“A valuable resource for anyone involved with a life insurance policy. It helps make a complex financial product understandable.”

— *INSURANCE BROADCAST NEWSLETTER*

QUESTIONS *and* ANSWERS *on* LIFE INSURANCE

THE LIFE INSURANCE TOOLBOOK

TONY STEUER, CLU, LA, CPFFE

Praise for
Questions and Answers on Life Insurance

"Tony's book is my comprehensive life insurance reference. He takes complex topics and breaks them down into plain English. I relied heavily on this book when studying for the CFP exam and continue to use it when I have life insurance questions in my role as a wealth manager."

—Janet Hoffman, CFA, CFP
Principal, Integral Financial Solutions, Inc.

"I am using your book again this summer and plan to use it in the fall as well. The students love the simple straightforward nature of your writing. It is easily understood for anyone who knows very little or nothing about life insurance. Your book demystifies what some would considers a very difficult topic to understand."

—John Gilliam, PhD, CFP, ChFC, CLU
Assistant Professor
Master's Program Advisor
Texas Tech University

"I found this book to be very thorough, covering many important topics regarding life insurance. This book is very consumer friendly, as well as informative to a seasoned professional. There does not seem to be very much on the topic of life insurance in the marketplace and it is refreshing to see Mr. Steuer tackle these issues in a consumer-friendly manner. I would be more than happy to recommend this book to anyone interested in learning about the life insurance industry. Many books are written on how to accumulate assets/wealth. More books, like this one, should tackle the issues of protecting financial assets."

—Jacob Zollett
Vice President, Cohen Insurance Agency

"*Questions and Answers on Life Insurance* is a great primer for anyone with life insurance questions. This is a particularly valuable resource since consumers never know who to believe when they are contemplating buying a policy. After reading this book, you'll increase your chances of obtaining a better policy or you may very well decide you don't need cash value life insurance at all. I share Steuer's belief that most people only need term insurance. If you want a rare unbiased look at insurance, this is your guide."

—Lynn O'Shaughnessy
College Solutions Blogger
& Financial Columnist

"I have had this book on my reference shelf for a while now, and find myself picking it up more often all the time. When looking at life insurance there are many pieces and topics to cover, and that can lead to not only confusion on the part of the consumer, but also to those in the industry to different extents. There is no 'best' policy—only the best policy for the financial objective of the buyer. Getting to that objective and then finding the policy type that fits that need is briefly mentioned specifically in the book under policy suitability. However, the underlying tone of the book throughout—its educational tone—provides information that will allow the reader to see what makes a particular type of policy applicable to the needs at hand—whether they be maximum cash values, specific business applications, etc. Mr. Steuer also touches on some more advanced upper market tools, such as premium financing, that may be of interest to those involved in sophisticated sales. As someone who has been involved with life insurance analysis for twenty-two years, I can say that overall this is a very useful and readable book."

—Roger Blease
Owner, Blease Research

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THE LIFE INSURANCE TOOLBOOK

TONY STEUER, CLU, LA, CPFFE

LIFE INSURANCE SAGE PRESS

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher and author are not engaged in rendering legal, accounting, insurance, or other professional services. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

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Fifth Edition

To my wife, Cheryl, and to my son, Avery

Families are what life insurance is about
and my family is what life is about.

Once in a while you get shown the light
in the strangest of places if you look at it right.

—*Scarlet Begonias,* Robert Hunter

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INTRODUCTION

Fools and their money are soon parted.

Many people go to casinos thinking they've got it figured out and that they can walk away winners. Yet there must be some reason why casinos are such big, fancy places with free entertainment, free drinks, and so many other temptations, right? (And there must be some way they can afford those utility bills!)

The Life insurance industry can to some degree be compared to casinos in the sense that odds are involved and that insurance companies did not get those big shiny buildings by paying out more than they take in. The U.S. life insurance industry is huge, and it did not get that way by being bargain oriented. Given that, it's time for a type of guide that helps you make the most out of your life insurance dollar. Unlike gambling, life insurance is a critical part of most financial plans. But like gambling, fools and their money are soon parted indeed.

Life insurance is widely regarded as one of the least exciting things to think about. But chances are (especially if you're reading this) that you have a life insurance policy, and with any product that you're spending large sums of money on, you should know what you're getting. I've worked with clients and advisors for thirty-five years, and I've discovered an astounding lack of knowledge about life insurance. That is why I've written this book.

Regardless of how much you know (or don't know) about life insurance, this book will help you best utilize your life insurance dollar and help you get the best deal you can. Why pay more than you need to? Unless, of course, you feel that insurance companies need your financial support.

If you do believe that, let's start off by looking at the size and scope of the life insurance industry. It is one of the biggest industries in the country, as these statistics from the 2007 ACLI Life Insurer Facts Book show:

- $12 trillion of individual life insurance in-force
- $83 billion of credit life
- Close to $7.4 trillion of group life insurance

That's for a whopping total of just under $20 trillion of life insurance in-force. That's a lot of dough, and anywhere there's a lot of money, there's a

lot of different things going on. The phrase "the rich get richer" didn't pop up out of nowhere.

Life insurance can be confusing, and this book will help you better understand this valuable financial tool. But keep in mind that this book is not about investing—it's about life insurance. It's about using life insurance as life insurance and not as an investment tool. If you want to invest, and by all means you should, look elsewhere, because no matter what you read or hear, life insurance is not an investment tool. While life insurance policies may have an investment component, they are insurance contracts.

As mentioned, I have spent 35+ years in the life insurance industry. In California, the Department of Insurance offers a license that is held by less than thirty people, known as the Life and Disability Insurance Analyst License. I hold that license as well as the Chartered Life Underwriter (CLU) designation, discussed in Chapter 5. My leadership roles include serving on the California Department of Insurance Curriculum Board, serving as President of the San Francisco Chapter of the American Society of CLU & ChFC, serving as President of the Leading Life Insurance Producers of Northern California, and serving on the Board of the San Francisco Life Underwriters Association.

My goal is to use my experience to provide you with a useful reference tool. This book is designed with the question and answer format so that you can access the specific information you would like to review. You only have to use the information that is most relevant to your situation. It's designed to be painless.

As a consumer, you can learn about life insurance from the ground up or by focusing on any particular topics that interest you. If you are an advisor, this book will assist you in finding answers that will allow you to better work with your clients. For both consumers and advisors, this book offers a go-to reference for verifying information that you gather from other sources.

This book is not a guide or advisory on buying term life insurance and investing the difference vs. buying whole life or universal life. I'm not here to sell you either way. No, what type of insurance you decide to buy is all up to you.

My biggest hope is that you find this book useful as a reference. The more informed you are, the better choices you can make.

CHAPTER 1

Introduction to Life Insurance

Q1 What Is Life Insurance, Where Did It Come From, and Why Should I Care?

Life insurance is a type of insurance that pays money when someone passes away. That's simple. However, to understand what life insurance is today you should look at how life insurance originated. Life insurance is one of the very oldest types of insurance/financial products in existence. It stems from the old principle that if a villager's house burned down, the other villagers would help to rebuild the house.

The first life insurance came from this concept. Then a concept known as the tontine annuity system was founded in Paris by the 17th century Italian-born banker Lorenzo Tonti. Although essentially a form of gambling, this system has been regarded as an early attempt to use the law of averages and the principle of life expectancies in establishing annuities. Under the tontine system, associations of individuals were formed without any reference to age, and a fund was created by equal contributions from each member. The sum was invested, and, at the end of each year, the interest was divided among the

survivors. The last remaining survivor received both the year's interest and the entire amount of the principal.

However, as the amount of money that people wished to be insured for increased, and the risk potential for violent fluctuations for those involved increased as well. To minimize this effect, it was necessary that the law of large numbers be applied to this situation. This is where we see the first roots of the actuarial practice. An actuary is a mathematician employed by an insurance company to calculate premiums, reserves, dividends, and insurance, pension, and annuity rates, using risk factors obtained from experience tables. These tables are based on the company's history of insurance claims as well as other industry and general statistical data.

This is an example of the principle known as the Law of Large Numbers. This principle states that the greater the number of similar exposures (in this case—lives insured) to a peril (e.g. death), the less the observed loss experience will deviate from the expected loss experience. Basically, the more people that the risk is spread out over, the more money (premiums) will be coming in. So, when a person does die, it will not be as big of a burden to the rest of the insureds. Of course, in certain circumstances, there will not be much that can be done.

The function of insurance is to safeguard against misfortunes by having the losses of the unfortunate few paid for by the contributions of the many that are exposed to the same peril. This is the essence of insurance—the sharing of losses and, in the process, the substitution of a certain small "loss" (the premium payment) for an uncertain large loss. (Reference—Black, H. and Skipper, K.; Life Insurance, Twelfth Edition, Prentice Hall (Englewood Cliffs, NJ), p. 18)

Life insurance, like any other financial product, is a tool to assist you in accomplishing a specific goal (or goals). As such, it will assist the beneficiary when there is an economic loss, due to the death of the insured that extends well beyond just funeral or final medical expenses. The loss of future income, due to the death of a breadwinner, can have a severe impact on the lifestyle of the surviving family members. Debt owed by the deceased may become due and payable as well as possible estate or inheritance taxes. Life insurance can create an immediate source of funds to enable the payment of these expenses and to provide a source of future income.

Benjamin Franklin helped found the insurance industry in the United States, in 1752, with the Philadelphia Contributionship for the Insurance of Houses from Loss by Fire. The current state insurance regulatory framework has its roots in the 19th century, with New Hampshire appointing the first insurance commissioner in 1851. Insurance regulators' responsibilities grew in scope and complexity as the industry evolved. Congress adopted the McCarran-Ferguson Act in 1945 to declare that states should regulate the business of insurance, and to affirm that the continued regulation of the insurance industry by the states was in the public's best interest.

The purchasing of life insurance is an uncomfortable task for many people, and the image of most life insurance advisors leave something to be desired with examples such as Bill Murray in *Groundhog Day* and Mel Brooks in *High Anxiety*. Typically, there is recognition of an obligation to protect one's dependents from the financial hardship of an untimely death, but no one likes to think about the fact that they will die someday. This is another reason—aside from the potential discomfort of dealing with a life insurance advisor—that can make it easy to delay and put off the decision to purchase life insurance.

Keep in mind as you go through this process that life insurance is not for you, it is for your survivors. Therefore, you typically will only have a need for life insurance when you are leaving behind someone or some entity that is dependent on your income.

"*Any road will get you there as long as you don't know where you're going.*"
—Socrates

Q2 Why Do I Need Life Insurance?

