurance company may simply increase the premium when it increases the coverage, or it might make advance assumptions about the rate of inflation and charge a slightly higher premium from the original inception date.
FLEXIBLE POLICIES

To some, level premiums, level face amounts, and fixed benefits imply stability and safety. But for others, these same features reflect inflexibility and missed opportunities. This is particularly true when an individual's insurance needs are changing or there are significant changes in economic conditions. In recent decades several new types of life insurance products have been developed and introduced to satisfy consumer demands for more flexibility in terms of premiums, face amounts and investment objectives. The main types of flexible policies available include adjustable life, universal life and variable life insurance.

Flexible life insurance products provide consumers with a wider range of options than traditional policies. Although these policies provide flexibility, they also pose a degree of uncertainty and increased risk. On the investment side, there is no guarantee that these products will perform better than alternative products. On the protection side, some flexible policies do not guarantee the amount of the death benefit, so there is a risk that an insured who is seeking a better return will actually end up with less protection than is needed.

ADVANTAGES OF FLEXIBLE POLICIES

Flexible life insurance products offer the following advantages:

- The convenience of making policy changes without exchanging policies
- The flexibility to change the premium payment or face amount as needs change
- An opportunity to earn higher rates of interest than are available under fixed-return contracts
- Investment returns under variable policies may exceed the fixed returns under guaranteed contracts

DISADVANTAGES OF FLEXIBLE POLICIES

Some of the potential disadvantages of flexible life insurance policies are:

- Proof of insurability may be required when an insured increases the face amount
- Policy changes which increase the death benefit could require substantially higher premium payments
- Making many policy changes could cause an insured to lose focus of the overall financial planning goals
- Flexible products were introduced during a period of historically high interest rates, and returns in recent years have fallen far below initial expectations
• The investment element in variable products is not guaranteed, and in many cases there is no guarantee of the amount of the death benefit
ADJUSTABLE LIFE INSURANCE

Adjustable life insurance allows a policyowner to make changes in the face amount, amount of premium payments, the length of protection, and the type of protection being provided. Adjustments may be made to the basic features of the life insurance policy, but this contract does not offer flexible interest rates or equity investments.

All of these changes may be made without having to complete a new application, drop or exchange any policies, or even have a new policy issued.

The flexibility of adjustable life is accomplished by allowing conversion from one form of insurance to another, and by making appropriate premium adjustments, if necessary. Whenever an adjustment in coverage is made which increases the amount of the death benefit, proof of insurability may be required before the additional coverage amount is approved.
UNIVERSAL LIFE INSURANCE

Universal life is permanent life insurance, it can serve the needs of individuals and businesses just as whole life has done for many years. However, the flexibility of universal life adds a new dimension to fitting the coverage to the changing needs of the insured.

Our financial climate has changed, and life insurance has had to change with it, in large part because of the intense competition for the dollars available for investment. As inflation and interest rates soared, some financial writers suggested that life insurance buyers purchase low-cost term insurance and put their savings where the return was better. They suggested that the client separate the protection and savings elements of a cash value policy: "Buy term and invest the difference!"

The concept of universal life insurance developed in the late 1970s from the idea that the two components of a whole life policy’s death benefit - the pure protection and the cash value - could be formally separated, giving the policyowner greater control over the funding of the cash value.

Universal life policies enjoyed a surge of success during the mid-1980s when high interest rates were widely available. Sales of universal life products grew at the expense of whole life sales. Since that time, interest rates have dropped dramatically, and universal life sales have fallen while whole life sales recovered much of their former market share.

Universal life insurance is a flexible premium policy that has an investment feature and separates the protection, savings, and expense components. The policy has a guaranteed minimum interest rate and guaranteed cash values. The policy also provides for the crediting of the cash value account with excess interest based on a higher current market rate of interest. Universal life insurance allows adjustments in the benefit and premium amounts, and also offers competitive interest rates on cash value. The distinctive feature of this contract is the variable rate of interest is provided.

Universal life is widely used as a funding vehicle for split dollar and salary continuation/deferred compensation plans. The flexibility of the contract and the high potential returns make the policy appealing to both the employee and the employer.

Universal life insurance has become popular in recent years. Universal life policies are frequently sold as an investment that combines life insurance protection with savings. The policyowner has a cash value account that is credited with the premiums paid less a deduction for the cost of the insurance protection and expenses charged. The balance in the account is then credited with interest at a specified rate. If the policy is surrendered, the cash value account may be reduced by a surrender charge.

One of the potential disadvantages of universal life policies is that they may not perform as expected. When originally introduced, some companies promoted them by using long-range projections of very high interest rates (12%-to-15%). Rates have now fallen so much that actual returns will be considerably lower. Even though agents and companies may warn that projections are not guarantees, overly optimistic projections can only lead to consumer disappointment when actual results are less favorable. Agents must be extremely careful to provide reasonable expectations.
**INFLATION**

Universal life insurance was developed in response to the relatively low interest rates (generally 3 1/2-5%) earned by traditional whole life insurance cash values, which made the whole life product less attractive during periods of high inflation. In order to be more competitive, insurers introduced universal life policies which might pay higher interest rates (such as 8%, 10% or even 12%) during inflationary times. These policies also provide greater flexibility, because they allow policyowners to adjust the death benefits and/or premium payments.

The effect of inflation on insurance face amounts and savings is well-documented. A policy having a fixed death benefit, purchased now, may very well be wholly inadequate 20 years from now. Also, the guaranteed interest rate in such fixed death benefit policies often falls short of keeping pace with current interest rates.

Universal life, however, can provide the flexibility to cope with inflation, and does this in large measure automatically because of the tax-deferred accumulation of cash values at current interest rates. Should the policyowner wish to increase the death benefit, it may be done, although proof of insurability may be required. Universal life insurance features competitive current interest rates to help keep pace with inflation.

**CASH ACCUMULATION FOR RETIREMENT**

People who plan for retirement really have two problems: they must provide life insurance protection for their beneficiary now, while at the same time, accumulate cash value for the future. Whole life insurance will accumulate cash value. However, few nonparticipating policies can match universal life. Participating policies may be able to achieve good returns but do not have the same premium flexibility as universal life. A whole life policyowner can only withdraw any dividend credits. To get more money out of this type of policy, either the insurance coverage would have to be surrendered or policy loans would need to be made, on which interest must be paid or accumulated. In addition to these methods of obtaining funds, a universal life policyowner can also withdraw the cash value without paying interest or surrendering the policy.

**FAMILY**

Universal life can be molded to the changing needs of the family, offering flexibility and versatility. The policy owner really designs the universal life policy based on his or her needs and ability to pay. This is possible because this unusual life insurance policy offers the policyowner the opportunity to change the policy in any or all of the following ways:

- Increase or reduce the amount of insurance protection.
- Increase, reduce, or even suspend premium payments.
- Pay in extra money to enjoy the tax-deferred buildup of cash value.

Through the flexibility that these versatile features permit, the policyholder can use the policy to meet most, if not all, of his or her present and future life insurance needs.
Basic Characteristics of Universal Life Insurance

Universal life is a flexible-premium, adjustable-benefit life insurance contract which accumulates a cash value. "Flexible premium" means that, subject to certain limitations, the policyowner may pay more or less than the premium stated in the contract.

Although there are many variations of universal life contracts, most have an initial required premium. Sales and administrative charges are deducted from the premium, and the balance goes into a fund. Each month, a charge that covers the difference between the cash value and death benefit amounts is deducted for pure term insurance. The balance of the premium earns at least the rate of interest guaranteed in the contract. If the insurer earns excess interest, additional interest credits can be added to the cash value. When interest rates are high, relatively high interest returns have been credited.

In addition to a flexible premium, the universal life contract also provides for an adjustable death benefit. Subject to certain limits, the policyowner may either increase or decrease the stated death benefit. Neither an increase nor a decrease in the death benefit requires the issue of a new policy. However, a policy owner may have to show evidence of insurability if an increase in the death benefit is desired.

Universal life insurance has several basic characteristics:

- Separation of protection, savings, and expense components
- Guaranteed minimum rate of interest
- Considerable flexibility
- Partial cash withdrawals option

First, there is separation ("unbundling") of the protection, savings, and expense components under the policy. The policyowner receives an annual disclosure statement that shows the premiums paid, death benefit, expense charges, interest credited to the cash value account, and cash surrender value.

Second, there are two interest rates credited to the cash value account is specifically stated. There is a current interest rate, which is higher than the guaranteed rate and fluctuates with the market. A guaranteed minimum interest rate is also stated in the policy, such as 4 or 4.5 percent. The interest rate credited to the cash value account can never be less than the guaranteed rate.

In addition, universal life insurance provides considerable flexibility. Premiums can be decreased, increased, or skipped as long as the cash value account is sufficient to pay the mortality costs and expenses; the death benefit can be increased (with evidence of insurability); the policyowner can add to the cash value at any time subject to any insurer restrictions; policy loans are permitted; and certain insureds can be added to the policy. If the cash value is insufficient to pay the mortality charge, then the policy owner would have to pay an additional premium to avoid lapse of the policy.
Partial cash withdrawals can be made. A surrender charge or transaction fee may be imposed for each withdrawal. Unlike a policy loan, a partial cash withdrawal does not obligate the policyowner to pay interest on the funds withdrawn or to repay the insurance company. The withdrawal simply reduces the cash value account. Funds withdrawn can be restored through voluntary additional premium payments.

**Uses of Universal Life Insurance**

Universal life insurance is appropriate for policyowners who want both an investment vehicle and life insurance protection in one policy. It is also appropriate for policyowners who want flexibility in their life insurance program as financial circumstances change over time. Premiums can be decreased or even eliminated by policyowners who are in tight financial times. Premiums may also be increased by policyowners in order to accumulate higher cash values for retirement purposes. Universal life insurance can be also used to save money for specific financial goals, such as a down payment on a home, the children's college education, or retirement income.

One disadvantage of universal life insurance is that because of the flexibility that allows policyowners to reduce or eliminate premiums, some policyowners might not be firmly committed to pay regularly. As a result, the policy might lapse due to insufficient cash value to keep the insurance in force.

**Universal Life Death Benefit Options**

There are two forms of universal life insurance. The first type (A) has an initial level death benefit; as the cash value increases, the amount of pure insurance protection declines. The second type (B) has an increasing death benefit; the death benefit is equal to the face amount of insurance plus the cash value. As the cash value increases, the total death benefit also increases. A higher premium is charged for the second type of policy.

Option A provides a level death benefit, and Option B provides an increasing death benefit. Under either option the death benefit is received free of income tax by the beneficiary.

At any specific age the insured is purchasing more pure insurance protection under Option B than under Option A. The insured will incur a greater cost for insurance under Option B than under Option A.

**Option A - Level Death Benefit**

Under **Option A** (also called Option 1) the death benefit remains level and equals the policy’s face amount. As the policy’s cash value increases, the net insurance protection decreases, but the face value stays the same. Due to the higher potential interest rates that may be credited to the account, if the cash value increases to an amount that exceeds the policy’s face amount, then the death benefit will automatically be increased. Under current tax laws, if the universal life policy is to maintain its status as life insurance and thus provide a tax free death benefit, there must be a degree of mortality risk (pure protection) until the insured’s age 95.

If the excessive funding would cause the policy value to accumulate too rapidly—so that it would mature before age 95, the policy would no longer meet the Internal Revenue Code's definition of “life insurance” and would immediately lose its tax advantages. To prevent this from happening,
insurers continuously monitor each policy to make sure the account value does not infringe upon the corridor of pure insurance protection required by the Code.

**Option B - Increasing Death Benefit**

Option B (also known as Option 2) provides for an increasing death benefit equal to the policy's face amount plus the accumulated cash value.

Option B does not risk a corridor problem since there will always be pure insurance protection. With Option B, the death benefit is always equal to the level amount of pure insurance protection and the policy's cash value.

**Sum Insured Option Provision**

The availability of two optional types of death benefit enhances the flexible character of universal life insurance. Virtually all UL policies permit policyowners to switch from Option A to Option B and vice versa with few restrictions. A common technique used to maximize the insurance opportunity calls for selecting Option B (increasing death benefit) initially, and switching to Option A later.

The policyowner's right to change between Option A and Option B is covered in the sum insured option provision. Most policies limit such changes to once per year.

- If the change is from Option A to Option B, the face amount of the policy will become equal to the pure insurance protection from the prior Option A. To that will be added the policy's account value (which doesn't change when a policy is switched from one option to the other) to yield the full death benefit.

- If the change is from Option B to Option A, the face amount will become equal to the full death benefit under the prior Option B (of which a portion is the account value); from then on, the pure insurance protection will decrease.

When a UL policy changes from an Option B death benefit (cash value plus level amount at risk) to an Option A death benefit (level death benefit with increasing cash value and decreasing amount at risk), the reduced future benefit under the policy may require an immediate reduction in cash value to bring the policy into compliance with the cash value accumulation or guideline premium/cash value corridor test.

**CASH VALUE**

An important feature of universal life is the tax-deferred accumulation of cash value. From each premium paid by the policyowner, a charge, or "load," is deducted to cover sales and administrative expenses. The remainder of the premium goes into a cash value account. From this cash value account the amount needed to pay the mortality charge for the desired death benefit is deducted, usually on a monthly basis and at current term rates. If the policyowner pays more premium than is required to provide the desired death benefit plus other costs, the universal life policy will accumulate cash value.

Premiums paid into a universal life policy earn a current rate of return which can be substantially greater than traditional permanent life insurance policies, and taxes on such earnings are
postponed until the policyowner surrenders the policy. If the policy is held until the insured's death, amounts paid as death benefits will never be subject to income tax.

At any time, the policyowner can make additional contributions above and beyond the regular premium payments, and in doing so can substantially increase the cash value in the policy. These contributions may be made as long as the total premiums paid and the cash value accumulated do not exceed the guideline limits established by the tax definition of life insurance.

The current rate of return is what the insurance company is currently paying. This rate can go up or it can go down. But it cannot drop below the company’s guaranteed minimum rate of return.

The Tax Reform Act of 1984 established a definition of life insurance which extended to all life insurance contracts including universal life. To meet the definition of life insurance, a contract must satisfy either of two tests in regard to premium or cash value. The policy’s failure to meet either of the two tests will result in income taxation of both the annual earnings on the cash value and the death proceeds paid to the beneficiary.

The corridor rules require that if a policy is to meet the definition of life insurance, there must be a minimum amount of pure insurance protection until at least age 95 (and to no later than age 100). At any age until 95, a stipulated percentage of the policy’s death benefit must consist of pure insurance protection as opposed to cash value. If the policy matures (or "endows") any earlier than 95, the contract is no longer considered life insurance under the Internal Revenue Code, and it immediately loses its tax advantages.

Provided the extra premium contributions remain within established IRC limits (under the so-called corridor rules), universal life policyowners may intentionally exceed the target premium (as the minimum required premium amount is sometimes called). If the excessively funded cash value reaches the corridor limit (the "guideline premium amount"), the death benefit is raised to accommodate the richer cash value. Consequently, the net amount at risk remains unchanged.

The corridor rules are primarily a concern only with universal life Option A. Option B policies cannot violate the corridor rules because the pure insurance protection remains level (and the death benefit face amount automatically adjusts upward with the increasing cash value).

The guideline premium is the maximum amount that could be accepted by the policy without violating the Internal Revenue Code corridor rules. Most insurers also have an administrative practice of not accepting premiums above the amount that would cause the policy to be considered a modified endowment contract.

<table>
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<th>Premium and Contract Charges</th>
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<td>The unbundled character of UL means that all policy charges are exposed.</td>
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Charges fall into three general types:

- Deductions from each premium
- Deductions from the policy account value
• Deductions upon policy surrender.

**Premium Charges**

The following charges may be deducted from each premium payment:

• State premium tax charge. This charge, usually around 2 percent to 3 percent of each premium payment, is generally a fixed percentage that represents an average of all state premium taxes.

• Federal PAC tax charge. In 1990, the Internal Revenue Code was amended to alter the way insurers can deduct policy acquisition costs. Most insurers today pass on the cost of the so-called PAC tax in the form of a premium charge, which is usually around 1 to 2 percent.

• Sales charge. Commissions, advertising and printing costs are recovered through a sales charge-usually around 4 percent to 6 percent-deducted from each premium.

**Account Value Charges**

Most **UL** policies deduct certain charges, usually monthly, from the policy's account value, including:

• Issue charge. Usually deducted only during the first policy year, this charge (generally stated as a dollar amount, such as $20 per month) compensates the insurer for expenses incurred in connection with the issuance of the policy (other than sales), including medical examinations, underwriting and establishing policy records.

• Maintenance charge. Unlike the issue charge, which is usually deducted during the first policy year only, the maintenance charge is deducted over the life of the policy. Charges may range from $5 to $10 per month.

• Insurance charge. This is the mortality charge and is based on the insured's attained age and the amount of pure insurance protection (amount at risk), plus an extra charge if the policy was issued on a substandard basis.

• Charge for optional benefits riders. Contract owners who elect optional benefit riders will pay for this increased protection through a monthly charge.

• Asset management fee. This daily charge covers the cost of managing the subaccounts within a separate account and will vary from one subaccount to another.

• Mortality and expense risk fee. This charge, also deducted daily, covers the risk that the insured may suffer an extremely premature demise or that the actual cost of administering the policy will be greater than was projected.

**SURRENDER CHARGES**
A universal life contract may be surrendered for its cash value whenever the policyowner wishes, although a flat surrender charge is usually applied.

Surrender charges typically decrease too over some time period, such as ten to fifteen years.

**GRACE PERIOD**

Under a universal life insurance contract the cost of insurance is deducted from the cash value account. When the cash value account no longer contains enough money to pay the next cost-of-insurance deduction, coverage under the contract expires. However, there is a grace period.

The Universal Life grace period stipulates that, beginning on the "date of default," the contract owner will be allowed 61 or 62 days to pay enough premium to cover all overdue charges and keep the policy funded at a minimum level.

During this time the policy owner must make a premium payment to keep the policy in force. If this is not done, coverage ends. At this point there would be no nonforfeiture options since there is no cash value left to forfeit.

**FRONT-END AND BACK-END LOADS**

Depending on policy design, universal life policies may have front-end sales loads, back-end sales loads, or some combination of the two. The sales loads are the charges that the insurance company levies against the values in a policy to cover its own expenses, including the agent's sales commissions.

In a front-end load, the part of the premium charged as a sales load would be deducted and the balance would go into the cash value account. Front-end load charges generally range from about 7 1/2% to 10%. Many insurers also charge a flat dollar amount of several hundred dollars at the time of policy issue.

The back-end load policy was designed to overcome the principal drawback of the earlier front-end load policies: the consumer did not have many dollars earning interest in the policy during the early years of the contract. The back-end loads usually take the form of service charges for withdrawals from the policy, for policy surrenders and for coverage changes. And instead of the flat first-year charge, insurers will levy penalties for policy cancellation. These penalties are usually highest in the early years and then decline gradually over time.

**ADJUSTMENTS TO THE CASH VALUE ACCOUNT**

Two adjustments are made to the cash value account, usually on a monthly basis. The first adjustment is a charge against the account to pay the cost of the desired insurance coverage at the current term rates. If the cash value account is sufficiently large so as to provide for the monthly cost-of-insurance deductions, the policy will remain in force even though premiums are not being currently paid. Premium payments could be skipped for months or even years. If the cash value is insufficient to pay the mortality charge, then the policyowner would have to pay an additional premium to avoid lapse of the policy.

The second adjustment to the cash value account is a credit of interest at the current rate. The "current rate" consists of two parts: a guaranteed interest rate (guaranteed for the life of the...
policy, and usually fairly low, and excess interest earned by the insurer. Current interest is equal to guaranteed interest plus excess interest. Excess interest is not guaranteed and may vary widely depending on economic conditions.

Some companies will guarantee their current interest rate for a full year. Some companies will choose a shorter period of time, while still others will not guarantee their current interest rates for any particular period of time, thus allowing them the flexibility to react quickly to fluctuating interest rates. Current interest rates are sometimes tied to a recognized index, such as the discount rate for 91-day U.S. Treasury Bills.

Not all of the cash value account receives interest at the current rate. Some policies do not pay excess interest on the first $1,000 in the cash value account.

In the first year, other charges may also be made in addition to the two just mentioned in a front-end load policy. Some insurers levy a monthly charge of a few cents to a dollar or more per thousand of death benefit. Other companies make a flat monthly charge. It is not unusual to find a combination of charges made in the first year which include:

- A charge of 71/2% to 10% of the premium.
- A load generated by not paying excess interest on the first $1,000 of cash value.
- A monthly charge per $ 1,000 of death benefit.
- A flat monthly charge of $20 to $50 or more.

One of the advantages of universal life is that the policy owner is made aware of all the charges and credits made with respect to the contract. Universal life contract holders are furnished with an annual report itemizing the current status of their policies.

The annual statement for a universal life policy illustrates premiums paid, expenses charged, cost of term insurance, and the interest credited to the cash value.

**POLICY LOANS**

Universal life provides for cash value loans in the same way that any permanent plan of insurance does. If a loan is taken, it is subject to interest and if unpaid, both the interest and the loan amount will reduce the face amount of the policy. Also, excess interest is usually not paid on cash value amounts borrowed under a universal life contract.

