
life-and-heal-insurance-license Documentation

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Sanhe Hu

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Chapter1. Basic Principles of Life and Health Insurance and Annuities

Keywords:

- *Reserves*
- *Multi-line Insurers*
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- *Reinsurer*
- *Fraternal Benefit Societies*
- *Fair Credit Reporting Act*
- *Buyer's Guide*
- *Policy Summary*
- *NAIC*
- *State Guaranty Association*

THE ROLE OF INSURANCE

Death may strike anyone prematurely. When death takes the life of a family provider, surviving family members often suffer if they are left without adequate income or the means to provide even basic necessities.

However, some people face the unpleasant prospect of outliving their income. Retirement may be forced upon them before they have adequately prepared for a non-income earning existence. Sickness and disability can also leave economic scars, often more intense than death.

Insurance evolved to produce a practical solution to economic uncertainties and losses. Health insurance also evolved from scientific principles to provide funds for medical expenses due to sickness or injury and to cover loss of income during a disability. Annuities provide income by making a series of payments to the annuitant for a specific period of time or for life.

AN INDUSTRY OVERVIEW

Reserves

Reserves are the accounting measurement of an insurer's future obligations to its policyholders. They are classified as liabilities on the insurance company's accounting statements since they must be settled at a future date. **Liquidity** indicates a company's ability to make unpredictable payouts to policyowners.

Types of Insurance Companies

There are many ways to classify organizations that provide insurance. In the broadest of terms, there are two classifications: private commercial and government. Within these two classes are many categories of insurance providers as well as insurance plans and insurance producers.

Private Insurance Companies - Commercial

Commercial insurers offer many lines of insurance. Some sell primarily life insurance and annuities, while others sell accident and health insurance, or property and casualty insurance. Companies that sell more than one line of insurance are known as multi-line insurers.

Stock Companies - Nonparticipating

A stock insurance company is a private organization, organized and incorporated under state laws for the purpose of making a profit for its stockholders (shareholders). It is structured the same as any corporation. Stockholders may or may not be policyholders. When declared, stock dividends are paid to stockholders. In a stock company, the directors and officers are responsible to the stockholders. A stock company is referred to as a nonparticipating company because **policyholders do not participate in dividends resulting from stock ownership**.

Mutual Companies - Participating

Mutual insurance companies are also organized and incorporated under state laws, but they have no stockholders. Instead, the owners are the policyholders. Anyone purchasing insurance from a **mutual insurer** is both a customer and an owner. He has the right to vote for members of the board of directors. By issuing participating policies that pay policy dividends, mutual insurers allow their policyowners to share in any company earnings. Essentially, policy dividends represent a "refund" of the portion of premium that remains after the company has set aside the necessary reserves and has made deductions for claims and expenses. Policy dividends can also include a share in the company's investment, mortality, and operating profits. Surpluses are typically distributed to policyowners on an annual basis.

Mutual companies are sometimes referred to as participating companies because the policyowners participate in dividends. Occasionally, a stock company may be converted into a mutual company through a process called mutualization. Likewise, mutuals can convert to stock companies through a process called demutualization. Stock and mutual companies are often referred to as commercial insurers. They both can write life, health, property, and casualty insurance.

Strong Assessment Mutual/Insurers

Assessment mutual companies are classified by the way in which they charge premiums. A pure assessment mutual company operates on the basis of loss-sharing by group members. No premium is payable in advance. Instead, each member is assessed an individual portion of losses that actually occur. An advance premium assessment mutual charges a premium at the beginning of the policy period. If the original premiums exceed the operating expenses and losses, the surplus is returned to the policyholders as dividends. However, if total premiums are not enough to meet

losses, additional assessments are levied against the members. Normally, the amount of assessment that may be levied is limited either by state law or simply as a provision in the insurer's by-laws.

Reciprocal Insurers

Similar to mutuals, reciprocal insurers are organized on the basis of ownership by their policyholders. However, with reciprocals, it is the policyholders themselves who insure the risks of the other policyholders. Each policyholder assumes a share of the risk brought to the company by others. Reciprocals are managed by an attorney-in-fact.

Lloyd's of London

Contrary to popular belief, Lloyd's of London is not an insurer but rather a syndicate of individuals and companies that individually underwrite insurance. Lloyd's can be compared to the New York Stock Exchange, which provides the arena and facilities for buying and selling public stock. Lloyd's function is to gather and disseminate underwriting information, help its associates settle claims and disputes and, through its member underwriters, provide coverages that might otherwise be unavailable in certain areas.

Reinsurers

Reinsurers are a specialized branch of the insurance industry because they insure insurers. Reinsurance is an arrangement by which an insurance company transfers a portion of a risk it has assumed to another insurer. Usually, reinsurance takes place to limit the loss any one insurer would face should a very large claim become payable. Another reason for reinsurance is to enable a company to meet certain objectives, such as favorable underwriting or mortality results. The company transferring the risk is called the ceding company; the company assuming the risk is the reinsurer. **A common reinsurance contract between two insurance companies is called treaty reinsurance, which involves an automatic sharing of the risks assumed.**

Captive Insurer

An insurer established and owned by a parent firm for the purpose of insuring the parent firm's loss exposure is known as a captive insurer.

Risk Retention Group

A risk retention group (RRG) is a mutual insurance company formed to insure people in the same business, occupation, or profession (e.g., pharmacists, dentists, or engineers).

Fraternal Benefit Societies

Insurance is also issued by fraternal benefit societies, which have existed in the United States for more than a century. Fraternal societies, noted primarily for their social, charitable, and benevolent activities, have memberships based on religious, national, or ethnic lines. Fraternal first began offering insurance to meet the needs of their poorer members, funding the benefits on a pure assessment basis. Today, few fraternal rely on an assessment system, most having adopted the same advanced funding approach other insurers use. To be characterized as a fraternal benefit society, the organization must be nonprofit, have a lodge system that includes ritualistic work, and maintain a representative form of government with elected officers. Fraternal must be formed for reasons other than obtaining insurance. Most fraternal today issue group and annuities with many of the same provisions found in policies issued by commercial insurers.

Industrial Insurer

Insurance is also sold through a special branch of the industry known as home service or “debit” insurers. These companies specialize in a particular type of insurance called industrial insurance, which is characterized by relatively small face amounts (usually \$1,000 to \$2,000) with premiums paid weekly.

Service Providers

Service providers offer benefits to subscribers in return for the payment of a premium. Benefits are in the form of services provided by the hospitals and physicians participating in the plan. They sell medical and hospital care services, not insurance. These services are packaged into various plans, and those who purchase these plans are known as subscribers.

Another type of service provider is the **health maintenance organization (HMO)**. HMOs offer a wide range of health care services to member subscribers. For a fixed periodic premium paid in advance of any treatment, subscribers are entitled to the services of certain physicians and hospitals contracted to work with the HMO. Unlike commercial insurers, HMOs provide financing for health care plus the health care itself. HMOs are known for stressing preventive health care and early treatment programs.

A third type of service provider is the **preferred provider organization (PPO)**. Under the usual PPO arrangement, a group desiring health care services (e.g., an employer or a union) will obtain price discounts or special services from certain select health care providers in exchange for referring its employees or members to them. PPOs can be organized by employers or by the health care providers themselves. The contract between the employer and the health care professional, whether physician or a hospital, spells out the kind of services to be provided. Insurance companies can also contract with PPOs to offer services to insureds.

Government as Insurer

As noted at the beginning of this unit, federal and state governments are also insurers, providing what are commonly called social insurance programs. Ranging from crop insurance to bank and savings and loan deposit insurance, these programs have far-reaching effects. Millions of people rely on these plans. Social insurance programs include the following:

Old-Age, Survivors, and Disability Insurance (OASDI), commonly known as Social Security

Social Security Hospital Insurance (HI) and Supplemental Medical Insurance (SMI), commonly known as Medicare
Medicaid

The government plays a vital role in providing social insurance programs. These programs pay billions of dollars in benefits every year and affect millions of people.

Self-Insurers

Though self-insurance is not a method of transferring risk, it is an important concept to understand. Rather than transfer risk to an insurance company, a self-insurer establishes its own self-funded plan to cover potential losses. Self-insurance is often used by large companies for funding pension plans and some health insurance plans. Many times, a self-insurer will look to an insurance company to provide insurance above a certain maximum level of loss. The self-insurer will bear the amount of loss below that maximum amount.

How Insurance is Sold

Insurance is sold by a variety of companies and methods. Most consumers purchase insurance through licensed producers who present insurers’ products and services to the public via active sales and marketing methods. Insurance

producers may be agents, who represent a particular company, or brokers, who are not tied to any particular company and can represent many insurers' products. In a sales transaction, agents represent the insurer and brokers represent the buyer. An agent has an agent's contract; a broker has a broker's contract. Agents are also classified as captive or career agents and independent agents. A captive or career agent works for one insurance company and sells only that company's insurance policies. An independent agent works for himself and sells the insurance products of many companies.

- The agent's contract and appointment with the insurance company grants the authority to bind an insurer to an insurance contract

In any dispute between the insured or beneficiary and the insurer, the agent who solicits an insurance application represents the insurer and not the insured or beneficiary. In most states, however, the agent may represent as many insurers as will appoint him. There are three systems that support the sale of insurance through agents and brokers. These are the career agency system, personal producing general agency system, and independent agency system.

Career Agency System

Career agencies are branches of major stock and mutual insurance companies that are contracted to represent an insurer in a specific area. In career agencies, insurance agents are recruited, trained, and supervised by either a manager employee of the company or a general agent (GA) who has a vested right in any business written by the GA's agents. GAs may operate strictly as managers, or they may devote a portion of their time to sales. The career agency system focuses on building sales staffs.

Personal Producing General Agency System

The personal producing general agency (PPGA) system is similar to the career agency system. However, **PPGAs do not recruit, train, or supervise career agents. They primarily sell insurance**, although they may build a small sales force to assist them. PPGAs are generally responsible for maintaining their own offices and administrative staff. Agents hired by a PPGA are considered employees of the PPGA, not the insurance company, and are supervised by regional directors.

Independent Agency System

The independent agency system, a creation of the property and casualty industry, does not tie a sales staff or agency to any one particular insurance company. Instead, independent agents represent any number of insurance companies through contractual agreements. They are compensated on a commission or fee-basis for the business they produce. This system is also known as the American agency system.

Independent agent represent any number of insurance companies through contractual agreements.

Other Methods of Selling Insurance

While most insurance is sold through agents or brokers under the systems previously described, a large volume is also marketed through direct selling and mass marketing methods.

With the direct selling method, the insurer deals directly with consumers by selling its policies through vending machines, advertisements, or salaried sales representatives. No agent or broker is involved. A large volume of insurance is also sold through mass marketing techniques, such as over the Internet, newspaper, magazine, radio, and television ads. Mass marketing methods provide exposure to large groups of consumers, often using direct selling methods with occasional follow-up by agents.

Evolution of Industry Oversight

The insurance industry is regulated by a number of authorities, including some inside the industry itself. The primary purpose of this regulation is to promote public welfare by maintaining the solvency of insurance companies. Other purposes are to provide consumer protection and ensure fair trade practices as well as fair contracts at fair prices. It is very important insurance agents understand and obey the insurance laws and regulations.

History of Regulation

A brief overview of the history of insurance regulation will show a seesaw between the authority of the states and the federal government. Though a balance between these two bodies has been reached and maintained for many years, arguments favoring control by one governing authority over another are still being waged.

1868-Paul v. Virginia. This case, which was decided by the U.S. Supreme Court, involved one state's attempt to regulate an insurance company domiciled in another state. The Supreme Court sided against the insurance company, ruling that the sale and issuance of insurance is not interstate commerce, thus upholding the right of states to regulate insurance. 1944-United States v. Southeastern Underwriters Association (SEUA). The decision of Paul v. Virginia held for 75 years before the Supreme Court again addressed the issue of state versus federal regulation of the insurance industry. In the SEUA case, the Supreme Court ruled that the business of insurance is subject to a series of federal laws, many of which were in conflict with existing state laws, and that insurance is a form of interstate commerce to be regulated by the federal government. This decision did not affect the power of states to regulate insurance, but it did nullify state laws that were in conflict with federal legislation. The result of the SEUA case was to shift the balance of regulatory control to the federal government. 1945-The McCarran-Ferguson Act. The turmoil created by the SEUA case prompted Congress to enact Public Law 15, the McCarran-Ferguson Act. This law made it clear that continued regulation of insurance by the states was in the public's best interest. However, it also made possible the application of federal antitrust laws "To the extent that [the insurance business] is not regulated by state law." This act led each state to revise its insurance laws to conform to the federal laws. Today, the insurance industry is considered to be state-regulated.

- A fine of \$10,000 or up to one year in jail is the penalty for any person who violates the McCarran-Ferguson Act

The National Conference of Insurance Legislators (NCOIL) was formed to help legislators make informed decisions on insurance issues that affect their constituents and to declare opposition to federal encroachment of state authority to oversee the business of insurance, as authorized under the McCarran-Ferguson Act of 1945.

1958-Intervention by the FTC. In the mid-1950s the Federal Trade Commission (FTC) sought to control the advertising and sales literature used by the health insurance industry. In 1958 the Supreme Court held that the McCarran-Ferguson Act disallowed such supervision by the FTC, a federal agency. Additional attempts have been made by the FTC to force further federal control, but none have been successful.