Times have changed, and the reasons people buy life insurance have grown from the original purpose. The following is a list of some of the more common reasons:

- **Income Replacement**—Protect the premature death of a spouse or parent so that the loss of income is not devastating to the family.
- **Payment of Outstanding Debts**—Such as mortgages, car payments, and credit cards.

- **Final Expenses—**Funeral and other administrative expenses.
- **Education Funding—**The death of a parent may mean that the quality of education, intended for a child, may be out of reach.
- **Emergency Fund—**Any adjustment expenses, such as time off work and medical and counseling expenses.
- **Special Needs Child—**Life insurance provides a guarantee that the funds will be there to care for those special needs.
- **Business Continuation—**To provide funding to assist in orderly transfer of business ownership in the case of an owner's death—life insurance guarantees that the business is transferred as intended.
- **Business Insurance—**Key Person, Executive Bonus, Split Dollar, and Deferred Compensation funded with life insurance.
- **Estate Taxes—**Under current tax law, life insurance can provide liquidity at death to pre-fund the estate tax liability. This may not be necessary if the Estate Tax is permanently repealed.
- **Charitable Giving—**A charitable-minded client may leave a gift to a favorite organization, without significantly reducing the size of the estate, by using the death benefit to replace the value of the property gifted to heirs.
- **Equalizing Inheritance—**Provides additional liquidity to assist in providing each child with equal shares of their parents' assets.
- **Income In Respect of a Decedent—**People die owning assets that have not yet been taxed; these taxes then become the obligation of the beneficiary. Life insurance provides liquidity to assist in the payment of these taxes.
- **Second Marriages—**There can be conflict when a parent with children remarries. Life insurance on the parent provides the new spouse financial security from the insurance coverage. At the same time it allows the children to receive the parent's estate immediately. This can avoid unwanted animosity between the children and the new spouse and allow them to live in harmony.

Please note that that life insurance is commonly used for business reasons. Further information is in Question 129.

Is proper planning for everyone?

As the famous saying goes, only two things in life are certain: death and taxes. This table looks at the fact that no matter how rich and famous you are, you should always expect the unexpected.

Chadwick Boseman	Actor	Age 43	Colon cancer, 2020
Kobe Bryant	Basketball player	Age 43	Helicopter accident, 2020
Princess Diana	Princess of Wales	Age 36	Car accident on August 31, 1997
Bob Marley	Musician	Age 36	Cancer, 1981
Freddie Mercury	Musician	Age 45	AIDS, pneumonia, 1991
James Dean	Actor	Age 24	Car accident on September 30, 1955
Florence Griffith Joyner	Olympian/sprinter	Age 38	Died from suffocation from an epileptic seizure, 1998
Buddy Holly	Singer	Age 22	Plane crash, 1959
Bruce Lee	Martial arts actor	Age 32	Possible allergic reaction, 1973
Karen Carpenter	Musician	Age 32	Cardiac arrest, 1983
Lou Gehrig	Major League Baseball player	Age 37	Amyotrophic lateral sclerosis, 1941

Q3 How Much Life Insurance Do I Need?

This is an excellent question to which there are as many answers as there are people to ask. Every advisor, financial columnist, and relative has a formula that they consider the best. This section is designed to present the various methods used, as well as the pros and cons of each method ranging from the simple to the extremely complex. As these issues deal with how to value a life, it is indeed a very complex proposition.

The method that makes the most sense to you is probably the one that may work the best for you. No method is perfect, as you are trying to hit a moving target. Life brings many changes and your needs will change with them. The more assumptions you make, the more complex you'll make your planning, and the more chances there are that something will not work as planned. This does not mean that you should only use the simplest methods—it is to give you a concept of why it is important to actively participate in all

of your planning, fully understand it, and constantly monitor it. After all, it is your money. Remarkably, the simplest formulas can often be the best.

All of the issues discussed in this question will have an impact on the amount of life insurance and other assets needed. Often the desired goals may not be financially feasible. These issues are not only financially based; they can also be extremely emotional.

Another thought to keep in mind is that as your other assets grow, such as retirement plans and investments, your need for life insurance will decrease.

These are some of the more commonly used approaches.

BASIC APPROACHES

Multiple of Income

This method (also known as the "human capitalization value") uses the approach of a multiple of your annual income—typically ranging from five to eight times your annual income. This is one of the oldest and best known methods to determine how much life insurance you need, as well as one of the easiest to use. It's also the most frequently mentioned by financial columnists in consumer publications.

While simple, this earnings-multiple method misses a range of important factors. For example, it ignores household demographics, past savings, Social Security offsets, housing expenses, taxes, etc. It also ignores expected life changes and individual preferences about sustaining the living standards of survivors. It is simply a "best guess."

Cover Your Debts

This entails buying only enough life insurance to cover debts such as your mortgage, student loan bills, or outstanding car notes. The issues are similar to the issues for the multiple of income approach discussed above in that it misses a whole range of factors, such as not considering any future debts or needs like child care or college education costs. This method is also too simplistic to provide any real value.

Human Life Value Concept

The human life value concept deals with human capital. Human capital is a person's income potential. We all have a human life value. In wrongful death

litigation, human life value is measured daily in court (however, the litigation value tends to be significantly different). Insuring human life value is the primary purpose of life insurance. The human life value concept goes beyond numbers and considers the entire impact caused by the loss of a human life and the value to a person's loved ones. Here are some questions to give you a start:

- If you had been killed in a car accident last week, and someone else had been responsible for your death, how much money would your family sue the responsible party for?
- If you had been killed in a car accident last week, and you had been responsible, how much money would you want your family to receive?
- If you died of cancer last week, how much money would you have wanted your family to receive?
- How much are your tomorrows worth? What is your Potential Earning Power (PEP)?

Here are the steps to use the human value approach. The future expected earnings of the insured needs to be capitalized and the present value of income flow to the family (for the time frame needed) determined. This generally involves a multistep process:

How to Calculate

1. Estimate the insured's earnings for the period of time replacement would be needed. When estimating earnings, future increases in salary may be considered and an "average" annual salary used. Whether or not to include "growth" of earnings has a significant impact on the amount of coverage that will be needed.
2. Subtract from earnings a reasonable estimate of annual taxes and living expenses spent on the insured, in order to arrive at the actual salary needed to provide for family needs. Commonly, this is a percentage of salary. Rather than calculating a composite of each separate need, it is often suggested that the survivors will need about 70% of the pre-death income to carry on after the insured's death. A higher or lower percentage may be needed depending on a particular family's circumstances. The percentage of salary needed can be more accurately determined through a detailed examination of the family budget.
3. Determine the length of time the net earnings need to be replaced. This could be until the insured's dependents are assumed to be grown

and no longer need the financial support of the insured, or until the assumed retirement age of the insured.

4. Select a rate of return with which to discount the future earnings. A conservative estimate on rate of return would be the return on U.S. Treasury bills or notes, or the rate of return paid for death proceeds left on deposit with the insurance company. A life insurance company will leave a death benefit in an interest bearing account. The rate paid on this type of account is the rate that should be used. A safe assumption would be the rate on a money market or certificate of deposit (CD) account.
5. Multiply the net salary needed by the length of time needed to determine the future earnings. Then calculate the present value of the future earnings using the assumed rate of return. This calculation can be performed using a spreadsheet, specialized software, a financial function calculator, or by using discount interest tables.

Example:
Let's assume you are age 40 and make $65,000 per year. By examining your family budget, it is determined that $48,500 per year is needed for family support. It is also determined that this income would need to be replaced until retirement at age 65 (25 years). If we assume a 5% discount rate, the present value of your future net salary would be $683,556. Stated another way, it would take this amount to pay $48,500 per year for 25 years based on a 5% rate of return. This assumes that the insurance proceeds will be liquidated over the needed period of income (the capital liquidation method). A more conservative approach would be to keep the principal intact and live off the income generated (the capital preservation method). See discussion under life needs analysis below.

The human value method is useful in situations where replacing the income lost due to the death of a breadwinner is the primary concern. However, this method only factors in the replacement of income and does not take into account any lump-sum needs at death. In addition, a client's financial situation may be more complex and additional analysis may be required. For example, the issues of funding a college education, integration with Social Security benefits, paying estate tax, and determining what other sources of

income are available are not included in the human value approach. In situations where a more detailed calculation is needed, the life needs analysis method can be used.

This method will provide only a rough sense of your human life value, which can be a factor in determining the amount of insurance you should have in your financial portfolio. It is most useful in situations where replacing the income lost due to the death of a breadwinner is the primary concern. Typically, the amount of life insurance indicated under this method is less than the actual need, as it does not take into account any lump sum needs at death as well as college-education funding, estate taxes, integration with social security, existing life insurance, and so forth. See the next section where we will discuss a needs analysis approach.

Capital Preservation and Capital Liquidation

This method can be used in conjunction with a needs analysis approach or separately as a quick calculation, if you just want do an income replacement approach on its own. Whether you are using this method strictly on its own or in conjunction with a needs analysis, once the amount of income that needs to be replaced is determined, a decision must be made as to whether the pool of capital to provide this income will be preserved or liquidated.

Capital Preservation:

The capital used for income replacement is left intact and the beneficiaries live off the income it produces.

Pros:

- Optimally provides an income stream indefinitely as the principal (death benefit) remains intact.
- Simple to calculate.
- The longer the payout period, the better this method becomes.

Cons:

- If the rate of return is lower than the assumed rate, the beneficiaries could run out of money prematurely. The interest rate chosen is up to you, but a conservative and realistic interest rate will have a greater chance of meeting your goal. A good guide might be the historical rate of return on U.S. Treasury Bills.

- The amount of money needed to fund income replacement is typically greater than that of other methods, as the beneficiaries live off income only (optimally) rather than principal and income.

How to calculate:

1. Arrive at the annual income (either before tax or after tax) needed using any suitable method, including your own estimate, if you wish.
2. Divide this figure by the assumed after-tax rate of return (conservative) that can be earned on the income replacement fund.

Example:

For an annual income need of $100,000 (after taxes) and an assumed after-tax rate of return on the principal (death benefit) that is presumed to be 5%, the replacement need would be $2,000,000 ($100,000 divided by 5% (.05)).

Capital Liquidation:

The length of time of income needs to be replaced becomes a major factor in determining the capital needed for income replacement.

Pros:

- Typically requires less money than the capital preservation method as both principal and income are used.

Cons:

- The length of time that the proposed insured's salary needs to be replaced is highly subjective.
- Requires all the factors mentioned on the worksheet, and human value needs to be examined.
- The survivor can outlive the income stream.
- More complex to calculate.