**WITHDRAWAL OR PARTIAL SURRENDER**

Many universal life policies will also permit a partial withdrawal or surrender from the cash account, which is not treated as a loan. A partial surrender is not subject to any interest and will simply reduce the total cash value in the account. If this withdrawal is later repaid, it will be treated as a premium subject to any sales load that the policy may have.

The death benefit, reduced when the withdrawal is made, is not automatically increased if the cash withdrawal is replaced at a later date. The insured would need to specifically request an increase in the death benefit, and the company may require evidence of insurability.

When the distribution is made to the policyowner, he or she recognizes ordinary income to the extent there is gain in the contract.
A 1986 law change resolved the tax issues related to partial withdrawals as follows:

1. In the first five years, the forced-out portion of a distribution is taxable to the extent there is gain in the contract. This will typically occur where the aggregate premiums paid approach the guideline premium limit.

2. In policy years 6 through 15, the portion of a force-out distribution that is taxable is determined by reference to the corridor percentages. This will typically occur in the longer policy durations when the policy has been substantially funded.

3. Partial withdrawals made after the first 15 policy years have elapsed will be considered a return of capital first, and then interest.

Policy loans are not treated as distributions under these rules.

As a general rule, policy loans should be used in policy years 1-15 for policies that are substantially funded. In policy years 16 and after, partial withdrawals could be made until the taxpayer's basis has been fully recovered. Then, the taxpayer could go back to policy loans to keep subsequent distributions from being currently taxed.

Cash value withdrawals are given favorable tax treatment. This approach to treating withdrawals is known as first in-first out (FIFO) treatment: that which is first put into the contract (premiums) is considered to be withdrawn first.

Withdrawals cause a reduction in policy cash values and death benefits which may be taxable. For policies which are MECS, there will generally be an additional 10% income tax penalty for early withdrawals prior to age 59 1/2.
VARIABLE LIFE INSURANCE

Variable life insurance was developed in response to the low returns earned by traditional cash value policies. The policy has two elements - death protection and a savings/investment element. However, instead of the cash values being linked to interest rates, they are backed by equity investments and securities and are not guaranteed. Variable life insurance generally has the following characteristics:

- A guaranteed minimum death benefit (the actual death benefit may be higher and will vary with the success of the investments)
- Cash values which are not guaranteed (these vary with investment success and may change daily)
- These contracts are regulated as securities

Variable life insurance is a life insurance policy in which the face amount of insurance and cash value vary according to the investment experience of a separate account maintained by the insurer. The policy provides permanent protection with level premiums that are invested in common stocks, bonds, or other investments. Variable life insurance is appropriate for policyowners who want some protection against inflation in the long run in their life insurance program.

Variable life insurance offers a hedge against inflation by establishing an investment account rather than a cash value account. Premiums may be fixed or flexible. Death benefits and the cash or investment value may depend upon the performance of the equity investments. This product is regulated as a life insurance product and as a security investment. Agents must have dual authority from state and federal regulators to sell this product.

According to the Model Variable Life Insurance Regulation of the National Association of Insurance Commissioners (NAIC), variable life insurance is a policy in which the death benefit varies with the investment experience of a segregated investment account maintained by the life insurance company.

According to the NAIC Model Variable Life Insurance Regulation, all variable life policies share three important features:

- Although the policy will provide variable death benefits and policy values, the premiums paid by the policy owner will remain level.
- It is required that the death benefit be greater than or equal to the original face amount of the policy.
- Coverage must be permanent.

Variable life insurance, first introduced in this country in the mid-1970s, with its minimum guaranteed death benefit and possibility of escalating benefits, it presents an attractive alternative to fixed benefit products.
Because the values in a variable life contract depend on the performance of an investment account, there is an inflation hedge only to the extent that the underlying investments keep pace with (or outperform) the general movement in prices. Client must be advised that there are no guarantees on the performance of the investment vehicle used to create and support the cash value of the policy.

Variable life insurance is not for everyone. Clients who are uncomfortable with the investment risks characteristic of variable contracts may not be suitable candidates for this product. Financial representatives have a responsibility at both the state and federal level-to ascertain the suitability of any financial or insurance product (but, especially variable contracts) before recommending its purchase to clients.

Compared to other permanent life insurance policies, variable life policies involve some risk. In periods of failing stock and bond prices or during a recession, the variable policy presents a less desirable plan than the other types of permanent life insurance. Producers should not sell variable policies to clients not willing to take this financial risk with their life insurance.

THE REGULATION OF VARIABLE LIFE INSURANCE

Premiums paid for variable life insurance contracts are placed in the insurer's separate account, consisting primarily of investments which are not guaranteed, so there is considerable investment risk to the policyowner. Due to this element of investment risk, the federal government has declared that variable contracts are securities and are regulated by the Securities and Exchange Commission (SEC), the National Association of Securities Dealers (NASD), and other federal bodies. Variable life insurance is also regulated by state Insurance Department as an insurance product.

As a result of the dual regulation of variable insurance products, agents selling variable life insurance must be registered with the NASD by passing the appropriate licensing exam (usually Series 6 or Series 7), and must also be licensed on a state level to sell life insurance. In some states, life agents are required to obtain a separate variable contracts license.

The principles underlying mutual funds and separate accounts are nearly identical. Like mutual funds, separate accounts are considered "securities" due to the direct pass-through of investment performance from asset to investor. Both mutual funds and variable contracts are regulated by many of the same federal securities laws as general securities.

Regulations

Practically all of the regulatory requirements facing variable life contracts revolve around the pure investment risk included with these products.

Most securities regulations were developed in response to the trading abuses that turned into the infamous stock market crash of 1929 and the Great Depression that followed it.

The Act of 1934 created the Securities and Exchange Commission (SEC) to oversee the industry and set up regulations to govern the conduct of people engaged in the secondary trading of securities.
This act was amended in 1938 by the Maloney Act, which provides for the establishment of a self-regulatory body to help police the industry. The National Association of Securities Dealers (NASD), regulates over-the-counter trading.

Today, anyone wanting to sell securities, including mutual funds and variable contracts, must first be registered with the NASD. Mutual fund and variable contract sales require a Series 6 (Investment Company/Variable Contracts Limited Representative) registration, while a Series 7 (General Securities) registration is required to sell all levels of securities.

Because variable life is a form of life insurance, a life insurance license is also required to sell these particular policies. States vary as to their specific requirements. Some require a separate variable contracts license, while others permit variable contract sales as long as the financial representative has a valid life insurance license and is properly registered with the NASD.

To prevent agents from misleading the public about the possible returns that can be expected with variable life insurance, during sales solicitations. Variable life illustrations may not be based on projected interest rates greater than 12%. This prevents both the agent and the policyholder from assuming excessive and unrealistic rates of return. A variety of policy performance illustrations at different rates (such as 8%, 10% and 12%) would be the preferred method for clearly explaining variable life products. Agents should also stress that rates are not guaranteed and that historical performance may not be duplicated in the future.

**Extra Risk Demands Extra Care**

The characteristic investment risk of variable contracts obligates all parties involved with the creation, marketing and sale of these products to be completely forthright in their dealings with the public.

SEC approval of a prospectus means only that the SEC has approved the manner in which the product was constructed and presented to the public—not the inherent quality or worthiness of the investment. Your role is to disclose all the information needed by the average investor to make an informed decision, not warranty the future performance of the separate account. Provided every effort is made to comply in good faith with state and federal disclosure requirements, producers should not feel responsible for the investment performance of the separate accounts selected by their clients.

State and federal securities laws emphasize the importance of making sure consumers have a clear understanding of (1) the general nature of variable contracts, (2) the specific nature of life insurance (especially whole life) and (3) the unique characteristics of the product being recommended. These issues are addressed in two basic ways: determining that the product is suitable for a client and fully disclosing all pertinent information about the product to the client.

**SUITABILITY OF VARIABLE CONTRACTS**

The issue of "suitability" -- common sense dictates proper conduct in selling variable contracts.

- Perhaps most important, determine first that the need exists for life insurance or annuity protection before recommending a variable contract.
- Never guarantee that which cannot be guaranteed.
• Make sure your client understands the risk inherent in any securities-based investment.

• Recommend specific separate accounts that conform to the client’s planning objectives and risk tolerance profile.

Suitability is addressed primarily at the state level. Most states require companies selling variable life insurance (including variable universal life) to formally adopt a statement of suitability. This standard must be respected by all employees, board directors and producers (agents and/or brokers) of the company. The suitability standard must be applied in every sale. No variable life insurance contract may be sold or issued unless the client meets the standards set forth in the statement of suitability. This requirement dovetails with the regulations found in most state insurance codes requiring producers to determine the suitability of life insurance for the prospective client.

From a state’s perspective, "suitability" means the purchase of variable life insurance is reasonably consistent with the insured’s objectives and needs as determined by his or her age, family situation, financial condition and other relevant information reasonably available to the insurer or producer.

Suitability is also determined by the likelihood that the insured will persist with the policy for a certain length of time. In determining whether suitability standards are being observed, state securities administrators review lapse rates for variable life policies during the first two policy years. Lapse rates significantly higher than expected (usually determined by comparing lapse rates among different companies) may indicate that policyowners are not being properly screened for suitability. (Instances where a policyowner exchanges a variable life contract for a conventional whole life contract are not considered lapses.)

Underlying the issue of suitability is the producer’s basic responsibility to make sure his or her clients understand (1) the fundamental investment risk characteristics of variable life insurance, (2) the relation between investment risk and reward, (3) their personal risk tolerance level and (4) the general nature of life insurance. The decision whether to buy conventional or variable life insurance, and the selection of separate accounts, should be made only after a thorough review of each of these issues.

Determining a prospective client’s risk tolerance is an important responsibility of financial representatives selling variable contracts. The suitability of one separate account relative to another will depend on the buyer’s risk tolerance as well as the separate account’s investment objective. Most companies provide their financial representatives with assistance in helping them determine the risk tolerance of their clients.

Like mutual funds, separate accounts offer different investment objectives. One account may promote capital growth, while another may promote income. Different objectives usually involve varying degrees of risk. An aggressive growth separate account may be appropriate for long-range investment horizons, but its volatility makes it questionable for meeting short-term (five years or less) objectives.

No financial instrument fits every situation, however variable contracts fit a great many situations, provided several conditions are met:

• A need for the basic insurance protection must exist.
The client must understand the long-term nature of all life insurance and annuity contracts.

You and the client must be familiar with the client’s investor profile (which you will likely prepare).

The client must understand the unique nature and characteristics of the variable concept in general and the recommended product in particular. This helps achieve suitability, and usually makes for a more committed client.

The client must understand the basic objectives of each separate or subaccount option, and realize that no selection is truly risk-free.

Full Disclosure

In addition to suitability standards, most states require that life insurance companies provide all life insurance applicants with a generic Buyer’s Guide to Life Insurance and a product-specific Policy Summary, which together explain the general nature of life insurance and the specific characteristics of the policy being recommended. Usually, these documents must be presented when the application is written, and in no instance later than the payment of the first premium.

At the federal level, the Securities Act of 1933 requires that a prospectus be given to the prospective variable life buyer before or at the time of the sale, it discloses the nature of the investment, expense and surrender charges, the investment objectives of each available investment fund, benefit provisions and so on.

The intent of these disclosure requirements is to foster a better understanding by the client of the unique risks and opportunities of variable contracts.

The application form also serves the disclosure need. In addition to the standard information covered in any life insurance application, those for variable life must contain:

- A statement, signed by the applicant, indicating that he or she understands that the death benefit may fluctuate in value but will never be less than the minimum guaranteed face amount;
- A statement, also acknowledged by the applicant, that the policy’s cash value will fluctuate in direct response to the performance of the underlying separate accounts; and
- Questions (and answers) that will aid the applicant in determining the suitability of variable life insurance.

Suitability and disclosure are especially sensitive issues with respect to variable contracts as compared to their conventional counterparts. Applicants who do not understand the variable nature of this product, the relationship between risk and reward and the operation of the separate accounts (including the difference in each account’s fund objectives) cannot be considered suitable candidates for a variable life insurance contract.

HOW A VARIABLE LIFE INSURANCE CONTRACT WORKS
In most respects, variable life insurance contracts function no differently than conventional policies. But variable life also has some features that make it unique, all related in some way to the contract’s separate account operation. Some important provisions and features of a standard variable life contract will illustrate how it compares with its conventional fixed interest counterpart.

Variable life does not "unbundle" the savings and protection elements of a policy the way universal life does. The cash value of the policy is invested in a side fund, and the cash value amount will vary directly with the performance of this side fund. There is no minimum guaranteed cash value.

Premiums on variable life are fixed and level over the contract period. Variable life policies do not pay dividends. The portion of each premium remaining after expense and mortality charges are deducted, and most variable life policies give the consumer a choice of investments: common stocks, money market instruments, corporate bonds, U.S. government securities, etc. The consumer can also switch among the various investment options at regular intervals.

There are basically two types of variable life insurance scheduled premium variable life and flexible premium variable life.

### Scheduled Premium Variable Life

Requires a periodic level premium be paid to keep the policy in force. Because a specific premium will be paid, this type of variable life provides a guaranteed minimum death benefit equal to the initial face amount of the policy. Excess death benefits may be paid depending on the performance of the policy’s separate account. If the portfolio of common stock in the separate account does well, then the variable life policy will perform well. However, the policy owner is guaranteed a minimum death benefit regardless of the performance of the separate account. The cash value of the scheduled premium variable life policy is not guaranteed. The values are solely dependent upon the performance of the separate account. Due to this factor, any cash value loan is usually limited to 75% of the policy's available cash value.

### Flexible Premium Variable Life

Flexible Premium VL provides the flexibility to adjust premiums in combination with investments that are a hedge against inflation. The performance of the policy is solely based on the performance of the separate account. There is usually no guaranteed death benefit because of the flexible premium concept.

**Premium Payments**

Variable life policies may be issued as scheduled premium variable life policies which require a periodic level premium be paid to keep the policy in force, or as flexible premium variable life policies which do not require fixed premium payments.

**Charges and Expenses**

Both conventional and variable life insurance charge policyowners for expenses. Conventional policies generally deduct charges from the gross premium. The gross premium is based on
Deductions from the Cash Value

Deductions of charges and expenses from the cash value reduce the investment return realized by the contract. The deductions often include three separate forms of mortality risk fees, including the standard mortality, or insurance charge; a charge for mortality risk; and a charge to cover the guaranteed minimum death benefit.

Other fees deducted from the separate account include investment management fees (covering the services of the separate account fund managers, normally less than 1 percent) and possibly a monthly contract issue charge. Some policies also charge an expense risk fee, covering the risk that the actual cost of issuing and maintaining policies will be greater than anticipated.

Variable life policies are not exclusively investment instruments; first and foremost, they are life insurance contracts, and like all life insurance contracts, they must cover the cost of the benefits they provide. Due to these costs, the return on the funds invested in a variable life policy will never equal that of a similar investment that does not provide a life insurance benefit (such as a mutual fund).

Monthly Revaluation of the Cash Value

While the separate account value changes daily, the cash values it supports need to be revalued only once per month. Between valuations, the cash value (for loan, surrender and nonforfeiture purposes) is set at the previous valuation amount. Some companies revalue their policies’ cash values more frequently. This represents mixed risks and opportunities for the policy owner. Temporary changes in market direction are frozen until the next valuation date, which may work for or against the policy owner.

Guaranteed Minimum Death Benefit

Variable life policies must provide that the death benefit shall at all times at least be equal to the initial face amount (the face amount when the policy was issued). The death benefit may increase if investment performance of the side fund is favorable, but can never drop below the guaranteed minimum.

Conversion (Exchange)

The conversion or exchange privilege assures variable contract owners that they can transfer to a fixed, guaranteed contract issued by the same insurer if, during the first two years, the owner decides the variable contract was not an appropriate choice. This usually affords a sense of relief to prospective buyers who may be uncertain if the variable contract is right for them.

The 24-month minimum time period for conversion is set by federal law; each state has the right to establish a longer minimum period.

The Separate Account: The Foundation of Variable Contract Values
An insurer must establish a separate account for its variable products. Premiums paid for variable life insurance must be placed in the insurer's separate account, which consists primarily of common stocks and other securities-based investments. This portfolio is subject to considerable investment risk.

The return is directly related to the performance of the assets underlying the separate account. Separate accounts are not insured by the insurer and the returns on their investments are not guaranteed. These accounts, and the funds within them, are separate from the company's general account.

To the insurer, this presents a means of transferring the investment risk from itself to the policyowner. The insurer can offer policyowners the possibility (though not the guarantee) of competitively high returns.

**Shelter from Creditors**

Shelter from the insurer's general creditors is another attractive feature of separate accounts. Because they are separate from the company's general account, separate accounts are protected from the claims of the insurer's general creditors.

Policy owners cannot lose the physical assets underlying their life insurance cash values in the event of company insolvency.

The single greatest reason for the variable contract's popularity is the investment control and opportunity for gains that may far exceed the conservative returns guaranteed in fixed contracts. Whereas an insurer may be capable of crediting a currently guaranteed rate of interest through its general account, a separate account investment may realize returns twice that or more.

**Buying Separate Account Units**

Contract owners usually select the separate accounts where they want their policy values invested, depending on their objectives. Most contracts permit contract owners to transfer funds between separate accounts, often at no charge, after the contract has been issued.

Each variable contract premium purchases "units" that represent an undivided interest in the separate account assets. A unit's value is equal to the value of all securities in the separate account divided by the outstanding units. The number of units purchased equals the premium payment divided by the unit value on that day. A variable contract's value at any time is equal to the total units owned multiplied by the unit value at the close of the business day of the valuation.

In cases where a policy's cash value is distributed among several subaccounts, the full contract value is determined by adding together the values of the different subaccounts.

**Separate Account Performance and the Variable Death Benefit**

The advantages and disadvantages of variable life insurance are both related to its investment feature. On one hand, it may perform well and provide higher death benefits than whole life insurance and better returns on investment. On the other hand, it may perform poorly -- and there is greater risk and no guarantees.
The death benefit payable under a variable life policy is determined in the same way as that of a conventional policy. The policy's cash value (generally increasing) plus the insurer's net amount at risk (usually decreasing) equals the death benefit.

With conventional contracts these two aspects of the policy are calculated (and guaranteed) to always equal a certain amount (the face amount), which remains level for the life of the policy.

As with conventional whole life, variable life insurance guarantees the policy's death benefit to be no less than the face amount at policy issue. But with variable life there's the possibility of realizing a death benefit larger than what is guaranteed.

The variable death benefit is directly related to the performance of the contract's separate account. If the separate account growth exceeds the policy's Assumed Interest Rate (AIR), the result is a higher death benefit.

Each year that the actual return exceeds the AIR, there is a positive net investment return, and the death benefit is increased. In years where the actual growth is less than the AIR, the effect is to decrease the death benefit from any previously attained levels. The death benefit however, will never drop below the face amount guaranteed at policy issue.

**Separate Account Performance and the Cash Value**

The cash value, with its direct relation to the separate account, also fluctuates in value daily. However, most contracts stipulate that a variable life policy's cash value will be recalculated once per month. Between these monthly recalculations the cash value amount remains set at the prior month's level.

**Death Benefit Redetermination**

The possibility of increasing death benefits is another popular feature of variable life insurance. The death benefit will be determined on the basis of the separate account value on the contract's valuation date. Changes in the policy's face amount must be redetermined at least annually.

**Variable Life Policy Loans**

Variable life insurance policies allow their owners to access the cash value through a policy loan. Policy loans are an attractive feature of any permanent life policy.

When a policyowner "borrows" from a policy's cash value, the insurer segregates a corresponding portion of the cash value as collateral for the loan. The "collateralized" cash value continues to earn interest, as does the "uncollateralized" portion.

The borrowed amount, like any loan, accrues interest due at a rate greater than what the cash value is earning. The result is, over time, a net decrease in the cash value.

The loaned amounts, however, earn a fixed, guaranteed rate of interest. Cash values that are subject to a loan do not participate in the separate account's investment performance, as do the unloaned policy values.
Some variable life policy designs allow partial withdrawals as well as surrenders and loans. A partial withdrawal is a permanent surrender of a portion of the cash value that has a direct influence on all policy values, including the death benefit. This option is not standard with variable life policies, but it is more common with variable universal life policies.

As with conventional whole life, variable life policy loans can be repaid at any time, in part or in full, but there is no requirement that they must be repaid. Unpaid loan balances accrue at compound interest and will reduce the death benefit. When loans are repaid, the repayment of the principal is reinvested in the separate account, at current unit values.

Variable life insurance policy loans are limited to something less than 100 percent of the total cash value—usually 75 percent (though some insurers permit loans of up to 90 percent of the cash value).

Under most states’ laws, policy loans must be made available (a cash value must start to develop) after the policy has been in force for three years. Variable contracts must permit loans of at least 75 percent of the cash value subject to the following:

- Any outstanding loan indebtedness, including accrued interest, will be deducted from the death benefit at death.
- Any outstanding loan indebtedness, including accrued interest, will be deducted from the cash value upon surrender or the election of a nonforfeiture option.
- The policy may stipulate that loans must be greater than a minimum amount.
- Loan amounts will be withdrawn from a separate account, and loan repayments will be deposited into a separate account.

### Description of Benefits

The cover page of the policy must contain certain paragraphs describing the variable nature of contract values. The differences between conventional whole life and variable life must be highlighted, including the death benefit, cash value, methods of determining benefits and the guaranteed interest rate credited to funds allocated to the company's "fixed interest" (general) account.