1959-Intervention by the SEC. In this instance, the issue was variable annuities: Are the insurance products to be regulated by the states or securities to be regulated federally by the Securities and Exchange Commission (SEC)? The Supreme Court ruled that federal securities laws applied to insurers that issued variable annuities and, thus, required these insurers to conform to both SEC and state regulation. The SEC also regulates variable life insurance. 1970-Fair Credit Reporting Act. In an attempt to protect an individual's right to privacy, the federal government passed the Fair Credit Reporting Act, **which is the authority that requires fair and accurate reporting of information about consumers, including applications for insurance. Insurers must inform applicants about any investigations that are being made.** If any consumer report is used to deny coverage or charge higher rates, the insurer must furnish to the applicant the name of the reporting agency conducting the investigation. Any insurance company that fails to comply with this act is liable to the consumer for actual and punitive damages.

- The maximum penalty for obtaining Consumer Information Reports under false pretenses is \$5,000 and 1 year imprisonment

1999-Financial Services Modernization Act. The Glass-Steagall Act of 1933, which barred common ownership of banks, insurance companies, and securities firms and erected a regulatory wall between banks and nonfinancial companies, came under repeated attack in the 1980s. In 1999 Congress passed the Financial Services Modernization Act, which repealed the Glass Steagall Act. Under this new legislation, commercial banks, investment banks, retail brokerages, and insurance companies can now enter each other's lines of business. The chronology cited reflects the roles the courts and the federal government have played in regulating the insurance industry. Let's now take a look at how individual states regulate this business and how the industry practices self-regulation.

Agent Marketing and Sales Practices

Marketing and selling financial products, such as life insurance and annuities, requires a high level of professionalism and ethics. Every state requires its licensed producers to adhere to certain standards designed to protect consumers and promote suitable sales and application of insurance products. Some of these standards are listed below.

Selling to needs. The ethical agent determines the client's needs and then determines which is best suited to address those needs. Two principles of needs-based selling include find the facts, and educate the client.

Suitability of recommended products. The ethical agent assesses the correlation between a recommended product and the client's needs and capabilities by asking and answering the following questions. 1. What are the client's needs? 2. What product can help meet those needs? 3. Does the client understand the product and its provisions? 4. Does the client have the capability, financially and otherwise, to manage the product? 5. Is this product in the client's best interest? **Full and accurate disclosure.** The ethical agent makes it a practice to inform clients about all aspects of the products recommended, including benefits and limitations. There should never be an attempt to hide or disguise the nature or purpose of the product nor the company being represented. Insurance products are highly effective financial planning tools. They should be presented clearly, completely, and accurately. **Documentation.** The ethical agent documents each client meeting and transaction. The agent uses fact-finding forms and obtains the client's written agreement for the needs determined, the products recommended, and the decisions made. Some documentation is required by state law. Ethical agents know these laws and follow them precisely.

Client service. The ethical agent knows that a sale does not mark the end of a relationship with a client, but the beginning. Routine follow-up calls are recommended to ensure that the client's needs always are covered and the products in place still are suitable. When clients contact their agents for service or information, these requests are given top priority. Complaints are handled promptly and fully.

Buyer's Guides and Policy Summaries

To help ensure that prospective insurance buyers select the most appropriate plan for their needs and to improve their understanding of basic product features, most states require agents to deliver a buyer's guide to consumers whenever they solicit insurance sales. These guides explain the various types of life insurance products (including variable annuities) in a way that the average consumer can understand. In addition, a policy summary containing information about the specific policy being recommended must be given to a potential buyer. It identifies the agent, the insurer, the policy, and each rider, and includes information about premiums, dividends, benefit amounts, cash surrender values, policy loan interest rates, and life insurance cost indexes of the specific policy being considered. Most states require this to be done before the applicant's initial premium is accepted. The policy summary also contains cost indexes that help the consumer evaluate the suitability of the recommended product. The net payment cost comparison index gives the buyer an idea of the cost of the policy at some future point in time compared to the death benefit. The surrender cost comparison index compares the cost of surrendering the policy and withdrawing the cash values at some future time. Because all states are interested in protecting the interests of the buying public, the actions of individuals soliciting insurance sales are strictly regulated. However, the laws regarding insurance marketing and trade practices vary from state to state. As a result, it is very important that you examine and understand your state's laws.

A buyer's guide and policy summary must be given to applicants before initial premium accepted.

National Association of Insurance Commissioners

All state insurance commissioners or directors are members of the National Association of Insurance Commissioners (NAIC). This organization has committees that work regularly to examine various aspects of the insurance industry and to recommend appropriate insurance laws and regulations. The NAIC has four broad objectives:

1. To encourage uniformity in state insurance laws and regulations
2. To assist in the administration of those laws and regulations by promoting efficiency
3. To protect the interests of policyowners and consumers
4. To preserve state regulation of the insurance business

Advertising Code

A principal problem of states in the past was regulating misleading insurance advertising and direct mail solicitations. Many states now subscribe to the Advertising Code developed by the NAIC. The Code specifies certain words and phrases that are considered misleading and are not to be used in advertising of any kind. Also required under this code is full disclosure of policy renewal, cancellation, and termination provisions.

Unfair Trade Practices Act

Most jurisdictions have also adopted the NAIC's Unfair Trade Practices Act. This act gives chief financial officers the power to investigate insurance companies and producers, to issue cease and desist orders, and to impose penalties. The act also gives officers the authority to seek a court injunction to restrain insurers from using any methods believed to be unfair. Included in the context of unfair trade practices are misrepresentation and false advertising, coercion and intimidation, unfair discrimination, and inequitable administration of claims settlements.

State Guaranty Associations

All states have established guaranty funds or guaranty associations to support insurers and to protect consumers if an insurer becomes insolvent. Should an insurer be financially unable to pay its claims, the state guaranty association will step in and cover the consumers' unpaid claims. These state associations are funded by insurance companies through assessments.

Rating Services

The financial strength and stability of an insurance company are two vitally important factors to potential insurance buyers and to insurance companies. The PRIMARY purpose of a rating service company, such as A.M. Best, Standard & Poor's, and Moody's, **is to determine the financial strength of the company being rated.**

- A+: Superior ability to meet ongoing obligations.
- AA-: Very strong capacity to meet policyholder & contract obligations.
- AA-: Very strong financial security characteristics.
- A1: Good financial security

Quiz

- Question 1: What is the primary purpose of a rating service company such as A.M Best?
 - Determine which insurer offers the best rates

- Determine which insurer offers the best policies
 - Determine financial strength of an insurance company <- The primary purpose of a rating service company is to determine the financial strength of the company being rated.
 - Determine which agent to use locally
- Question 2: What is considered to be the primary reason for buying life insurance?
 - Provide death benefits <- The primary reason for purchasing life insurance is to provide death benefits.
 - Provide money for retirement
 - Provide living benefits
 - Provide money for college
- Question 3: An insurer's ability to make unpredictable payouts to policyowners is called
 - investment values
 - liquidity <- Liquidity indicates a company's ability to make unpredictable payouts to policyowners.
 - assets
 - capital
- Question 4: Which of the following is NOT considered advertising?
 - A rating from a rating service company, such as A.M. Best <- An A.M. Best company rating is not considered advertising.
 - An illustration
 - A sales presentation
 - Direct mailing from an agency
- Question 5: A plan in which an employer pays insurance benefits from a fund derived from the employer's current revenues is called
 - A self-derived plan
 - A multiple-employer plan
 - A blanket plan
 - A self-funded plan <-
- Question 5: A nonparticipating policy will
 - provide a return of premium
 - provide tax advantages
 - not pay dividends <- When an insurer offers a policy that is nonparticipating, the insurer's policy does not pay dividends.
 - give policyowners special privileges
- Question 6: What kind of life insurance policy issued by a mutual insurer provides a return of divisible surplus ()?
 - nonparticipating life insurance policy

- participating life insurance policy <- A mutual insurer issues life insurance policies that provide a return of divisible surplus.
 - divisible surplus life insurance policy
 - straight life insurance policy
- Question 7: Why are dividends from a mutual insurer not subject to taxation?
 - Because insurance premiums are tax-deductible
 - Because dividends are already subject to capital gains
 - Because dividends are payable directly to the policyholder
 - Because dividends are considered to be a return of premium <- Dividends are not subject to taxation because paying dividends is equivalent to returning a premium.
- Question 9: A life insurance company has transferred some of its risk to another insurer. The insurer assuming the risk is called the
 - mutual insurer
 - reinsurer <- When risk is transferred from one insurer to another, the insurer assuming the risk is called the reinsurer.
 - reciprocal insurer
 - participating insurer
- Question 10: A nonparticipating company is sometimes called a(n)
 - alien insurer
 - mutual insurer
 - reinsurer
 - stock insurer <- A stock insurer is referred to as a nonparticipating company because policyholders do not participate in dividends resulting from stock ownership.
- Question 11: A type of insurer that is owned by its policyowners is called
 - domestic
 - mutual <- A mutual insurer is owned by its policyowners.
 - stock
 - in-house

Chapter2. Nature of Insurance, Risk, Perils and Hazards

Keywords

- *Law of Large Numbers*
- *Risk*
- Peril
- Speculative Risk
- Pure Risk

- *Risk Avoidance*
- *Risk Reduction*
- *Risk Retention*
- *Risk Transfer*
- *Adverse Selection*
- Reinsurance
- *Hazard*
- *Moral Hazard*
- *Morale Hazard*

THE NATURE OF INSURANCE

Risk Pooling

Risk Pooling, also known as loss sharing, spreads risk by sharing the possibility of loss over a large number of people. It transfers risk from an individual to a group.

Law of Large Numbers

The law of large numbers states that larger groups provide an increased degree of accuracy in loss predictions, based on past experience. The higher the exposure, the more likely the event can be predicted.

RISK

Risk is defined as the **potential for loss**.

Peril () is something that can cause a financial loss, such as an earthquake or tornado. Perils can also be referred to as the accident itself.

Loss is the unintentional decrease in the value of an asset due to a peril.

Homogeneous exposure units are similar objects of insurance that are exposed to the same group of perils.

Types of Risk

- **Speculative risk** is a risk that presents the chance for both loss and gain. Gambling is an example. *Speculative risks are not insurable.*
- **Pure risks** are the only insurable risks and present **a potential for loss only with no possibility of gain**, such as injury, illness, and death.

Treatment of Risk – how people deal with risk

Avoidance – Don't do anything - the elimination of a hazard is an example of risk avoidance

Reduction – Minimizing the severity of a potential loss – smoke alarms, stop smoking

Retention – Self insure - Used when losses are highly predictable and the worst possible loss is not serious. (, ,)

Transfer – Buying insurance is the best way to transfer risk. Incorporation is also a risk transfer

Sharing- Each party assumes a portion of the risk receiving benefits under the system

Elements of Insurable Risk

Loss must be due to chance (accident) – Outside the insured's control

Loss must be definite and measurable – Time, place, amount, and when payable

Loss must be predictable – Estimate the average frequency and severity

Loss cannot be catastrophic – Must be reasonable, 1 trillion dollar policy is not reasonable

Loss exposure to be insured must be large – Insurance company must be able to predict loss

Loss must be randomly selected – Adverse selection

Risk Management

The process of analyzing exposures that create risk and designing programs to handle them is called risk management.

Principle of Indemnity ()

The principle of indemnity involves making an insured whole by restoring them to the same condition as before a loss.

Adverse() Selection

Insurers must minimize adverse selection, which is defined as the tendency for poorer than average risks to seek out insurance. For example, **a person who takes 12 prescriptions is a poor risk**. If an insurer cannot compensate poor risks with better than average risks, then its loss experience will increase and its ability to pay claims may be compromised.

Reinsurance

One way insurers deal with catastrophic loss is through reinsurance, which is defined as spreading risk from one insurer to one or more other insurers. Many insurers are able to minimize exposure to loss by reinsuring risks.

HAZARDS

Hazard

A condition or situation that creates or increases a chance of loss is called a hazard.

Hazard Examples: Icy roads, driving while intoxicated, improperly stored toxic waste.

Types of Hazards

- Physical – Poor health, overweight, blind.
- Moral – Dishonesty, drugs, alcohol abuse.

- Morale – Careless attitude – reckless driving, jumping off a cliff, stealing, racing motorcycles, carefree, careless lifestyle

Quiz

- Question 1: Insurance companies determine risk exposure by which of the following?
 - Insurable interest
 - Insurance exchanges
 - Law of large numbers and risk pooling <- “ All forms of insurance determine exposure through risk pooling and the law of large numbers.”
 - Population table data
- Question 2: Which of these are considered to be events or conditions that increase the chances of an insured's loss?
 - Risks
 - Hazards <- Hazards are events or conditions that increase the likelihood of an insured's loss.
 - Indemnity
 - Perils
- Question 3: People with higher loss exposure have the tendency to purchase insurance more often than those at average risk. This is called
 - risk retention
 - preexisting conditions
 - law of large numbers
 - adverse selection <- Adverse selection is the tendency of persons with higher loss exposure to purchase insurance more often than those at average risk.
- Question 4: An example of risk sharing would be
 - Adding more security to a high-risk building
 - Choosing not to invest in the stock market
 - Doctors pooling their money to cover malpractice exposures () <- Doctors pooling their money to cover malpractice exposures is an example of risk sharing.
 - Buying an insurance policy to cover potential liabilities
- Question 5: Which of these techniques will remove the risk of losing money in the stock market by never purchasing stocks?
 - Risk reduction
 - Risk transference
 - Risk avoidance <- Risk avoidance could eliminate the risk of losing money in the stock market by never investing in stocks.
 - Risk retention

Chapter3. Legal Concepts of the Insurance Contract

Keywords

- *Offer & Acceptance*
- *Consideration*
- *Legal Purpose*
- *Competent Parties*
- *Aleatory - Adhesion*
- *Unilateral*
- *Conditional*
- *Utmost Good Faith - Warranty - Representation - Concealment - Insurable Interest - STOLI*
- *Express Authority*
- *Implied Authority - Apparent Authority*
- *Waiver*
- *Void/Voidable Contract*

GENERAL LAW OF CONTRACTS

A contract is an agreement enforceable by law. It is the means by which one or more parties bind themselves to certain promises. With a life insurance contract, the insurer binds itself to pay a certain sum upon the death of the insured. In exchange, the policyowner pays premiums. The voluntary act of terminating an insurance contract is called **cancellation**. For a contract to be legally valid and binding, **it must contain certain elements** - offer and acceptance, consideration, legal purpose, and competent parties. Let's consider each.