How to calculate:

1. Determine the number of years of income replacement needed.
2. Multiply the net income shortage by number of years of income replacement.
3. Add immediate cash needs and any new capital needed to determine total capital needs.

4. Subtract existing capital from total capital needs to arrive at additional capital required.

Because the family (in the prior example) lives off income only rather than both principal and income, $2,500,000 would be needed to generate $100,000 per year using capital preservation, while only $1,562,208 would be needed using capital liquidation (assuming 4% after-tax return for both).

However, as the period of income replacement lengthens, the difference between income preservation and liquidation narrows. For instance, if we assume a 35-year income replacement need for the above example, the capital preservation value does not change while the capital liquidation value becomes $1,866,461.50.

Example:
As this example demonstrates, the capital-liquidation approach requires a lower income replacement need. However, this example assumed the income-replacement fund would be consumed over 20 years. If earnings are less than expected, the fund could be depleted sooner. Also, if the twenty-year figure is based upon the spouse's life expectancy, the spouse could live beyond that expectancy and there would not be any money available after 20 years. This points out the inherent risk of the capital-liquidation approach, while also assuming a 4% after-tax rate of return.

Assumptions about rate of return and life expectancy must be very conservative in order to avoid premature depletion of the fund. The capital-liquidation method may be appropriate in situations when the income-replacement period is certain or is short term. An example would be when income replacement would continue only until the children reach a specified age.

Life-Cycle Model of Consumption and Savings

As shown in the prior methods, planning can vary in complexity. These prior approaches are on a static, predictable future and are based on rough calculations.

The life-cycle model of consumption and savings is a new approach that is based on the life-cycle model which was developed in the 1950s and 1960s by Professor Franco Modigliani and his colleagues at Massachusetts Institute of Technology. Modigliani won the Nobel Prize in 1985 for devel-

oping the model, which built on early work by Yale economist Irving Fisher in the 1920s.

This model assumes that an insured's goals are to secure the living standards of the household and ensure comparable living standards for his or her survivors. In the economic approach, spending targets are derived by calculating how much the household can afford to consume in the present and still be able to preserve the same living standard in the future. Although spending targets under the Capital Needs Analysis approach can be adjusted to approximate those derived under the economic approach, there are practical limits to doing so. This is particularly true in the case for households experiencing changing demographics or facing borrowing constraints.

This approach is based on the fundamental goal of saving money and having insurance—the desire to avoid major disruptions in a household's standard of living. This approach uses advanced mathematical techniques to calculate the savings and life insurance needed to balance consumption in the present with consuming in the future and to preserve a household's living standard for survivors. This method describes how life insurance holdings are adjusted as life insurance needs change. All economic resources, tax liabilities and benefits—Social Security retirement benefits, and survivor benefits, etc.—are taken into account in the calculation, along with family demographics, tax-deferred savings, housing plans, special expenditures, estate plans, capacity to borrow, and lifestyle preferences.

This type of modeling includes contingent planning, which recognizes that survivors may have special needs and different incomes. Key variables—age of retirement, Social Security benefits, and tax-deferred asset withdrawals, for example—can be changed to determine how these factors alter the maximum sustainable living standard. The insurance recommendations are substantially different from those of the conventional methods. This type of approach (in theory) would allow the agent/representative to use a more comprehensive base to determine life insurance needs rather than the historical guessing/estimating theory. Without an economic modeling process, there is no mathematical ability for determining an appropriate amount of insurance.

A benefit of this approach is that it incorporates the fact that as other assets grows; the need for life insurance to replace income will diminish.

The downside of this approach is that it depends on a large number of assumptions and the more assumptions that are relied upon, the greater the chance that the calculations will be further off. The other issue is the complexity of this type of model.

To the best of my knowledge, the only software currently available for this type of calculation is ESPlanner available on the Web at www.esplanner.com.

The (Capital) Needs Analysis Method

The (Capital) Needs Analysis method is used by most insurance agents/planners and at most financial-planning Web sites. Chartered Life Underwriters (CLUs) know the method as the Human Life Value Concept or the Human Capitalization Method. These methods give you the income you will earn from your present age until your retirement age, assuming a rate of interest that represents salary increases through that period. These concepts are sometimes treated as one and the same and sometimes as differing methods.

Like the earnings-multiple method, the Capital Needs Analysis method projects the income the insured will earn between now and retirement (or later) and sometimes discounts these flows. But this procedure goes further; it calculates the net contribution of the insured to the family's living standard by subtracting the insured's present values of future tax payments and living expenses from his or her present earnings. The net contribution of the insured is then compared with today's spending needs of potential survivors. Such a needs analysis incorporates factors such as mortgage payments, other household expenses and special expenditures.

Here are some of the factors that are considered (if not all):

How to Calculate:

1. Estimate the individual's average annual earned income from the person's present age to the age of retirement.
2. Deduct the amount that is not allocated to others. Money spent for income taxes, life and health insurance premiums, and all other self-maintenance expenses should be deducted in this step. Typically this is a percentage of salary. A good starting point is this Consumer Expen-

ditures Survey by the Bureau of Labor Statistics, where the percentage of income required after taxes and expenses would be:

Annual Gross Income:	**% of Gross Income Required:**
Under $48,000:	70%
$48,000 to $53,000:	66%
$53,000 to $59,000:	63%
$59,000 to $65,000:	60%
Over $65,000:	57%
All two-income families:	70%

Please keep in mind that these are only averages. This table also assumes that educational expenses are taken care of separately and the mortgage is paid for.

3. Using a reasonable rate of interest, determine the present value of the amounts allocated to others for the working period used in step one. Most financial calculators can perform this equation for you.

However, the Capital Needs Analysis method raises several concerns:

- If the household sets a spending target too high for survivors, the method will generate a larger amount of life insurance than is appropriate. This will cost the household too much in life insurance premiums. If the spending target is set too low, the recommendation would leave the household underinsured.
- It does not take into account what your beneficiary's needs will be.
- Please keep in mind that these are only averages. Also it assumes that educational expenses are taken care of separately and the mortgage is paid for.
- It does not integrate with Social Security.
- It does not take into account other sources of income.

This method only factors in the replacement of income and does not take into account any lump sum needs at death.

Sample Worksheet:
(see after worksheet for more information on the various factors)

INCOME NEEDS

1. Annual income your family would need if you die today (typically between 60% and 80% of total income). Consider any lifestyle changes, and include any current expenses, such as mortgage/rent, groceries, clothing, utility bills, entertainment, travel, transportation, child care, etc.:
$______________

2. Annual income available to your family from other sources—include all salaries, dividends, interest, current (or estimated) Social Security benefits, along with all other sources of income:
$______________

3. Annual income to be replaced (subtract line 2 from line 1):
$______________

4. Funds (capital) needed to provide income for your required number of years:
$______________

   Multiply line 3 by the appropriate factor* below:
   *10 Years × 8.1; 15 Years × 11.1; 20 Years × 13.6; 25 Years × 15.6; 30 Years × 17.3; 35 Years × 18.7; and 40 years × 20.0

EXPENSES

5. Funeral expenses—average cost of an adult funeral is about $10,000:
$______________

6. Administrative expenses (also referred to as an emergency fund and/or final expenses) can vary when cleaning up the affairs of the deceased (e.g., advisor fees, filing taxes). But this number should be approximately six months of the higher wage earner's salary (50% of annual salary):
$______________

7. Mortgage and other outstanding debts (credit card debt, car loans, home equity loans, etc.). It may make sense to pay off these debts if the survivor will have a substantial income:
$______________

8. College costs*: 2020–2021 cost of a four-year education: public college, $107,280; private college, $219,520; multiply by number of children; costs are increasing more rapidly than inflation:
$______________

9. Capital needed for college—multiply line 8 by the appropriate years before college Factor:

$____________

5 Years × .82; 10 Years × .68; 15 Years × .56 And 20 years: × .46**

10. Total capital required—add lines 4, 5, 6, and 9:

$____________

ASSETS

Keep in mind that current asset value may be considerately different at time of liquidation and the value may be significantly discounted due to forced sale such as real estate, family business, or other investments:

11. Bank accounts, money market accounts, CDs, stocks, bonds, mutual funds, real estate:

$____________

12. Retirement savings IRAs, 401(k)s, Keoghs, pension and profit-sharing plans:

$____________

13. Present amount of life insurance (including group life insurance assumed to continue):

$____________

14. Total income-producing assets—add lines 11, 12, and 13:

$____________

15. Life insurance needed—subtract line 14 from line 10:

$____________

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* Factors: Inflation is assumed to be 3%. College costs indexed at 6%. The rate of return on investments is assumed to be 6% after tax.

** Source: The College Board, *Trends in College Pricing 2020.* Costs include tuition and fees, room and board, and allowances for books and supplies, transportation, and other personal expenses. Information and factors are based on information from the Life and Health Insurance Foundation for Education, a nonprofit organization.

An application of the capital liquidation/preservation model will assist in a more detailed analysis. A custom worksheet will allow you to include what is important to you and to control the degree of complexity. Please note that a separate worksheet should be required for each spouse.

This can be done by using all or some of the following steps as they apply; the factors are discussed previously and are listed for you to keep in mind.

Outflows

One-Time (Lump Sum) Expenses:

1. Funeral expenses (See following pages)
2. Estate administration, final and other miscellaneous expenses—(See following pages)
3. Estate taxes (See following pages)
4. Emergency fund/readjustment period (See following pages)
5. College fund(s) (See following pages)
6. Debt resolution (See following pages)
7. Uninsured medical costs
8. Workforce retraining
9. Offset for any assets included below
10. Home mortgage pay-off
11. Property taxes

Total One-Time (Lump Sum) Expenses: $____________________

Income Need (Ongoing Expenses):

1. Annual income replacement needed by survivor(s) (including special needs dependents)—this includes all day-to-day expenses like groceries.
2. Multiply by % reduction, typically 60–70% (lower since one less person).
3. Multiply line 2 by ___ (use factor/discounted rate of return) years required.
4. Total Annual Income Needs (Ongoing Expenses): $_____________
5. Grand Total Outflows: $_____________

Inflows:

1. Social Security benefits (See following pages)
2. Savings and investments (See following pages)
3. Retirement assets (See following pages)
4. Present amount of life insurance (See following pages)
5. Non-cash assets that could/would be liquidated
6. Total any lump sum assets
7. Multiply line 6 by same factor as line 3 above

Total Inflows: $____________________

Total Life Insurance Needed
(Subtract Total Inflows From Total Outflows): $____________________

Keep in mind that your insurance needs will change from year to year and when you have any major changes in your life like a marriage, divorce, the birth of a child, a child moving out, retirement, purchase and/or sale of a home, changes in occupation, business relationships, worth, disability, and death. These are just some changes to keep in mind. Basically, any change that affects any of the factors above or any factor you add in will call for a reevaluation of your life-insurance needs. In any event, it would be optimal to review your needs annually and at a minimum of every three years. If you know when certain life events will be occurring, then you may have an idea of how long you will need certain amounts of life insurance. This can help you make the decision of whether you need permanent life insurance and/or term life insurance (and the number of level premium years). Keep in mind also that as your asset base grows, your need for life insurance will most likely decline; however, protecting against estate taxes may become a concern.