### Investment Objectives

Variable life contracts must include a provision stating that a separate account's investment objective cannot be changed without the approval of the state Insurance Commissioner.
VARIABLE UNIVERSAL LIFE

This product blends a combination of the variable and universal life insurance concepts. The policy has elements of variable life insurance because it is backed by equity investments. The policy has elements of universal life insurance because it allows the policyowner to adjust the amount of the death benefit and/or the premium.

Variable Universal Life (VUL) is similar to universal life insurance with two major exceptions. First, the cash values are not guaranteed, and there is no minimum interest rate guarantee. The cash value of the policy is determined by the investment experience of a separate account maintained by the insurer. The second major difference is that the cash value is held in a separate account, and VUL policy owners may choose to invest their policies' cash value in any of a variety of separate or subaccounts.

Guaranteed Death Benefit Rider

Some VUL insurers offer a death benefit guarantee, either through an optional rider or as a built-in contract provision. The guarantee protects against poor investment performance only; underfunded policies are not protected under the guaranteed death benefit.

Death Benefit Amount Depends on Death Benefit Option

VUL offers the same two death benefit options described earlier in Universal Life Insurance. If Option A (decreasing pure insurance protection) is elected, the death benefit remains level as long as the minimum guideline premium is paid and investment returns match assumptions made at policy issue. With Option B, the death benefit rises from the outset and is always equal to the level pure insurance protection plus the policy's account value. If the policyowner wants a death benefit that varies up and down with the performance of the contract's underlying investments, he or she should select Option B.
## Comparison of Traditional Life Insurance Forms and Variable Life Insurance

<table>
<thead>
<tr>
<th></th>
<th>Scheduled Premium VL</th>
<th>Whole Life</th>
<th>Flexible Premium VL</th>
<th>Universal Life</th>
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<tbody>
<tr>
<td><strong>Death Benefit</strong></td>
<td>Guaranteed minimum death benefit</td>
<td>Guaranteed death benefit</td>
<td>Not guaranteed</td>
<td>Flexible</td>
</tr>
<tr>
<td><strong>Premium</strong></td>
<td>Fixed</td>
<td>Fixed</td>
<td>Flexible</td>
<td>Flexible</td>
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<tr>
<td><strong>Cash value</strong></td>
<td>Not guaranteed</td>
<td>Guaranteed</td>
<td>Not guaranteed</td>
<td>Guaranteed</td>
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<tr>
<td><strong>Risk</strong></td>
<td>The insured</td>
<td>The insurer</td>
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<td><strong>Performance</strong></td>
<td>Separate Account</td>
<td>General Account</td>
<td>Separate Account</td>
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<td><strong>Laws</strong></td>
<td>State &amp; Federal</td>
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Industrial Life Insurance

Industrial life insurance is characterized by the following features:

- Relatively small amounts of coverage (a few thousand dollars or less)
- Frequent premium payments (monthly or weekly)
- Personal collection of premiums by the agent or a company representative
- Coverage may be available for family members (from birth to age 65 or 70)
- Medical exams are not required
- Grace period of four weeks (28 days) if premiums are paid weekly; 33 days if paid monthly

This form of insurance grew out of the Industrial Revolution and was originally sold to factory workers. Benefits were used primarily to pay for a last illness and burial expenses. Today, this type of insurance is not very practical, due to the very small amounts of coverage involved and the fact it is not economical for agents to personally collect small premiums.

In many states, the maximum aggregate amount of industrial life insurance that can be sold to an individual by an agent is $10,000.

Home Service Life Insurance

A variation of industrial life is known as home service life insurance. Policies are usually modest in size, ranging from $10,000 to $15,000 in face value, and are typically sold on a monthly debit plan (automatic bank draft) or payments by mail, which eliminates the need for an agent to collect the premiums.

Credit Life Insurance

Credit life insurance is designed to insure the lives of debtors for the benefit of a creditor (who is the policyowner). In the event that the insured debtor dies, it pays the outstanding balance of the loan.

Credit life insurance may be written on an individual or group basis. It is usually written as decreasing term insurance in connection with a purchase being financed. The total premium is often added to the installment loan payments so that the insurance premium is being financed along with the item being purchased. Insureds are given a certificate of coverage. Coverage terminates if debt is paid off, transferred, refinanced, or becomes significantly overdue.
Endowments can generally be perceived as forced savings plans with a death benefit. Endowments pay the face amount of insurance to the designated beneficiary if the insured dies within a certain period. If the insured survives to the end of the period, the face amount is paid to the policyowner. From the IRS’s viewpoint, endowments are not considered life insurance.

Endowment insurance is seldom sold today because most endowment policies cannot meet the tax definition of life insurance. Adverse tax consequences have discouraged the sale of new endowment policies. However, many older endowment policies are still in force, and endowment contracts are sometimes used in retirement plans.

An endowment policy has the same structure and all of the same features as a whole life policy, the only difference is an earlier maturity date. An endowment contract has a level face value, level premiums, a declining amount of insurance protection and an increasing cash value which equals the face value on the maturity date. Endowments are purchased for various periods of time, such as 10 or 20 years, or until age 65.

Because endowment policies mature at an earlier age than whole life policies, they have an accelerated rate of cash value accumulation, and the premiums for an endowment policy must be considerably higher than premiums for a whole life policy. An endowment policy will have higher cash and loan values throughout most of the policy period in comparison to a similar amount of whole life insurance.

**Types of Endowments**

Endowments can be used for different purposes. Retirement endowment contracts are usually sold specifically to provide retirement income, and are designed to mature at age 65 or some other planned retirement date.

A pure endowment contract pays the face amount only if the policyowner lives to the maturity date. It offers no life insurance protection, and pays nothing if death occurs prior to the maturity date. This contract is hardly ever sold because it is basically a savings plan with a risk of forfeiture of the savings.

A more common variation is the juvenile endowment policy, which is designed to mature when a young person reaches a specific age, such as age 18. It is frequently used to build funds for a college education. The contract may be written on the life of the child or on the life of an adult policyholder, usually a parent. It is often more practical to insure the life of the parent, because whether the parent lives or dies, the funds would be available for education.

**Advantages of Endowments**

The primary advantage of an endowment policy is the forced savings element combined with the life insurance benefit. Unlike voluntary contributions to a savings account, the premiums must be paid to keep the policy in force. This creates a strong incentive to systematically save money. The savings plan is backed up with life insurance protection against premature death.
Disadvantages of Endowments

The forced savings element is also the principal disadvantage of an endowment. Endowments should not be purchased if the person's primary need is for life insurance protection. An endowment policy would provide the least amount of protection per premium dollar. Endowment policies have higher premiums than any other form of life insurance. Since they don't meet the IRS definition of "life insurance," the policy owner does not enjoy most of the tax benefits of life insurance.
LIFE INSURANCE POLICY PROVISIONS

Life insurance policies contain a number of important contractual provisions, including the incontestable clause, suicide clause, grace period, reinstatement clause, misstatement of age or sex provision, beneficiary designations, and assignment clause.

Many life insurance policy provisions have become standardized by law, custom, legal challenges, and a desire within the industry for consistency and clarity. Variations do occur, but typical provisions in use today are similar from one contract to another, and from one company to another.

Most states have established minimum standards which are based on model laws which require that certain provisions be included in individual life insurance policies, prescribe language for some provisions, and prohibit the use of specific provisions. Generally, an insurer may use alternative provisions, provided that the terms are at least as favorable for insureds and beneficiaries.

The insurance companies also have an interest in using standard contract provisions. Most of the common provisions in use today have been tried and tested in courts of law and, when necessary, modified to clarify intent and reduce confusion or disputes that might arise in the future.

Important policy provisions establish the general agreement between the insurance company and the policy owner. These specify the rights of the parties and the procedures that govern premium payments, grace periods, default and reinstatement of the policy, and transfers and assignments of the incidence of ownership.

<table>
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<tr>
<th>Insuring Clause</th>
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<tr>
<td>The insuring clause usually states that, subject to all other terms and conditions of the policy, the company agrees to pay the face amount to the named beneficiary upon due proof of death of the insured, or to pay certain benefits if the insured lives to some specified age, such as 65. It sets forth the basic agreement between the company and the policy holder.</td>
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<tr>
<th>Consideration Clause</th>
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<tr>
<td>This part of the insuring clause states that the company promises to pay the policy benefits in consideration of the premium payments. An insurance policy is a legal contract. One of the requirements for formation of a contract is that each party give up something of value (consideration). The consideration given by the policyholder is payment of the premiums. The consideration given by the insurance company is the promise to pay policy benefits.</td>
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<tr>
<th>Premium Clause</th>
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<td>This provision specifies when, where, and how premiums are to be paid. Usually premiums are to be paid in advance either at the company's home office or to the agent. The various modes of paying the premium will also be identified, such as monthly, quarterly, semiannually and annually.</td>
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The least expensive ways to pay the premium are annual payments or monthly bank plan payments. The other premium modes usually require the payment of a service charge added to the basic premium. Service charges are frequently waived for monthly bank plan payments because this is a very reliable method of providing for timely payments. The insurer simply sends a monthly premium notice to the policyowner’s bank and the bank sends the insurer a check for the monthly premium.

The actual payment date for premiums and the frequency of the payments are listed on the declarations page of the policy. Changes to payment schedules are allowed. After the policy is issued, paying the premium is the only responsibility of the insured or owner.

**Grace Period**

The insured has a grace period of 30 or 31 days from the premium due date in which to make a premium payment.

The purpose of the grace period is to protect the policyholder against an unintentional lapse of the policy. Universal life policies usually have a longer grace period, such as sixty-one days. During the grace period coverage continues in force. If death occurs during the grace period, the overdue premium is deducted from the death benefits.

**Default and Lapse of Policy**

If a premium is not paid before the end of any grace period, the policy will terminate or lapse as of the premium due date, unless coverage was continued as extended term insurance or paid-up insurance under nonforfeiture options.

**Reinstatement**

A reinstatement clause gives the policyowner the right to reinstate a lapsed life insurance policy if certain requirements are met.

- The lapsed policy must be reinstated within five years.
- All unpaid premiums plus interest must be paid.
- The policy must not be surrendered for its cash value.
- All policy loans must be repaid or reinstated.
- Evidence of insurability may be required. However, evidence of insurability is often waived if the policy is reinstated within thirty-one days after the grace period ends.

Usually, the reinstatement process requires submission of a reinstatement request or application, evidence of continued insurability, payment of all overdue premiums (plus interest), and repayment of any outstanding loans or other indebtedness against the policy.
If the policy has not been in force for very long, it may be better to simply purchase a new policy rather than pay back premiums plus interest to reinstate the lapsed policy. However, there are several reasons for considering reinstatement if the lapsed policy had been in effect for a number of years, including:

- The lapsed policy may have more liberal policy provisions
- The lapsed policy may offer lower interest rates on policy loans
- The suicide and incontestable clauses probably no longer apply
- The lapsed policy probably has a much lower premium rate than a new policy would.

**Premium Refund at Death**

This provision states that any portion of a premium payment, which applies for a period beyond the month in which the insured died shall be refunded as part of the policy proceeds. Since premiums are paid in advance, the insurance company has no right to keep premiums paid for any months of coverage after the insured’s death.

**Ownership Rights**

When a life insurance policy is issued, a number of parties may be involved with respect to contract obligations and benefits. The insurance company is a party to the contract - in exchange for the premium payment, it has agreed to pay certain benefits if the insured dies.

There are 3 additional parties involved:

- The insured is the person whose life is insured. A death benefit will be paid if this person dies while the insurance is in effect.

- The owner of a policy is the person who applies for the insurance, agrees to pay the premiums, and has certain ownership rights. It is the policy owner who has the right to change the beneficiary, to elect settlement options, and to assign ownership to another person.

- A beneficiary is someone who is entitled to death benefits if the insured person dies. There may be one or more designated beneficiaries. There may be primary beneficiaries who are entitled to the proceeds if they are living, and contingent beneficiaries who are entitled to the proceeds if there is no surviving primary beneficiary when an insured dies.

The owner of a policy may or may not be the insured person, and may or may not be the beneficiary. The same person cannot be both the insured and the beneficiary, but the insured's estate may be the beneficiary.

The owner of a life insurance policy is entitled to certain valuable rights, including the right to assign or transfer the policy, and the right to select and change the payment schedule, beneficiary and settlement option. Depending upon the type of insurance, the owner may also have the right to receive dividends, to receive cash values, and to borrow against cash values.
The incidence of ownership in a life insurance policy may affect the taxation of the proceeds. Life insurance proceeds are generally not subject to federal income taxes, but they are included in the deceased's gross estate for federal estate tax purposes if the insured was the owner of the policy at the time of their death, or if the benefits are payable to the insured's estate. However, if the insured is not the owner and the benefits are payable directly to a named beneficiary, the proceeds may be received tax free.

**INSURABLE INTEREST**

People are not permitted to purchase life insurance on the lives of just anybody. In order to purchase life insurance, a person must have a legitimate insurable interest in the subject of the insurance. There must be a personal risk of emotional or financial loss, and a legitimate interest in preserving and protecting the life being insured. Without a requirement for insurable interest a person might actually act to cause another person's death or fail to exercise reasonable safety precautions to protect someone else if they had no personal risk of loss and stood to gain financially from the death.

Every person is presumed to have an insurable interest in his or her own life. However, if the amount of insurance applied for is disproportionate to a person's apparent needs, it will raise underwriting concerns.

An individual also has an insurable interest in the lives of close relatives through blood or marriage. Usually this extends to those who could be considered "immediate family members," such as a spouse, children, parents, and perhaps brothers and sisters. The requirement for insurable interest becomes more difficult to justify when insuring the lives of more distant relatives, such as uncles, aunts, nephews, nieces, and cousins.

Insurable interest may also be established on the basis of business and financial relationships. Members of a partnership have an insurable interest in the lives of other partners. Lenders have an insurable interest in the lives of borrowers to the extent of the loan. Any commercial enterprise may have insurable interests in the lives of key employees and other individuals who make significant contributions to sales and profits.

In the life insurance business, insurable interest must exist at the time of application and inception of the policy and not necessarily at the time of death. If the insurable interest is valid when it is issued, the death benefit is payable even if insurable interest no longer exists at the time of the insured's death. The requirement for insurable interest applies only to the owner of a policy. Insurable interest is not required of a beneficiary.

**Transfer or Assignment of Ownership**

Ownership of a policy may be transferred or assigned to the insured, to the insured's new spouse, to children, or to someone else who has a more current insurable relationship with the insured, or even to a charity or other business organization.

The owner of a policy has the right to transfer or assign all or any portion of the rights of ownership to another person. Usually this is accomplished by written request. When the request is received by the insurance company, the change takes effect as of the date it was
signed by the owner regardless of whether the owner is still living at that time. However, the company is not liable for any action taken before the request is received.

The interests of a life insurance policy may be assigned to anyone, even those without an insurable interest in the life of the insured. The assignment clause specifies the procedures for notifying the life company of the assignment. There are two types of assignments of life insurance contracts.

- An absolute assignment gives the assignee every right in the policy that the owner possessed before the assignment. All "incidents of ownership" are transferred. An absolute assignment is a permanent and complete assignment of a policy's ownership rights and privileges.

- A collateral assignment is a more limited type of assignment that only transfers some of the "incidents of ownership" to the assignee for a limited period of time. A collateral assignment is a temporary and partial assignment of the ownership rights.

A collateral assignment might be used to provide security (collateral) to a lender if the policyholder borrowed some money. If a collateral assignment is made, as security for repayment of the loan, the lender receives only those rights necessary to provide security for the loan. The owner would retain other rights (such as the right to designate or change a beneficiary), but could not cash in the policy or exercise any ownership right that would impair the security arrangement of the collateral assignment.

### Policy Loan Provisions

Policy loan provisions are found in all policies that include cash values. By law, after a policy has been in force for a specified period of time (usually three years), it must contain some cash value which may be borrowed by the policyowner.

Generally, a policyowner may borrow up to the amount of the current cash value less any indebtedness against the policy (previous loans and Interest charges). The insurance company will charge interest on policy loans. The amount of interest is usually relatively nominal and regulated by state laws. If the loan amount and Interest due are not repaid, these amounts will be considered an indebtedness against the policy and will be deducted from the death benefit should the insured die while the indebtedness is outstanding.

The reason that the face value (death benefit) must be reduced by any outstanding loans, and that any outstanding indebtedness (loans plus interest) must be repaid to fully restore policy values, is that the contract values all depend upon the required premium payments being made when due, and upon the schedule of cash value accumulation and the interest rate stated in the policy. While a loan is outstanding, part of the cash value is no longer being held by the insurance company and is no longer earning interest for the client.

Also, remember that the death benefit consists of the pure protection plus the cash value. Since the loan has reduced the cash value, it has also reduced the death benefits payable. If a loan is not repaid, the remaining cash surrender value and the face value must be reduced.

An insurer may defer a loan request for up to six months from the date of the loan application, unless the reason for the loan is to pay premiums due. If the automatic premium loan provision
is added (at no cost) to a cash value policy, an overdue premium is automatically borrowed from the cash value at the expiration of the grace period. This provision prevents the policy from lapsing because an overdue premium has not been paid.

**Incontestability**

The incontestable clause has great value for the insured. Under this clause, the insurance company agrees not to use any error, concealment, misstatement, or even fraud on the part of the policyowner, as a defense against a claim after the policy has been in effect for a certain length of time, usually two years. After that time, the policy coverage may not be challenged except for nonpayment of premiums.

The purpose of the incontestable clause is to protect the beneficiary if the insurer attempts to deny payment of the death benefit several years after the policy is issued. Since the insured is dead, the insurer’s allegations concerning statements in the application cannot be easily refuted. After the contestable period has expired, the insurer must pay the death benefit.

The initial period of time during which the contract may be challenged should provide the insurer with a reasonable opportunity to discover any material misrepresentations through background checks, medical exams, and other sources of underwriting information.

**Entire Contract and Representations**

The policy, together with the application attached, constitutes the entire contract. This provision limits the use of evidence other than the contract and the attached application to challenge the contract’s validity. All statements made by the insured in the application are deemed to be representations, and not warranties.

The distinction between warranties and representations is significant. Under a strict interpretation, any breach of warranty (whether or not material) would provide grounds for voiding the insurance. In the case of representations, the validity of a policy may be challenged by the insurance company only on the basis of a material misrepresentation made in the application.

The entire contract provision also specifies that an insurance agent cannot alter or change the policy. Only company officers have the authority to change or amend the insurance contract, and any such changes or modifications must be in writing and be attached to the policy.

**Policy Dates**

Policy years, policy months, and policy anniversaries are measured from the policy date. As some of the provisions in a life insurance policy are limited or dependent on the passage of time, this provision is important. The suicide and incontestable clauses are also measured from the policy date. Some states allow, “back dating” a policy. Backdating establishes an earlier policy date, may grant the insured a lower premium because of an age change.

**Modification of Policy**
This clause specifies that only certain officers of the insurance company have the authority to change or modify the insurance contract. All changes or modifications to the policy must be made in writing, and must be attached as an endorsement or rider. Life insurance riders will contain the required signature of a company officer (such as a vice president or secretary). When an endorsement or rider is issued by the company and attached to the policy, it becomes part of the legal contract. No agent has the authority to change a policy or to obligate (bind) the insurance company in any way by making a promise which is not contained in the policy.

**Policy Change (Conversion Option)**

Some policies may contain a provision which permits the policyowner to exchange the policy for another type of policy currently being issued by the company. This exchange is usually made from one policy type to another policy form with the same face amount.

When a change is made to a policy with a higher premium (such as when term insurance is converted to whole life), then the insured merely has to pay the higher premium and no proof of insurability would be required. However, if the exchange results in a lower premium, proof of insurability may be required since this could result in adverse selection against the insurer.

**Misstatement of Age or Sex**

The misstatement of age or sex provision states that if the insured's age or sex is misstated in the application, the amount of death benefit payable is the amount that the premiums paid would have purchased at the correct age and sex. The adjustment in the policy benefit may be upward or downward depending on whether the insured was younger or older than the misstated age.

These adjustments are not limited to claims for death benefits. If a misstatement of age or sex is discovered while an insured is alive, the policy will be adjusted accordingly. This may affect the face value of the policy, cash values, and other policy values. This is not limited by the incontestability period.

**Free Look**

In most states a policy of individual life insurance must contain a free look provision. This is a notice stating that the policyholder has a period of time (usually 10 days to 30 days) from the date the policy is delivered to review it and return it for cancellation and receive a full refund of premium if not satisfied for any reason. This provision gives the policyholder a reasonable opportunity to review the entire contract and reevaluate the decision to purchase.

**Medical Examinations and Autopsy**

Some states require life insurance policies to include a provision that gives the insurance company the right and opportunity, at its own expense, to conduct a medical examination of the insured as often as reasonably required when a claim is pending, and to make an autopsy in case of death where it is not forbidden by law.

**Beneficiary Provisions**
Since all life insurance policies pay a death benefit, each policy will include some kind of beneficiary provision.

A beneficiary is the person or interest to whom payment of the life insurance proceeds will be made upon the death of the insured. The owner of a policy has the right to direct the payment of proceeds to any person or entity he or she chooses. A variety of different parties or interests may be designated as beneficiaries under a life insurance policy. The beneficiary may be a person or an institution, such as a foundation or charity. A specifically designated person, more than one person, or a class or classes of persons may be named as beneficiaries; in addition a policyowner may name his or her estate, an institution, a corporation, a trust, or any other legal entity as a beneficiary.