Offer and Acceptance

To be legally enforceable, a contract must be made with a **definite, unqualified proposal (offer)** by one party and the acceptance of its exact terms by the other. In many cases, the offer of an insurance contract is made by the applicant when the application is submitted with the initial premium. The insurance company accepts the offer when it issues the policy as applied for. **When an offer is answered by a counteroffer, the first offer is void.**

Consideration

For a contract to be enforceable, the promise or promises it contains must be supported by consideration. Consideration can be defined as the value given in exchange for the promises sought. In an insurance contract, **consideration is given by the applicant in exchange for the insurer's promise to pay benefits**. It also consists of the application and the initial premium. This is why the offer and acceptance of an insurance contract are not complete until the insurer receives the application and the first premium. The Consideration clause also contains information such as the **schedule and amount of premium payments**.

Legal Purpose

To be legal, a contract must have a legal purpose. This means that the object of the contract and **the reason the parties enter into the agreement must be legal**. A contract in which one party agrees to commit murder for money would be unenforceable in court because the object or purpose of the contract is not legal. Insurance contracts are always considered to possess a legal purpose.

Competent Parties

To be enforceable, a contract must be entered into by competent parties. With a contract of insurance, the parties to the contract are the applicant and the insurer. The insurer is considered competent if it has been licensed or authorized by the state(s) in which it conducts business. The applicant, unless proven otherwise, is presumed to be competent with three possible exceptions:

Minors

The mentally infirm

Those under the influence of alcohol or narcotics Each state has its own laws governing the legality of minors and the mentally infirm entering into contracts of insurance. These laws are based on the principle that some parties are not capable of understanding the contract they agree to.

SPECIAL FEATURES OF INSURANCE CONTRACTS

The elements just discussed must be contained in every contract for it to be enforceable by law. In addition to these, insurance contracts have distinguishing characteristics that set them apart from many other legally binding agreements. Some of these characteristics are unique to insurance contracts. Let's review these distinctions.

Aleatory ()

Insurance contracts are aleatory. This means there is an element of chance and potential for **unequal exchange of value or consideration for both parties**. An aleatory contract is conditioned upon the occurrence of an event. Consequently, the benefits provided by an insurance policy may or may not exceed the premiums paid. **For example, an individual who has a disability insurance policy will collect benefits if she becomes disabled.** However, if no disability strikes, benefits are not paid. **Both insurance and gambling contracts are typically considered aleatory contracts.**

Adhesion

Insurance contracts are contracts of adhesion. This means that the contract has been prepared by one party (the insurance company) with no negotiation between the applicant and insurer. In effect, the applicant "adheres" to the terms of the contract on a "take it or leave it" basis when accepted. Any confusing language in a contract of adhesion would be interpreted in favor of the insured. The purpose is to correct any advantage that may result for the party who prepared the contract. **A policy of adhesion can also be described as one which the insurance company can modify.**

Unilateral

Insurance contracts are unilateral. **This means that only one party (the insurer) makes any kind of enforceable promise.** Insurers promise to pay benefits upon the occurrence of a specific event, such as death or disability. The applicant makes no such promise. In fact, the applicant does not even promise to pay premiums. The insurer cannot require the premiums to be paid. Of course, the insurer has the right to cancel the contract if premiums are not paid.

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Personal Contract

Life insurance is a personal contract or personal agreement between the insurer and the insured. The owner of the policy has no bearing on the risk the insurer has assumed. For this reason, people who buy life insurance policies are called policy owners rather than policyholders. Policy owners actually own their policies and can give them away if they wish. This transfer of ownership is known as assignment. To assign a policy, a policy owner simply notifies the insurer in writing. The company will then accept the validity of the transfer without question. The new owner is granted all of the rights of policy ownership.

Conditional

An insurance contract is conditional. This means that the insurer's promise to pay benefits depends on the occurrence of an event covered by the contract. If the event does not materialize, no benefits are paid. Furthermore, the insurer's obligations under the contract are conditioned on the performance of certain acts by the insured or the beneficiary. For example, the timely payment of premiums is a condition for keeping the contract in force. If premiums are not paid, the company is relieved of its obligation to pay a death benefit.

Valued or Indemnity

An insurance contract is either a valued contract or an indemnity contract. **A valued contract pays a stated sum regardless of the actual loss incurred.** Life insurance contracts are valued contracts. If an individual acquires a life insurance policy insuring her life for \$500,000, that is the amount payable at death. There is no attempt to value actual financial loss upon a person's death.

An indemnity contract, however, is one that pays an amount equal to the loss. Contracts of indemnity attempt to return the insured to their original financial position. Fire and health insurance policies are examples of indemnity contracts. An insured that owns a \$50,000 fire insurance policy and suffers a \$5,000 loss due to fire will be able to collect up to \$5,000, not \$50,000.

Utmost Good Faith

Insurance is a contract of **utmost good faith**. This means both the policyowner and the insurer must know all material facts and relevant information. There can be no attempt by either party to conceal, disguise, or deceive. A consumer purchases a policy based largely on the insurer and agent's explanation of the policy's features, benefits, and advantages. **Insurance applicants are required to make a full, fair and honest disclosure of the risk to the agent and insurer.** Concepts related to utmost good faith include warranties, representations, and concealment. These represent grounds through which an insurer might seek to avoid payment under a contract.

Warranty

A warranty in insurance is a statement made by the applicant that is **guaranteed to be true in every respect**. It becomes part of the contract and, if found to be untrue, can be grounds for revoking the contract. Warranties are presumed to be material because they affect the insurer's decision to accept or reject an applicant.

Representation

A representation is a statement made by the applicant that they **consider to be true and accurate to the best of the applicant's belief**. It is used by the insurer to evaluate whether or not to issue a policy. Unlike warranties,

representations are not a part of the contract and need be true only to the extent that they are material and related to the risk. Statements made by applicants for insurance are considered to be representations and not warranties.

Concealment The issue of concealment is also important to insurance contracts. Concealment is defined as the **failure by the applicant to disclose a known material fact when applying for insurance**. If the purpose for concealing information is to defraud the insurer (that is, to obtain a policy that might not otherwise be issued if the information were revealed), the insurer may have grounds for voiding the policy. Again, the insurer must prove concealment and materiality.

In most cases, life insurers have only a limited period of time to uncover false warranties, misrepresentations, or concealment. After that time period passes (normally two years from policy issue), the contract cannot be voided or revoked for these reasons.

Insurable Interest ()

Another element of a valid insurance contract is insurable interest. Insurable interest is a component of legal purpose. **This means that the person acquiring the contract (the applicant) must be subject to loss upon the death, illness, or disability of the person being insured. To have “an insurable interest” in the life of another person, an individual must have a reasonable expectation of benefiting from the other person’s continued life.** A policy obtained by a person not having an insurable interest in the insured is not valid and cannot be enforced. Thus, insurable interest must exist between the applicant and the individual being insured. When the applicant is the same as the person to be insured, there is no question that insurable interest exists. Individuals are presumed to have insurable interest in themselves.

It is important to note that insurable **interest must only exist at the time of the application** of a life or health insurance contract. It doesn’t have to continue throughout the duration of the policy nor does it have to exist at the time of claim.

Stranger-Originated Life Insurance (STOLI)

Stranger-Originated Life Insurance (STOLI) transactions are life insurance arrangements where investors persuade individuals (typically seniors) to take out new life insurance, **naming the investors as beneficiary. This is sometimes called Investor-Originated Life Insurance (IOLI). These arrangements are used to circumvent state insurable interest statutes.**

Generally, the investors loan money to the insured to pay the premiums for a defined period (usually two years based on the life insurance policy’s contestability period).

Eventually the insured assigns ownership to the investors, who receive the death benefit when the insured dies. In return, the seniors receive financial incentives. This normally includes: an upfront payment, a loan, or a small continuing interest in the policy’s death benefit. After the two year period, the investors make the premium payments on behalf of the insured.

AGENTS AND BROKERS

Contracts of insurance are binding and enforceable. As such, all parties to the contract (the insurer and the applicant) are subject to specific legal requirements. We discussed some of the more important regulations that states impose on people who solicit and sell insurance. Next, we will focus on the legal aspects of negotiating and issuing contracts of insurance.

The Law of Agency

As noted earlier, an agent is an individual who is authorized by an insurer to sell its goods and services on its behalf. An agent’s role involves the following duties:

Describing the company's insurance policies to prospective buyers and explaining the conditions under which the policies may be obtained

Soliciting applications for insurance

Collecting premiums from policyowners

Rendering service to prospects and to those who have purchased policies from the company

The authority of an agent to undertake these functions is clearly defined in a "contract of agency" (or agency agreement) between the agent and the company. Within the authority granted, the agent is considered to be the insurance company. The relationship between an agent and the company represented is governed by agency law.

Principles of Agency Law

By legal definition, an agent is a person who acts for another person or entity (known as the principal) with regard to contractual arrangements with third parties. An authorized agent has the power to bind the principal to contracts (and to the rights and responsibilities of those contracts). With this in mind, we can review the main principles of agency law:

The acts of the agent (within the scope of his authority) are the acts of the principal

A contract completed by an agent on behalf of the principal is a contract of the principal

Payments made to an agent on behalf of the principal are payments to the principal

Knowledge of the agent regarding business of the principal is presumed to be knowledge of the principal

Agent Authority

Agent authority is another important concept of agency law. **Authority is what's given by an insurer to a licensee to transact insurance on their behalf.** Technically, only those actions for which an agent is actually authorized can bind a principal. In reality, an agent's authority can be quite broad. There are three types of agent authority: express, implied, and apparent. Let's take a look at each.

1. **Express authority. Express authority is the authority a principal deliberately () gives to its agent.** Express authority is granted by means of the agent's contract, which is the principal's appointment of the agent to act on its behalf. For example, an agent has the express authority to solicit applications for insurance on behalf of the company. (,)
2. **Implied authority. Implied authority is the unwritten authority that is not expressly granted, but which the agent is assumed to have in order to transact the business of the principal.** Implied authority is incidental to express authority because not every single detail of an agent's authority can be spelled out in the agent's contract. For example, an agent's contract may not specifically state that he can print business cards that contain the company's name, but the authority to do so is implied. (,)
3. **Apparent authority. Apparent authority is the appearance or assumption of authority based on the actions, words, or deeds of the principal. It can also exist because of circumstances the principal created.** For example, by providing an individual with a rate book, application forms, and sales literature, a company creates the impression that an agency relationship exists between itself and the individual. The company will not later be allowed to deny that such a relationship existed. ()

The significance of authority (whether express, implied, or apparent) is that it ties the company to the acts and deeds of its agents. The law will view the agent and the company as one and the same when the **agent acts within the scope of his authority. An insurer may be liable to an insured for unauthorized acts of its agent when the agency contract is unclear about the authority granted.**

Agent as a Fiduciary ()

Fiduciary is another legal concept which governs the activity of an agent. A fiduciary is a person who holds a position of financial trust and confidence. Agents act in a fiduciary capacity when they accept premiums on behalf of the insurer or offer advice that affects a person's financial security.

Brokers versus Agents

Unlike agents, brokers legally represent the insureds. A broker (or independent agent) may represent a number of insurance companies under separate contractual agreements. A broker solicits and accepts applications for insurance and then places the coverage with an insurer.

Professional Liability Insurance (E&O)

Just as doctors should have malpractice insurance to protect against legal liability arising from their professional services, insurance agents need **errors and omissions** (E&O) professional liability insurance. Under this insurance, the insurer agrees to pay sums that the agent legally is obligated to pay for injuries resulting from professional services that he rendered or failed to render.

OTHER LEGAL CONCEPTS

In addition to the principles of contract and agency law, there are other legal concepts that apply to insurance and the power of agents. These include waiver, estoppel, parol evidence rule, void vs voidable contracts, and fraud.

Waiver

A waiver is the voluntary giving up of a legal, given right. **If an insurer fails to enforce (waives) a provision of a contract, it cannot later deny a claim based on a violation of that provision.**

Estoppel ()

The concepts of waiver and estoppel are closely related. Estoppel is the legal impediment to one party denying the consequences of its own actions or deeds if such actions or deeds result in another party acting in a specific manner or if certain conclusions are drawn. In other words, it is the loss of defense.

Parol Evidence Rule

Parol evidence is oral or verbal evidence, or that which is given verbally in a court of law. The parol evidence rule states that when parties put their agreement in writing, all previous verbal statements come together in that writing and a written contract cannot be changed or modified by parol (oral) evidence.