OUTFLOWS AND INFLOWS

Outflows

Funeral Costs

These can vary depending on location, type, and many other reasons. More than 2,400,000 funerals are arranged by Americans every year; they can cost

$7,000 to $12,000 or more. The average cost of an adult funeral is about $10,000. This is often a difficult subject to talk and think about. Nevertheless, it is a critical area to include in your life-insurance planning as well as in your overall financial strategy. The Federal Trade Commission (FTC) has developed extensive consumer resources on shopping for funeral services. These resources will help you estimate the potential cost. These resources can be accessed from the FTC Web site at: https://www.consumer.ftc.gov/articles/0070-shopping-funeral-services.

Highlights include:

- Funeral planning tips
- The FTC funeral rule
- Funeral costs and pricing checklist
- Types of funerals
- Choosing a funeral provider
- Buying a cemetery site
- Planning your own funeral
- Funeral terms and contact information

Administrative, final, and other miscellaneous expenses can vary for cleaning up the affairs of the deceased, advisor fees, filing taxes, and a number of other reasons can typically reach 50 percent of the higher wage earner's salary.

Estate Taxes

"Two weeks of solid work on his estate may be worth more to an executive than his financial gains of the past ten or fifteen years."—Price Waterhouse

Please note that this quote applies to all, whether or not they are an executive, male, or female—the Tax Code is non-discriminatory.

"The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits cannot be doubted."—Gregory vs. Helvering, 293 U.S. 465; 55 Supreme Court Reporter 266

"Over and over again, courts have said that there is nothing sinister in so arranging one's affairs to keep taxes as low as possible. Everybody does, rich and poor, and all do right because nobody owes any public duty to pay more than the law demands. Taxes are enforced exactions, not voluntary contributions."—Judge Learned Hand

Estate Tax Table:

The Tax Cuts and Jobs Act of 2017 has changed the federal estate tax numbers. Below are the non-guaranteed changes:

Year	Exemption	Maximum Tax Bracket
2022	$12.06 M	40%
2023–2025	Adjusted for inflation from prior year**	40%
2026 and beyond**	$5.49 million (indexed for inflation)	40%

**In 2026, the Estate Tax will revert back to the prior exemption of $5.49 million (indexed for inflation).

How to roughly calculate your potential estate tax:

Step 1: Total your gross estate. Include anything of fair market value in which you have an ownership interest: Home and other real estate, retirement plan balances, stocks, mutual funds, other investments, businesses, life insurance proceeds (not held outside your estate), etc.

Step 2: Subtract all allowable deductions, such as funeral and administrative expenses, mortgages, loans, credit card debt, qualified charities, Adjustable Taxable gifts (post-1976 lifetime taxable transfers not included in gross estate), gift taxes paid on post-1976 taxable gifts, and applicable tax credits (e.g., unified tax credit, state death tax credit, foreign tax credit, tax on prior transfers credit, marital deduction, other applicable expenses).

Step 3: Add the value of lifetime taxable gifts.

Step 4: Deduct the exemption amount.
Year 2022: $12.06 million (single person) and $24.12 million for a married couple
Years 2023-2025: Indexed for inflation*
Year 2026: Exemption reverts to $5 million indexed for inflation ($5.49 million)

Step 5: Multiply the balance by the applicable estate tax rate. For the first $1 million over the exemption, there's a sliding tax rate of

18% to 39%, which results in a total tax of $345,800 on the first $1 million. For any amount over $1 million, the tax rate is 40%.*

*Visit the IRS Web site for the exemption amount for years 2023-2025 and the tax rate for the first $1 million over the exemption (here: https://www.irs.gov/businesses/small-businesses-self-employed/estate-tax).

Notes

Your lifetime exemption is subtracted from your tentative tax, if unused during your lifetime. The lifetime exemption means that no federal estate tax is payable on a taxable estate equal to your exemption equivalent. Estate taxes are due when your tentative tax is greater than your lifetime exemption.

Your estate may be valued at death or six months later, whichever is more beneficial. If you own a farm or closely held business, your method of paying tax will be different. This will depend on the estate at death and what the executor decides, based typically on advice from attorneys and other professional advisors.

Please note that this is to generate a rough idea of a potential estate tax. Please be sure to check on whether this is the current tax table by visiting the IRS Web site at www.irs.gov. You should consult with a properly certified estate planning advisor.

Emergency Fund/Readjustment Period

Consider at least two to six months, to cover time off from work and other expenses that may need to be covered (replaced).

College Costs

Knowing how much college costs is to some degree an uncertainty, as it will depend on many factors, including tuition, room and board, books, and expenses.

There are two types of college costs for which you will need to plan:

Direct costs—fixed charges established by the college, such as tuition and room and board (on-campus student housing and meals).

Indirect costs—expenses controlled by the student, such as personal expenses, books, and transportation. The college may be able to give you some guidelines on typical indirect expenses at their campus.

Estimate your expenses for one year, or you can request expense lists from colleges that interest you and adjust them for anticipated transportation and personal expenses.

If college is a few years away, you'll need to build future cost increases into your planning. If you have a particular college in mind, you may want to use current costs at that college to forecast your future expenses. College tuition costs have continued to increase by 3% per year, according to the College Board (www.collegeboard.com)

This is only an estimate of your educational expenses. The actual cost may vary depending on many factors. This section provides a limited overview of different resources for you to ascertain possible higher education costs, as well as how to plan for them.

Quick facts

- College costs average $107,280 for four years ($26,820 per year) at a public school and $219,520 ($54,880) at a private school. This includes tuition and fees, room and board, and allowances for books and supplies, transportation, and other personal expenses.[1]
- College tuition has historically risen about 3% per year.[2]
- The odds of receiving a "full ride" scholarship are less than 1%. A full ride scholarship is an award that covers all expenses related to college.[3]

1. Source: The College Board, Trends in Pricing 2020
2. Source: The College Board, Trends in Pricing 2020
3. Source: accreditedschools.org (this is an estimate)

There are a tremendous number of resources available on the Web. These are just a few of them. For more, simply go to any search engine and type in "College Costs." You may want to visit https://bigfuture.collegeboard.org/pay-for-college/college-costs/college-costs-calculator. This site has a number of resources and a full planning center.

The main site is www.collegeboard.com. This is one of the most comprehensive sites for figuring savings for future education.

Confusion occurs because there is much discussion of using life insurance as a funding vehicle for college. This is not applicable toward the purpose discussed here, where we are looking strictly at the death benefit rather than the cash value of a life insurance policy. Of course, if there are significantly more assets than you would need, then you will need either less or no life insurance

at all for the purpose of college costs. That said, a word of caution: as most Web sites are built for sales purposes, their information may be biased toward their companies and services. However, they can assist you in determining a range of appropriate costs and savings plans.

Debt Resolution

Short-term obligations ranging to long-term obligations. Paying these off is not always a necessity and may not be the best option. Include mortgage balance, credit card debt, car loans, home equity loans, etc.

The Home Mortgage

This is an issue that should be addressed during the planning process. There are two options:

1. Pay off the mortgage. The advantage is that this reduces the overall debt load. The disadvantage is that this can use a sizeable chunk of the death benefit. This would be listed under one-time expenses and would reduce the income replacement/survivor living expense need.
2. Continue with the mortgage. This allows you to have more funds available for other purposes and to continue having the income-tax deductions.

Determining the Income Replacement/Survivor Living Expenses

Consider any lifestyle changes (impact of the insured's death), what portion of your income the survivor is dependent upon, etc. Include any current expenses, such as mortgage/rent, groceries, clothing, utility bills, entertainment, travel, transportation, child care, etc. There are two different methods, as discussed previously in this question. You can multiply the proposed insured's income by a certain percentage (70% is typical). Or, if you would like, you can perform a more detailed analysis with these steps:

1. Determine the gross income of the insured. This can be difficult due to potential promotions and cost-of-living increases in the future. It may be appropriate to assume that the insured's income conservatively increases each year to keep pace with inflation. Then take an average income based on the period that needs to be replaced. Factoring in future increases provides a measure of inflation protection for the family.

2. Consider how many years the survivor will require financial support—if they are a non-working spouse, will they go back to work, is there an adjustment for remarriage, and when will the children no longer need any financial support. Also consider if there is a special-needs child.
3. Subtract from the insured's gross income any costs associated with the self maintenance of the insured. Examples would include employment taxes, medical costs, insurance premiums, food, clothing, contributions to retirement plans, and discretionary funds set aside as savings. These costs can be arrived at through a detailed examination of the family budget. This should leave the net income that is needed to provide support for the family.
4. Ascertain any other sources of income that will be available to the family. These would include survivor benefits from deferred compensation plans, income from pension plans and IRAs, income from investments, and any Social Security survivor benefits.
5. Decide whether the capital needed for income replacement will be preserved or liquidated. As discussed earlier, under the capital preservation approach, income can be provided to the family indefinitely. However, if capital liquidation is used, the length of time income needs to be replaced becomes a major factor in determining the capital necessary for income replacement.
6. Adjust the number of years of funds needed by investment growth: Discount the sum by the net (after tax and inflation) rate of return to arrive at new capital needed.

Inflows

With any inflow, consider that there may be penalties, or other charges or other reductions for early withdrawal:

- Social Security benefits—survivor's income
- Retirement assets—IRAs, 401(k) plans, Keoghs, pension and profit-sharing plans, etc.
- Savings and investments—bank accounts, CDs, stocks, bonds, mutual funds, real estate/rental property, etc.
- Present amount of life insurance—include group insurance and personal insurance purchased on your own

- Other assets—keep in mind that assets should grow, hopefully reducing the future amount of needed life insurance (however, they may increase the need for survivor life insurance), and only include liquid assets, not assets that would change your lifestyle, such as a car or home.
- Other sources

Social Security Benefits

Please note that as indicated above, this is based on information at the time of the writing of this book. Please contact the Social Security Administration to confirm this information. Their Web site is www.ssa.gov and their toll-free number that operates from 7AM to 7PM, Monday to Friday is 1-800-772-1213.