Beneficiary selection is first made in the application for the life insurance. The beneficiary designation clause in the policy establishes how a beneficiary may be changed.

The beneficiary provision itself may be very brief. Generally, it states that upon the death of the insured, the policy proceeds will be paid to one or more designated beneficiaries. The choice elected in the application will stay in effect unless changed by the policyowner. It is important to keep beneficiary designations up-to-date as situations change. It is also important to understand the rights associated with a beneficiary designation, and how the type of designation made may affect the payment of life insurance proceeds.

If no beneficiary is living or chosen upon the death of the insured, proceeds will be paid to the owner or the owner's estate. Some policies may include more detailed provisions concerning payments to a succession of beneficiaries, payment of proceeds in the absence of a beneficiary, and procedures for changing a beneficiary designation. There are different types of beneficiary designations.

**Revocable vs. Irrevocable**

A revocable beneficiary designation is one that may be changed at any time by the policy owner. Almost all life insurance beneficiary designations are revocable unless the policyowner has specifically given up the right to change the beneficiary.

An irrevocable beneficiary designation is one that cannot be changed without the consent of the beneficiary. When an irrevocable designation is made, the owner has given up the future right to change designations. In the event that an irrevocable beneficiary dies before the insured, the right to select the beneficiary often reverts back to the policyowner.

**Methods of Designating Beneficiaries**

There are two methods for naming and changing life insurance beneficiaries - the filing method and the endorsement method. Under the filing or recording method the request must be "filed" in writing with the insurer. The request is made effective by the insurance company "recording" the change in its records. Once recorded, the change takes effect as of the date the policyowner signed the request.

Under the endorsement method the beneficiary designation or change is on or affixed directly to the policy. The policyowner must make a written request and mail the request along with the policy to the insurance company. The insurance company will then make sure that the beneficiary change is made to the policy.
Succession of Beneficiaries

A policy may provide for multiple beneficiaries as well as a succession of potential beneficiaries. Types of beneficiaries that can be designated in life insurance policies include the following:

- The primary beneficiary is the first party entitled to receive the death benefit at the insured's death. If there is more than one primary beneficiary, they may share equally or according to some predetermined arrangement.

- The contingent (or secondary) beneficiary is the beneficiary who is entitled to receive the death benefit if there is no surviving primary beneficiary.

- A tertiary beneficiary occupies the third level of succession of beneficiaries and would be entitled to receive the proceeds only if all primary and contingent beneficiaries have died before the insured.

Beneficiaries Must Be Clearly Named

It is important to clearly name intended beneficiaries and to clearly state intent, because careless wording of beneficiary designations can result in undesirable consequences. When the intention is not clear, the insurer must distribute the funds according to the apparent intent of the insured, or ask the court for a judicial determination of the proper distribution. Intended beneficiaries may end up without a share of the proceeds, and heirs may end up fighting in court.

- A specific beneficiary designation means that the beneficiary is named and can be clearly identified, such as "First Name, Last Name, son of the insured."

- A class beneficiary designation means that a specific individual is not identified but is a member of a group to whom the proceeds are paid, such as "children of the insured."

Designating a "husband" or "wife" (not specifically named), might cause a problem if that person was married more than once. Designating current children by name, might not provide for unborn or adopted children.

DESIGNATION OPTIONS

An individual may designate a wide variety of beneficiaries. Many people are primarily concerned with providing for a surviving spouse and children. A very wealthy individual might also wish to allocate funds to various charities, trusts, and non-relatives. Designation options may include any combination of the following:

- Individuals
- Minors (guardian required to receive funds for minor)
- Classes of individuals
- Trusts (funds to be administered according to trust agreement)
- The insured's estate

Minor Child
When a minor named as beneficiary, it is necessary for a guardian to be appointed to receive the funds on behalf of the minor. Insurance companies usually will not pay proceeds directly to a minor, since the minor cannot give a valid release for receipt of the funds.

Some parents anticipate this problem by establishing a trust to administer the life insurance proceeds and all other property in the estate of the parents in the event that both parents die leaving minor children.

**Class Designations**

Class designations should be used when individuals of a specific group (such as children of an insured) are to share the policy proceeds equally and when the composition of that group might change.

The wording of a class designation, just as the wording of an individual designation, must be chosen carefully to specify the insured's actual intentions. Different approaches may be taken to class designations.

**PER CAPITA**

Under a per capita designation, which means "by heads," each surviving class member shares equally in the death benefit. If any class member predeceases the insured, that portion of the proceeds is forfeited to the remaining class members, who receive a greater share. No benefits are preserved for any descendants of a deceased beneficiary.

**PER STIRPES**

Under a per stripes designation, which means "by stock" or family line, the portion of proceeds intended for each class member is preserved for their descendants, if any. Each child, grandchild, or great grandchild of a beneficiary moves up in place of a deceased beneficiary. If any class member predeceases the insured, that portion passes to any children or grandchildren, and the other class members would not get a greater share.

**A Trust**

A trust is formed when the owner of property (the grantor) gives legal title of that property to another (the trustee) to be used for the benefit of a third individual (the trust beneficiary). A trust may be established either during the grantor's life or after the grantor's death. An inter vivos trust is one that takes effect during the lifetime of the grantor. A testamentary trust is one created after the grantor's death, according to the provisions of the grantor's will.

When a trust is named as beneficiary, upon the death of the insured, the proceeds would be paid to the trust and the trustee would then administer the funds in accordance with instructions in the trust agreement.

**Insured's Estate**

An insured's estate may be named as the beneficiary. The insured may direct that the policy proceeds be payable to his or her executors, administrators or assignees. Such a designation might be made by in order to provide funds to pay estate taxes, expenses of past illness, funeral
expenses, and any other debts outstanding prior to the settlement of the estate. Designating the insured's estate as beneficiary may aid in the settlement of the estate by avoiding the need to sell other assets of the estate to pay these last expenses.

It is usually not desirable however, to name the estate as beneficiary because the insurance proceeds then become assets of the estate and are subject to the claims of creditors. In addition, these proceeds will increase the size of the estate as well as the expenses, inheritance taxes, and federal estate taxes involved in estate administration and settlement.

**The Uniform Simultaneous Death Act**

A problem often arises when an insured and the primary beneficiary die simultaneously with no evidence as to who died first. Many states have adopted the Uniform Simultaneous Death Law. Under it, if there is no evidence as to who died first, the policy will be settled as though the insured survived the beneficiary. The life insurance proceeds would be paid to any contingent beneficiaries or to the estate of the insured - not to the estate of the beneficiary. If there is clear evidence that the beneficiary survived the insured, however, then the proceeds are payable to the beneficiary's estate.

**Common Disaster Clause**

Many policies include a common disaster provision to address the problems that could arise when an insured and beneficiary die at virtually the same time, or when the beneficiary dies a short time after the insured.

This provision stipulates that the primary beneficiary must survive the insured by a specified period of time, such as 30, 60 or 90 days, in order to receive the proceeds. When such a provision is in effect and the primary beneficiary survives the insured by only a few hours or a few days, the proceeds would be paid directly to any contingent beneficiaries or to the insured's estate.

**Facility of Payment**

Typically, this provision is found in policies with relatively small death benefits. It permits the insurance company to facilitate the payment of death proceeds by selecting a beneficiary if no beneficiary has been named or if a named beneficiary cannot be found after a reasonable time. Usually the insurer will select someone who is in the deceased insured's immediate family (such as a spouse, parent, brother, sister, etc.) or someone who has incurred expenses for the insured's last illness or funeral.
EXCLUSIONS & LIMITATIONS

While life insurance policies generally have few exclusions, each contract is likely to include some limitations. The most common exclusions relate to:

- Aviation exposures
- Hazardous occupations
- Suicide
- War risks

**Suicide**

A suicide clause in a life insurance policy states that the insurer will not pay the death benefit if the insured commits suicide within a certain period (usually two years) after the policy becomes effective. In some policies, suicide is excluded for only one year. The only payment the beneficiary receives in this case is a refund of the premiums paid less any policy loans. The suicide clause provides the insurer with some protection against an insured who purchases a life insurance policy with the intention of committing suicide.

After the policy is in effect for two years, suicide is covered since it is not likely that anyone who intends to commit suicide would buy life insurance and then wait two years to do it.

**Aviation Restrictions**

When aviation exclusions are found in life insurance policies they usually apply only to pilots, student pilots, and crew members, or to occupants of military aircraft - these restrictions do not apply to fare-paying passengers on regularly scheduled airlines. Companies will often provide coverage for civil aviation deaths for an additional premium charge.

**Hazardous Occupations and Avocations**

Today few applicants are declined life insurance because of their occupations. Firefighters and police personnel can purchase life insurance at standard rates. Even commercial airline pilots can usually purchase life insurance (although possibly at higher than standard rates). As a result, occupational exclusions are rarely found in modern life insurance policies.

An underwriter today is more likely to be concerned with hazardous avocations or hobbies. If an applicant participates in a hazardous hobby such as auto racing or sky diving, then the amount of insurance available may be limited, or an extra premium may be charged due to the additional risk. Depending on the hobby, the underwriter may want to include a waiver which excludes payment of the death benefit if death is caused as a result of participation in a particularly hazardous activity.

**War and Military Service**
Today, most insurers will provide some form of life insurance coverage for those on military duty. During war, a war-related death exclusion may be attached to new policies of insureds of military age. Traditionally, there are usually two types of restrictions or clauses which may be used.

- A status clause may limit the amount of insurance that a person is available for while on active military duty, or it may impose a higher premium to cover the higher risk involved.

- A results clause may exclude payment of the death benefit if the insured is killed as a result of an act of war.

In cases where a war or military restriction applies to a death claim, the insurance companies will often refund the premiums paid (plus interest), or pay an amount equal to the policy's cash value, if greater.

**PROHIBITED PROVISIONS**

By law in most states, life insurance policies are not permitted to contain the following provisions:

- A provision that limits the time for bringing any lawsuit against the insurance company to less than one year after the reason for the lawsuit occurs

- A provision that allows a settlement at maturity of less than the face amount plus any dividend additions, minus any outstanding indebtedness and overdue premiums

- A provision that allows forfeiture of the policy because of the failure to repay any policy loan (or interest on the loan) if the total owed is less than the loan value of the policy

- A provision making the soliciting agent the agent of the person insured under the policy or making the acts or representations of the agent binding on the insured (under the law, an agent represents only the insurance company, not the insured)
LIFE INSURANCE POLICY OPTIONS

Life insurance contracts offer a number of policy options which give insureds and beneficiaries the opportunity to make choices that affect how certain features of the policy will apply. This creates a degree of flexibility in the ways in which life insurance products may be used to meet the specific needs of a particular individual or family.

The major types of life insurance policy options include settlement options, nonforfeiture options, and dividend options.

SETTLEMENT OPTIONS

Settlement options are available under all types of life insurance. Settlement options refer to the various ways that the policy proceeds can be paid other than in a lump sum. The purpose for which the insurance was originally purchased and the situation at the time the benefits are to be received often dictate the most appropriate method of settlement.

Electing an Option

The policy owner can elect a settlement option before the insured's death. If the policyowner has not selected a settlement option the Beneficiary has the right to select the method of payment after the death occurs. The purpose of the insurance often dictates the most appropriate mode of settlement.

The same options are available whether the proceeds are being distributed to an insured or at retirement or maturity to a beneficiary at the insured's death. Generally, the following optional modes of settlement are available:

- Lump sum (default)
- Interest only
- Fixed-period installments
- Fixed-amount installments
- Life income
- Joint and survivor
- Any other method approved by the insurer

In addition, most companies will agree to distribute the proceeds under any reasonable and actuarially sound mode.

Lump Sum (Default Mode)
Life insurance proceeds may be paid as a lump sum. It is the method of settlement when no other method has been elected -- the default mode.

There may be occasions when a lump sum settlement is ideal, such as when the proceeds are intended to pay off a specific obligation, or when a designated beneficiary is highly skilled in handling and managing money. But in many cases, other options may be more appropriate.

**Interest Only**

Under this form of settlement, the proceeds are held by the insurance company and the interest earned on the proceeds is paid to the beneficiary, at least annually. The rate of interest paid is stated in the policy. The interest option is appropriate when the funds will not be needed until a later date.

This option might also be ideal when there is a need to provide a continuing income for a long period of time and/or when the beneficiary is unable to handle large sums of money, as in the case of minors or elderly persons.

Several conditions may be elected in connected with the interest only option. A policyowner might specify:

- That the proceeds will remain on an interest only basis for a stated period of time, and the remainder paid in cash or under one of the other settlement options; or
- That no part of the principal is ever to be paid to the beneficiary, but will be paid to a contingent beneficiary upon the death of the primary beneficiary; or
- That the beneficiary may withdraw the principal, in whole or in part, or elect another settlement option, at any time

**Fixed-Period Installments**

Under this option, the proceeds are retained by the insurance company and paid out in equal installments over a specified period of months or years. The payments are comprised of both principal and interest, and are designed to exhaust the principal at the end of the installment period.

The fixed-period option is appropriate when income is needed over some fixed period, such as income during the readjustment, dependency, or black-out periods.

The advantages of this method of payment are that the payment period is guaranteed, and payments will continue even if the primary beneficiary dies. The disadvantages of this method are that the beneficiary(ies) may outlive the payment period, in which case benefits are exhausted and all payments stop, and the survivors might not have developed alternative sources of income during the transition period. Additionally, the amount of the periodic payments may not provide an adequate income for survivors.

**Fixed-Amount Installments**
In this case, the proceeds are retained by the insurance company and paid out in specified amounts on a fixed, periodic basis (annual, semiannual, quarterly, or monthly). Payments of the predetermined amount are made until the proceeds (principal) and interest are exhausted.

Under this option, benefit payments may also be continued to one or more contingent beneficiaries if the primary beneficiary dies before the proceeds are exhausted. This option might be selected when the primary focus of the perceived need for insurance is on the amount needed by survivors, rather than on the length of time income is needed.

The advantages of this method of payment are that the amount of each payment is guaranteed, and payments will continue even if the primary beneficiary dies. The disadvantages of this method are that the higher the amount of each benefit installment, the more rapidly the principal is exhausted, and the beneficiary(ies) may outlive the payment period before they have developed alternative sources of income.

**Life Income**

Under the life income option, the proceeds are retained by the insurance company and paid out in equal installments (monthly, quarterly, semiannually, or annually) as long as the recipient (insured or beneficiary) lives.

The benefit amount is calculated on a basis of the recipient's life expectancy at the time payments begin. Life expectancy figures for men and women at various ages are statistical averages shown in mortality tables. The older the recipient at the beginning of the payment period, the larger the benefit per $1,000 of proceeds.

Actual amounts paid under the life income option may exceed the insurance proceeds (if the person lives a long time) or may only be a portion of the proceeds (if the person dies sooner than expected).

**Life Income With Period Certain**

Adding a period certain to the life income option reduces the size of the income installments. The longer the period certain, the greater the reduction. A period certain increases the chance that payments will be made beyond a recipient's lifetime.

If the initial recipient dies prior to the end of the period certain, payments would continue to be paid to a beneficiary or contingent beneficiary until the end of the period (or the value might be paid to the estate of the last surviving beneficiary).

**Joint and Survivor**

A variation of the life income concept is the joint and survivor settlement option. Under this method, installment payments are guaranteed to be made during the lifetimes of two recipients. When this option is in effect, periodic installments are paid initially to both parties. Upon the death of either one of the recipients, periodic payments continue to be made to the survivor for life.

Electing payments on a joint and survivor basis is the most practical way to provide a guaranteed lifetime income for two people. A joint and survivor option is always a wise recommendation to make when benefits are to be shared by two people.
Under a joint and full survivor option (also known as a “straight joint and survivor” option), the same benefit amount is paid to both recipients while living and to the survivor after one of them dies. Under a joint and one-half survivor option, a higher benefit is paid while both are living and one-half of that amount is paid to the survivor after the other person dies. Other variations of this method include the "joint and two-thirds survivor" and "joint and one-quarter survivor" options.

The amount of the installment payments is based on the life expectancies of both recipients. When a reduced benefit is elected for the survivor, the joint benefit paid while both are living will be greater because the insurance company does not have to set as much aside to provide for the survivor benefit.

Other Methods

In addition to the traditional methods of settlement which are widely available, most insurance companies will agree to distribute the proceeds under any reasonable and actuarially sound method. Special settlement arrangements are sometimes desirable in order to accomplish the estate planning objectives of an insured, or to provide different degrees of security when multiple beneficiaries are involved. Insurance companies will cooperate with almost any arrangement that is reasonable.

Payment of Small Amounts

Insurance companies have rules to avoid arrangements which are uneconomical to administer. A common provision found in the settlement options section of a policy states that if net proceeds of less than $5,000 are payable to any one payee, the proceeds will be paid as a single sum.

Another common provision addresses the problem of minimum Installments. If periodic payments based on the number of dollars of benefit per $1,000 of proceeds is less than $50, the payment intervals will be lengthened so that minimum payments of at least $50 will be made.

Time Limitations

Time limitations may also apply to some settlement options. It is not a good business practice, and might not even be legal, to hold insurance proceeds for an indefinite period of time. Consequently, a company may set a time limit for holding proceeds at interest, such as for the lifetime of the primary beneficiary or the lifetime of a contingent beneficiary.

Withdrawal Provisions

This provision is sometimes used in connection with settlement options, especially the "interest only" option. A withdrawal provision gives the beneficiary the right to withdraw a portion of the funds left on deposit with the insurer in the event of certain contingencies or emergencies. The provision may specify that the beneficiary has a right to withdraw only a percentage or a dollar amount of the proceeds.

Other Settlement Options
All life insurers have spendthrift provisions available, which allow the owner of a policy to predetermine the settlement option for a beneficiary. The beneficiary then has little or no chance to change the options. It prevents a beneficiary from exchanging a life income for a lump sum. The theory is that less money is squandered if it is received periodically instead of in a lump sum.

**Advantages of Settlement Options**

One of the principal advantages for the insured or beneficiary in selecting one of the various settlement options is freedom from investment concerns. If a beneficiary elects a lump sum settlement of the death benefit, then he or she must decide how to use or invest the money. When lump sum settlements are spent recklessly, the funds do not provide any long-term security. By electing a settlement option other than a lump sum, the beneficiary is trusting in the expertise and knowledge of the insurance company to administer these proceeds and provide some form of income over a period of time.

Another advantage to settlement options is the fact that any of the options will guarantee a greater return than taking the full proceeds in a lump sum, since the insurance company pays interest on any funds it retains.

One of the unique features of life insurance is that the life insurance proceeds are exempt from the claims of a deceased insured's creditors as long as there is a named beneficiary other than the insured's estate. A similar provision that protects payments to a beneficiary from claims of the beneficiary's creditors is known as the spendthrift clause. It is designed to protect the proceeds from attachment or assignment to others. However, it does not apply to lump sum settlements - it applies only to installment settlement options, and it only protects the portion of the proceeds not yet paid (due, but still held by the insurer) from the claims of creditors. This must be elected by the policyowner during the insured's lifetime.

When in effect, as long as the proceeds are being paid by periodic installments to the beneficiary, both the principal retained by the insurance company and the payments received by the beneficiary are exempt from the claims of creditors and from any other assignment or attachment.
NONFORFEITURE OPTIONS

All states have nonforfeiture laws that require insurers to pay at least a minimum nonforfeiture value if a policyowner surrenders a cash value policy. Nonforfeiture provisions protect a policy owner’s equity, the accumulated cash value, in a life insurance policy. By law, this equity cannot be lost (forfeited) if the policy is surrendered at any time or if premium payments stop and the policy lapses or terminates. The standard nonforfeiture options include taking the cash value, converting the cash value to extended term insurance, or converting the cash value to reduced paid-up insurance.

Traditional Options

Nonforfeiture options in a life insurance policy give the policyowner a choice of ways to use the cash value if the policy is terminated and protect the policyowner from forfeiting the cash value. There are three nonforfeiture options:

- Cash surrender value
- Extended term insurance
- Reduced paid-up insurance

These three options are specified in the guaranteed values or nonforfeiture provisions section of permanent life insurance policies. The extended term option is usually automatic unless the policy owner selects another option.

Cash

The policy can be surrendered for its cash surrender value, and protection under the policy ceases. When this done, the policy terminates and all interest in the policy ceases. This is known as "cashing in" an insurance policy. Cash values are relatively low during the early years but can accumulate to sizable amounts over time.

Surrender charges may be imposed when a policy is cancelled during the early years, to cover the expenses of a policy surrender.

Extended term insurance

Under this nonforfeiture option, the cash surrender value is used to buy level term insurance in the same face amount as the current policy, for as long as the cash value will pay the new policy premium. Once converted to extended term insurance, no further premium payments are required.

The face amount of the policy would remain as originally issued. If any loans are outstanding, they will reduce the face amount. Similarly, if there are any "dividend additions," they will increase the face amount.

Reduced paid-up insurance
Under this nonforfeiture option, the cash value of the policy is used as a single premium to provide life insurance on the same type of policy as the current policy, for as large an amount as the cash value will purchase at the insured's age when the option becomes effective. The new policy is fully paid-up. The policy owner now has the same type of insurance, for the same period of time, but with a reduced amount of face value.