Void versus Voidable Contracts

The terms void and voidable are often incorrectly used interchangeably. **A void contract is simply an agreement without legal effect.** In essence, it is not a contract at all, for it lacks one of the elements specified by law for a valid contract. A void contract cannot be enforced by either party. For example, a contract having an illegal purpose is void, and neither party to the contract can enforce it. **An insurer may also void an insurance policy if a misrepresentation on an application is proven to be material.**
~~~~~ A \*\*voidable

**contract** is an agreement which, for a reason satisfactory to the court, may be set aside by one of the parties to the contract. It is binding unless the party with the right to reject it wishes to do so. Say that a situation develops under which the policyholder has failed to comply with a condition of the contract: the policyholder ceased paying the premium. The contract is then voidable, and the insurance company has the right to cancel the contract and revoke the coverage.

## Fraud

In the event of fraud, insurance contracts are unique in that they run counter to a basic rule of contract law. Under most contracts, fraud can be a reason to void a contract. With life insurance contracts, an insurer has only a limited period of time (usually two years from date of issue) to challenge the validity of a contract. After that period, the insurer cannot contest the policy or deny benefits based on material misrepresentations, concealment, or fraud.

## Quiz

- **Question 1:** What makes an insurance policy a unilateral contract?
  - Only the insured pays the premium
  - Only the insured can change the provisions
  - Only the insurer is legally bound <- Insurance contracts are unilateral, meaning that only the insurer makes legally enforceable promises in the contract.
  - Only the insured is legally bound
- **Question 2:** Intentional withholding of material facts that would affect an insurance policy's validity is called a(n)
  - estoppel
  - concealment <- Deliberate withholding of material facts that would affect the validity of an insurance policy or a claim under the policy is known as concealment.
  - adhesion
  - misrepresentation
- **Question 3:** Legal purpose is a term used in contract law meaning
  - there must be an offer and acceptance
  - the contract must be aleatory ()
  - there must be legal reasons for entering into the contract <- In contract law, legal purpose refers to the fact that the reasons for entering into a contract must be legal.
  - the contract must be a contract of adhesion
- **Question 4** What are an applicant's statements concerning occupation, hobbies, and personal health history regarded as?
  - warranty
  - guarantee



- representation <- Statements by an applicant concerning personal health history, family health history, occupation, and hobbies are referred to as representations.
  - collateral ()
- Question 5: Which type of clause describes the following statement: “We have issued the policy in consideration of the representations in your applications and payment of the first-term premium”.
  - Premium clause
  - Consideration clause <- This statement refers to the consideration clause.
  - Adhesion clause
  - Contestability clause
- Question 6: When the principal gives the agent authority in writing, it’s referred to as
  - express authority <- Express authority is given when the principal gives the agent authority in writing.
  - implied authority
  - apparent authority
  - imposed authority
- Question 7: The term which describes the fact that both parties of a contract may NOT receive the same value is referred to as
  - Apparent
  - Estoppel
  - Aleatory <- Aleatory is a term that describes the fact that both parties of a contract may NOT receive the same value.
  - Unilateral
- Question 8: Bob and Tom start a business. Since each partner contributes an important element to the success of the business, they decide to take life insurance policies out on each other, and name each other as beneficiaries. Eventually, they retire and dissolve the business. Bob dies 12 months later. The policies continue in force with no change. Both partners are still married at the time of Bob’s death. In this situation, who will receive Bob’s policy proceeds?
  - Tom’s spouse
  - Bob’s estate
  - Bob’s spouse
  - Tom <- Insurable interest only has to exist at the time of the application, not at the time of the claim. Being there was no change in beneficiary prior to Bob’s death, Tom will still receive the policy proceeds.
- Question 9: What is implied authority defined as?
  - Authority given in writing to an agent in the agency agreement
  - Authority that is not specifically given to an agent in the agency contract, but that an agent can reasonably assume to carry out his/her duties <- “ Implied authority is defined as the authority that is not specifically granted to an agent in the agency agreement, but that an agent can reasonably assume to accomplish the day-to-day activities of the job.”

- Authority given to handle claims and process payments
  - Authority given to an agent to act outside the scope of the agency agreement
- **Question 10:** In an insurance contract, the element that shows each party is giving something of value is called
  - offer
  - acceptance
  - consideration <- Consideration is the element of an insurance contract which demonstrates that each party is giving something of value.
  - purpose
- **Question 11:** In order for a contract to be valid, it must
  - be filed with the state
  - be signed and witnessed by an attorney
  - be in writing
  - contain an offer and acceptance <- For a contract to be valid it MUST include an offer and an acceptance.
- **Question 12:** A professional liability for which producers can be sued for mistakes of putting a policy into effect is called
  - fiduciary bond
  - errors and omissions <- Errors and omissions is a professional liability for which producers can be sued for mistakes of putting a policy into effect.
  - fiduciary trust
  - errors and oversights
- **Question 13:** Insurable interest does NOT occur in which of the following relationships?
  - Sister and brother
  - Parent and children
  - Business partners
  - Business owner and business client <- There would not be insurable interest between a business owner and its customer.
- **Question 14:** The power given to an individual producer that is not specifically addressed in his/her contract is considered what type of authority?
  - discreet
  - apparent
  - implied <- “Implied authority is the unwritten authority that is not expressly granted, but which the agent is assumed to have in order to transact the business of the principal.”
  - express
- **Question 15:** The deeds and actions of a producer indicate what kind of authority?
  - Express
  - Apparent <- Apparent authority is the appearance or assumption of authority based on the actions, words, or deeds of the producer.

- Implied
- Conditional

## Chapter4. Life Insurance Policies - Provisions, Options and Riders

### TYPES OF POLICIES

Keywords:

- *Ordinary Life Insurance*
- *Group Life Insurance*
- *Term Life Insurance*
- *Option to Renew*
- *Option to Convert*
- *Whole Life Insurance*
- *Cash Value*
- *Endowment Policy*
- *Family Income Policies*
- *Joint Life Policy*
- *Joint Life Survivor*
- *Juvenile Insurance*
- *Credit Life Insurance*
- *Adjustable Life*
- *Universal Life*
- *Variable Insurance*

Life insurers issue three basic kinds of coverage: ordinary insurance, industrial insurance, and group insurance. Many companies offer all. Some companies specialize in one or another. These coverages are distinguished by types of customers, amounts of insurance written, underwriting standards, and marketing practices.

#### Ordinary Life

Ordinary life insurance is individual life insurance that includes many types of temporary and permanent insurance protection plans written on individuals. Premiums are normally paid monthly, quarterly, semiannually, or annually. Ordinary life insurance is the principal type of life insurance purchased in the United States and includes such types of insurance as whole, term, universal, and variable life coverage as well as endowment policies.

#### Industrial Insurance

**Industrial life insurance is characterized by comparatively small issue amounts, such as \$1,000, with premiums collected on a weekly or monthly basis by the agent at the policyowner's home. Quite often it is marketed and purchased as burial insurance.**

## Group Insurance

Group life insurance is written for employer, employee groups, associations, unions, and creditors to provide coverage for a number of individuals under one contract. Underwriting is based on the group, not the individuals who are insured. Group insurance, which has grown tremendously over the past few decades, will be discussed in detail later.

Keep in mind that the coverages previously described are general categories of insurance. Let's turn our attention now to the various life insurance plans: term, whole life (or permanent), and endowment.

## Term Life Insurance

Term life insurance is the simplest type of life insurance plan. **Term life provides low-cost insurance protection for a specified period (or term) and pays a benefit only if the insured dies during that period.** For example, assume Steve purchases a 20-year \$50,000 level term policy on his life, naming his sister, Amy, the beneficiary. If Steve dies at any time within the policy's 20-year period, Amy will receive the \$50,000 death benefit. If Steve lives beyond that period, nothing is payable. The policy's term has expired. If Steve cancels or lapses the policy during the 20-year term, nothing is payable. **Term policies do not build cash values.**

- **One advantage of term life insurance is the initial premium is lower than for an equivalent amount of whole life insurance.**
- **Term life provides the greatest amount of death benefit per dollar of initial cash outlay.**

Term life is also called temporary life insurance since it provides protection for a temporary period of time. The period for which these policies are issued can be defined in terms of years (1-year term, 5-year term, or 20-year term, for example) or in terms of age (term to age 45, term to age 55, term to age 70, for example). **Term policies issued for a specified number of years provide coverage from their issue date until the end of the years so specified. Term policies issued until a certain age provide coverage from their date of issue until the insured reaches the specified age.**

## Basic Forms of Term life

There are a number of forms of term life insurance that insurers offer. These forms, distinguished primarily by the amount of benefit payable, are known generally as **level term, decreasing term, and increasing term.**

## Level Term Insurance

Level term insurance provides a level amount of protection for a specified period, after which the policy expires.

Level term policies are able to offer level premiums because the premiums are averaged over the term of the policy. A \$100,000 10-year level term policy, for example, provides a straight, level \$100,000 of coverage for a period of 10 years. A \$250,000 term to age 65 policy provides a straight \$250,000 of coverage until the insured reaches age 65. If the insured under the \$100,000 policy dies at any time within those 10 years, or if the insured under the \$250,000 policy dies prior to age 65, the insured's beneficiaries will receive the policy's face amount benefits. If the insured lives beyond the 10-year period or past age 65, the policies expire and no benefits are payable.

A, X; B, Y; 0

## Decreasing Term Insurance

Decreasing term policies are characterized by benefit amounts that **decrease gradually** over the term of protection and have **level premiums**. A 20-year \$50,000 decreasing term policy, for instance, will pay a death benefit of \$50,000 at the beginning of the policy term. That amount gradually declines over the 20-year term and reaches \$0 at the end of the term.

- **Credit life insurance, sold to cover the outstanding balance on a loan, is based on decreasing term insurance** (Credit LifeDecreasing Term).
- **Decreasing term insurance is commonly used to protect an insured's mortgage** , , ).

## Increasing Term Insurance

Increasing term insurance is term insurance that provides a death benefit that increases at periodic intervals over the policy's term. **The amount of increase is usually stated as specific amounts or as a percentage of the original amount.** It may also be **tied to a cost of living index, such as the Consumer Price Index.** Increasing term insurance may be sold as a separate policy, but is usually purchased as a cost of living rider to a policy ( ).

## Features of Term Life

Term policies are issued for a specified period, defined in terms of years or age. Most contain two options that can extend the coverage period. These are the option to renew and the option to convert the policy.

### Option to Renew

**A guaranteed renewable policy allows the policyowner to renew the term policy before its expiration date, without having to provide evidence of insurability (that is, without having to prove good health).** For example, a five year renewable term policy permits the policyowner to renew the same coverage for another five years at the end of the first five-year term. **The premiums for the renewal period will be higher than the initial period,** reflecting the insurer's increased risk. Renewal options with most term policies typically provide for several renewal periods or for renewals until a specified age. The advantage of the renewal option is that it allows the insured to continue insurance protection, even if the insured has become uninsurable.

A common type of renewable term insurance is annually renewable term (ART). This is also called yearly renewable term, or YRT. Essentially, this type of policy represents the most basic form of life insurance. It provides coverage for one year and allows the policyowner to renew coverage each year, without evidence of insurability.

### Option to Convert

The second option common to most term plans is the option to convert. **The option to convert gives the insured the right to convert or exchange the term policy for a whole life (or permanent) plan without evidence of insurability.** This exchange involves the issuance of a whole life policy at a premium rate reflecting the insured's age at either the time of the conversion (**the attained age method**) or at the time when the original term policy was taken out (**the original age method**). The option to convert generally specifies a time limit for converting, such as 10 years in force or at age 55, whichever is later.

- **The cost of insurance** is most important when an insured owner is trying to decide whether to convert term insurance at the insured's **original age** or the insured's **attained age**.

The option to convert and the option to renew can be (and typically are) combined into a single term policy. For instance, a 10-year convertible renewable policy could provide for renewals until age 65 and be convertible any time prior to age 55.

## Whole Life Insurance

A second type of life insurance plan is whole life insurance (also known as permanent insurance). **Whole life insurance is called this because it provides permanent protection for one's entire life-from the date of issue to the date of the insured's death.** The benefit payable is the face amount of the policy, which **remains constant throughout**

**the policy's life (Whole Life).** Premiums are set at the time of policy issue, and they too remain level for the policy's life.

## Features of Whole life

There are certain features of whole life insurance that distinguish it from term insurance: **cash values and maturity at age 100.** These two features combine to produce living benefits to the policyowner.

### Cash Values

Unlike term insurance, which provides only death protection, whole life insurance combines insurance protection with a savings element. This accumulation, commonly referred to as the policy's cash value, builds over the life of the policy. This is because whole life insurance plans are credited with a certain guaranteed rate of interest. This interest is credited to the policy on a regular basis and grows over time. Income taxes may be due when the policy is surrendered.

Though it is an important part of funding the policy, **the cash value is often regarded as a savings element because it represents the amount of money the policyowner will receive if the policy is ever surrendered.** It is often called the cash surrender value. This value is a result of the way premiums are calculated and interest is paid, as well as the policy reserves that build under this system.

The amount of a policy's cash value depends on a variety of factors, including:

- The face amount of the policy
- The duration and amount of the premium payments
- How long the policy has been in force

**The larger the face amount of the policy, the larger the cash values. The shorter the premium-payment period, the quicker the cash values grow.** The longer the policy has been in force, the greater the build-up in cash values. The reason for these things can be clarified with an understanding of the maturity of a whole life policy.

### Maturity at Age 100

Whole life insurance is designed to mature at age 100. The significance of age 100 is that, as an actuarial assumption, every insured is presumed to be dead by then. (While some people live beyond age 100, the number of people who do live that long is not a statistically significant portion of the population.) Consequently, the premium rate for whole life insurance is based on the assumption that the policyowner (usually the insured) will be paying premiums for the whole of life, to the insured's age 100. At age 100, the cash value of the policy has accumulated to the point that it equals the face amount of the policy, as it was actuarially designed to do. At that point, the policy has completely matured or endowed. No more premiums are owed. The policy is completely paid up.