Social Security will provide a survivor's benefit upon the death of a worker eligible for Social Security. Of course, you will have to make a decision as to how you feel about the future of Social Security and consider the political risk (Congress) as well. Any Social Security benefits payable will reduce the amount of income that will need to be replaced.

Social Security benefits are also available to the surviving spouse if there are children under the age of 16. Social Security is also paid to a child (or children) until they turn age 18 or 19 if still in high school. Also, note that Social Security is available to widows or widowers at age 60 if the spouse had been covered. The period when no Social Security benefits are available is called the "blackout period."

Calculating the amount payable is complex. You may contact the Social Security Administration directly or visit their Web site and use their online retirement estimator.

Retirement Plans

Retirement plans, which are usually defined as pension plans, 401(k), and other profit-sharing plans, along with tax-sheltered annuities (TSAs), SEP, Simple Plans, and IRAs can all be used as a source of income replacement. Distributions from retirement plans require careful planning and thought in order to receive the maximum benefit from the plan. Besides the issues of capital preservation as opposed to capital liquidation, there is the issue of

whether these funds should be left to grow on a tax-deferred basis as well as the issues of avoiding any income tax on the gain from the funds.

Current Life Insurance

This includes any personal, individual insurance as well as any group life insurance (through an employer, etc.). With group life insurance, you may also choose to not include it as usually it is only effective while you are with your current employer.

Life Expectancy and Mortality Issues

When faced with designing a life insurance portfolio (as well as for any financial planning), an important factor is estimating your life expectancy. This is a guessing game as much as a science.

There are a number of resources, tables, and Web sites (with simple to complex calculators), available for this purpose. Please keep in mind that the more variables you introduce, the greater the likelihood that your estimate will be wrong.

A good starting point is the table issued by the U.S. government, for use by life insurance companies in determining a basis for life insurance premiums. This table is updated every few years and is called the Commissioners Standard Ordinary Mortality Table (see the 2017 version on the next page).

The following are some of the many factors that can impact your life expectancy:

- **Gender—**males generally have shorter life expectancies than females as shown in the mortality table.
- **Tobacco use—**if you use tobacco, your life expectancy will be shorter than for those who don't use tobacco. Smoking will especially shorten your life expectancy.
- **Build—**being overweight can reduce your life expectancy. Your target weight is determined by your height. Exceeding that weight reduces your life expectancy. Please see Question 77 for further information.
- **Alcohol use—**excessive alcohol drinking can reduce your life expectancy.

Commissioner's Standard Ordinary Mortality Table 2017

AGE Last Birthday	MALE Life Expectation	FEMALE Life Expectation	AGE Last Birthday	MALE Life Expectation	FEMALE Life Expectation
0	78.81	81.95	36	44.03	46.57
1	77.83	80.97	37	43.10	45.61
2	76.84	79.99	38	42.17	44.66
3	75.85	78.99	39	41.25	43.70
4	74.86	78.00	40	40.33	42.75
5	73.87	77.01	41	39.42	41.80
6	72.88	76.01	42	38.51	40.85
7	71.88	75.02	43	37.60	39.91
8	70.89	74.03	44	36.69	38.96
9	69.90	73.03	45	35.79	38.01
10	68.90	72.04	46	34.88	37.07
11	67.91	71.04	47	33.97	36.12
12	66.92	70.05	48	33.06	35.18
13	65.93	69.06	49	32.16	34.25
14	64.94	68.06	50	31.25	33.31
15	63.96	67.07	51	30.34	32.38
16	62.98	66.09	52	29.44	31.46
17	62.02	65.11	53	28.54	30.54
18	61.07	64.13	54	27.64	29.62
19	60.12	63.15	55	26.75	28.71
20	59.17	62.17	56	25.86	27.80
21	58.22	61.19	57	24.98	26.90
22	57.27	60.21	58	24.11	26.00
23	56.33	59.23	59	23.24	25.11
24	55.38	58.25	60	22.38	24.23
25	54.44	57.28	61	21.53	23.36
26	53.49	56.30	62	20.69	22.49
27	52.55	55.32	63	19.87	21.64
28	51.60	54.34	64	19.05	20.79
29	50.65	53.37	65	18.24	19.96
30	49.70	52.39	66	17.45	19.14
31	48.75	51.42	67	16.67	18.32
32	47.80	50.44	68	15.90	17.52
33	46.85	49.47	69	15.13	16.74
34	45.91	48.50	70	14.39	15.96
35	44.97	47.54	71	13.65	15.20

Commissioner's Standard Ordinary Mortality Table 2017

AGE Last Birthday	MALE Life Expectation	FEMALE Life Expectation	AGE Last Birthday	MALE Life Expectation	FEMALE Life Expectation
72	12.93	14.46	97	2.01	2.20
73	12.23	13.72	98	1.84	2.00
74	11.55	13.00	99	1.69	1.81
75	10.89	12.30	100	1.55	1.65
76	10.25	11.60	101	1.43	1.50
77	9.62	10.93	102	1.32	1.38
78	9.01	10.27	103	1.22	1.26
79	8.42	9.63	104	1.13	1.16
80	7.85	9.01	105	1.05	1.07
81	7.30	8.41	106	0.96	0.98
82	6.76	7.83	107	0.87	0.88
83	6.25	7.27	108	0.78	0.80
84	5.76	6.74	109	0.70	0.71
85	5.30	6.24	110	0.62	0.63
86	4.87	5.76	111	0.54	0.55
87	4.48	5.32	112	0.47	0.48
88	4.11	4.90	113	0.40	0.41
89	3.78	4.51	114	0.33	0.34
90	3.49	4.15	115	0.27	0.28
91	3.22	3.81	116	0.21	0.21
92	2.98	3.50	117	0.15	0.16
93	2.77	3.21	118	0.10	0.10
94	2.57	2.94	119	0.05	0.05
95	2.38	2.68	120	0.00	0.00
96	2.19	2.43			

- **Driving**—unsafe driving indicates a greater risk of accidents and death and will therefore reduce your life expectancy.
- **Blood pressure**—especially uncontrolled high blood pressure will reduce life expectancy.
- **Family medical history**—if a parent or sibling has/had a history of heart disease, cancer, diabetes, or high blood pressure prior to age 60, then life expectancy may be lower and is a factor though it is hard to measure.

A good resource is the life tables available from the U.S. Department of Health and Human Services—Center for Disease Control and Prevention (CDC). Annually, they publish a life expectancy table on their Web site. This table can be a valuable resource and is found at http://www.cdc.gov/nchs/fastats/lifexpec.htm.

Here are some current life expectancy figures, as of 2017:

- All Americans, at birth: 78.6 years
- All Americans, at age 65: 19.4 years
- All males, at birth: 76.1 years
- All males, at age 65: 18.0 years
- All females, at birth: 81.1 years
- All females, at age 65: 20.6 years

Source: National Vital Statistics Reports, Volume 68, Number 7, United States Life Tables, 2017; Published June 24, 2019.(All figures are for the U.S.)

Another site of interest is www.livingto100.com. The Living to 100 Life Expectancy Calculator was designed to translate what has been learned from studies of centenarians and other longevity research into a practical and empowering tool for individuals to estimate their longevity potential. The average person is born with a set of genes that would allow them to live to 85 years of age and maybe longer. People who take appropriate preventive steps may add as many as 10 quality years to that. People who fail to heed the messages of preventive medicine may subtract substantial years from their lives.

A search on any Internet search engine will find a multitude of sites and calculators on the Web. Almost everyone will give you a different estimate. Therefore, in doing your planning, the best option will typically be the one you best understand and makes the most sense to you.

How long will you live? http://deanfoster.net/mortality/ is another interesting site—sponsored by the University of Pennsylvania—that provides different "life calculators" and links to other supporting sites.

CHAPTER 2

TYPES OF LIFE INSURANCE

Q4 What Are The Basic Types of Life Insurance Products Out There?

There is a confusing array of life insurance products, almost rivaling the mutual fund industry and its bewildering variety of choices. With over 750 life insurance companies active in the business and with each company usually offering several different types of policies/contracts, you can see that there are many thousands of different contracts available.

No guide, advisor, or reference can feasibly cover every type of policy and every nuance. Yet there are major similarities between certain types of life insurance contracts. For example, a universal life policy issued by company A will be similar to a universal life policy issued by company B. State insurance regulations make this so. This chapter is designed to help you with the differences between the different types of policies.

All life insurance policies promise to pay an agreed sum of money if the insured person should die while the policy is in-force, but all life insurance policies are not the same. A wide variety of plans are available. Some policies

provide permanent coverage while other coverage is only temporary (i.e., term life insurance). Some policies build cash values (i.e., "permanent" life insurance) while others do not. Some policies combine different kinds of insurance (e.g., a permanent base policy with a term "rider"), and yet others let you change from one type of insurance coverage to another. Your choice should be based on your needs and what you can afford. Some permanent life insurance policies allow you to add additional, term life insurance during the period of your greatest life insurance need. Usually the term insurance is on your life, but it can also be bought for your spouse and children if needed.

Q5 How Do I Tell the Basic Differences Between Term and Permanent Life Insurance?

Let's look at the differences between term and permanent life insurance. For our present purpose, permanent life insurance includes any policy that is not term life insurance (i.e., one that gradually accumulates a cash value). Typical examples include whole life, universal life, and variable life policies. Unfortunately, it can get confusing. When a term policy accumulates a cash value, then it is typically a form of universal life policy and not term insurance at all. But there are exceptions. For example, a "term to age 65" policy will typically accumulate a cash value in the intermediate in-force years. This cash value will then gradually reduce to zero by age 65, when the coverage automatically ends.

Here is a summary of each of these kinds of insurance:

TERM INSURANCE:

- As the name implies, it is purchased for a specified term of years.
- The cost (premium) is lower, especially for younger applicants.
- Premiums systematically increase year by year as you get older.
- Term insurance has no residual value. That is, it expires without value at the end of the term.
- Less than 1% of term policies ever pay a death benefit, according to the most recent study of its kind.[1] Don't be misled by this statistic. Most term policies cannot be renewed beyond age 75, but annual renewal term policies ("ART") may usually be renewed to age 100.

1. A 1993 study of over 20,000 policies by Penn State University.

However, ART policies become prohibitively expensive at the older ages, so renewing them much beyond age 70 or 75 is impractical for most people.