**TABLE OF GUARANTEED VALUES**

Nonforfeiture rights are protected by state law. The laws specify the formulas, mortality tables, interest rates and other factors that must be used for determining minimum surrender values and other nonforfeiture benefits. Each policy that includes nonforfeiture benefits includes a table of guaranteed values which shows the guaranteed values at the end of various policy years. Usually, these values are shown annually for each of the first 20 policy years, and for representative years thereafter (such as at age 60 and age 65).

A cash value policy contains a table of nonforfeiture options that shows the value of each option at various attained ages. A sample table of guaranteed values is shown below.

<table>
<thead>
<tr>
<th>End of Policy Cash Value</th>
<th>Paid-up Insurance</th>
<th>Extended Insurance</th>
<th>End of Policy Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year</td>
<td></td>
<td></td>
<td>Years Days</td>
</tr>
<tr>
<td>2</td>
<td>$350</td>
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<td>3 273 2</td>
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<tr>
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<td>7 135 3</td>
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<td>10 19 4</td>
</tr>
<tr>
<td>5</td>
<td>1,700</td>
<td>4,400</td>
<td>12 19 5</td>
</tr>
<tr>
<td>6</td>
<td>2,175</td>
<td>5,450</td>
<td>13 254 6</td>
</tr>
<tr>
<td>7</td>
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<td>15 18 7</td>
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<td>8</td>
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<td>15 345 8</td>
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<td>9</td>
<td>3,675</td>
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<td>16 273 9</td>
</tr>
<tr>
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<td>9,200</td>
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<td>Age 60</td>
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</tr>
<tr>
<td>Age 65</td>
<td>19,025</td>
<td></td>
<td>13 343 Age 65</td>
</tr>
</tbody>
</table>

**Electing an Option**
A policy's nonforfeiture provisions begin to apply when a premium payment is in default. The policyowner usually has the right to elect one of the available nonforfeiture options within 90 days after the premium default date. The election is usually required to be in writing.

If the policy owner does not designate a nonforfeiture option, the extended term option will be selected by the company. It gives the insured the same amount of protection for the longest period of time.

### Automatic Premium Loan

The automatic premium loan (APL) option protects a policyowner from an unintentional lapse of the policy. If the APL is selected, at the end of the grace period the insurer automatically borrows enough money from the cash value to keep the policy in full force. None of the nonforfeiture options will be necessary if APL is added to the policy.
DIVIDEND OPTIONS

Life insurance policies may be issued on either a nonparticipating or participating basis. A participating policy is one that pays dividends. Generally, the premiums for participating policies are higher than for non-participating policies, and dividend payments declared by the insurer are considered to be a return of the excess premiums.

Policy dividends are not guaranteed, but are usually declared as long as the insurance company remains profitable. As a matter of practice, most insurance companies declare and pay dividends annually on participating policies.

The owner of a participating policy is usually offered several options for receiving the policy dividends.

Traditional Options

Standard dividend options have been developed to satisfy the most common preferences for applying dividends but, as is the case with settlement options, many companies will agree to any other method which is found to be acceptable. Available options may differ somewhat by company. The most commonly offered dividend options include:

- Cash payment
- Application to reduce premium
- Accumulation at interest
- Paid-up additions
- Accelerated endowment
- Paid-up option
- One-year additional term option
- Any other method approved by the insurer

Cash Payment

Under this option, dividends are simply paid to the policyowner in cash as declared by the insurer. The policyowner receives a check from the insurer, usually on the anniversary date of the policy. The dividend is relatively small in the early years but can increase to sizable amounts in later years.

Premium Reduction
Under this option, the current dividend is used to reduce the next premium payment. After this option has been elected, the premium notice will usually show the gross premium due minus the dividend amount, and the policyowner merely has to send a check for the net amount.

**Accumulation At Interest**

This means electing to allow dividends to accumulate and be retained by the insurance company, and to earn interest at a rate specified in the policy. This option usually permits the withdrawal of the accumulations at any time. Although dividends are not taxable as income, any interest earned on them is taxable.

**Accelerated Endowment**

Under this option, policy dividends are used to convert the policy into an endowment or, in the case of an existing endowment contract, to shorten the endowment term. In either case, the dividends are allowed to accumulate, and when the combination of dividends and cash value equal the face value, the policy matures at an earlier date.

**Paid-Up Additions**

Under this option policy dividends used to buy additional amounts of paid-up participating insurance, written on the same basis as the underlying policy. These increments (often referred to as “dividend additions” or “paid-up ads”) are actually small amounts of additional insurance purchased with a single premium. No new policies are issued; the original policy is simply amended to reflect the additional paid-up values.

When this option is elected at the time of policy application, the additional paid-up insurance is provided without proof of insurability. The company may require proof of insurability if this option is elected several years after the policy is issued.

**One-Year Term Option**

Under this option, dividends are used to buy an additional amount of one-year term insurance. Unlike other “additions,” any term insurance additions are not allowed to accumulate. Each term addition will automatically expire at the end of the policy year, so that only one term insurance addition purchased with dividends may be in effect at any one time. If the one-year term insurance option is not selected at the time the policy is issued and it is requested later, evidence of insurability will usually be required to guard against adverse selection.

**Other Methods**

In addition to the traditional dividend options, many insurance companies will agree to apply dividends in any manner which is reasonable and mathematically sound.

The owner of a participating policy is usually offered several options for receiving the policy dividends.

**Electing an Option**

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**Other Methods**

In addition to the traditional dividend options, many insurance companies will agree to apply dividends in any manner which is reasonable and mathematically sound.

The owner of a participating policy is usually offered several options for receiving the policy dividends.
Initially, a dividend option is usually selected at the time of application for insurance. Application forms frequently include a place to select one of the standard dividend options when a participating policy is applied for. However, the policy provisions typically permit the policyowner to elect any dividend option within 31 days after the dividend due dates. Dividends are most commonly payable annually and become due on the policy anniversary.
LIFE INSURANCE POLICY RIDERS

Riders are attachments or endorsements to a life insurance policy which change the contract in some manner. Riders may be used to add benefits to a policy or to take benefits away or impose restrictions. When a rider adds an additional benefit, an additional premium is usually charged. But the addition of a rider has no effect on the cash value of a policy.

Some common riders include the following:

- Multiple Indemnity – Accidental Death
- Accidental Death & Dismemberment
- Waiver of premium
- Guaranteed insurability
- Cost-of-living rider
- Accelerated death benefits

MULTIPLE INDEMNITY (ACCIDENTAL DEATH)

This rider provides an additional death benefit only if the death is accidental. The accidental death benefit is frequently called as double or triple indemnity. Double indemnity pays twice the policy's face amount, and triple indemnity pays triple the base policy's face amount if death occurs accidentally.

Multiple indemnity riders are relatively inexpensive because the chance of accidental death is small and accidental deaths are included in mortality tables.

There can be value in the accidental death benefit, but it should not be oversold. There is a tendency among insureds to think that they have more life insurance than they really have because of the endorsement. The life insurance policy to which the rider is attached is the most that most people will receive. The human life value or the needs do not change if the insured dies in an accident rather than by natural causes. Premium dollars spent on accidental death insurance might be more wisely used on additional life insurance.

Death from disease, suicide, war, inhalation of gas or fumes, commission of a felony, and certain aviation activities other than as a fare-paying passenger are typically excluded. Also, the death must occur within a certain number of days (usually ninety) after the accident. And, the death must occur before some stated age, such as age sixty-five or seventy.

ACCIDENTAL DEATH & DISMEMBERMENT (AD&D)

The dismemberment benefit pays specified sums if the insured loses one or more limbs, or sight of one or both eyes, and in some cases hearing, as the result of an accidental injury.

It usually pays of the full principal sum in the event that the insured suffers the loss of two limbs, or the sight of both eyes, or the loss of one limb and sight of one eye, due to an accidental
injury. Frequently, one-half of the principal sum will be paid for the loss of one limb or the sight of one eye. Some companies will also pay one-quarter of the principal sum for lesser losses, such as the loss of a finger. In order for loss of limbs to be covered, generally there must be actual severance of the hand or foot. Loss of sight is usually defined as irrecoverable loss of vision, and physical separation or removal of the eye is not necessary. Covered dismemberment losses must usually occur within 90 days of the accident.

**WAIVER OF PREMIUM**

One of the most commonly found and useful additional benefits is known as waiver of premium. It is actually a disability insurance benefit, which pays the life insurance premiums while an insured is totally disabled. The waiver of premium rider is very practical since it is inexpensive and keeps life insurance in force without premium payments.

This coverage is temporary and applies only to disabilities that begin before the insured reaches age 60 or 65. However, if a total disability begins prior to the age limit, the premiums will continue to be waived for the duration of the disability, even if it continues beyond that age.

Normally there is a six-month waiting period before waiver of premium benefits begin. An insured must be totally disabled for at least six months, and must continue to pay any premiums that are due within that period. Any premiums paid during the waiting period will be refunded to the policyowner, and all future premiums are waived while the disability continues.

This coverage is very inexpensive. A small additional premium, usually about $1 annually per thousand dollars of insurance, is charged for this rider. The insured will be required to show continuing disability unless total and permanent disability has been determined.

**Definition of Total and Permanent Disability**

The definition of "total and permanent disability" is important to the insured and varies among insurers. A liberal definition states that the insured is totally and permanently disabled if the insured is not able to work at the occupation held prior to disability, even if a new job were found that paid as much or more money.

The most common definition of "total and permanent disability" however, is that the insured is disabled if the insured is unable to work at any job for which the insured is reasonably fit by education and training.

**WAIVER OF PREMIUM WITH DISABILITY INCOME**

This variation of the waiver of premium rider provides an additional disability income benefit. The same concept applies with respect to the definition of total disability, the age limitation, and the initial waiting period, but this rider also pays a weekly or monthly disability income benefit to the insured in addition to the life insurance premiums being waived. If the insured has a choice of the amount of the benefit (the number of dollars of disability income benefits per $1,000 of underlying life insurance), the premium charge will be greater for the higher benefit amounts.

**GUARANTEED INSURABILITY**
A guaranteed purchase option (GPO) protects the insured's ability to purchase life insurance in the future. The option states that no matter what the insured's health or occupation, at certain dates in the future, he or she may buy additional life insurance at standard rates. The typical option permits additional amounts of life insurance to be purchased every three years without evidence of insurability up to some stated age, such as forty.

The amount of insurance which can be purchased on the option dates is usually limited to the amount and type of the original policy. The rate for any additional insurance purchased will be the rate for the insured's then attained age, not the age at which the original policy was issued. The premium for the benefit would be in the $20-to-$30-per year range.

**RETURN OF PREMIUM**

This rider was developed primarily as a sales tool. The rider is simply an increasing amount of term insurance that equals the total of premiums paid at any point during the effective term period. The rider does not actually return the premium dollars paid for the base policy, but pays an additional death benefit equal to the amount of those premiums. The policyowner who purchases this rider is simply increasing the term insurance rider on top of the regular insurance policy.

**RETURN OF CASH VALUE**

This rider, which is similar to the return of premium rider, consists of increasing term insurance in an amount which is roughly equal to the cash value accumulation in a whole life policy. It was developed mainly as a sales tool to help agents overcome any objection to the fact that upon death a whole life policy pays only the face value.

The premium for this rider will be based on the age of the insured at the time it is purchased, and the amount and duration of the term insurance being purchased.

**COST OF LIVING**

This rider was designed to offset concerns about high inflation. It increases the face amount of a policy each year according to increases in an inflation index, such as the Consumer Price Index.

Some cost-of-living plans feature the automatic purchase of one-year term insurance whenever the CPI increases a specified amount. If the CPI does not increase (or does not increase enough), no additional insurance is purchased that year. The face amount never decreases below the face amount of the original policy no matter how low the CPI drops.

One advantage of the cost-of-living policy is that evidence of insurability usually is not required. Another advantage is that the additional protection may be less expensive because agents' commissions normally are not paid on the additional insurance.

**ADDITIONAL INSUREDS**

Riders are also commonly attached to life insurance policies to provide coverage on the lives of one or more additional insureds. Usually these are term insurance riders or small amounts of
additional whole life insurance covering a spouse, one or more children, or all family members in addition to the insured.

Although other family members can always be insured under separate policies, there may be advantages to using riders for this purpose, particularly when small amounts of insurance are involved. Administrative expenses are often reduced, which leads to lower cost for the coverage. For the insured, attaching additional family coverage to a base policy offers the convenience of a single premium payment, instead of payments for multiple policies.

### Substitute Insured

Although the idea of substituting an insured may seem unusual in personal insurance planning, it is often desirable in business situations, when a key employee or executive is insured for the benefit of the business. Should this person terminate employment or retire, the insurance can be “switched” over to apply to the person’s replacement. This allows the same policy to continue (avoiding termination and issuance of a new policy). However, the insurance company is likely to require evidence of insurability from a substitute insured, and will rate the coverage based on the new person’s age and sex. A new contestability period may also be imposed.

### LIVING NEED -- Accelerated (Living) Benefits

“Accelerated Benefits” and “Viatical Settlements” are two relatively recent developments in the life insurance field. Both concepts provide a means for an insured who has a serious or terminal illness to receive an advance portion of the proceeds to provide for medical care or living expenses during the final stages of life.

Accelerated benefits are living benefits paid by the insurance company which reduce the remaining death benefit available for the beneficiary.

Under a viatical settlement, the policyholder actually sells all rights to the policy to a viatical settlement company, which advances a percentage (usually 60% to 80%) of the eventual death benefit. The viatical settlement company then receives the entire death benefit when the insured ultimately dies.

The living needs rider is a relatively recent development in life insurance. In this case, a portion of the proceeds that would otherwise be payable as a death benefit is advanced to an insured who has a terminal disease and a need for special medical care. The benefit is designed to improve the quality of life for the terminally ill person during his or her remaining days. The funds are often used to ease pain, suffering and discomfort during the final period of life.

There are two basic types of accelerated death benefits riders:

- Terminal illness rider. This rider allows insureds with a life expectancy of six months or one year to collect part or all of the available proceeds.

To be eligible for this benefit the individual must present medical proof of the terminal illness. Most companies offering this benefit will limit the amount of the insurance proceeds which may be paid in this manner.
Catastrophic illness rider. Insureds who have certain catastrophic diseases, such as life-threatening cancer, coronary artery disease, or AIDS, can receive part of the face amount of insurance.

**LONG TERM CARE (LTC)**

A long term care (LTC) rider is another variation of the living need or accelerated benefits (paid in advance) concept. However, in this case the benefits are specifically targeted to apply to a variety of specified long term care services, and the insured does not necessarily need to be suffering from a terminal disease.

When the LTC rider is attached to life insurance, it allows an insured to borrow against future life insurance proceeds to provide current benefits for long term care. Most companies will allow up to 70% or 80% of the policy's death benefit to be used in this manner. If a terminal illness is involved, some companies allow up to 90% or 95% of the death benefit to be used for health care and medical expenses.

A period of prior hospitalization may be required before an insured becomes eligible for long term care benefits, and there generally is an elimination period of 10 to 100 days before benefits are payable. Once benefits begin, the benefit period may be three-to-five years. Benefits are specifically designed to apply to such things as custodial care (assistance with chores of daily living, such as feeding, dressing, or bathing, provided by nonmedical personnel), skilled or intermediate nursing care (provided by medical personnel), and home health care (which may consist of medical and nonmedical care). Coverage may also be provided for adult day care and hospice care.

Although life insurance is generally intended to benefit survivors, it is more practical and humane to use life insurance proceeds to provide needed care to make an insured's final days as comfortable as possible. The LTC rider is simply one method of making life insurance resources available for special care if the need arises.

Some insurers also have a benefit structure for their LTC rider which is like that of the disability rider, where a specified benefit (such as $10) is available per each $1,000 of face amount to pay LTC expenses.
TAX DEFINITION OF LIFE INSURANCE

A comprehensive definition of life insurance was established in 1984 which extends to all life insurance contracts issued after December 31, 1984. This is significant, as there had been no statutory definition established prior to this time. Basically, the law states that in order for a contract to qualify as life insurance for tax purposes, it must meet either (1) a cash value accumulation test or (2) a guideline premium and cash value corridor test.

### Cash Value Accumulation Test

A policy meets the cash value accumulation test if the cash surrender value does not at any time exceed the net single premium which would have to be paid to fund future benefits.

### Target Premium

The minimum amount of premium needed to support both the minimum sum insured (pure insurance) and the cash value is called the target premium. This amount represents the level of funding the insurer recommends to maintain the policy. It is typically based on relatively conservative investment return assumptions and is usually comparable to premiums for a similar whole life policy. Most insurers base their first-year commissions on the target premium, paying up to 50 percent commissions on the target amount and a much lower percentage (3 to 5 percent is common) on excess premium amounts.

### The IRS Corridor

A universal life policy must include an amount at risk. If the cash value approaches the face amount, the death benefit must increase so as to provide for this amount at risk. This minimum separation between the cash value and the death benefit is called the "risk corridor." With the establishment of the Tax Reform Act of 1984, the law now states that the ratio of the death benefit to cash value at any time cannot be less than a specified percent. The face amount of a contract at age 40 or less can never be less than 250% of the cash value. This percentage declines steadily each year until age 95.

To maintain this minimum insurance corridor, insurers typically reserve the right to refuse additional premium payments if they would cause the cash value to increase beyond the upper limits relative to the death benefit.

If the policy meets the test, all death benefits from the life insurance contract would qualify for income tax-free treatment. However, if not, both the earnings on the cash value and the proceeds paid to the beneficiary will be taxable.

The IRS will get its share of the policy's earnings, but only if and when funds are withdrawn from the policy. There is no tax payable if the policy pays the death benefit. And, because funds are usually withdrawn after the insured retires, the tax rate should be lower than when the insured was working, which is another financial advantage for the insured.
MODIFIED ENDOWMENT CONTRACTS

The Technical and Miscellaneous Revenue Act of 1988 defined a new class of life insurance products called "modified endowment contracts" and singled them out for unique tax treatment. These contracts are policies that qualify as life insurance under the statutory definition reviewed earlier but which fail to meet a 7-pay test.

If at any time during the first seven years, if cumulative premiums have been paid which exceed the cumulative funding limit at that point, the policy will be treated as a modified endowment contract (MEC) from that point on.

Example:
The target premium is $1,000 per year:

<table>
<thead>
<tr>
<th>Year</th>
<th>Premium</th>
<th>Cumulative Total</th>
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</thead>
<tbody>
<tr>
<td>1</td>
<td>$1,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>2</td>
<td>$1,000</td>
<td>$4,000</td>
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<td>$5,200</td>
</tr>
<tr>
<td>6</td>
<td>$800</td>
<td>$6,000</td>
</tr>
</tbody>
</table>

In the 4th year the policyholder paid more than the target premium. The policy would not, however, be a MEC at this point, even though the premium exceeded the target premium, because the cumulative total still meets the rules. However, the policy does become a MEC in the 5th year when the extra $200 pushes the policy over the cumulative total allowed. From that point on, the policy is a MEC. Even though the policyholder pays only $800 the following year bringing the cumulative total back in line. Once the policy is a MEC it is always a MEC.

If a policy is found to be a MEC, distributions from that policy are subject to unfavorable tax rules. Such distributions may be in the form of total or partial surrenders, assignments, pledges, withdrawals, policy loans or loans secured by the policy.

The rules for the taxation of distributions from MECs are as follows:

- First, all money withdrawn, loans, etc., are deemed to be income (excess of cash values over premiums) before capital. The policy holder can't recover his or her tax-free cost basis until after all income has been distributed out of the contract and taxed as ordinary income.

- Second, "premature" distributions from modified endowment contracts are generally subject to a 10% penalty tax, in addition to the regular income tax. A premature distribution is a distribution made to a nondisabled policyholder before age 59 1/2% in a form other than an annuity.

The new rules for modified endowment contracts generally apply to contracts entered into, or materially changed, on or after 6-21-88. While the rule was originally designed to combat misuse of single-premium life, it can affect any policy in which excessive premiums are paid in the early years.
INCOME TAX TREATMENT OF LIFE INSURANCE

A full appreciation of the planning opportunities presented by life insurance requires a working knowledge of the income tax treatment of life insurance in general. Due to the scope of this course, a full discussion of taxation is not possible. Agents are encouraged to obtain additional information from, and/or refer clients to, tax experts for sophisticated tax, estate, or financial planning. The subject of taxation of life insurance is not always clear-cut due to some of the complex ways in which life insurance may be used. But some basic guidelines can be given to agents to enhance their understanding of how the tax laws work in general.

Life insurance proceeds represent a great deal of money, often the bulk of an insured's estate, so tax considerations become very important. While a tax attorney or tax expert should be consulted for advice on complex matters, a life insurance agent should have a basic understanding of how taxes may affect life insurance.

There are three unique tax advantages enjoyed by life insurance:

- With both term and permanent life insurance, the death benefit is usually not subject to income taxation.
- The cash value of permanent life insurance accumulates on a tax-deferred basis and is distributed income tax free if paid as part of the death benefit.
- Borrowing or withdrawing funds from the cash value is given favorable "first in-first out" (FIFO) treatment (except in cases where the policy is designated a Modified Endowment Contract).