For those lucky insureds that live to age 100, the insurance company will issue checks for the full value of their policies. Practically speaking, very few people live to age 100. It's far more likely that a whole life policy will be cashed in for its surrender value or that its face amount will be paid out as a death benefit prior to maturity.

### Living Benefits

Another unique feature of whole life insurance is the living benefits it can provide. Through the cash value accumulation build-up in the policy, a policyowner has a ready source of funds that may be borrowed at reasonable rates of interest. These funds may be used for a personal or business emergency. For example, they could be used to help pay for a child's education or to pay off a mortgage. It is not a requirement of the policy that the loan be repaid. However, **if a loan is outstanding at the time the insured dies, the amount of the loan plus any interest due will be subtracted from the death benefit before it is paid.**

Cash values belong to the policyowner. The insurance company cannot lay claim to these values. This concept is discussed in more detail later, under “Nonforfeiture Values.”

## Whole Life Premiums

As noted, whole life is designed as if the insured will live to age 100. Accordingly, the amount of premium for a whole life policy is calculated, in part, on the basis of the number of years between the insured’s age at issue and age 100. **The shorter the payment period, the higher the premium.** This time span represents the full premium-paying period, with the amount of the premium spread equally over that period. This is known as the level premium approach. As is the case with level premium term insurance, **this approach allows whole life insurance premiums to remain level rather than increase each year with the insured’s age.**

## Basic Forms of Whole Life

Just because whole life premiums are calculated as if they were payable to age 100, they do not necessarily have to be paid this way. Whole life is flexible and a number of policy types have been developed to accommodate different premium-paying periods. Three notable forms of whole life plans are straight whole life, limited pay whole life, and single premium whole life.

### Straight Whole Life

Straight whole life is whole life insurance providing permanent level protection with level premiums from the time the policy is issued until the insured’s death (or age 100).

### Limited Pay Whole Life

Limited pay whole life policies **have level premiums that are limited to a specified number of years.** This period can be of any duration. For example, a 20-payment life policy is one in which premiums are payable for 20 years from the policy’s inception, after which no more premiums are owed. A life paid-up at 65 policy is one in which the premiums are payable to the insured’s age 65, after which no more premiums are owed. **This type of coverage would best suit a prospective insured who desires permanent insurance but does not want to pay premiums indefinitely.** Keep in mind that even though the premium payments are limited to a certain period, **the insurance protection extends until the insured’s death, or to age 100.**

### Single-Premium Whole Life

The most extreme form of limited pay policies is a single-premium policy. A single-premium whole life policy involves a large one-time only premium payment at the beginning of the policy period. **From that point, the coverage is completely paid for the full life of the policy.** Here are the common traits of a single premium whole life policy:

- An immediate nonforfeiture value is created
- An immediate cash value is created
- A large part of the premium is used to set up the policy’s reserve
- The advantage offered by a single premium policy is that the policyowner will pay less for the policy than if the premiums were stretched over several years

## Premium Periods

The length of the premium-paying period also affects the growth of the policy's cash values. **The shorter the premium paying period** (and consequently, the higher the premium), **the quicker the cash values will grow. This is because a greater percentage of each payment is credited to the policy's cash values.** By the same token, **the longer the premium paying period, the slower the cash values grow.**

Cash values build up in limited-pay policies faster during the premium paying years than during the non-premium paying years. **After the premium paying period, the cash values continue to grow,** but more slowly, until the policy matures and the cash value equals the face amount, again, at age 100.

## Other Forms of Whole Life

There are many other forms of whole life insurance, most of which are characterized by some variation in the way the premium is paid. Let's review these policies next.

### Modified Whole Life

Modified whole life policies are distinguished **by premiums that are lower than typical whole life premiums during the first few years (usually five) and then higher than typical thereafter.** During the initial period, the premium rate is only slightly higher than that of term insurance. Afterwards, the premium is higher than the typical whole life rate at age of issue. ( , , Whole LifeFixed)

The purpose of modified whole life policies is to make the initial purchase of permanent insurance easier and more attractive, especially for individuals who have limited financial resources, but the promise of an improved financial position in the future.

### Equity Index Whole Life

Equity index whole life insurance is a type of whole life where **80% to 90% of the premium is invested in traditional fixed income securities and the remainder of the premium is invested in contracts tied to a stipulated stock index.**

### Graded Premium Whole Life

Similar to modified whole life, graded premium policies also redistribute the premiums. **Premiums are lower than typical whole life rates during the preliminary period after the policy is issued (usually lasting five to ten years). The premiums will initially increase yearly during the preliminary period then remain level afterwards.**

## Endowments

Besides term and whole life insurance, life insurers also issue endowment policies. An endowment policy is characterized by cash values that grow at a rapid pace so that the policy matures or endows at a specified date (that is, before age 100). An endowment policy provides benefits in one of two ways:

- As a death benefit to a beneficiary if the insured dies within the specified policy period (known as the endowment period)
- As a living benefit to the policyowner if the insured is alive at the end of the endowment period, at which time the policy has fully matured

Because an endowment policy pays a death benefit if the insured dies during a certain period, it can be compared to level term insurance. The new concept presented here is that of pure endowment. Pure endowment insurance is a contract that guarantees a specified sum payable only if the insured is living at the end of a stated time period. Nothing



is payable in the case of prior death. These two elements (level-term insurance and endowment) together provide the guarantees endowment contracts offer.

Endowment policies can be compared to whole life policies with accelerated maturity dates; age 65 is a common maturity age. At the maturity age, the cash value has grown to match the face amount, just like what occurs at age 100 with a whole life policy.

Because they are designed to build cash values quickly, endowment policies are typically purchased to provide a living benefit for a specified future time—for retirement, for example, or to fund a child’s college education.

## Endowment Premiums

Due to their rapid cash value build-ups to provide early policy maturity, endowment policies have comparatively high premiums. Remember that the shorter the policy term, the higher the premiums.

It should be noted that the purchase of endowment policies has been on the decline for several years. This is because they no longer meet the income tax definition of “life insurance,” and consequently, they no longer qualify for the favorable tax treatment life insurance is given.

## Modified Endowment Contracts

In 1988, Congress enacted the Technical and Miscellaneous Revenue Act, commonly referred to as TAMRA. Among other things, this act revised the tax law definition of a “life insurance contract”. It was passed primarily to discourage the sale and purchase of life insurance for investment purposes or as a tax shelter. By redefining life insurance, Congress effectively created a new class of insurance, known as modified endowment contracts, or

**MECs. A modified endowment contract is considered to be a policy that is overfunded, according to IRS tables.**

For the producer who sells life insurance and the consumer who purchases life insurance, the significance of this is the way a life policy will be taxed if it is deemed an MEC. Historically, life insurance has been granted very favorable tax treatment, as shown in the following.

- Cash value accumulations are not taxed to the policyowner as they build inside a policy.
- Policy withdrawals are not taxed to the policyowner until the amount withdrawn exceeds the total amount the policyowner paid into the contract.
- Policy loans are not considered distributions and are not taxed to the policyowner unless or until a full policy surrender takes place, and then, only to the extent that the distribution exceeds what was paid into the policy.

However, for those policies that do not meet the specific test (described below) and consequently are considered MECs, the tax treatment is different. It is the policyowners who pay.

- Penalty taxes (10%) on premature distributions prior to age 59 ½ from a modified endowment contract (MEC) normally apply to policy loans.
- Any gains received from a Modified Endowment Contract (MEC) is included in the insured’s gross income for the year and a 10% tax penalty is assessed on the gain if the insured is under the age of 59 ½.

How does a life insurance policy become an MEC? More importantly, how does a policy avoid being classified as an MEC? It must meet what is known as the 7-pay test. The 7-pay test has nothing to do with the actual number of premium payments. Instead, it is a limitation on the total amount you can pay into your policy in the first seven years of existence. The test is designed to discourage premium schedules that would result in a paid-up policy before the end of a seven year period. **If there is a material change in the contract, the seven pay test applies again.**

In addition to the basic types of life insurance policies, there are a number of “special use” policies that insurers offer. Many of these are a combination or “packaging” of different policy types, designed to serve a variety of needs.

## SPECIAL USE POLICIES

### Family Plan Policies

The family plan policy is designed to insure all family members under one policy. Coverage is sold in units. For example, a typical plan could insure the family breadwinner for \$20,000. The coverage on the spouse and children is level term insurance in the form of a rider. The spouse's and children's coverage is usually convertible without evidence of insurability.

### Family Income Policies

A family income policy consists of both whole life and decreasing term insurance. This policy will provide monthly income to a beneficiary if death occurs during a specified period beginning **after date of purchase**. The family income portion of this type of coverage is supplied by a decreasing term policy. Income payments to the beneficiary begin when the insured dies, and continue for the period specified in the policy, which is usually 10, 15, or 20 years from the date of policy issue, and not from the date of the insured's death. If the insured dies after the specified period, only the face value (whole life) is paid to the beneficiary since the decreasing term insurance expired.

### Family Maintenance Policy

**A family maintenance policy consists of both whole life and level term insurance, which provides income for a specific period beginning on the date of death of the insured.** Provided the insured dies before a predetermined time, this policy provides income to a beneficiary for a stated number of years from the date the insured dies. In addition, the beneficiary will receive the entire face amount (whole life) of the policy at the end of the income-paying period. If an insured dies after the selected period has ended, however, the beneficiary receives only the face amount (whole life) of the policy.

### Joint Life Policies

A joint life policy covers two or more people. Using some type of permanent insurance (as opposed to term), it pays the death benefit **at the first insured's death**. The survivors then have the option of purchasing a single individual policy without evidence of insurability. The premium for a joint life policy is less than the premium for separate, multiple policies. The ages of the insureds are "averaged" and a single premium is charged for each life.

Joint Life Joint First to die (JFTD), , , , ,

### Joint Life and Survivor Policies

**A variation of the joint life policy is the last survivor policy, also known as a "second to die" policy. This plan also covers two lives, but the benefit is paid upon the death of the last surviving insured.** This type of coverage is sometimes referred to as a "survivorship life insurance policy" and normally will cover two lives. As with a joint life policy, the premium for a survivorship life policy is lower than the combined premium for separate life insurance policies on two individuals. Survivorship life insurance policies are useful in estate planning because they can provide money to pay taxes on assets.

Survivor Joint Last to die (JLTD), , ,

### Juvenile Insurance

**A juvenile life insurance policy is a life insurance policy that insures the life of a minor.** Application for insurance and ownership of the policy rests with an adult (**which does not require the minor's consent**), such as a parent or

guardian. The adult applicant is usually the premium payor as well until the child comes of age and is able to take over the payments. A **payor provision** is typically attached to juvenile policies. It provides that in the event of death or disability of the adult premium payor, the premiums will be waived until the insured child reaches a specified age (such as 25) or until the maturity date of the contract, whichever comes first.

## Credit Life Insurance

**Credit life insurance is designed to cover the life of a debtor and pay the amount due on a loan if the debtor dies before the loan is repaid. The beneficiary of such a policy is usually the lender.** The type of insurance used is decreasing term, with the term matched to the length of the loan period (though usually limited to 10 years or less) and the decreasing insurance amount matched to the outstanding loan balance.

Credit life is sometimes issued to individuals as single policies, but most often it is sold to a bank or other lending institution as group insurance that covers all of the institution's borrowers.

- **The cost of group credit life insurance usually is paid entirely by the borrower.**

## NONTRADITIONAL LIFE POLICIES

In the 1980s, insurance companies introduced a number of new policy forms, most of which are more flexible in design and provisions than their traditional counterparts. The most notable of these are interest-sensitive whole life, adjustable life, universal life, variable life, and variable universal life.

## Interest-Sensitive Whole Life

Interest-sensitive whole life is characterized by premiums that vary to reflect the insurer's changing assumptions with regard to its death, investment, and expense factors. However, interest sensitive products also provide that the cash values may be greater than the guaranteed levels. If the company's underlying death, investment, and expense assumptions are more favorable than expected, policyowners will have two options: lower premiums or higher cash values.

Underlying assumptions could also turn out to be less favorable than anticipated, which would call for a higher premium than that at policy issue. The policyowner may then either pay the higher premium or choose to reduce the policy's face amount and continue to pay the same premium.

## Face Amount Plus Cash Value

**A face amount plus cash value policy is a contract that promises to pay at the insured's death the face amount of the policy plus a sum equal to the policy's cash value.**

## Adjustable Life

Adjustable life policies are distinguished by their flexibility that comes **from combining term and permanent insurance into a single plan**. The policyowner determines how much face amount protection is needed and how much premium the policyowner wants to pay. The insurer then selects the appropriate plan to meet those needs. Another option would be the policyowner may specify a desired plan and face amount.

The insurer would then calculate the premium. As financial needs and objectives change, the policyowner can make adjustments to the coverage, such as:

- increasing or decreasing the premium, the premium paying period, or both
- increasing or decreasing the face amount, the period of protection, or both(\*\*increasing the

face amount normally requires providing proof of insurability\*\*)

Depending on the desired changes, the policy can be converted from term to whole life or from whole life to term. It can also be converted from a high premium contract to a lower premium or limited pay contract. Due to its design and flexibility, adjustable life is usually more expensive than conventional term or whole life policies.

Adjustable Life:

- , , deal
- conventional termwhole life

## Universal Life

Universal life insurance is essentially a term policy with cash value, **characterized by flexible premiums and an adjustable death benefit**. Part of the premium goes into an investment account that grows and earns interest. You are able to borrow or withdraw your cash value. **Universal life allows its policyowners to determine the amount and frequency of premium payments and adjust the death benefit up or down to reflect changes in needs. Consequently, changes may be made with relative ease by the policyowner and no new policies will need to be issued when changes are desired.**

Universal life provides this flexibility by “unbundling” or separating the basic components of a life insurance policy. These components include: the insurance element, the savings element, and the expense element. As with any other life policy, the policyowner pays a premium. Each month, a mortality charge is deducted from the policy’s cash value accumulation for the cost of the insurance protection. **This mortality charge may also include a company expense, or loading charge.**

Like term insurance premiums, the universal life mortality charge steadily increases with age. Even though the policyowner may pay a level premium, an increasing share of that premium goes to pay the mortality charge as the insured ages. **The policy specifies the percentage of each premium that goes toward the insurance protection and that which is used to build cash value.**

**As premiums are paid and as cash values accumulate, interest is credited to the policy’s cash value. This interest may be either the current interest rate declared by the company (and dependent on current market conditions) or the guaranteed minimum rate, specified in the contract.** As long as the cash value account is sufficient to pay the monthly mortality and expense costs, the policy will continue in force, whether or not the policyowner pays the premium. Of course, premium payments must be large enough and frequent enough to generate sufficient cash values. **If the cash value account is not large enough to support the monthly deductions, the policy terminates.**

A specific percentage of all premiums must be used to purchase death benefits or the universal life policy will not receive favorable tax treatment on its cash value.

At stated intervals (and usually upon providing evidence of insurability), the policyowner can increase or decrease the face amount of the policy. A corresponding increase (or decrease) in premium payment is not required as long as the cash values can cover the mortality and expense costs. By the same token, the policyowner can elect to pay more into the policy, thus adding to the cash value account.

**Another factor that distinguishes universal life from whole life is the fact that partial withdrawals can be made from the policy’s cash value account.** (Whole life insurance allows a policyowner to tap cash values only through a policy loan or a complete cash surrender of the policy’s cash values, in which case the policy terminates.) Also, the policyowner may surrender the universal life policy for its entire cash value at any time. However, the company probably will assess a **surrender charge** unless the policy has been in force for a certain number of years. **The company must disclose the policy’s surrender charges.**

## Universal Life Death Benefit Options

Universal life insurance offers two death benefit options. Under Option One, the policyowner may designate a specified amount of insurance. The death benefit equals the cash values plus the remaining pure insurance (decreasing term plus

increasing cash values). This level death benefit is composed of the increasing cash values and the remaining pure insurance (decreasing term). If the growing cash value-to-total death benefit ratio exceeds a certain percentage fixed by federal law, an additional amount of pure insurance, called the “corridor,” is added to maintain the minimum death benefit requirement.

Under Option Two, the death benefit equals the face amount (pure insurance) plus the cash values (level term plus increasing cash values). To comply with the Tax Code’s definition of life insurance, the cash values cannot be disproportionately larger than the term insurance portion.

## Equity Index Universal Life Insurance

Equity Index Universal Life Insurance is permanent life insurance that allows **policyholders to link accumulation values to an outside equity index, like the S&P 500**. Indexed universal life insurance policies typically contain a **minimum guaranteed fixed interest rate** component along with the indexed account option. **If the return on the index exceeds the policy’s guaranteed rate of return, the cash value will reflect that of the index.** Indexed policies give policyholders the security of fixed universal life insurance with the growth potential of a variable policy linked to index returns.

## Variable Insurance Products

With a variable life policy, premium payments are fixed. Part of the premium is placed into a separate account, which is invested in a stock, bond, or money market fund. The death benefit is guaranteed, but the cash value of the benefit can vary considerably according to the ups and downs of the stock market. Your death benefit can also increase if the earnings of that separate fund increase.

**Variable insurance products do not guarantee contract cash values, and it is the policyowner who assumes the investment risk.** Variable life insurance contracts do not make any promises as to either interest rates or minimum cash values. What these products do offer is the potential to realize investment gains that exceed those available with traditional life insurance policies. This is done by allowing policyowners to direct the investment of the funds that back their variable contracts through separate account options.

**By placing their policy values into separate accounts, policyowners can participate directly in the account’s investment performance, which will earn a variable (as opposed to a fixed) return.** Functioning on much the same principle as mutual funds, the return enjoyed-or loss suffered-by policyowners through their investment in a separate account 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. For 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 without facing the investment risk posed by its guaranteed fixed policies.

Because of the transfer of investment risk from the insurer to the policyowner, **variable insurance products are considered securities contracts as well as insurance contracts.** Therefore, **they fall under the regulatory arm of both state offices of insurance regulation and the Securities and Exchange Commission (SEC).** To sell variable insurance products, an individual must hold a life insurance license and a Financial Industry Regulatory Authority (FINRA) registered representative’s license (FINRA was formerly known as the National Association of Securities Dealers, or NASD). Some states may also require a special variable insurance license or special addendum to the regular life insurance license. Agents who have fully satisfied the requirements for a life insurance license, including successful completion of a licensing exam that covers variable annuities, may sell or solicit variable annuity contracts.

Keep in mind that while these policies involve investment management and offer the potential for investment gains, they are primarily life insurance policies, not investment contracts. The primary purpose of these plans, like any life insurance plan, is to provide financial protection in the event of the insured’s death.

## **Non-Medical Life Insurance**

Non-Medical Life Insurance typically does not require a medical exam and tends to be more expensive than medically underwritten policies. The insurer will average out everyone's risk and charge accordingly. Although insurers typically will not require a medical exam, they will still inquire about the applicant's medical history and lifestyle.

## **Policy Provision, Options and Riders**

Keywords:

- Entire Contract
- Insuring Clause
- Owner's right
- Free Look
- Consideration
- Grace Period
- Reinstatement
- Policy Loan
- Incontestable
- Absolute Assignment
- Collateral Assignment
- Accelerated Benefits
- Suicide Provision
- Misstatement of Age
- Automatic Premium Loan
- Nonforfeiture Options
- Cash Surrender Options
- Extended Term Option
- Policy Dividends
- Guaranteed Insurability Option
- Waiver of Premium
- Payor Provision
- Accidental Death Benefit
- Return of Premium

## Rights of Policy OwnerShip

Entire Contract  
Insuring Clause  
Owner's Rights  
Free Look  
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Accidental Death Benefit  
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KEYWORDS

### RIGHTS OF POLICY OWNERSHIP

Generally, the person who pays the premium for an insurance contract is designated as the policyowner or policyholder. Although there are no provisions in a life insurance policy specifically titled "Rights of Ownership", the fact is, owning a life insurance policy does entail important rights. These rights are woven throughout the policy in various clauses and provisions. The most significant rights of ownership include the following:

- The right to designate and change the beneficiary of the policy proceeds
- The right to select how the death proceeds will be paid to the beneficiary
- The right to cancel the policy and select a nonforfeiture option
- The right to assign ownership of the policy to someone else

The clauses and provisions that set forth these rights will be examined in this and later chapters.



## Standard Policy Provision



## Entire Contract Provision

### STANDARD POLICY PROVISIONS

In an effort to promote state-by-state uniformity of insurance industry regulation, most states have adopted the standard wording of NAIC Model Regulations.

Despite efforts by insurance companies to offer products different from their competitors, insurance policies are more notable for their many similarities than differences. The foundation of the uniformity is rooted in the state level regulation of the industry and the adoption of NAIC guidelines. Regulators in each state protect consumers by establishing strict guidelines as to what must and must not be included in an insurance policy. Furthermore, in an effort to promote state-by-state uniformity of insurance industry regulation, most states have adopted the standard wording of NAIC Model Regulations. Accordingly, policy language is similar among the many different life insurance contracts available to consumers.

We will begin this section with a discussion of the standard provisions that appear in most life insurance contracts, and then take a look at some of the common exclusions.

#### Entire Contract Provision

*The entire contract provision, found at the beginning of the policy, states that the policy document, the application (which is attached to the policy), and any attached riders constitute the **entire contract**.* Nothing may be "incorporated by reference," meaning that the policy cannot refer to any outside documents as being part of the contract.

The entire contract clause has another important function- it prohibits the insurer from making any changes to the policy, either through policy revisions or changes in the company's bylaws, after the policy has been issued. This clause does not prevent a mutually agreeable change from being made to the policy if the policy specifically provides a means for modifying the contract after it has been issued (for example, changing the face amount of an adjustable life policy).

## Insuring Clause



## Owner's Rights Provision

### STANDARD POLICY PROVISIONS

#### Insuring Clause

*The insuring clause or provision sets forth the company's basic promise to pay benefits upon the insured's death. Generally, this clause is not actually titled as such, but appears on the cover of the policy.* An insuring clause might state that the promise to pay is subject to a policy's provisions, exclusions, and conditions.

One company's insuring clause reads:

*"The Insurance Company agrees, in accordance with the provisions of this policy, to pay to the beneficiary the death proceeds upon receipt at the Principal Office of due proof of the insured's death prior to the maturity date. Further, the Company agrees to pay the surrender value to the owner if the insured is alive on the maturity date."*

The insuring clause is typically undersigned by the president and secretary of the insurance company.

#### Owner's Rights Provision

*The owner's rights provision defines the person who may name and change beneficiaries, select options available under the policy, and receive any financial benefits from the policy.*



## Free-Look Provision

## Consideration Clause

## Grace Period Provision

## Reinstatement Provision

### STANDARD POLICY PROVISIONS

#### Free-Look Provision

*The free-look provision, required by most states, gives policyowners the right to return the policy for a full premium refund within a limited period of time after the delivery of the policy.*

#### Consideration Clause

Consideration is the value given in exchange for a contractual promise. *In a life insurance policy, the consideration clause states that the policyowner's consideration consists of completing the application and paying the initial premium.* The consideration clause or provision in a life insurance policy specifies the amount and frequency of premium payments that the policyowners must make to keep the insurance in force.

#### Grace Period Provision

Grace periods are common in a lot of other financial products such as consumer loans, mortgages, credit card payments, etc. The grace period in a life insurance policy is meant to protect the insured. If there is a slight lapse in the payment of a premium, it is to prevent the life insurance company from forcing the insured to provide insurability again. In policies for which the premiums are paid monthly, the grace period is one month, but no less than 30 days. *If an insured dies during the grace period and the premium has not been paid, the policy benefit is payable. However, the premium amount due is deducted from the death benefits paid to the beneficiary.*

#### Reinstatement Provision

It is always possible that, due to nonpayment of premiums, a policy may lapse, either deliberately or unintentionally. In cases where a policyowner wishes to reinstate a lapsed policy, the reinstatement provision allows the policyowner to do so with some limitations.

## Policy Loan Provision

### STANDARD POLICY PROVISIONS

*With reinstatement, a policy is restored to its original status and its values are brought up to date. Most insurers require the following to reinstate a lapsed policy:*

- *All back premiums must be paid*
- *Interest on past-due premiums may be required to be paid*
- *Any outstanding loans on the lapsed policy may be required to be paid*
- *The policyowner typically will be asked to prove insurability*

In addition, there is a limited period of time in which policies may be reinstated after a lapse. This period is normally three years and in some cases may be as long as seven years. A new contestable period usually goes into effect with a reinstated policy, but there is no new suicide exclusion period.

#### Policy Loan Provision

State insurance laws require that cash value life insurance policies include a policy loan provision. This means that, within prescribed limits, *policyowners may borrow money from the cash values of their policies* if they wish to do so. A policy loan is more an advance on proceeds than a true loan. As such, these "loans" may not be "called" by the company and can be repaid at any time by the policyowners. *If not repaid by the time the insured dies, the loan balance and any interest accrued are deducted from the policy proceeds at the time of claim.* If the policy is surrendered for cash, the cash value available to the policyowner is reduced by the amount of any outstanding loan plus interest.

- *When a life insurance policyowner obtains a policy loan, the collateral for the loan is the cash value of the policy*

## Incontestable Clause

### STANDARD POLICY PROVISIONS

- Interest rates on policy loans vary, but most states stipulate a maximum allowable rate. *Some newer policies are issued with a variable interest rate tied to the Moody's corporate bond index.*
- *If the policyowner does not make a scheduled interest payment on a policy loan, the amount of interest due will be added to the loan balance*
- *In the event a policy loan plus interest exceeds a life insurance policy's cash value, the policy is no longer in force*