PERMANENT INSURANCE:

- Premium payments usually (but not always) remain the same each year.
- Premium payments generally are considerably higher than for term life insurance policies in the early years of the contract.
- Premium payments may be discontinued under certain circumstances. Some policies provide significant degrees of flexibility.
- Interest or other earnings on the cash value is tax deferred.
- Permanent policies typically make no sense without a long term commitment from the buyer, since little or no cash surrender value accumulates in the first few years (in most cases).
- Coverage may stay in-force to age 100 or longer and the policy will have a residual value (cash value—sometimes called cash surrender value).

Access to the cash value is available through loans and withdrawals.

Q6 The $64,000 Question—Should I Buy Term Life Insurance or Permanent Life Insurance and Invest the Difference?

This the perhaps the most controversial question of all when it comes to selecting a life insurance policy. Life insurance people generally line up in one of two "camps": The whole life camp consists of True Believers, to whom buying permanent life insurance is the answer to every problem except cancer (and maybe that, too). These people have some valid points in their favor, but neither camp owns the moral high ground on this issue. The term insurance camp is often referred to in derisory terms by the permanent folks as "termites"—those whose recommendation is "buy term and invest the difference." This means investing the difference between the (cheap) term life insurance premium and the (expensive) permanent policy in stocks or mutual funds. The theory is that, over time, the investment component of the two

will accumulate more money than the permanent policy would accumulate. There is little or no love lost between the two sides on this issue.

As you might expect, the truth often lies somewhere in between the two opposing points of view. The two sides have polarized the issue into a dichotomy—an either/or situation, when in reality very often a combination of term and permanent life insurance is the most appropriate recommendation. So which is better for you depends on your specific needs and circumstances. There is no one size-fits-all solution to the life insurance planning problem.

Term insurance is generally agreed to be an excellent short-term solution to a temporary need for life insurance coverage, while permanent life insurance is intended to remain in-force until your death or until your needs change. The one that is better suited for your needs depends on your particular situation. If you would like assistance in making this determination, please contact me.

Most people need some life insurance. As Dr. Joe Belth, Indiana University Professor Emeritus and one of the most respected critics of the life insurance industry, pointed out some years ago, there is no substitute for life insurance. No other financial product will do what life insurance accomplishes. It becomes a question of determining a specific life insurance solution for you. While you are young, with a growing family and limited budget, you will probably need a higher death benefit than you could afford if you purchased only permanent insurance. Term insurance makes sense for you at this stage in life. Rates are low and benefits are high. At some point, however, you will probably need to own some permanent coverage in order to accomplish the intended purpose that life insurance is designed to fill. Permanent insurance provides coverage for the rest of your life prospectively. It is a vehicle for cash accumulation, it can provide liquidity to pay estate taxes, and it is a method for leveling out premiums. The last point can be very important.

While term insurance is very cheap if purchased at younger ages, it becomes prohibitively expensive much beyond age 70 or 75. Buying permanent life insurance early helps to ensure its affordability. The invested cash value element accumulates over time, helping to cover the increasing cost of the pure life insurance protection element in the later years. The tradeoff is

paying a higher, more or less level premium for many years, to avoid the problem of un-affordability in the later years. Term insurance, then, is temporary coverage intended to meet a short-term need over a specific time horizon. Permanent insurance is a long-term solution for lifetime needs. Again, which one is right for you depends on your individual situation.

Q7 What Are the Different Types of Term Life Insurance?

With that brief overview of term and permanent coverage in mind, now let's take a more in-depth look at each type of insurance. Term insurance provides coverage for a specified period (term) of one or more years. It pays a death benefit only if you die during the specified term and if you have paid the required premiums to keep it in-force for the term. Term insurance usually provides the largest amount of death protection for your premium dollars. Most term policies are guaranteed renewable for one or more additional terms, even if your health has changed. Each time you renew the policy for a new term, the premium payment will be higher and it will usually remain level for the balance of the term. If you are considering term insurance, be sure to check the premium schedule at the specified renewal ages, and find out for how long the policy can be renewed, if you decide to keep it.

Many term insurance policies can be exchanged for a permanent policy during the term period. This conversion privilege could prove to be very important, especially if your health deteriorates and you are unable to qualify for a new permanent policy. Be sure to check the conversion eligibility period as you review the coverage, before applying for a policy. Common types of term insurance include:

- **Annual Renewable Term** (also known as yearly renewable term, "ART" or "YRT")—features an annually increasing premium and a level death benefit.
- **Level Premium Term**—features a level premium for a specified number of years (the premium may or may not be guaranteed to remain level). At the end of this level premium period, some policies allow you to renew coverage for another term at very favorable rates, provided that you meet the company's underwriting criteria (i.e., your health remains good). This type of coverage is known in the industry

as re-entry term. If you don't meet the company's current underwriting standards and thereby do not qualify for the re-entry term rate, you can still keep the coverage in-force for a specified period of years by paying a higher rate set forth in the policy.

- **Decreasing Term Insurance** (sometimes known as Mortgage Insurance because this type of coverage is often used for mortgage cancellation in the event of the premature death of the family's primary wage earner)—features a level premium and a decreasing death benefit. Since coverage decreases gradually over the years, the premium will be considerably lower than level premium term.
- **Return of Premium Term**—allows the policy owner to receive the sum of premiums paid (sometimes with interest) after a certain term of years, usually the end of the level premium period.

Q8 How Do I Recognize the Advantages and Disadvantages of Term Life Insurance?

Advantages of Term Life Insurance:

- Premiums are lower than permanent insurance, allowing younger people to buy more coverage when the need for protection is usually greatest.
- Term is also useful for insuring specific needs that will disappear in time such as mortgages or loans. Mortgage cancellation insurance, for example, is decreasing term coverage whose face amount (i.e., insurance amount) at any given time roughly approximates the amount of the outstanding mortgage. If the insured person dies, the insurance proceeds are used to pay off the mortgage.

Disadvantages of Term Life Insurance:

- Premiums increase over time as the insured person grows older. This is also true of level term coverage; at renewal time, the premium goes up and remains level for the next term.
- Coverage ceases when the term ends. Even when the policy may be renewed for another term, the ever increasing premium may make coverage too expensive to continue.

- Generally, term policies don't offer cash value or a reduced paid-up insurance option.
- According to a Penn State University study covering more than 20,000 policies, only 1% of the policies resulted in a death claim.

Q9 What Are Some of the Characteristics of Permanent (Cash Value) Life Insurance?

Permanent life insurance refers to any cash value type of insurance that provides continuous coverage to age 95 or 100 or longer. This type of policy generally has a level premium that must be paid to keep the coverage in-force. Under some circumstances, premium payments may be reduced or stopped, but this cannot be counted upon. Permanent policies typically will accumulate a cash value, which is tax deferred. Most permanent policies allow you to borrow against the policy value or withdraw all or a portion of the cash value.

Premiums are higher than you would pay for the same face amount of term insurance, but they are less than the cumulative premiums you would eventually pay if you were to keep renewing a term policy into advanced age. This is because interest earned on the cash value helps to offset the higher cost of pure life insurance protection as the insured person grows older.

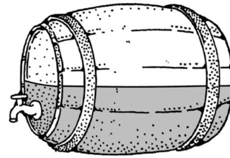
Some policies (e.g., universal life) allow you to vary your premium payments every year and even skip a payment if you wish. The premiums you pay (less expense charges deducted from the premium payments) go into an accumulation account that earns interest. Mortality (insurance) charges are deducted from the account. Insurance coverage continues as long as there is enough money in the account to pay the insurance charges. These insurance and expense charges are the cost of the policy, not the premium.

The cash value of many life insurance policies may be affected by an insurance company's actual experience over time. For example, mortality expense charges are based on actuarial assumptions that may require periodic adjustment as national mortality experience gradually changes. Likewise, expense charges are affected by such factors as how efficiently the company operates, economies of scale, overall company expenses, and so forth. Policy loans will also affect the long-term performance of a policy.

Q10 What Are the Types of Permanent (Cash Value) Life Insurance?

There are many types of permanent life insurance, including:

- Endowment
- Whole, Ordinary, or "Straight" Life (terms are synonymous)
- Limited Pay
- Adjustable Life
- Adaptable Life
- Universal Life
- Joint or Survivorship Life
- Variable Life
- Variable Universal Life
- Equity Indexed Universal Life



Every so often (annually, semi-annually, quarterly, or monthly); premiums are paid into the policy. This increases the level of water of barrel.

Monthly, the insurance company turns the spigot and takes out its expenses (EXP) and the mortality charges (cost of insurance/COI). If there is not enough water in the barrel, the policy will lapse/terminate.

The remaining water in the barrel is the accumulated value. Subtract the surrender fees and this is your surrender value.

Q11 What Are Endowment Life Insurance Policies?

Endowment policies are infrequently sold today, yet many of these policies remain in-force. An endowment policy is similar to a whole-life policy (described below), in that the face amount of coverage is paid to the beneficiary upon the death of the named insured. The difference is that at the specified time the face amount is paid as a living benefit to the person designated to receive it, as long as the insured person is living at that time. Endowment

policies have a number of variations. Some run for 30 years or so and then "endow" for the face amount, while others set the maturity or endowment date at attainment of a specified age (e.g., 65). Usually, premiums must be paid for the entire in-force period, but a few limited pay endowment policies exist.

Q12 How Can I Tell The Difference Between the Many Types of Whole Life Insurance?

Whole life—often called ordinary life and sometimes straight life—is the original permanent life insurance coverage and is still the most commonly found in-force life insurance policy today. The concept is simplicity itself: (1) premium payments are made for life at a rate fixed by the company and agreed to by the applicant; (2) when the named insured dies, the company pays the face amount to the named beneficiary. It's that simple. The company can never raise the premium rate nor can it cancel the policy as long as the premium is paid on a timely basis (absent fraud, in which case the policy can be rescinded, but fraud claims are very rare). The insurance company is therefore promising to pay the face amount upon death, whether that occurs the day after coverage becomes effective or at age 99. To keep this promise, the company employs actuaries who determine the premium payment levels that will be adequate to fund the guarantees in the policy. Life insurance company actuarial science is, as the term implies, very scientific and fairly precise. It involves the pooling of risks over a large population of insured persons. The company has no idea which specific insured persons will die in any given year, but it knows with considerable accuracy how many will die each year, and their likely age distributions. This knowledge allows actuaries to calculate premiums and set adequate reserve levels necessary to keep the promises made by the company. Although this is not usually specified in the policy, if the insured person lives to the end of the specified mortality table, the company usually considers the policy "endowed" and pays the full face amount to the policy owner.