Death Benefits Income Tax Free

One of the most important advantages of life insurance, term as well as whole life, is the income tax-free nature of the death benefit. Section 101(a)(1) of the Internal Revenue Code states as a general rule that death proceeds are excluded from the beneficiary's gross income.

Life insurance proceeds may or may not be subject to federal income taxes and/or estate taxes. Generally, death proceeds from a life insurance policy are received tax free by the beneficiary, however there are exceptions.

With respect to federal income taxes, generally, the following rules apply:

- Lump sum settlements are not taxable as income, whether the policy is individually owned or business owned.
- Whenever life insurance proceeds are taken other than in a lump sum, part of the proceeds received will be tax free and part will be taxable. The basic concept is that each installment received is part principal and part interest, and the interest portion of the installment is taxable as income.
If the policyowner decides to surrender the policy for the cash value at age 65, he or she will generally pay income tax only on the amount of cash value which is in excess of the total of the premiums paid (less dividends received in cash or used to reduce premiums). This is the cost basis.

**Tax-Deferred Cash Value Growth**

Permanent life insurance policies enjoy a special tax advantage. The cash value accumulates on an income tax-deferred basis, leveraging its growth. More of the insureds money is working for them than it would in a taxable savings or investment. Permanent life's tax-deferred growth makes the cash value an important policyowner asset.

**Favorable Withdrawal Treatment**

Another advantage of permanent life insurance is the favorable accounting treatment of cash value withdrawals and loans. The policyowner has the right to withdraw—either as a policy loan or, in the case of universal life insurance, through a cash withdrawal—a portion of the cash value.

Withdrawals up to the policy’s cost basis are treated as tax-free returns of the policyowner's contributions. If the withdrawn amount is treated as a policy loan, even amounts exceeding the adjusted basis escape income taxation. However, failure to repay the loan plus accrued interest reduces the death benefit ultimately paid.

If the policy is designated as a modified endowment contract (MEC), however, a different, less favorable tax treatment applies.

**Estate Tax Consequences**

Although life insurance proceeds payable to a beneficiary are not subject to income taxes, they are frequently subject to estate taxes. The proceeds are subject to inclusion in the deceased's estate for federal estate tax purposes if the death benefits are payable to the estate, or if the deceased was the policyowner. This means that in all cases where the insured is also the policyowner, the benefits are included in the estate value even if payable to a beneficiary other than the estate.

Due to the large estate tax exemption, the tax consequences for many middle class families may be minimal. But if insurance proceeds are included in an estate, they also increase the gross estate value subject to taxation.

With respect to federal estate taxes, life insurance proceeds are subject to inclusion in the deceased's estate for federal estate tax purposes if any of the following apply:

- The estate was the named beneficiary, or
- The deceased was the policyowner, or
- The deceased ownership transferred the policy to another person within three years of death
Life insurance proceeds on the life of a top executive and payable to a corporation, under a policy owned by the corporation, would not be included in the deceased person's estate because the corporation was the owner and beneficiary (not the estate of the deceased).

However, many individually owned life insurance policies could be subject to estate taxes because the insured is often the policyowner. Under federal law a unified tax credit applies to gift and estate taxes, so estate taxes should only be a concern for those with assets greater than the federal tax credit.

If the policy is transferred into an irrevocable life insurance trust (and assuming the insured has no continuing incidents of ownership in the policy), the proceeds will not be recognized as part of the decedent's estate. (Again, readers are encouraged to obtain more information, as this is a complicated subject.)

One exception to the taxation of an estate is the marital deduction. An entire estate may be left to a surviving spouse with no tax consequence. However, this simply shifts or postpones the estate tax burden to the surviving spouse. When the second spouse dies, the assets in the estate become taxable. Through the use of trusts and other estate planning tools, the impact of this taxation can be minimized.

**Cash Surrender Value**

If a policyowner surrenders a policy for its cash value, some of the cash value received may be subject to ordinary income tax if it exceeds the sum of the premiums paid for the policy. Generally, the amount equal to premium payments is not taxable. Any additional amount in excess of the premium payments, the earnings on the cash value made would be taxable as income.

**Transfer for Value**

Lump sum life insurance proceeds if transferred to a person in exchange for valuable consideration, (such as money, services, or something else of value), would be taxable as income.

**1035 Exchanges**

Under section 1035(a) of the Internal Revenue Code, certain exchanges of insurance policies and annuities may occur as nontaxable exchanges. Generally, if a policyowner exchanges a life insurance policy for another life policy with the same insured and beneficiary and a gain is realized, it will not be taxed as income under section 1035(a).

**Policy Loans**

Policy loans under life insurance policies are not taxable as income because they are treated as a debt against the policy. Under contract terms, policy loans must be paid back with interest in order to maintain policy values. Otherwise, outstanding loans reduce the death benefit.
When a business buys group term life insurance for its employees, premiums are generally considered a necessary business expense and are tax deductible. However, when a business buys life insurance to perpetuate the business (for example, under a buy-sell agreement, or key person insurance), the premiums are not tax deductible. Proceeds, however, are received tax-free by the business.

Premiums paid for individual life insurance are considered a personal expense and therefore not deductible from current income. However, since the insurance is purchased with after-tax dollars, taxes have already been paid and the benefits will not usually be subject to taxes.

### Dividends

Since dividends are considered a return of excess premium paid by the policy owner, they are not taxable as income. However, any interest earned on dividends and accumulated by the insurer or paid to the policy owner is taxable in the year received.

### Summary

<table>
<thead>
<tr>
<th>Income</th>
<th>Tax Consequences</th>
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</thead>
<tbody>
<tr>
<td>Proceeds:</td>
<td>Proceedings may be subject to Estate Taxes depending upon who owns the policy and who is the beneficiary</td>
</tr>
<tr>
<td>Lump Sum</td>
<td>No income tax</td>
</tr>
<tr>
<td>Installments</td>
<td>Interest portion taxable as income</td>
</tr>
<tr>
<td><strong>Cash Surrender Value</strong></td>
<td>Cost Recovery Rule (portion in excess of premium payments taxed as income)</td>
</tr>
<tr>
<td><strong>Premium Payments</strong></td>
<td></td>
</tr>
<tr>
<td>Individual -</td>
<td>Not deductible;</td>
</tr>
<tr>
<td>Group paid by employer -</td>
<td>Cost for the first $50,000 of life insurance is deductible for employer, and the cost for coverage in excess of $50,000 is taxable as income to the employee</td>
</tr>
</tbody>
</table>
ETHICS

Agents and financial representatives have both a legal and ethical obligation to be especially careful regarding representations made in life insurance sales presentations.

Those selling variable contracts must respect both the insurance trade practice rules of their state’s insurance code as well as the NASD’s rules on the solicitation and sale of securities. Agents must possess the knowledge and skill required to assist clients.

Selecting the market to sell is vital. Different markets require different degrees of expertise. Selling mortgage redemption life insurance requires little technical knowledge. However, handling a complex estate plan requires knowledge of tax laws and the need to coordinate life insurance with the other assets of the insured’s plan through attorneys and accountants.

POLICY ILLUSTRATIONS

Computer-generated ledger illustrations, are especially sensitive to the need for realistic assumptions and full disclosure. NASD regulations and policies clearly restrict securities firms from projecting the future value of any security, including a mutual fund, in any part of its solicitation. Life insurance, on the other hand, is largely defined by the growth of policy values and projecting future growth is a standard practice in life insurance sales. The NASD prohibition against growth projections in the sale of securities does not preclude life insurers from projecting the growth of future policy values, though state insurance laws and regulations exercise a high degree of control over this important issue.

Basing the illustration on realistic financial and economic conditions is the best defense against possible future charges that the product's sale was made on the basis of unrealistic expectations. Many consumers regard policy illustrations as reliable indicators of future policy values. Financial representatives have the responsibility of making sure their illustrations are realistic and explaining to their prospective clients that the illustrations are purely hypothetical in nature.

Provided all policy charges are reflected and a realistic average investment return assumption is used, illustrations can provide a reasonably accurate picture of policy values in the future, as long as the consumer understands the uncertainty surrounding the projected values.

It is at this time that the service and advice of an insurance agent become important. Agents can help guide the consumer in determining what combination of policies and riders are appropriate for addressing the individual’s temporary and permanent insurance needs.

Helping prospective clients make the right choice when considering life contract is easier if one observes the following rules.

- An informed consumer is your strongest marketing tool. Consumers who clearly understand the contract are your best prospects.

- Emphasize the concept, not the numbers. The danger of a prospective client placing too much faith in a ledger illustration can be minimized by relying less on projected numbers.
and more on explaining the underlying concept of the policy, in terms of needs and benefits the consumer will understand.

- Make sure there is a need for life insurance protection. While some policies include notable investment features, these should be promoted as an enhancement to the underlying life insurance product.

- Determine the consumer’s risk tolerance. Use a questionnaire to determine the prospect’s risk tolerance profile, then explain how the program recommended by you conforms to their profile.

- Keep good notes. Copies of illustrations, risk tolerance questionnaires, correspondence and other correspondence or notes regarding conversations with clients, will provide at least some protection against potential later charges of misrepresentation.

- Maintain good client contact after the sale. Periodic correspondence with the client will give the client an opportunity to express concerns and be reminded of important services.

**COST COMPARISON METHODS**

To help insureds make cost-effective selections about life insurance products, there are two basic methods that may be used to compare the cost of different policies - the traditional net cost method, and the interest-adjusted cost method.

**The traditional net cost method**

Under this method, premium payments for a specified number of years are added together, the projected cash value accumulation and any dividend payments for the period are then subtracted, and the result is divided by the number of years under consideration to produce an "average annual net cost." The traditional method makes a comparison without regard to the time value of money, which takes into account both the ability to earn interest and the tendency for cash value accumulations to lose relative value during inflationary periods.

**The interest-adjusted cost method**

Under this method, the calculation is similar except that an adjustment is made for an interest rate. For example, dividends will be assumed to earn a specified interest rate, and the future aggregate of cash value and dividends will be discounted by an interest rate when determining the "interest-adjusted average annual net cost." This method factors in the time value of money.
LIFE INSURANCE UNDERWRITING

Underwriting is the process of selection and classification of risks. The process consists of evaluating information and resources to determine if the client will be accepted or rejected and how an individual will be classified (standard or substandard). Once this part of the underwriting procedure is complete, the policy will be rated and the premium which the applicant will pay will be determined. The policy will then be issued and subsequently delivered by the agent.

An underwriter’s job is to use information gathered from many sources to determine whether or not to accept a particular applicant. An underwriter will also consider perceived hazards which may appear to be present.

Acceptable applicants should be placed in the correct underwriting class and pay an appropriate premium that reflects the exposure for that class.

Life insurance underwriting is based, in part, on the basic principle of emphasizing the standard acceptable group, so that most applicants are accepted at standard rates. A large number of rejections increases the insurer's cost of doing business, erodes the morale of the sales force, and may also lead to a loss of goodwill among the buying public.

Important underwriting factors for individual life insurance include age, sex, build, physical condition, personal and family health history, smoking habits, involvement in hazardous sports or hobbies, personal habits and morals, country of residence, and occupation.

In addition to the individual pieces of information received, an underwriter must frequently exercise judgment based on his or her years of experience in order to form an overall opinion about the nature of a particular risk. An underwriter might decide to reclassify or reject a risk, or maybe simply take a closer look by ordering an investigative report, requesting a medical examination, or checking some of the facts a second time.

ADVERSE SELECTION

One of the underwriter's tasks is to protect the insurance company from the consequences of adverse selection against the insurance company. Adverse selection means that there is a greater tendency of those who have a greater risk of loss to apply for, and obtain, insurance.

Among those who voluntarily contact an insurance company or agent for the purpose of buying life insurance, it is likely that an above-average proportion of the applicants already have health problems, have a family history of premature death, or are engaged in dangerous occupations. Those most eager to buy life insurance may be motivated to do so because they are at a higher risk of premature death.

If too many poor risks are accepted, the insurance company will lose money, so it is an underwriter's job to evaluate risks, to reject uninsurable risks, and to require higher premiums for insurable substandard risks. If excessive losses lead to higher premium charges, insurance would become less affordable and fewer people would buy insurance.

LAW OF LARGE NUMBERS
To stay in business an insurance company must strive for a reasonable balance between the affordability of insurance to consumers, and having the ability to pay expected loss payments.

In order for the insurance concept to work, underwriters must rely on the Law of Large Numbers. The principle of the Law of Large Numbers is based on this premise: The greater the spread of risk, the more predictable losses become. The greater the premium base, the more affordable insurance becomes.

Without an adequate spread of risk, losses cannot be predicted. Without an adequate premium base, loss experience is likely to swing erratically. When the Law of Large Numbers applies, adverse selection is minimized and loss experience should approach broad statistical averages.

Centuries of marketing life insurance products have made consumers aware of the need for life insurance and the important role it plays in providing security.

A large number of persons insured over a long time period gives life insurers a large amount of statistical data on which to base their rates.

### LOSS AND EXPENSE RATIOS

In order to monitor experience and adjust underwriting guidelines, insurance companies calculate loss and expense ratios. They also look at the combined ratio to determine whether they are experiencing an underwriting profit or loss. These ratios may be calculated by account (all policies written for a particular client), by line of insurance (all policies of the same type), by "book of business" (all accounts placed by each agent or agency), and for all business written by an insurer (the total for all types of insurance written by the company). Loss ratio information may be used to make decisions about whether to renew accounts, whether to continue agency contracts, and whether to tighten underwriting standards on a given line of insurance.

**Loss Ratio**

The loss ratio is determined by dividing losses by total premiums received. If an insurance company pays out $6 million in death claims under individual life insurance policies that generated $8 million in premiums for the year, its loss ratio for the year would be 75%.

**Expense Ratio**

The expense ratio is determined by dividing an insurer's operating expenses (including commissions paid) by total premiums received. If an insurance company has total expenses of $4 million on business that produced $20 million in premiums, its expense ratio would be 20%.

**Combined Ratio**

The combined ratio is the total of the loss and expense ratio. When the combined loss and expense ratio is 100%, the insurer breaks even. If the combined ratio exceeds 100%, an underwriting loss has occurred. If the combined ratio is less than 100%, an underwriting profit, or gain, has been realized.
• If an insurance company has a combined ratio of 85% for the year, it has experienced an underwriting profit equal to 15% of the premiums written.

• If an insurance company has a combined ratio of 110% for the year, it has experienced an underwriting loss equal to 10% of the premiums written.

**SELECTION CRITERIA - UNDERWRITING FACTORS**

Life insurers use a number of important underwriting factors to determine whether applicants for life insurance are acceptable, substandard, or uninsurable. The major factors are summarized as follows:

<table>
<thead>
<tr>
<th>Personal Health</th>
</tr>
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<tbody>
<tr>
<td>The current health of an applicant is important for obvious reasons. An applicant with a serious disease, such as AIDS or cancer in the advanced stages, would have a reduced life expectancy and is probably uninsurable. An applicant with lesser diseases which can be managed, such as diabetes, may be insurable but the condition may present additional risks, which may require a higher premium rate. A combination of conditions, such as being overweight and having high blood pressure, will usually increase the underwriter's concern. Minor conditions, even some chronic conditions such as allergies, may have no impact on life expectancy, but the underwriter still wants to know about them.</td>
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<table>
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<tr>
<th>Age</th>
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<tr>
<td>The mortality rate correlates with age. Generally, the older the applicant, the higher the premium.</td>
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<tr>
<th>Sex (Gender)</th>
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<tr>
<td>Women have a longer life expectancy than men the same age. As a result, women typically are charged lower premiums than men.</td>
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<th>Build</th>
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<tr>
<td>Build refers to the relationship between height, weight, and girth (the comparison of an expanded chest with the abdomen). Mortality rates are substantially higher for overweight people.</td>
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<tr>
<th>Physical Condition</th>
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<tr>
<td>Depending on the amount of life insurance desired, certain tests may be required to determine the applicant's physical condition. These tests include a blood pressure test, a urinalysis test to detect kidney disease, a blood test for AIDS, and an electrocardiogram to detect heart disease.</td>
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<th>Health History</th>
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Both the applicant’s personal and family health history will be considered when evaluating the risk. An applicant who is currently healthy may have a history of past health problems, even recurring problems, which could affect the decision. An applicant who has no present or past symptoms of illness or disease may come from a family where there is a history of diseases. Certain health characteristics are hereditary. Applicants are asked questions concerning the health history of family members, such as heart disease, cancer, diabetes, and other serious disabilities.

**Lifestyle**

An applicant’s lifestyle must be considered independently from the applicant’s current health, family history, occupation and hobbies. This area of concern relates to personal habits and activity patterns. Behaviors like smoking, drinking alcohol, taking drugs, or exercising regularly may reveal either positive or negative lifestyle patterns.

**Smoking & Tobacco Use**

Smokers have higher mortality rates than non-smokers. Applicants are asked questions concerning whether they smoke or when they discontinued smoking. Other types of tobacco use are also related to higher mortality rates and most insurers today also request information about usage of any tobacco products.

**Hazardous sports and hobbies**

In modern society, recreational activities and hobbies may present a greater risk than occupations. Some sports and hobbies are hazardous and can increase the insurer’s mortality risk. These activities include sky diving, hang gliding, scuba diving, and race car driving, among others.

**Personal Hazards**

In general, a hazard is something that increases the likelihood that a loss may occur. With respect to an applicant for life insurance, there are two types of possible personal hazards that an underwriter may be concerned with moral hazards and morale hazards. These stem directly from an individual’s attitudes and values.

- A moral hazard arises out of an individual’s tendency to lie or be dishonest. An applicant who conceals or misrepresents information about health status, health history, or occupation on an insurance application to mislead the underwriter in order to provide insurance, or to provide it at a lower rate than should be charged.

- A morale hazard arises out of an applicant’s carelessness or indifference toward taking risk. For example, an applicant with a history of indifferent or apathetic attitudes toward his or her own health and safety, and that of others, presents a morale hazard to the underwriter.

**Habits and Morals**
Applicants are asked questions concerning the use of alcohol and drugs. However, alcoholics who have successfully undergone treatment or have not consumed alcohol for a number of years may be insurable at standard rates. Moral factors are also considered, including serious financial problems such as bankruptcy.

### Residence

Mortality rates vary throughout the world due to living standards, climate, disease, sanitation, war, and other factors. Underwriters may take into consideration the fact that an applicant travels a great deal, especially in certain parts of the world.

### Occupation

Occupation is not as critical a concern as it once was in the days before state and federal safety standards were established for the workplace, but it still may be significant. Insurance is usually available for applicants involved in more hazardous occupations, but higher premiums are frequently charged.

Certain occupations have relatively high accident rates, while other occupations expose workers to certain types of occupational disease. Hazardous occupations include underground mining, lumber mills, construction, farming, and jobs where the workers are exposed to dust and poisons.

### What the Underwriter Needs

What the underwriter needs most is a fully completed application. If any information or signatures are missing, the underwriter might return the application (with no coverage in force) for the missing information and initials or signature of the prospect required with the added information. The application is attached to the policy and becomes a part of the contract, and complete information is essential to have a prospect's life insurance underwritten and issued quickly.

Once the policy is in force, the insurer has few rights to cancel, deny, or modify coverage, so the decision to accept coverage must be made with all the facts at hand. Producers do not have binding authority and the life policy is in force only upon delivery to and with payment from the policy owner (accurate).

Every life insurer has a guide detailing the additional information and underwriting requirements that must accompany the application.

### SOURCES OF INFORMATION

An underwriter uses several resources to provide the necessary information for completing the risk selection process. The major sources of underwriting information include:

- The insurance application
- The insurance agent
- Medical exams and history
- Inspection reports
- The Medical Information Bureau (MIB)

**The Application**

The application for insurance is the most important source of underwriting information. The statements on the application may prompt the underwriter to request additional types of information (such as a medical exam or inspection report). An application must always be submitted, while other sources of information are used only when deemed necessary.

The form of an application may differ from one company to another. However, most applications have places for recording general information and medical information about the proposed insured(s).

The general information section usually has spaces for writing the name and address, date of birth, occupation, and marital status of the proposed insured. It may ask for information about any high risk activities (such as racing or diving). A list of other life insurance in force is usually requested, as well as whether any prior application for insurance has been rejected or specially rated. The amount of insurance being applied for, riders to be attached, and various policy options elected will be shown in this section. Names of beneficiaries are to be shown and, if the applicant and the insured are not the same person, the name and address of the policyowner and relationship to the proposed insured must be shown.

If the amount of insurance applied for qualifies as "nonmedical" (no medical exam required), then the agent and the insured will complete the health statement or medical questions section of the application. If the applicant is required to take a medical exam, this section is usually left blank at the time of application and is completed by the doctor or paramedic at the time of examination.

The medical questionnaire or health statement asks questions about the proposed insured's height, weight, and past medical history. Many questions are to be answered on a "yes" or "no" basis only. Specific questions are usually asked about types of illnesses or conditions. Other questions ask whether any proposed insured has had a checkup, been an inpatient, or received various types of treatments during a specified period of time prior to the application. Usually, this section will ask for the ages of other living family members, causes of death and ages of any deceased family members, and for the details of any "yes" answers to the health questions.

A completed application provides a lot of information about the insurance policy requested (types and amounts of coverage, insureds and beneficiaries, and policy options), and it reveals a lot about the insured's personal and family history. The signatures of the agent and proposed insured (and the owner, if different) are required to complete an application.