#### Incontestable Clause

*The incontestable clause or provision specifies that after a certain period of time has elapsed (usually two years from the issue date), the insurer no longer has the right to contest the validity of the life insurance policy so long as the contract continues in force.* This means that after the policy has been in force for the specified term, the company cannot contest a death claim or refuse payment of the proceeds even on the basis of a material misstatement, concealment, or fraud. Even if the insurer learns that an error was deliberately made on the application, it must pay the death benefit at the insured's death if the policy has passed the contestable period.

Although the incontestable clause applies to death benefits, it generally does not apply to accidental death benefits or disability provisions if they are part of the policy. Because conditions relating to accidents vary and are often uncertain, the right to investigate them usually is reserved by the company.

- The incontestable clause applies to the policy face amount plus any additional riders that are payable at death
- *The incontestable clause allows an insurer to contest a claim during the contestable period*

The time limit for a legal action provision in a contract is limited to no more than 5 years.

## Assignment Provision

### STANDARD POLICY PROVISIONS

It should be noted that there are three situations to which the incontestable clause does not apply. A policy issued under any of these circumstances would not be considered a valid contract, which gives the insurer the right to contest and possibly void the policy at any time:

- **Impersonation.** When application for insurance is made by one person but another person signs the application or takes the medical exam, the insurer can contest the policy and its claim.
- **No insurable interest.** If no insurable interest existed between the applicant and the insured at the inception of the policy, the contract is not valid to begin with. As such, the insurer can contest the policy at any time.
- **Intent to murder.** If it is proven that the applicant applied for the policy with the intent of murdering the insured for the proceeds, the insurance company can contest the policy and its claim. Since the policy did not have a legal purpose from the start, the insurance company may simply deny coverage. The policyowner is powerless to enforce such a claim as no court of law will force an insurer to provide coverage under these circumstances.

#### Assignment Provision

People who purchase life insurance policies are commonly referred to as policyowners rather than policyholders because they actually own their policies and may do with them as they wish. They can even give them away, just as they can giveaway any other kind of property they own. This transfer of ownership is known as assignment. The assignment provision in a life insurance contract sets forth the procedure necessary for ownership transfer. This procedure usually requires that the policyowner notify the company in writing of the assignment. The company will then accept the validity of the transfer without question. A policyowner does not need the insurer's permission to assign a policy.



## STANDARD POLICY PROVISIONS

The new owner is known as the assignee. For example, if an individual gave a policy to his church as a donation, the church would be the assignee. An insurable interest does not have to exist between the insured and the assignee. As the owner of the policy, the assignee is granted all the rights of policy ownership, including the right to name a beneficiary. If the assignee does not change the beneficiary designation, the proceeds will be paid to the beneficiary named by the original owner. However, the assignee does have the right to change the beneficiary as long as the original beneficiary designation was revocable. If a policyowner names an irrevocable beneficiary (meaning the beneficiary cannot be changed), the policyowner must get the beneficiary's agreement to any assignment.

There are two types of assignments: absolute and collateral.

**Absolute assignment:** *Under an absolute assignment, the transfer is complete and irrevocable, and the assignee receives full control over the policy and full rights to its benefits.*

**Collateral assignment:** *A collateral assignment is one in which the policy is assigned to a creditor as security, or collateral, for a debt. If the insured dies, the creditor is entitled to be reimbursed out of the benefit proceeds for the amount owed.* The insured's beneficiary is then entitled to any excess of policy proceeds over the amount due to the creditor.

Though there may be exceptions, most jurisdictions will not allow an assignee to change the beneficiary designation if it was originally designated irrevocable.

### Accelerated Benefits Provision

## Suicide Provision

### STANDARD POLICY PROVISIONS

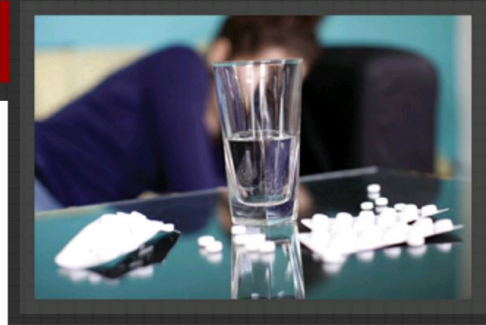
#### Accelerated Benefits Provision

Until recently, traditional whole life insurance policies provided cash benefit payments in the event of the insured's death (or in the rare case of an insured living to a contract's maturity date). The only way an insured could access the policy's cash value while living was through policy loan or policy surrender. If an insured was faced with a life-threatening medical condition, the life insurance policy, by design, could provide no immediate financial relief.

Today, accelerated benefits provisions are standard in life insurance policies. *They provide for the early payment of some portion of the policy face amount should the insured suffer from a terminal illness or injury. The death benefit, less the accelerated payment, is still payable.* For example, a \$100,000 policy that provides for a 75% accelerated benefit would pay up to \$75,000 to the terminally ill insured, with the remaining \$25,000 payable as a death benefit to the beneficiary when the insured dies. Accelerated payment can be made in a lump sum or in monthly installments over a special period, such as one year. This provision is given without an increase in premium.

#### Suicide Provision

*The suicide provision, found in most life policies, protects the insurer against the purchase of a policy in contemplation of suicide.* With this provision, a life insurance policy discourages suicide by stipulating a period of time (usually one or two years from the date of policy issue) during which the death benefit will not be paid if the insured commits suicide. If that happens, the premiums paid for the policy will be refunded. Of course, if an insured takes his own life after the policy has been in force for the period specified in the suicide clause, the company will pay the entire proceeds, just as if death were from a natural cause.



## Misstatement of Age or Sex Provision

## Automatic Premium Loan Provision

### STANDARD POLICY PROVISIONS

#### Misstatement of Age or Sex Provision

The misstatement of age or sex provision is important because the age and sex of the applicant are critical factors in establishing the premium rate for a life insurance policy. To guard against a misunderstanding about the applicant's age, *the company reserves the right to make an adjustment if the age of the insured is misstated*. Likewise, an adjustment is made if an applicant's sex is incorrectly indicated in a policy because, age for age, premium rates for females generally are lower than for males. Normally, such adjustments are made either in the premium charged or in the amount of insurance. Assume an error in age is discovered after the death of an insured. If the insured was younger than the policy showed, the amount of proceeds would be *increased* to a sum the premium paid would have bought at the correct age. If the insured was older than the policy indicated, the amount of proceeds would be *decreased* to whatever the premium paid would have purchased at the correct age.

If an error is discovered while the insured is living, the premium will be adjusted downward if the insured is younger than the policy shows and a refund of the premium overpayments will be made. By the same token, if the insured is older than the policy indicates, the company will either adjust the premium upward and require the difference in premium or reduce the amount of insurance to what it should be for the amount of premium being paid.

#### Automatic Premium Loan Provision

A provision that is now commonly added to most *cash value policies* is the automatic premium loan provision. *This provision authorizes the insurer to withdraw from the policy's cash value the amount of overdue premium if the premium has not been paid by the end of the grace period.*

## Other Policy Provisions

### Discretionary Provision ()

### STANDARD POLICY PROVISIONS

The amount withdrawn becomes a loan against the cash value, bearing the rate of interest specified in the contract. If the loan is not repaid, the interest will also be deducted from the cash value. Should the insured die, the loan plus the interest will be deducted from the benefits payable. Depending on the insurer, this provision may be standard to the contract or added as a rider, with no additional charge to the policyowner.

Note that this provision may be very beneficial for a policyowner who forgets to pay the premium within the grace period or who cannot pay the current premium because of financial difficulties. *Most importantly, the policy does not lapse and coverage continues.* If the policyowner allows the automatic premium loan to continually pay the premiums, the policy eventually will lapse when the cash value is reduced to nothing. The owner then would have to reinstate the policy and pay back the loans.

#### Other Policy Provisions

There are two additional provisions that appear in all policies. The first is beneficiary designation, where the policyowner indicates who is to receive the proceeds. The second is settlement options, where the ways in which the proceeds can be paid out, or "settled", are explained. Beneficiaries and settlement options are discussed later.

#### Discretionary Provision

A Discretionary provision gives discretionary authority to the insurer when determining the eligibility of an insured for benefits under the policy. This provision limits the way a court can review a claim denial and makes it difficult for the court to conduct a fair review of the claim. Some states have enacted laws that prohibit Discretionary provisions because they are *designed to protect the insurance company*.



## STANDARD POLICY PROVISIONS

Most life insurance policies contain restrictions that exclude from coverage certain types of risks. If there were no exclusions, premium rates would be much higher. Exclusions can be stated in the policy itself or attached as riders. The most common types of exclusions include:

- **War.** This exclusion provides that the death benefit will not be paid if the insured dies as a result of war. The war exclusion prevents an insurer's financial catastrophe and typically applies to declared and undeclared wars. This is typically called the *results clause*.
- **Aviation.** This exclusion is found in older policies. Few policies issued today exclude death as a result of commercial aviation. However, some insurers will exclude aviation deaths for other than farepaying passengers.
- **Hazardous occupations or hobbies.** Individuals who have hazardous occupations or engage in hazardous hobbies may find that their life insurance policies will not pay if death was a result of their occupation or hobby. However, sometimes these risks can be covered with an increased premium charged.
- **Commission of a felony.** Some contracts exclude death when it results from the insured committing a felony.
- **Suicide.** As previously noted, almost all policies exclude payment of the benefit if the insured commits suicide during the specified time period. After that period passes, death by suicide is covered.



### Nonforfeiture Options

## Cash Surrender Option

### NONFORFEITURE VALUES

At one point in time in the life insurance industry, if you did not pay your premiums and failed to pay it by the end of the grace period, the policy would lapse and you would forfeit any equity held in the policy. In response to this problem, many life insurance companies adopted the nonforfeiture option. *This means you are allowed to stop paying premiums and not forfeit any of the equity in the policy.* In simple terms, you have three options on how you want to surrender your policy. The amount of cash value will be reduced by any loans that have been taken out.

#### Nonforfeiture Options

There are three nonforfeiture options from which policyowners can select:

#### Cash Surrender Option

Policyowners may request an immediate cash payment of their cash values when their policies are surrendered. The amount of cash value the policyowner receives is reduced by any outstanding policy loans or debts. *Insurers are required to make cash surrender values available for ordinary whole life insurance after the first three policy years.* However, most policies begin to generate cash values in as little as one year.

- Most states permit insurers to postpone payment of cash surrender values for up to *six months* after policyowners request payment. This is stated in the delayed payment provision.
- *Some policies require a penalty to be paid if a policy is surrendered in its early years. These surrender charges, sometimes referred to as a "rear-end load", are deducted from the cash value when the policy is discontinued.*
- The cost recovery rule states that when a life policy is surrendered for its cash value, the cost basis (total premiums paid) is exempt from taxation
- *A partial surrender can allow the policyowner to withdraw the policy's cash value interest free*

## Reduced Paid-Up Option

## Extended Term Option

## NONFORFEITURE VALUES

**Reduced Paid-Up Option**

A second nonforfeiture option is to take a paid-up policy for a reduced face amount of insurance. By doing this, the policyowner does not pay any more premiums but still retains some amount of life insurance. In essence the cash value is used as the premium for a single-premium whole life policy at a lesser face amount than the original policy.

When this option is exercised, the paid-up policy is the same kind as the original, but for a lesser amount of coverage. Riders and accidental death benefits from the original policy are excluded. Once the paid-up policy has been issued, the new face value remains the same for the life of the policy, which also builds cash values.

**Extended Term Option**

The third nonforfeiture option is to use the policy's cash value to purchase a *level term* insurance policy in an amount equal to the original policy's face value, for as long a period as the cash value will purchase. When the *level term* insurance expires, there is no more protection. Moreover, all supplemental benefits included with the original policy, such as a term rider or accidental death or disability benefits, are dropped.

- For most companies, extended term is the "automatic" nonforfeiture option for a standard insured risk

## ► POLICY DIVIDENDS

As noted previously, life insurance policies may be either participating or nonparticipating. *The major difference between participating and nonparticipating is the presence of policy dividends.* At any given age, people who buy participating (par) policies normally pay premiums that are slightly higher than premiums paid by those who purchase nonparticipating (nonpar) policies. This is because an extra charge to cover unexpected contingencies is built into premiums for par policies.

Most states permit insurers to postpone payment of cash surrender values for up to six months after policyowners request payment. This is stated in the delayed payment provision.

## POLICY DIVIDENDS

At the end of each year, the insurance company analyzes its operations. *If fewer insureds have died than was estimated, a divisible surplus results and the company can return to the policyowners a part of the premiums paid for participating policies.* A company also can issue returns stemming from positive operating or investment income. These payments are called dividends but should not be confused with the dividends paid on stocks. *Policy dividends are really a return of part of the premiums paid. As such, policy dividends are generally not taxable income*, unlike corporate dividends, which are reportable for income tax purposes. However, policy dividends can be taxed when they exceed the cost of the policy.

- *A whole life policy that provides a choice of dividend options must include a statement that dividends are not guaranteed*

The paid-up additions dividend option is popular with many policyowners. A close look at the benefits of this option will explain why.

When a dividend is declared, it is used in effect as the premium for a single-payment whole life policy of the same type as the base policy under which the dividend is declared. The face amount of this paid-up addition is generally small, but over time the sum of these additions can be substantial.

When electing the Paid Up Additions (PUA) as your dividend option, you use 100% of the dividends being paid out each year. These dividends are then used to buy additional blocks of permanent whole life insurance, paid up for life. The payment of policy dividends hinges on if the company has experienced a divisible surplus for that reporting period. The size of the surplus will affect the amount of the dividend. Policy dividends normally vary from year to year and cannot be guaranteed. Stock companies can issue either participating policies or nonparticipating policies. If a stock company issues both types of policies, it is said to be doing business on a mixed plan. Mutual companies can issue only participating policies.