Whole life has become much less popular over the years, with the introduction of universal life, variable life, indexed life, and variable universal life. Whole life policies are more rigid than adjustable life, universal life, and variable universal life in the sense that premiums must be paid on time or else the policy "lapses" (i.e., ceases or goes into a so-called non-forfeiture option mode,

such as extended term coverage or reduced paid-up life insurance). Whole life policies usually included the "automatic premium loan" feature that would allow the company to pay any overdue premium payments by making a loan from the cash value. The distinguishing feature of the whole life policy is its simplicity. Pay the premiums on time and the policy will pay off upon the insured's death, period. The main disadvantage of whole life is the premium payment, which is higher than for universal life, variable universal life, and their variants. If the policy owner is unable to pay the premiums due to job loss, illness, or other circumstances, the policy will lapse.

Policy loans are usually available, but borrowing from a policy can lead to its eventual lapse if the loan is not repaid. For more information on policy loans, please refer to Chapter 10, Questions 106–109, which discuss policy loans in detail, as policy loans can be a very complex and destructive factor to your coverage.

The cash value in a whole life policy is invested by the insurance company through its general investment portfolio. In contrast, variable universal life policies have the cash value component invested in separate accounts (more on this later).

Whole life policies are either participating or non-participating (par v. non-par). A participating policy charges a higher premium and in return pays regular dividends to the policy owner. Non-par policies pay no dividends and premiums are usually lower than par policies. Dividends can be utilized in several different ways. Dividends are not guaranteed and depend on the company's actual experience with the book of in-force business. Dividend options include (a) cash; (b) purchase of fully paid-up life insurance in small increments with each dividend; and (c) reduction of the next premium payment; (d) retention by the company at interest; and (e) purchase of one-year term insurance in an amount equal to the then cash value (the so-called fifth dividend option; that was popular with policy owners who wanted to maximize the face amount of coverage during the early in-force years). It is important to understand that dividends are bought and paid for when you apply for a participating policy. The trade-off for dividends is higher premiums.

Here is a brief overview of the many types of whole life insurance:

> ***Ordinary Life*** provides permanent lifetime coverage with premiums payable for the whole of life. This is the original whole life policy also

known as straight life and continuous premium whole life. Ordinary life policies provide permanent protection for a level annual premium outlay (the mortality costs are spread over the life of the policy). Cash values normally increase at a fairly constant rate, equaling the face amount at age 100. Cash values in early years are typically low, due to the high costs of policy sale and issuance. These costs include underwriting and administrative expenses, with the largest portion represented by the agent's commission, ranging from 40% to 80% or more of the first-year premium.

Limited-Payment Whole Life pays the face amount at death, but the premium payments are compressed into a shorter payment period. At the end of the premium payment period, the policy becomes paid up for its full face amount. This limited payment period is expressed as "paid up at age X" or by the number of years premiums must be paid (e.g., 20 pay life or paid-up-at-65). Since the premium-paying period is shortened, the annual premium is higher and is the actuarial equivalent of lifetime premium payments. This category also includes single-premium whole life, which is no longer popular due to changes in the tax laws several years ago that established the so-called Modified Endowment Contract Rules ("MEC"). In general, however, MEC rules involve a calculation to determine whether a life insurance policy will be treated for tax purposes as an insurance contract or an investment contract. If the former, withdrawals are treated as a tax-free recovery of the contract's original cost basis until the entire basis has been withdrawn. Subsequent withdrawals are fully taxable at ordinary income tax rates. If the latter, withdrawals are treated for tax purposes on a last-in, first-out basis. This means that all withdrawals are treated as taxable interest until they cumulatively equal all interest earnings in the contract. Further withdrawals are then treated as nontaxable recovery of basis.

Indeterminate-Premium Whole Life sets the premium payment at a rate lower than the maximum rate that the company reserves the right to charge. Usually, the actual premium rate represents a significant discount from the maximum premium the company may charge, and

this discounted premium rate may be guaranteed for several policy years. Thereafter, the company annually declares (sets) the premium rate, which is usually lower than the maximum rate but may be more than the initial rate. The policy is designed and priced so that when the company has favorable mortality, investment, and expense experience, the policy owner shares in that favorable experience in the form of lower premium payments.

Current-Assumption Whole Life is a whole life variant that makes use of a current interest rate in setting the cash value, along with an indeterminate premium structure (see the explanation above). This coverage type is also commonly referred to as "Interest-Sensitive Whole Life." Most of these products take into account current mortality and expense charges rather than those guaranteed by the contract.

The policies described above work as follows: The premium is paid to the insurance company, which deducts expense charges (the contract specifies the maximum that can be charged; however, most companies usually charge less). Many of these types of policies have no stated expense charges; instead there are higher mortality charges and a margin built into the interest earnings credited to the cash value. The net amount remaining is added to the preceding year's accumulated fund balance to come up with a beginning year balance. Interest is added to the balance based on the insurer's current rate. Then mortality charges are deducted (these charges are calculated based on the maximum permissible rates as set forth in the contract or, more often, on lower current rates). This rate is applied to the policy's net amount at risk (face amount less cash value). Typically the contracts stipulate that surrender charges will be levied against the fund balance to arrive at the net surrender value. This value is never less than that required by non-forfeiture law.

These come in many variations, such as limited-pay and lifetime-pay premiums. The shorter the premium payment period, the higher the premium. The company sets the premium rate and deducts certain expense charges from premiums received. The contract states the maximum premium that can be charged; although companies often charge less.

The net amount remaining is added to the preceding year's accumulated fund balance to constitute a beginning year balance. Then the insurer credits

interest to this balance and then mortality charges are assessed. These charges are calculated based on the maximum permissible rates allowed in the contract or, as is typical, on lower current rates. Most of these contracts stipulate that surrender charges will be levied against the fund balance to arrive at the net surrender value. This value is never less than that required by the standard non-forfeiture law. The surrender charges decline in percentage annually and usually last for ten to sixteen years.

> ***Variable (Whole) Life Insurance***—See Question 14
>
> ***Single Premium Whole Life*** ("SPWL") policies never really caught on with the public, probably due to the high initial outlay (often approaching 50% of the initial face amount for an insured at age 35). An exception is the early 1980s, when this type of policy was heavily promoted for its then favorable tax treatment (which Congress changed in the mid-1980s). At that time, the policy owner could pay a single premium and then borrow the interest earnings each year, while deducting the loan interest. The modified endowment contract ("MEC") rules adopted in 1987 ended this practice (the MEC rules are addressed later in this report). With SPWL, the purchaser pays a single premium to the insurance company, which credits current rates of interest to the fund value. Instead of mortality and expense charges being deducted annually from the cash value, they are netted against the interest credited to the fund. Unfortunately, this tends to create the appearance that there is no deduction for these charges.

Other, less common types of whole life policies include modified life, the so-called "Economatic" policy, indexed whole life, graded premium whole life and, as briefly discussed above, single premium whole life.

Q13 What Is Universal Life Insurance?

Universal life arrived on the insurance scene in the early 1980s. It was billed as the ultimate in life insurance flexibility, because it gives the policy owner considerable flexibility as to the amount and timing of premium payments, and the face amount of coverage can be changed (down at any time, up with evidence of continued insurability).

Universal life—popularly known as "UL"— is unique in the sense that a UL policy "unbundles" the pricing elements that make up a traditional cash value policy (interest earnings, mortality costs, and company expenses) and prices them separately.

Think of a UL policy as a bucket into which you pour liquid money. The bucket has a spigot at the bottom, and the company turns the spigot to drip money out of the bucket to pay for the expenses associated with the policy. Meanwhile, money left in the bucket earns interest at a rate declared by the company. It is the policy owner's responsibility to keep enough money in the bucket (by making adequate, timely premium payments) to pay the policy expenses as they come due. While the policy owner must put enough money into the bucket to keep the policy in force (otherwise, it will lapse), there is complete discretion as to when premium payments will be made and in what amounts.

Alas, while UL policies are appropriate in the right circumstances, they have failed to live up to their initial billing as the complete solution to most permanent life insurance needs. To better understand why, think of a traditional whole life policy. The policy owner has but one responsibility—to pay the premiums when due. If premiums are paid when they come due, the policy will never lapse, and eventually it will mature as a death claim, period. UL is different. If the policy owner fails to fund it adequately, UL may turn out to be temporary rather than permanent life insurance. On a traditional whole life policy, the pricing elements are bundled together and guaranteed for the life of the policy. On a UL policy, the company may change pricing elements subject to certain limits set forth in the policy. Thus, the company may raise the expense charges and mortality costs and lower the amount of interest credited to the accumulating funds "bucket." Many UL policy owners have been disappointed to learn that what they thought was permanent life insurance turned out to be unaffordable as they grew older. Moreover, the life insurance industry generally did an inadequate job of educating their customers about UL. As a result, thousands and perhaps tens of thousands of policy owners today own UL policies that are ticking away like time bombs destined to explode (lapse) because of inadequate cash value.

UL policies were designed to be transparent to the consumer in the sense that the policy owner sees exactly how much money is put into the bucket, how much interest is credited on the bucket funds, and how much is withdrawn periodically by the company to pay the expense elements in the policy. In theory, this is a major step forward, but the problem is one of communication. In reality, many policy owners do not understand how their UL policies work and therefore are unaware that their policies are likely to lapse before life expectancy has been attained. Companies report to their policy owners by means of periodic statements showing the amount of money in the bucket, interest earned, and amounts withdrawn. Inevitably, these statements are complex and not easily understood. While these periodic reports are useful, their main benefit is the comparison between actual results achieved and forecast results.

UL policy owners are well advised to ask the company for a so-called in-force illustration at least every two or three years. An in-force illustration is a printout that consists of several columns of numbers based on current values and assumptions compared with guaranteed minimum values. Some such illustrations provide three separate projections, including a minimum guaranteed projection, a favorable projection, and a slightly pessimistic one. An in-force illustration is essential because it is the only effective way to monitor the progress of a UL policy. Keep in mind that most UL policies sold prior to the mid-1990s were based on the assumption that the higher interest rates of that era would continue indefinitely. Falling interest rates mean that many of those policies are destined to lapse long before the policy pays off as a death claim due to inadequate premium funding. Furthermore, some UL companies have subsequently increased their mortality and expense charges to levels higher than those illustrated when the policies were originally issued.

Guaranteed universal life policies, which are discussed later, allow a policy owner to pay a specific premium that will guarantee the death benefit.

EQUITY-INDEXED UNIVERSAL LIFE

Equity-indexed universal life insurance (EIUL) is a newer form of universal life that is extremely complex and combines elements of variable life insurance into the mix. The main difference between this and traditional universal life is in how excess interest is credited. Most EIUL policies have two separate accounts that can be used to credit interest. One account has a fixed interest rate that

is declared by the insurance issuer periodically. The second account provides an equity index option that offers you the opportunity to earn rates of interest based on positive equity (stock) market returns. However, the cash value of the EIUL policy is not exposed to losses due to negative market returns.