**The Agent**

Another significant source of information for the underwriter is the insurance agent. The underwriter usually does not have personal contact with the applicant, but the agent does. In addition to assisting the applicant by completing the general and medical sections of the application, the agent is also required to complete a separate section which constitutes the
agent’s own report or statement about the insured. The agent’s statement is part of the
application and it requires the agent to provide certain information regarding the proposed
insured. Generally, this includes information regarding the agent’s relationship to the insured (if
any), how long the agent has known the proposed insured, data about the proposed insured’s
financial status, habits, general character and any other information which may be pertinent to
the risk being assumed by the insurer.

This section includes a blank space for additional comments. Here the agent has an obligation
to enter any information which may be important. This may include comments about anything
material that the application questions failed to address. It may also include comments about
any information given by the applicant which appears to be contradictory or false.

An insurance agent is legally and ethically obligated to disclose important information to the
insurer. It would be illegal for an agent to withhold information due to a desire to sell the policy
and receive the commission.

Medical Exams

A medical examination will more accurately reveal current health status. Medical exams are
frequently not required for small amounts of insurance. For intermediate amounts of coverage,
they may or may not be required. Medical exams are almost always required for large amounts
of insurance. The doctor will record current height, weight and blood pressure, in addition to
performing other tests (blood, urine, x-rays, etc.).

Another related source of medical information available to the underwriter is an Attending
Physician’s Statement or (APS). This is a report from the insured’s own physician regarding the
applicant’s health status and history. After a review of the medical information contained in the
application or revealed by a medical exam, the underwriter may request an APS from the
proposed insured's doctor to provide more specific information about a particular medical
problem.

Inspection Reports

Inspection reports, from independent investigating firms or credit agencies, usually cover the
applicant's financial situation and moral reputation. This information may be used to help
determine the insurability of the applicant by discovering moral or morale hazards. When an
investigative report is prepared, the information is based on interviews with the applicant's
associates at home, at work, and elsewhere.

Medical Information Bureau

Another source of information which may aid the underwriter in determining whether or not to
accept a risk is the Medical Information Bureau (MIB). This is a nonprofit trade association
which maintains medical information on applicants for life insurance.

MIB information is reported in code form to member companies in order to preserve the
confidentiality of the contents. The report does not indicate any action taken by other insurers,
nor the amount of life insurance requested. In addition, an insurer may not refuse to accept a
risk based solely on the information contained in an MIB report. There must be other
substantiating factors which lead an insurer to decide to deny coverage.
UNDERWRITING ACTIONS

Although the underwriting process may consist of many stages, ultimately all risks are either accepted or rejected. At the conclusion of the process, final underwriting actions fall into one of three categories:

- Reject the risk
- Accept the risk as standard
- Accept the risk on some other basis

CLASSIFICATION OF RISKS

Underwriting also involves the classification and rating of acceptable risks. Risk classification means making a determination as to whether a risk is standard or substandard based on the underwriting or risk evaluation process.

After evaluating the information provided by the applicant and other sources, several underwriting decisions are possible. First, the applicant may be rated as standard and charged the normal premium for the desired coverage. More than 90 percent of life insurance applicants are accepted at standard rates. Second, the applicant may be rated as substandard and charged a higher premium. About 6 to 7 percent of the applicants are insured at substandard rates. Finally, the applicant may be rejected. About 3 percent of the applicants are denied insurance altogether.

**Standard Risks**

A standard risk is simply an average acceptable risk. The vast majority of applicants fall into this classification.

**Substandard Risks**

A substandard risk is a risk which is acceptable, but which has some negative characteristics that suggest these risks will have an actual mortality experience which is higher than normal. Most insurers use one or more rating plans or methods to develop the higher rates that must be charged for applicants who are not acceptable at standard rates, sometimes called "extra risk" or "substandard."

For substandard risks, an additional premium must be charged. Common techniques for developing an additional premium are to rate the risk at a higher age, apply a flat additional amount, apply a percentage increase, or to apply graded benefits which are initially lower than the premium charge would otherwise suggest. In some cases, a premium credit or discount may be offered to a preferred (above standard) risk.

One approach is known as rated-up age, which simply means that the premium is based on an age which is greater than the insured’s actual age. While this method simple to handle, it is not very scientific and depends heavily on judgment.
Another approach is to charge a flat additional premium for the element of extra mortality. This charge is a constant dollar amount that does not vary with age. This constant amount is added to the standard premium, which is based on standard rates and the insured's attained age.

Higher premiums may also be obtained by charging a percentage increase, instead of a flat dollar amount. Under a method known as tabular rating, applicants are classified on the basis of the extent to which mortality for their class of risk exceeds that of the "standard" risk. Extra percentage table is usually designated as "Table A," "Table B," etc. Each usually reflects about a 25% increase above 100%, or "standard." Insurers vary in the number of tables on which they will accept risks.

Under another method known as graded death benefits, the insured pays the standard premium for insurance but receives a policy with a face amount lower than the premium would pay at his age. After some time has elapsed the company may increase the amount of insurance periodically and when the company considers the substandard condition to no longer exist, the full amount of coverage would be granted.

**Preferred Risks**

In addition, some applicants qualify as a preferred risk. Life insurance is provided at reduced rates to individuals whose mortality experience is expected to be lower than average. Often, a minimum amount of life insurance must also be purchased. Sometimes certain coverage features and enhancements are only available to applicants that qualify as preferred risks.

A preferred risk is one that presents a below average risk of loss - mortality experience for this group is expected to be better than average. Applicants who may be eligible for preferred risk classification and rates are those who work in low risk occupations and do not participate in high risk hobbies, who have a very favorable medical history, who are presently in good physical condition without any serious medical problems, who do not smoke, and who meet certain weight limitations.
GROUP LIFE INSURANCE

In addition to individual life insurance, group life insurance is also important in providing financial security to families. Today group life insurance accounts for almost half of the total amount of life insurance in force in the United States.

Group life insurance differs from individual life insurance in several respects. Many individuals can be insured under a master contract between the insurer and policyowner; experience rating is used in larger groups to determine the premiums charged; individual evidence of insurability is usually not required because group underwriters evaluate the overall characteristics of the group; and the coverage usually provides low-cost protection to the employee.

Most states have enacted standard provisions for group policies, including:

- Grace period (usually 31 days)
- Incontestability (usually one or two years after the policy becomes effective; usually two years from the insured's effective date of coverage)
- Entire contract (the application must be attached to and made part of the contract)
- Evidence of insurability (individual insurability must be proven if the employee or member joins the plan after the enrollment period)
- Misstatement of age (premium is adjusted to the correct age; under individual insurance benefits are adjusted)
- Facility of payment (allows payment of policy proceeds to a close relative or friend if no beneficiary is named or living)
- Conversion (the right to convert to an individual policy when the insured's coverage is terminated or the master policy is terminated)
- Individual certificates (issued as evidence of coverage)

A group master policy is issued to the policyholder, and individual certificates (evidences of coverage under the group master policy) are issued to all enrolled employees or members.

**Basic Characteristics**

Group life insurance is frequently issued to employers, labor unions, trusts or associations to cover employees or members. The plan sponsor (the employer, union, association, etc.) is the policyholder responsible for administering the plan and making premium payments to the insurance company. Coverage is generally available without individual medical examinations. Premiums are based on the experience of the group as a whole.

Group life insurance has certain basic characteristics:
• Numerous individuals are insured under a master contract, which contains all of the provisions concerning the coverage provided. There are only two parties to the master contract: the insurer and policyowner. In most cases, the group policyowner is the employer. Each individual insured receives a certificate of insurance, which provides evidence of coverage.

• Individual members are not normally required to provide evidence of insurability. Group insurance underwriters evaluate the overall characteristics of the group of persons to be insured rather than the individual characteristics of each person in the group.

• If the group is sufficiently large, experience rating is used to determine premiums. Under experience rating, past losses sustained by the group are considered in determining the policy premium.

• For covered employees the cost of group life insurance is generally lower than individual coverage because the employer may pay part or all of the cost, which reduces the cost to the employees.

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<th>Group Underwriting Factors</th>
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Based on state law and insurer practices, most groups today are eligible for group life insurance. However, before a group can be covered, insurers consider certain underwriting factors to determine whether the group is acceptable.

• The group must not be formed solely for the purpose of purchasing insurance. This requirement protects the insurer against the possibility of a substandard group being formed solely to obtain insurance.

• Ideally there should be a moderate turnover of persons in the group. Groups with high turnover will increase the administrative expenses under the plan. However, groups with low turnover will increase the average age of the group, which might result in higher premiums.

• The size of the group is an important underwriting factor. If the group is large, prior group loss experience rating can be used to determine the premium.

**Small Groups**

Smaller groups are less desirable from an underwriting viewpoint. A small group presents two important problems: (1) administrative expenses tend to be relatively higher than for large groups and (2) adverse selection is more prevalent. To deal with these problems, the insurer's underwriting practices might be more restrictive for small groups, such as less liberal contractual provisions and individual underwriting in some cases.

**Contributory vs Noncontributory Groups**

In addition, minimum participation requirements are important in group underwriting. A minimum percentage of eligible group employees must participate in the plan.
In group insurance, a noncontributory plan is one for which the employer pays the entire cost. If the plan is noncontributory, most insurers and many state laws require coverage of 100 percent of the eligible employees.

A contributory plan is a plan for which employees pay part or all of the insurance cost. If the plan is contributory, a lower percentage of employees is required, such as 75 percent. A minimum participation requirement helps to protect the insurer against adverse selection.

**Other Factors**

Finally, some additional factors are considered in group underwriting. These include efficient administration, such as payroll deduction by employers; prior loss experience of the group; age and sex composition of the group; and occupational hazards in the industry that the group represents.

**Eligibility Requirements**

Employees must meet certain eligibility requirements before the coverage becomes effective:

- The employer may limit coverage to only full-time employees. The employer determines the number of hours for full-time employment, which must be at least 20-30 hours weekly. However, depending on insurer practices, part-time employees may also be covered.

- In some group plans, new employees must satisfy a probationary period, which is a short waiting period of one to six months, before they can participate in the plan. The purpose of the probationary period is to eliminate coverage of transient workers.

- New employees must sign up for the insurance either before or during their eligibility period. The eligibility period is typically a thirty-one day period during which the employee can sign up for the insurance with no evidence of insurability. If the employee requests coverage after the eligibility period expires, the insurer usually requires evidence of insurability to protect against adverse selection.

- Before the coverage becomes effective, the employee must be actively at work. If the employee is absent from work because of sickness or injury, coverage begins when the employee returns to work.

**Group Life Insurance Benefits**

Most group life insurance plans provide yearly renewable term insurance to the members. The amount of insurance can be based on the employee’s earnings, position, or length of service, or it can be a flat amount for all. Most group term insurance plans provide an amount of insurance equal to some multiple of the employee’s annual earnings, such as one or two times annual earnings. If employment is terminated, the employee has the right to convert the term insurance to an individual policy within thirty-one days with no evidence of insurability.

Some group life insurance plans also provide accidental death and dismemberment benefits that pay additional benefits if the employee dies in an accident or incurs certain types of injuries.
**Dependent Coverage**

Many group plans also offer dependent life insurance, providing modest amounts of life insurance on the lives of the employee's dependents. Dependents include the insured's spouse, children, dependent parents, or any person for whom dependency can be proven. Children may be stepchildren, foster children, or adopted children. Dependent children must be under a specified age (such as 19) which may be raised to age 21 or 22 if attending school full time.

**Conversion Privilege**

Group life insurance policies must include a conversion privilege that gives insured members the right to convert to an individual policy upon termination of the master policy, or the loss of group coverage due to termination of employment or loss of eligibility on the part of a class of insureds. Generally, anyone whose coverage terminates has 31 days in which to exercise the conversion privilege. If an individual dies after the group coverage has terminated and before the end of the 31-day conversion period, the group coverage is still in effect and the specified death benefit will be paid under the group policy.
INSURANCE APPLICATIONS & RECEIPTS

SALES PRESENTATIONS

Life insurance sale presentations usually begin with information gathering, a needs analysis, and a review of the applicant's existing life insurance coverages. Once needs and goals are clear, and the unmet insurance need has been brought into focus, the agent will usually make a sales proposal which consists of one or more specific recommendations.

Life insurance sales do not occur in a vacuum. Rarely does an applicant step forward and request a specific type of policy and specific amount of insurance. Rarely would an insurance agent proceed with an application on the basis of such a request without further discussion about the applicant's situation, insurance needs, and existing insurance coverages. In most cases, life insurance must be sold to an applicant, often depending upon making a convincing sales proposal.

There are two reasons why an agent should not hastily conclude a life insurance sale without exploring the applicant's overall needs and current insurance status:

- An agent has a duty to act in the best interests of the applicant and to recommend appropriate types and amounts of coverage.
- Sales opportunities could be lost if an agent fails to fully explore and expose an applicant's unmet insurance need.

Sales presentations are sometimes concluded in a single session, but successful presentations frequently consist of at least two separate sessions. Generally, the first session is exploratory in nature. The agent asks probing questions and has an opportunity to assist in determining the applicant's actual insurance needs and goals. Once the overall insurance need has been clarified, it is extremely important to review an applicant's existing insurance coverages.

The information gathered will help the agent to analyze the situation. The agent will try to determine the applicant's immediate vs. long-term need for insurance, how much the applicant can afford to pay (or is willing to pay) for insurance, how much the applicant is currently paying for insurance, and how appropriate existing coverages are in satisfying the applicant's overall needs.

The sales proposal itself is usually made in a subsequent session, after the agent has taken some time to analyze all of this information and to prepare alternative recommendations. The primary proposal should focus on the applicant's general unmet needs with a realistic balance between cost, benefits, and affordability.

Formal proposals consisting of typewritten comparisons of alternatives or computer printouts are usually more effective than hand written proposals, because they are neater and appear much more professional. Once a specific proposal is accepted by a proposed buyer, the insurance application process begins.
APPLICATIONS

When an application is taken, the agent is responsible for making sure that all questions are answered completely and accurately. Applications contain information about the policy being applied for, existing insurance, and the applicant's personal health history and family history. Much of this information is used in the underwriting process and the application itself usually is attached to, and becomes a part of the actual insurance policy itself.

Information Practices

As part of the application process, an agent may be required to provide to the applicant a Notice of Insurance Information Practices. Specific requirements vary by state, but state laws are generally based on two federal laws, the Fair Credit Reporting Act and the Privacy Act. Generally, these laws regulate the use and disclosure of insurance information, specify the types of information that may be included in investigative reports, prohibit certain types of information, establish procedures under which consumers may gain access to and challenge inaccurate information, and impose penalties for violations of permitted information practices. Since federal law sets minimum requirements, where specific state laws have been passed they are often more stringent in some areas than federal law.

Notices are also usually required in connection with policy reinstatements or requests for increases in benefits. These notices typically explain the types of information to be collected, the sources used for gathering information, the parties who will have access to the information, and persons to whom the information might be disclosed without the applicant's prior authorization. Recent privacy legislation contained in HiPAA imposes further responsibilities on agents when dealing with private information of clients.

In cases where specific investigative reports are prepared or information is to be obtained through interviews with persons other than the applicant, a specific notice must be given at the time information gathering begins - this is usually mailed by the insurance company. Other notices may be required to be provided when a policy is delivered by the agent.

Information Disclosure Authorization Forms are frequently included in, or are used in conjunction with, insurance applications. These forms are signed by the applicant and authorize physicians, hospitals, or other medical practitioners to release medical information about the proposed insured to the insurance company. The forms also explain that the information is generally confidential, but may be released to certain parties, such as the Medical Information Bureau, any reinsurers involved, and any other insurance company to which a claim has been submitted concerning the applicant's life or health.

An applicant's signature on a disclosure authorization form is usually effective for a limited period of time (typically two or three years). After this period expires, the insurer would have to obtain a new authorization before it could engage in such information gathering practices. Once a policy has been issued, subsequent needs for information gathering are usually triggered by a specific event - such as a policy lapse and reinstatement, a request for increased benefits, or a claim.

The privacy and information practice laws are designed to protect consumers against the improper use of information, and from the negative consequences of incorrect information. If a person's application for insurance is turned down on the basis of the information contained in an
investigative report, that person has the right of access to the information, a right to know to whom it was distributed, and a right to challenge the information and request that a correction be made.

REPLACEMENT TRANSACTIONS

Replacement of life insurance refers to any sales transaction involving the purchase of new life insurance which replaces existing life insurance. Any new sales transaction in which existing insurance is to be surrendered, lapsed, terminated, or reissued with a reduction in benefits or cash value is considered to be a replacement transaction.

Replacement transactions are not prohibited, but they are highly regulated because of the potential for abuse. Replacing existing insurance may be disadvantageous to the insured because an older policy may have more favorable policy loan interest rates, incontestability and suicide clauses may have expired, the proposed insured must prove to be currently insurable, and the premium for a new policy will be based on the higher mortality cost associated with the insured's current attained age. In the past, unscrupulous agents have persuaded consumers to give up old policies for new ones, even when it was not in the best interests of the policyholder, largely because the front-end commissions paid to agents for selling new policies are particularly lucrative. This is why replacement transactions are carefully regulated.

However, there may be legitimate reasons for replacing an existing policy. A policy may be inappropriate for an insured's current needs. It may have originally been misrepresented, or it may be the wrong type to satisfy a particular financial plan, or the cost may be excessive, which results in the insured being seriously underinsured from purchasing an inadequate amount of coverage. In such cases, the premiums being paid for existing policies might be put to better use, and it might be more appropriate to apply existing cash values as deposits towards other insurance or investment plans.

The most important thing to remember is that any recommendations for replacement be based on the best interests of the insured, and not principally on the desire of an agent to make a sale. It is vitally important that the prospective insured fully understands how the costs and benefits of the proposed and existing insurance policies compare, and that the agent complies with state laws regarding notice, disclosure and reporting of replacement transactions.

In most states, an agent has certain legal duties when new life insurance is to be purchased and it is known, or should reasonably be known, by the agent that replacement of existing life insurance is involved as part of the transaction. Agents are supposed to obtain, along with an application for life insurance, a signed statement from each applicant as to whether or not existing insurance is to be replaced. If replacement is involved, the agent is usually required to make a list of all existing life insurance policies to be replaced. This list must be submitted to the insurance company proposing to issue the replacement policies. Additionally, the agent is required to give the applicant a Notice Regarding Replacement of life insurance. Frequently, the signatures of both the agent and applicant are required on the notice. This notice cautions the applicant about the risks involved and urges the applicant to compare the policies and any outlines of coverage very carefully.

Copies of the notice, list of policies to be replaced, and other documents related to the transaction must be submitted by the agent to the insurance company. In many states, the replacing insurer is required to forward a written notice of replacement along with other
documents and policy summaries to the existing insurer within a minimum number of days. This gives the existing insurer an opportunity to challenge the transaction by attempting to conserve its policies (keep them in effect). The conserving actions are also subject to strict rules regarding disclosure and honesty.

**AGENT'S COLLECTION OF PREMIUM**

It is a good idea to collect the initial premium with the application because it demonstrates a greater commitment to the sale, reduces the chances that the policy might not be accepted, and could protect the proposed insured if death or insurability occurs between the date the application is signed and the date the policy is actually issued.

Life insurance coverage never takes effect until the initial premium has been paid. If the applicant dies before the policy is issued and actually accepted by payment of the premium, there will be no insurance coverage. This unnecessary risk that can be eliminated by payment of the premium with the application.

**Offer and Acceptance**

An insurance policy is a legal contract, and in order for a contract to exist there must be an offer and acceptance of that offer, as well as an exchange of consideration between the parties. In a life insurance transaction, either party can initiate the offer, but who actually makes the offer depends upon the circumstances.

When the initial premium is paid with the application, the applicant has made an offer. If the insurance company issues the policy, it has accepted the offer. At this point a contract exists and, if the insured died before the policy was actually delivered, a death claim would be payable.

When the initial premium is not paid with the application, no contract is in force, even if the application is acceptable to the underwriter. The applicant has not made a legal offer to the insurance company. The applicant has merely invited the insurer to make an offer by issuing the policy. If the company issues the policy, it has initiated the offer. But a contract does not yet exist, because the offer is not accepted until the applicant pays the premium and takes delivery of the policy. This is why there would be no insurance if an applicant who has not paid the premium dies before the policy is delivered.

**Fiduciary Duties**

All premium funds received by an insurance agent from an applicant or insured, and all return premiums received by an agent from an insurance company, are received in a fiduciary capacity and must be held as such. It is illegal to mix these funds with other funds, or to divert them to personal use. Usually these funds must be paid promptly to the insured or insurance company entitled to them. In some states, if premium funds are not paid immediately to the party entitled, they must be deposited in an account which is separate from all other agency and personal funds (a trust account). However, it is not necessary to establish a separate account for each insured, as long as the amounts payable to or on behalf of each can be determined from the agent’s accounting records. In some cases, if the agent holds the funds for a certain length of time (10-30 days), the agent must pay interest on the funds as well to the party who the funds actually belong.
USE OF RECEIPTS

Usually, coverage is not effective until the policy has been delivered and the initial premium has been paid. However, when the applicant has paid the initial premium with the application, coverage may take effect retroactively back to an earlier date. In some cases, a period of coverage may apply even if the application is rejected by the insurance company. Whether coverage applies and when that coverage takes effect and terminates depends upon the type of receipt issued to the applicant.