- If life insurance policy dividends are left with the insurance company, the policy may be paid up when the cash value plus accumulated dividends equal the net single premium for the same face amount at the insured's attained age

## Dividend Options

### POLICY DIVIDENDS

- Only interest on accumulations is taxed on policyowner dividends

#### Dividend Options

Policyowners are generally permitted by insurers to utilize their dividends through one of five options:

- **Cash Dividend Option:** When dividends become payable, they usually are paid on policy anniversary dates. Policyowners who elect to take their dividends in cash automatically receive their dividend check after the company approves a dividend.
- **Accumulation at Interest Option:** Another option is to leave the dividends with the company to accumulate with interest, available for withdrawal at any time. Note that while policy dividends are not taxable, any interest paid on them is taxable income in the year the interest is credited to the policy, whether or not it is actually received by the policyowner.
- **Paid-Up Additions Option:** Dividends can also be used to purchase paid-up additions of life insurance. These additions will be of the same kind as the original or base policy. *The amount of the paid-up addition that is purchased each year is determined by the insured's attained age, the amount of dividend paid, and the type of coverage purchased.*
- **Reduce Premium Dividend Option:** Allows a policyowner to use the dividend to pay all or part of the next premium due on the policy. Sometimes called the Reduction of Premium Dividend Option.
- **One-Year Term Dividend Option:** A fifth option, though not utilized as frequently as the others, is to use dividends to purchase as much one-year term insurance as possible.



## Guaranteed Insurability Option Rider

### POLICY RIDERS

#### ► POLICY RIDERS

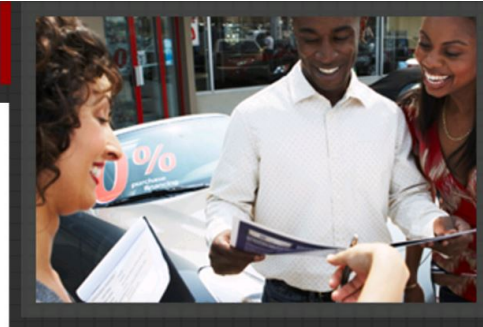
The flexibility of life insurance policies is demonstrated by the ability policyowners have to customize a policy to meet their specific needs. Imagine buying a new car without being able to purchase optional features, such as air conditioning or GPS. Chances are good you might not even buy that car.

Insurers offer their applicants the privilege of adding options (in the form of policy riders) to their policies to meet their unique needs. Like new car options, policy riders are available at an extra cost but are justified because of the increased value the riders give to the base policy.

Most of the optional riders described below must be selected at the time the policy is applied for. The automatic premium loan rider (if it is an option and not a standard policy feature) is the only optional rider available at no cost to the policyowner. It can sometimes be added after the policy is in force.

#### **Guaranteed Insurability Option Rider**

*This rider allows a policyowner to purchase additional life insurance coverage at specified dates without providing evidence of insurability.* This rider provides specific dates on which additional life insurance policies can be bought. The policyowner can only transact purchases during these days. Usually, the older the insured gets, the fewer dates the policy owner has to purchase more life insurance. In some instances, after a certain age, this rider may not be available for purchase or be added. The option amount is the maximum life insurance a policyowner can buy on the specified date (option date). The policyowner can buy the option amount or less on the option date, or none at all. However, the option amounts cannot be added from one option date to another if the earlier option date was not exercised.



## Waiver of Premium Rider

### POLICY RIDERS

- *Costs for new coverages purchased under this rider are calculated on the basis of the insured's attained age*
- *This rider also will allow the policyowner to purchase additional coverage at marriage or the birth of a child*

#### Waiver of Premium Rider

The waiver of premium rider provides valuable added security for policyowners. It can prevent a policy from lapsing for nonpayment of premiums while the insured is disabled and unable to work. *The waiver of premium rider is available on both permanent and term insurance policies.* If the company determines that the insured is totally disabled, the policyowner is relieved of paying premiums as long as the disability continues. Some companies include the waiver of premium as part of the contract with the cost built into the overall premium. In other companies, the waiver may be added to a policy by rider or endorsement for a small, additional premium. Some policies specify that an insured must be totally and permanently disabled for the waiver to take effect. It does not apply to short term illnesses or injuries. *In fact, an insured generally must be seriously disabled for a certain length of time, called the "waiting period" (usually 90 days or six months).* The policyowner continues paying premiums during the waiting period. If the insured is still disabled at the end of this period, the company will refund all of the premiums paid by the policyowner from the start of the disability.

The company then continues to pay all premiums that become due while the insured's disability continues. If the insured recovers and can start back to work, premium payments then must be resumed by the policyowner. No premiums paid by the company have to be repaid by the policyowner.

For the waiver to become operative, *the insured must meet the policy's definition of "totally disabled."* Totally disabled may be defined as the insured's inability to engage in any work for which the insured is reasonably fitted by education, training, or experience. With some policies, the definition is worded in terms of the insured's inability to work at the insured's own occupation for a stated period (for example, 24 months) and at any occupation thereafter.

## Automatic Premium Loan Rider

## Payor Provision or Rider

### POLICY RIDERS

A waiver of premium rider generally remains in effect until the insured reaches a specified age, such as 60 or 65. When the provision expires, the policy premium is reduced accordingly. If an insured becomes disabled prior to the specified age, all premiums usually are waived while the disability continues—even those premiums falling due after the insured passes the stipulated age. Although premiums are waived for a disabled insured, the death benefit remains the same. In addition, cash values will increase at their normal rate and dividends for a participating policy are paid as usual. In fact, cash values continue to be available to the policyowner at all times while the insured's disability continues.

#### Automatic Premium Loan Rider

The automatic premium loan feature, discussed earlier in this chapter, is a standard feature in some life insurance policies. In others, its provisions are added to the policy by rider. In either case, it is available to the policyowner at no additional charge. As previously noted, it allows the insurer to pay premiums from the policy's cash value if premiums have not been paid by the end of the grace period. These deductions from cash values are treated as "loans" and are charged interest. If the loan is not repaid, the interest will also be deducted from the cash value. Should the insured die, the loan plus interest will be deducted from the benefits payable.

Automatic premium loans provide that, as long as premiums are not paid, the loan procedure will be repeated until the cash value of the policy is exhausted. When the cash value is depleted, the policy lapses. An automatic premium loan option can be elected at the time of application or, with some insurers, added after the policy is issued.

#### Payor Provision or Rider

As noted earlier in the discussion of juvenile insurance, a payor provision is usually available with such policies, *providing for waiver of premiums if the adult premium-payor should die or, with some policies, become totally disabled*. Typically, this payor provision extends until the insured child reaches a specified age, such as 21 or 25.

## Accidental Death Benefit Rider

### POLICY RIDERS

#### Accidental Death Benefit Rider

The accidental death benefit rider (sometimes called a "double indemnity" provision) provides an additional amount of insurance usually equal to the face amount of the base policy if the cause of death was an accident. Consequently, if the insured died as a result of an accident and the insured had a double indemnity rider, the total benefit paid would be double the policy's face value. A "triple indemnity" provision would provide a total death benefit of three times the face amount. Any policy loans are subtracted from the policy's face amount and not from the accidental death riders.

"Accidental death" is strictly defined. It does not include accidents resulting, directly or indirectly, from an ailment or physical disability relating to the insured. The additional proceeds are paid only if the insured dies as a result of bodily injury from some external, violent, and purely accidental cause. Also, death must occur within a specified time (usually 90 days) following the accident. Deaths that might be considered accidental, such as those resulting from self-inflicted injury, war, or private aviation activities, are excluded.

An accidental death rider provides an additional death benefit for a limited period of time at the lowest possible cost. Many companies do not offer the accidental death benefit to anyone older than age 55 or 60, and the extra protection generally expires after the insured reaches age 60 or 65. While in effect, the additional insurance does not build any cash value. The extra premium for this benefit is not payable beyond the date when the additional benefit expires, nor does the benefit apply to any paid-up additions that may be purchased with policy dividends. The benefit also drops off in the event the policyowner surrenders the policy and selects one of the nonforfeiture options.

## Return of Premium Rider

## Cost of Living Rider



## Long-term Care Rider

### POLICY RIDERS

#### Return of Premium Rider

*A return of premium rider provides that in the event of the death of the insured within a specified period of time, the policy will pay, in addition to the face amount, an amount equal to the sum of all premiums paid to date.* In actuality, this rider does not return premiums but pays an additional benefit equal to premiums paid upon the date of death. The policyowner is simply purchasing term insurance that increases as the total amount of premiums paid increases. Many insurers now also offer a return of premium to a living policyowner after a specified time. There are also Return of Premium (ROP) policies that is whole life insurance with an increasing term insurance rider equal to the amount of premiums paid. If the insured dies within the term period, the beneficiary will receive the face amount plus the value of all paid premiums

#### Cost of Living Rider

Some companies offer their applicants the ability to guard against the eroding effects of inflation. A cost of living (COL) or cost of living adjustment (COLA) rider can provide increases in the amount of insurance protection without requiring the insured to provide evidence of insurability. The amount of increase is tied to an increase in an inflation index, most commonly the Consumer Price Index (CPI). Depending on the type of base policy, these riders can take several different forms.

#### Long-term Care Rider

A long-term care rider can help safeguard against the financial burden of long-term care. This rider provides an acceleration of the death benefit to help pay for costs involved with long-term care. Under normal circumstances, an insured would require assistance in at least 3 Activities of Daily Living (ADL's) to be eligible to receive benefits. Benefits are typically paid out income tax-free and will reduce both the death benefit and cash surrender values of the life insurance policy.

## Quiz 1

- Question 1: Julie has a \$100,000 30-year mortgage on her new home. What type of life insurance could she purchase that is designed to pay off the loan balance if she dies within the 30-year period?
  - Adjustable life insurance
  - Decreasing term insurance <- Decreasing term insurance is normally used to pay off a mortgage balance in the event of death of the insured.
  - Increasing term insurance
  - Modified life insurance
- Question 2: Joe has a life insurance policy that has a face amount of \$300,000. After a number of years, the policy's cash value accumulates to \$50,000 and the face amount becomes \$350,000. What kind of policy is this?
  - Increasing Term Life policy
  - Nonparticipating policy
  - Modified Whole Life policy
  - Universal Life policy <-
- Question 3 What does the word "level" in Level Term describe?
  - The period of coverage
  - The face amount <-

- The premium payments
  - The cash value
- Question 4: The type of multiple protection coverage that pays on the death of the last person is called a(n)
  - joint life policy
  - survivorship life policy <-
  - annuity joint policy
  - dual life policy
- Question 5: Which type of policy combines the flexibility of a universal life policy with investment choices?
  - Adjustable universal life policy
  - Flexible universal life policy
  - Variable universal life policy <-
  - Modified universal life policy
- Question 7: A life insurance policy that has premiums fully paid up within a stated time period is called
  - stated payment insurance
  - limited universal insurance
  - stated modified insurance
  - limited payment insurance <- Limited payment insurance is characterized by premiums that are fully paid up within a stated period, after which no further premiums are required.
- Question 8: Which of these is NOT subject to income taxation under a Modified Endowment Contract (MEC)?
  - Loan against the cash value
  - Policy withdrawal
  - Policy dividend
  - Death benefit <- The correct answer is "Death benefit". The death benefit would NOT be subject to income tax under a Modified Endowment Contract (MEC) .
- Question 9: A Modified Endowment Contract (MEC) is best described as
  - A life insurance contract which accumulates cash values higher than the IRS will allow <-
  - An annuity contract which was converted from a life insurance contract
  - A modified life contract which enjoys all the tax advantages of whole life insurance
  - A life insurance contract where all withdrawals prior to age 65 are subject to a 10% penalty
- Question 10: What kind of life insurance policy covers two or more people with the death benefit payable upon the last person's death?
  - Dual Life insurance
  - Joint Life insurance
  - Last Survivor Life insurance <-
  - Shared Life insurance
- Question 11: A renewable Term Life insurance policy allows the policyowner the right to renew the policy

- at anytime the policyowner chooses
- as many times as the policyowner chooses
- paying the same premium as before the renewal
- without producing proof of insurability <-
- Question 12: The premium for a Modified whole life policy is
  - higher than the typical whole life policy during the first few years and then lower than typical for the remainder
  - lower than the typical whole life policy during the first few years and then higher than typical for the remainder <-
  - normally graded over a period of 20 years
  - level for the first 5 years then decreases for the remainder of the policy
- Question 13: A securities license is required for a life insurance producer to sell
  - modified life insurance
  - Modified Endowment Contracts (MEC)
  - variable life insurance <- A life insurance producer needs to possess a securities license to sell variable annuities.
  - universal life insurance
- Question 14: Which of these riders will pay a death benefit if the insured's spouse dies?
  - Guaranteed Insurability rider
  - Family term insurance rider <-
  - Family whole insurance rider
  - Payor benefit rider
- Question 15: A life insurance policy which contains cash values that vary according to its investment performance of stocks is called
  - Increasing Term Life
  - Modified Whole Life
  - Variable Whole Life <-
  - Adjustable Whole Life
- Question 16: Level premium permanent insurance accumulates a reserve that will eventually
  - equal the face amount of the policy
  - pay a dividend to the policyowner
  - require the policyowner to make periodic withdrawals
  - become larger than the face amount
- Question 17: Which type of life insurance offers flexible premiums, a flexible death benefit, and the choice of how the cash value will be invested?
  - Adjustable life policy

- Variable universal policy <- A variable universal life policy has three key elements- flexible premium, death benefit, and the choice of how the cash value will be invested.
- Universal policy
- Modified whole life policy
- **Question 18:** A Renewable Term Life insurance policy can be renewed
  - at a predetermined date or age, regardless of the insured's health <-
  - only if the insured provides evidence of insurability
  - anytime at the policyowner's request
  - typically with no change in premium
- **Question 19:** When a decreasing term policy is purchased, it contains a decreasing death benefit and
  - increasing premiums
  - level premiums <-
  - decreasing premiums
  - variable premiums
- **Question 20:** Which type of multiple protection policy pays on the death of the last person?
  - Joint life policy
  - Survivorship life policy <-
  - Dual life policy
  - Multiple life policy

## Quiz 2