Conditional Receipt

Agents most commonly issue a conditional receipt when an applicant pays the initial premium at the time of the application. This type of receipt makes coverage effective on the date of the application, if the applicant is found to be insurable as a standard risk under the company’s general underwriting rules in effect at the time of application. Some conditional receipts make coverage effective the date of the application or the date of the medical examination, whichever is later.

Under a conditional receipt, coverage will begin on the application date if the proposed insured is later found to be insurable as a standard risk and the policy is issued as applied for. Under a binding receipt, coverage begins on the application date whether or not the proposed insured is insurable, and will continue for a specified period of time even if the application is rejected and the policy is never issued.

If an applicant is acceptable but is found to be a substandard risk requiring a higher premium, then the conditional receipt is null and void and no coverage would be effective. The original offer of the applicant is rejected and issuance of a substandard policy becomes a counteroffer by the insurance company. This coverage would not take effect until the substandard policy is delivered to the applicant and accepted by payment of the additional premium required.

Another possibility is that the applicant could become sick and uninsurable before the policy is delivered. When the premium has not been paid in advance, many companies require the insured to sign a health statement at the time of policy delivery, verifying that no change in health status has occurred since the date of the application. If health has deteriorated, the agent would not be permitted to deliver the policy and there would be no insurance coverage.

Binding Receipt

A less frequently used type of receipt is known as an "unconditional" or binding receipt. This makes the insurance company liable for the risk from the date of application for insurance. This coverage lasts for a specified period of time, or until the insurer either issues a policy or declines the application, whichever is earlier. The specified time limit is usually 30 to 60 days.

Unlike a conditional receipt, under which retroactive coverage is contingent upon acceptance of the risk, coverage under a binding receipt always takes effect on the application date regardless of the applicant’s insurability. The applicant may not be acceptable as a standard risk, or the applicant may not be insurable at all. Nonetheless, with a binding receipt he or she is covered for the specified number of days following completion of the application and payment of the initial premium.
SUBMITTING APPLICATIONS

It is important for an agent to submit the application, initial premium, and any questionnaires, notices, statements, or other forms required to the home office underwriter promptly. The agent should review all forms for completeness and be sure that they are properly signed. Unnecessary delays in delivering the policy can cause the applicant undue anxiety and result in a loss of confidence in the agent. Since agents are handling money belonging to their clients, it is important to keep an accurate record of each transaction. It is also wise for an agent to keep copies of applications and related documents in order to avoid unnecessary delays or other problems if the originals are lost.

POLICY DELIVERY

In most cases, a life insurance policy will be issued as applied for. In some cases, the coverage will be issued as applied for, but the rate and premium will be higher because the risk was classified as substandard. In rare cases, a modified or amended policy will be issued, such as when a waiver is attached to exclude death by a specific cause this might occur if the applicant has a particularly hazardous occupation or hobby.

Since policy delivery is necessary to complete the life insurance transaction, the best way to assure delivery is to do it in person. In addition to knowing the policy has been delivered, this method also gives the agent an opportunity to thoroughly explain all coverage provisions, exclusions, and riders to the applicant or policyowner. It will be especially important to explain any features of the policy which are different from the policy applied for. Personal contact at the time of delivery also gives the agent an opportunity to reinforce the relationship of good will developed during the sales presentation, and to ask for referrals now that a successful transaction has been completed.
PREMIUM COMPONENTS

Whole life policy premiums include the standard premium elements: a charge for the mortality cost of the insurance, a loading for expenses such as commissions and overhead expenses, and an interest discount factor resulting from application of the level premium concept. These are the basic components of any life insurance premium charge for the protection.

However, with whole life policies is also an element of cash value or savings, and a charge is made for this. The amount of the charge for each $1,000 of face value depends upon the age at which the policy goes into effect. Each policy is designed to mature at age 100, so the amount of time available is a major factor in determining how much must be set aside to grow at the guaranteed interest rate if the target is to be reached.

Mortality is not the only premium component, although it may be the most significant variable for life insurance. In the case of the death benefits, nothing has a greater relationship to the benefit payments than mortality, however other elements contribute to life insurance rates and premiums. The three major components of a life insurance premium rate are:

- Mortality cost
- Interest
- Expenses

The final rate charged to a policyholder equals the mortality cost discounted for interest, plus the added expense loading.

**Mortality Cost**

The pricing of life insurance, especially the pure protection element provided by any policy, is based primarily on the probability of when the applicant or insured will die. This probability or chance of death is known as the "mortality risk." Out of any large pool of applicants, the insurance company must receive enough premium dollars to cover the projected amount that will be paid out in death claims.

The process begins by accumulating statistics about deaths among the general population. These statistics are gathered on a nationwide basis for a number of years. It is then tabulated according to total numbers of persons at each age, and the number of deaths occurring within each age group, compared with the total number of persons in the group.

Mortality rates are reported on the basis of deaths per 1,000 persons and life insurance rates apply per $1,000 of insurance, so the mortality rate is the average mortality cost when it is turned into dollars and cents.

**Rates Increase With Age**

One of the reasons why it is advantageous to purchase life insurance at an early age is that the insured can "lock in" a much lower premium rate (depending on the type of coverage).
A fundamental principle of life insurance pricing is that the chance of death, and therefore the mortality cost, increases with age. Generally, mortality tables confirm this general trend, but there are two exceptions to the pattern that are worth noting:

- Infant mortality rates are higher than the rates for older children and young adults. The rate during the first year of life is very high, and then it plunges dramatically. For both males and females, the rate does not reach such a high level again until after age 40.

- The mortality rate for males rises rapidly at ages 15 through 18, and remains high through age 21. After that, it actually falls each year through age 28, after which it begins to rise annually for the remainder of life. The rates for males ages 18 to 22 are actually higher than the rates for males ages 28 to 32. This has much more to do with social trends than normal longevity - young males tend to take more risks and may be exposed to more risks than members of the general population. A disproportionate number of young males die in automobile accidents or become victims of violent acts. This trend is significant enough to be reflected in life insurance mortality tables.

At this point, we are not talking about a complete rate. The mortality cost is merely the total cost for the pure protection element of a life insurance policy. Other forces may reduce the mortality cost and add to the total policy cost.

### Interest

Premiums are paid in advance, which means the insurance company can use the money, and has time to invest the money and earn interest, before it needs to pay benefits. This interest is applied to reduce the mortality cost as a discount in the insurance rate calculation.

The basic cost for life insurance protection, the cost of mortality, is therefore reduced (offset) by the amount of interest applied. The mortality cost discounted for interest, without any other expense adjustment, is sometimes referred to as a “net premium” rate.

### Expenses

Insurers incur many types of additional costs which must be reflected in the rate and passed on to policyholders. For this reason, an expense loading is added to the net premium rate. The expense loading consists of a variety of items.

One of the most significant items is the initial charge for acquisition costs - all costs in connection with putting the policy on the books. Acquisition costs are recorded as immediately incurred by the accounting department. In most cases, these costs are so high that they must be amortized over a period of years. One of the highest acquisition costs is the agent's first year commission. A policy that lapses during the first few years often creates a loss for the insurer, because it has not yet recovered its acquisition costs.

Another important part of the expense loading is the charge for general overhead expenses - managerial and clerical salaries, furniture, fixtures, rent, supplies, and all of the other general operating costs of running a business. All business enterprises have overhead expenses, which must be averaged and included in the charges for its goods or services.
It is reasonable for a company to add some percentage for expected profit (actual results may be more or less favorable). Companies also need to establish some type of contingency fund for emergencies and unforeseen events.

When an average loading for all of these expenses are added to the net rate, we have the “gross premium” rate - the amount the policyowner actually pays for the policy on an annual basis. It is equal to the mortality cost discounted for interest, plus the added expense loading.

**LEVEL PREMIUM CONCEPT**

Although the mortality cost increases each year, many policies are sold under the level premium plan. In order to compensate for growing mortality costs in later years, premiums charged during the early years exceed the amounts needed to cover the initial mortality cost. This excess premium plus the interest it earns is applied to offset the higher cost in later years.

Level premium policies were developed because the mortality cost accelerates rapidly after middle age. If based on actual attained age, the premiums paid at age 45 would have to double by age 55, and to increase four- or five-fold by age 65. This increasing strain on family budgets might make insurance unaffordable at precisely the time when it may be needed most. It could also force many insureds to allow their policies to lapse or to cash in their policies prematurely.

Mathematically, the level premiums paid by the policyowner (plus accumulated interest) will be equal to the amounts that would have been charged if the insurer collected increasing annual premiums to cover the growing risk of mortality. However, level premiums are usually easier on the insured's budget. Many policyholders prefer to pay the same amount for insurance each year, even if they are paying a little bit more during the early years.

The level premium concept may be applied to both term and permanent insurance. The annual premium for a 10-year level term policy is level during the policy term. The same concept of overcharges during the early years to fund growing mortality in later years applies. However, if the policy is renewed at the end of the term, the premium will jump to a new level at that time based on the insured's current attained age.
A loss exposure is any condition or situation that presents the possibility of a financial loss. A personal loss exposure is a type of exposure that has a financial impact on individuals and families.

Financial planning is a process that helps individuals and families to identify their financial goals and to develop a realistic plan for attaining these goals. Common financial goals include an increase in personal wealth, a higher standard of living, protection of the family and property, accumulating a fund for retirement, the purchase of a home, a college education for the children, an emergency fund, getting out of debt, and minimizing federal and state income and estate taxes.

Developing a proper financial plan may require the assistance of an accountant and an attorney in addition to an insurance agent. Depending upon the size and complexity of an insured's estate, the services of a trust officer may also be needed to implement certain features of a financial plan.

Determining amounts of life insurance to recommend requires planning. Individuals have needs and goals which must be considered and analyzed.

Planning usually involves a detailed needs analysis, based on the proposed insured's income, marital and family status, objectives, and personal preferences and priorities. Some companies provide agents with formulas, checklists and other tools which may be used in the information gathering and planning process.

A proper needs analysis should consider both the needs created by the possibility of premature death and the needs created by the possibility of living for a long time.

When establishing the role for life insurance in a financial plan, the potential tax consequences should be considered.

The financial insecurity associated with most personal loss exposures can be reduced or eliminated by adequate life and health insurance, disability income insurance, and retirement plans. Individuals and families often have additional financial goals, such as saving for a down payment on a home or the children's college education. Attaining these goals requires a financial plan, including an effective savings and investment program.

### Developing a Financial Plan

Financial planning is a process that helps individuals and families to identify their financial goals and objectives and to develop a realistic plan for attaining these goals. The process involves five steps:

1. Gather important financial information. The first step in financial planning is to gather relevant and important financial information, including the following:
   - Current income—the amount of monthly and annual earnings, net take-home pay, and other sources of income
- **Assets**—present financial assets, including stocks, bonds, mutual funds, and savings accounts; value of individual retirement accounts (IRAs) and employer sponsored pension or retirement plans; value of life insurance policies and real estate

- **Outstanding liabilities and debts**—the amount of present installment debts, remaining mortgage balances, and educational and other loans

- **Current spending**—preparation of a monthly or yearly cash flow statement to determine the amounts spent on food, housing, installment debts, medical bills, insurance premiums, taxes, and other necessary living expenses

- **Number and ages of dependents**

2. Analyze the present financial situation. This step includes a review of spending habits to determine whether the individual is spending more than his or her annual income. It also includes a review of outstanding debts, amounts presently saved and invested, and net worth.

3. Determine specific financial goals and objectives.

4. Design a financial plan for attaining these goals. The financial plan should be realistic and have a time limit. The plan should include drawing up a cash-flow budget so that spending does not continuously exceed income over an extended period with a subsequent increase in consumer debt.

5. Periodically review and revise the plan. The financial plan should be reviewed periodically and changed if marriage, birth, divorce, job change, disability, unemployment, or any other change affects finances.

**Net worth** is the difference between assets and liabilities.

### Common Financial Goals

An effective financial plan requires identifying specific financial goals and objectives. Many Americans do not have well-defined financial goals. Many Americans have little financial expertise and require increased knowledge about personal financial planning, especially with respect to life and health insurance and mutual fund investments.

Because all individuals and families are not the same, financial goals and objectives differ. However, certain financial goals are common to most individuals and families:

**Increase in Personal Wealth**

Most Americans would like to increase the amount of their present savings and personal wealth.

**Higher Standard of Living**

A higher standard of living means that real income increases over time. Real income (money income adjusted for inflation) refers to the goods and services that can be purchased with
money income. An effective saving and investing program can increase future real income and standard of living.

**Protection of the Family and Property**

An extremely important financial goal is protection of the family and its property against loss exposures that create financial insecurity.

**Saving for Retirement**

Saving for retirement is another important financial goal for most Americans. Social Security retirement benefits provide only a minimum base income. Additional retirement income can be attained by establishing retirement plan.

**Purchase of a Home**

Purchase of a home is a high priority financial goal for many people, however, the down payment and closing costs may require thousands of dollars. The amount needed can be accumulated through an effective saving and investing program.

**College Education for Children**

For many families, the college education of their children is an important financial goal, requiring financial planning, regular saving, and effective investing.

**Emergency Fund**

Financial planners typically recommend a savings fund, equal to three to six months of take-home pay, for unexpected emergencies. An emergency fund is especially important with respect to the unemployment loss exposure. Other emergencies could involve health care expenses or disability, as well as the breakdown, theft, or destruction of the client's property.

**Getting Out of Debt**

Getting out of debt is an important financial goal for many Americans, who are deeply in debt because of overspending, abusing credit cards, and taking out high-interest consumer loans. Consumer loans typically include car loans, appliance and furniture loans, personal loans, education loans, consolidation loans, and similar types of consumer installment loans. According to VISA, the average American has 8 credit cards in their wallet.

**Minimizing Taxes**

An important financial goal is to minimize the taxes that consumers pay. Average income earners can easily pay 40 percent or more of their total annual income in taxes of all types. These taxes include federal and state income tax, sales tax, property tax, gasoline tax, telephone tax, and numerous other taxes. In addition, taxation does not end at death. In many cases, particularly if the estate is large, state and federal estate taxes apply to the deceased person's estate.
## SUMMARY

### Advantages of Financial Planning

Developing a financial plan offers numerous advantages to individuals and families. Personal wealth can be increased; an improved standard of living is more easily attained; financial goals can be achieved; the family can be protected against major property, liability, and personal loss exposures; credit problems can be avoided or reduced; and taxes can be minimized.

### Obstacles to Financial Planning

Despite the above advantages, many Americans do not have an effective financial plan because of certain obstacles. These obstacles include the unwillingness of many consumers to save and invest; the excessive use of high-interest credit cards and continued overspending; the natural tendency to procrastinate and delay saving for specific goals, such as retirement and the children's college education; and inadequate knowledge about financial planning.

Agents and brokers can have a positive impact on the lives of many Americans and their families by helping them with their life insurance needs.
**LIFE INSURANCE GLOSSARY**

**401 (k)** A form of company pension plan whereby the employee determines the amount of contribution to be deducted from the employee's wages and how it will be invested; it often has matching funds furnished by the employer

**Accidental death benefit** Increases the face amount of the policy if the insured dies accidentally

**Endorsement**

**Annuity** A savings & investment product that will pay out its cash value at retirement or death of the owner

**Automatic premium loan** The insurer automatically borrows enough money from the cash value of the policy to keep the policy in force should the owner be unable to make the premium payment

**Cash surrender** The owner may decide to give up all insurance benefits and select a cash surrender option in return for the policy's cash value

**Convertible term** An option to convert a term policy to a permanent form of life insurance

**Extended term insurance** A nonforfeiture option whereby the policy will provide continued coverage at the same death benefit, but for a length of time based on a table in the policy

**Guaranteed purchase option** Protects the insured's ability to purchase life insurance at specified times in the future

**Guaranteed renewable** The same as noncancelable except the premium can be changed by the carrier if it does so for all the policies in that class of business and with the approval of the state insurance department

**Incontestable clause** After a certain period of time, the insurer is not allowed to challenge the validity of the policy

**Individual retirement accounts (IRAs)** Tax-deductible investment plans for those not having a company pension plan to be drawn upon at retirement

**Medigap** A supplemental health policy that wraps around Medicare benefits

**Mutual funds** Pools of stocks, bonds, or other investments chosen by the fund managers in the hopes of earning good returns on the invested funds

**Noncancelable** As long as the premium is paid on time, the insurer cannot cancel the policy, change any provisions, add restrictions, or increase the premiums

**Nonforfeiture provisions** Section of the policy in which the policyowner's options are specified (options) in the event of nonpayment of premium

**Optionally renewable** The insurer can change the rate or cancel the contract as long as it does so for all policies in that class

**Permanent life insurance** Coverage until death

**Reduced paid-up insurance** A nonforfeiture option whereby the owner accepts a reduced paid up amount of permanent insurance that requires no further premium payments

**Reinstatement** Option allowing the owner to reinstate coverage after the policy has lapsed
Renewable term  An option to renew coverage each year but at a higher rate

Settlement options  An option that the owner may select for benefits payment or the beneficiary may select after the insured's death

Term life insurance  Temporary life insurance

Universal life policy  A combination of one-year-renewable-for-life term insurance and a fund (cash value) into which premiums are paid

Variable life insurance  A form of life insurance providing a death benefit that may change with time due to its variable cash value

Waiver of premium  Provides that the insurer will waive future premiums if the insured endorsement becomes totally and permanently disabled
INDEX

7
7-pay test ..................................................116

A
Accelerated benefits ....................................113
Accelerated death benefits ..........................110
Accelerated endowment ..............................107
Accept ......................................................130
Accidental death .......................................149
Accumulation .........................................107, 108, 115
Accumulation at interest ..............................107
Acquisition costs ......................................143
AIR ..........................................................79
Analysis ...................................................23
Annual renewable term ................................35
Annuity .....................................................149
Application to reduce premium ....................107
APS ..........................................................129
Assets ......................................................46, 146
Assignment ..............................................92
Assumed Interest Rate ..................................79
Automatic premium loan ............................149
Autopsy .....................................................97
Average ....................................................27, 147
Aviation ......................................................97
Avocations .................................................97

B
Beneficiary .............................................92, 93, 99
Bequests ...................................................11
Blacksout period ....................................... 29
Build .......................................................125
Business ....................................................18
Buy-sell agreement ....................................21

C
Capital .......................................................30
Cash payment .........................................107
Cash surrender .........................................104, 149
Cash value .............................................11, 70, 71, 79, 82, 104
Catastrophic ............................................114
Changes ....................................................79, 87
Child-care expenses ..................................11
Commissions .......................................... 67
Conditional .................................................140
Consideration .......................................... 86
Consumers Price Index ..............................57, 112
Consumers .............................................10, 121
Contract ..................................................66, 67, 77, 78, 91, 117
Contracts ................................................49, 73
Contributory ............................................133
Conventional ..........................................12, 76
Conversion ............................................35, 77, 92, 132, 135
Convertible .............................................35, 149
Cost-of-living rider ...................................110
CPI .............................................................112
Credit .......................................................25, 32, 83
Credit life ................................................32, 83
Credit life insurance ..................................32, 83
Creditors ............................................... 18, 78
Current assumption ....................................48

D
Death benefits .........................................9, 71
Decrease ..................................................36, 37, 39
Decreasing term ......................................37, 39
Deductions .............................................66, 67, 77
Default ...................................................87, 99
Definition .................................................111
Dependency income ...................................11
Dependent children ...................................135
Dependants .............................................135
Deposit term insurance ...............................57
Disability ...............................................111
Disaster ...................................................96
Disclosure .............................................. 75
Dividends ...............................................11, 109, 120
Duties .....................................................139

E
E&O .............................................................31
E&O claims ............................................31
Economistic .............................................49
Education ................................................147
Eligibility ................................................134
Emergency .............................................147
Employees ..............................................134
Endorsement .........................................149
Endowment ..........................................84, 85, 108, 117
Endowments ..........................................33, 84, 85
Entire contract ..........................................132
Estate ....................................................11, 17, 95, 118, 120
Estate plan .............................................17

151
Straight life ................................................. 44
Substandard .............................................. 130
Suicide ...................................................... 97
Suitability ............................................... 74, 75
Sum ......................................................... 65, 99, 120
Surrender charges .............................. 68, 104

T
Tax Reform Act ........................................ 66, 115
Tax-advantaged growth ......................... 12
Tax-deferred ........................................... 15
Term .... 28, 32, 33, 34, 35, 36, 37, 38, 39, 40, 41, 42, 44, 108, 150
Terminal illness .................................. 113
Tobacco ..................................................... 126
Total ....................................................... 111, 116
Traditional families ......................... 15
Transfer ............................................... 89, 119
Treasury .................................................. 69

U
UL ............................................................ 65, 66, 67

Underlying .............................................. 74
Underwriting ..................................... 123, 125, 130, 133
Uniform Simultaneous Death Law ............ 96
Units .......................................................... 78
Universal life .................. 61, 62, 63, 64, 69, 87, 150

V
Variable life insurance ........... 71, 72, 79, 80, 150

W
Waiver .................................................... 110, 150
Waiver of premium ......................... 110, 150
War ......................................................... 97
We ......................................................... 9, 33
Withdrawal ........................................... 102
Withdrawals ..................................... 70, 118

Y
Yearly renewable term ......................... 35
You ......................................................... 75
Your ....................................................... 73