The amount of interest credited to your cash value is tied to the performance of the policy's particular equity index. Therefore, in years where the index performs well, the interest credited to the policy's cash value rises, and in years where the index performs poorly, your interest rate falls. Typically EIUL policies guarantee that the interest rate will never fall below zero so that the policy won't lose money if the stock market index declines.

The first thing to watch out for is that these policies usually have a cap or limit on the amount of interest that can be credited to your policy. Therefore, if the the cap is 10%, and the index return is 14%, you will only participate in the 10% return. The reasoning is that this would offset the life insurance company's assumption in years where there is a negative return in the stock market index. Companies use a range of indexes that include the S&P 500, Dow Jones Industrial Average, Lehman Brothers Bond Index, and FINRAAQ.

The insurance companies can, at their discretion, adjust the participation rate, so that a policy owner receives a lesser percentage of the total return. This is an important thing to look for. Some companies will offer a 100% participation rate guaranteed for the life of the policy, while others will not provide such a guarantee.

Therefore, if the market returns 14% as mentioned above, the policy has a cap of 10% and the participation rate is 80%—the actual credited return rate on the policy is 8% (10% overall return rate times 80%).

There are also different indexing methods that are used in measuring the market return:

- **Annual point-to-point method**—The annual point-to-point method compares the value of the equity index at the beginning of the term to its value at the end of the term, disregarding market fluctuations in between. Each term is one year. If the ending index value is higher, interest is credited annually subject to the participation rate and cap. If the ending index value is lower, then no interest is credited, unless the policy guarantees a minimum interest credited to the cash value.

- **Daily averaging method**—The daily averaging method takes the average daily index value over the entire index term and compares this average to the beginning index value on the first day of the index term. Most index terms are one year. If the average daily index value over the entire index term is greater than the beginning index value, interest is credited subject to any applicable participation rate and cap.
- **Monthly averaging method**—The monthly averaging method is similar to the daily averaging method except that the index value is recorded on a particular date of each month, usually for 12 consecutive months. The average of each of the 12 monthly values is then compared to the beginning index value on the first day of the index term. If the average index value over the entire index term is greater than the beginning index value, interest is credited subject to the participation rate and cap if applicable.

Q14 What Are Variable Life and Variable Universal Life and Why Are They Different?

Variable Life and Variable UL provide death benefits and cash values that vary with the performance of an underlying portfolio of investments. These are some of the most difficult policies to understand. UL policies earn interest on the cash value bucket, as described above. The company invests the premium dollars as part of the company's so-called General Account. In other words, the insurance company bears the risks inherent to investing and credits in-force UL policies with interest based on the company's investment results. There is, however, no direct link between the company's investment portfolio and the declared interest rate on UL policies. There is a relationship between what the company earns on its investments and the interest it credits to UL policies, but this relationship is indirect. In contrast, Variable Life and Variable UL policies invest the cash value bucket in a variety of investments from which the policy owner chooses. These are usually referred to as investment sub-accounts. There is a direct link between the performance of the investment sub-accounts and the amount earned on the cash value bucket. For example, if the policy owner chooses one or more sub-accounts that are invested in the stock market, and the market drops, the policy may be inad-

equately funded and the policy owner will have to put in additional funds to keep it in force. On the other hand, if the stock market does well, the earnings on the cash value bucket may well exceed considerably the amount that would be earned on a UL cash value bucket.

Variable Life comes in both UL and whole life versions. Usually, the policy owner has a choice of investment sub-accounts that range from the conservative (bond or money-market funds) to aggressive (growth-stock funds). Variable Life and Variable UL must by law be sold with a prospectus, and you will definitely want to read the prospectus before buying one of these policies. The prospectus is a lengthy document and it is tedious to pore through it. Nonetheless, it will disclose vitally important information that will affect the policy's future performance. If you cannot or do not want to bother with the prospectus, it is essential that you seek competent advice from someone qualified to help you choose the right policy for your circumstances. Because of the direct link between performance of the investment sub-accounts and the cash value bucket, the cash value of a Variable Life/Variable UL policy is not guaranteed and the policy owner bears that risk. However, by choosing among the available fund options, the policy owner can create an optimum allocation of funds to the available investment sub-accounts in order to best meet the stated objectives and risk tolerance. Good investment performance leads to higher cash values and, ultimately, higher death benefits. On the other hand, poor investment performance leads to reduced cash values and death benefits. Some policies guarantee that death benefits cannot fall below a minimum level.

When you are discussing the possibility of purchasing a Variable Life or Variable UL policy, you will be provided with a proposal and the prospectus. Because the policy owner decides how the cash value bucket will be invested, there are more choices to make than on a UL policy—and more things that can go wrong. On the other hand, the policy owner has more control over the cash value bucket. Whole life, UL, as well as Variable Life and Variable UL all permit policy loans. Keep in mind that taking out a loan puts the policy at much higher risk of lapsing prematurely. A loan can also result in adverse tax consequences under certain circumstances. A Variable Life or Variable UL policy may be surrendered for its cash value at any time and the policy owner also has the option of exchanging the policy for an annuity contract.

It is always a good idea to be mindful of the fact that buying any form of permanent life insurance and keeping it only a few years will prove to be an expensive way of buying temporary life insurance. Term life insurance is extremely cheap and, if the need for insurance is temporary, term is the preferred solution.

Issues to consider with Variable Universal Life that can offset the tax advantages of life insurance are the following charges:

- Federal and state premium taxes that vary among states but average around 3% of premiums
- M&E (mortality and expense) charges assessed against cash values that range, among policies studied, from 60 to 90 basis points (with 100 basis points equaling 1 percentage point)
- Investment management assets charges that vary, among policies studied, from 20 to 162 basis points
- Surrender charges that typically exceed the first year's premium and last from 10 to 15 years

  (The issues on the preceding page are from a report on Variable Universal by James Hunt, Consumer Federation of America.)

Before allocating future premium payments to the investment subaccounts, check them out carefully. Make sure they fit the policy owner's risk tolerance. Are they well balanced? Is there a range of investment choices that suits all risk tolerances? There are many factors that affect the performance and well being of a Variable Life or Variable UL policy. Please note that this is not investment advice and is strictly advice from the life insurance perspective. For advice on the investment accounts, please consult a properly licensed financial/investment advisor.

Q15 What Are No-Load/Low-Load Life Insurance Products?

There is one other type of life insurance coverage and those are no-load life insurance products, which are designed for advisors who are compensated on a fee basis. At least in California, this is limited to those who meet the criteria discussed in Question 60. However, this regulation is frequently broken. You may wish to check with your State's Insurance Department (see Appendix A

for a directory with contact information). Some states do not have any type of regulation for fee-based life insurance advising and consulting.

These products were designed to help reduce policy costs, allow more of each premium to be credited to the policy and enable cash values to grow quickly. Some of the products have no percent-of-premium charges, no policy charges, and no surrender charges. The companies do take a cost-of-insurance charge and credit interest (to the client).

Traditional "load" policies pay a first-year commission ranging from 25% to 90% or more (of the premium). Renewal commissions (on future premiums) range from 2% to 5%. On most term policies, there is no renewal commission paid.

On the traditional "load" policies there are very high (up to 100%) surrender charges for at least the first five years. After the first year, the surrender charges decrease at a faster rate until they become non-existent anywhere from the tenth up through the twentieth year (usually). A surrender charge is the percentage that a company deducts from your cash/accumulation value.

As no-load policies have no first-year commissions, there are much higher early cash values. Usually, there are minimal if any surrender charges. Depending on the situation, the first-year cash value may exceed the premium. However, while greater access to policy account values is a clear benefit, no-load policies may or may not charge lower costs in the long run. Cost of Insurance (COI) charges are the largest expense charged in any insurance policy (typically 85%), and these COIs vary by as much as 80% (source: Veralytic). On the other hand, sales loads average at most 15% over the life of a policy, so it's important to understand both sales loads and COIs.

Very few life insurance companies (less than 1%) have no-load life insurance policies. This is due to the fact that there has not been a high demand for these products. It is basically a catch-22 situation; the companies do not introduce these products as they say that the advisors are not interested; which is true, because most advisors are not properly licensed (which does not stop many of them) and also because the agents are not willing to forgo the high first-year commission. If the companies introduced a wider selection of products and worked with the agents as discussed in Question 60, then the advisors might get properly licensed and be able to sell these products.

The other issue at this time is that, for the most part, while the cash value of a no-load/low-load policy for the first few years is significantly higher than with a traditional product, over the long term the cash values become similar. The concept of these products is excellent; however, their day has not come yet.

Q16 What Are Some Advantages and Disadvantages of Permanent (Cash Value) Life Insurance:

Advantages of Permanent (Cash Value) Life Insurance:

- As long as the necessary premiums are paid, protection is guaranteed for life.
- Premium payments can be fixed or flexible to meet personal financial needs.
- The policy accumulates a cash value that may be borrowed against. (Loans must be paid back with interest or else the beneficiary will receive a reduced death benefit.) You may borrow against the policy's cash value to pay future premiums or use the cash value to provide paid-up insurance (with certain policies).
- The policy's cash value may be surrendered partially or wholly for the cash value, or it may be converted to an annuity. (An annuity is an insurance product that provides an income for a person's lifetime or for a specific period of time.)
- A "rider" (additional feature) can be added to a policy, giving you the option to purchase additional insurance without taking a medical exam or having to furnish evidence of insurability.
- It pre-funds rising high insurance costs.
- The cash value accumulates on a tax-deferred basis in most cases (based on current tax law, which could change).

Disadvantages of Permanent (Cash Value) Life Insurance:

- Higher premium payments, compared to term life insurance, may make it hard to buy enough protection.
- It may be more costly than term insurance if you don't keep it long enough. Premiums are higher than term in the early years of the contract.

Questions 9 through 15 are an overview of the various types of policies available. Since there are many unique products available in the marketplace, be sure that you are making a valid, "apples to apples" comparison between policies.

Q17 What Is a Policy Rider?

A policy rider is an optional benefit that can be added to a policy for an extra premium. Legally, it is defined as a document that amends the policy or certificate. It may increase or decrease benefits, waive the condition of coverage, or in any other way amend the original contract. Examples are:

- Accelerated Death Benefit Rider—Rider that allows payment of a portion of the face amount prior to the death of the insured, if the insured is diagnosed with a terminal illness or injury.
- Accidental Death Benefit—A benefit in addition to the face amount of a life insurance policy, payable if the insured dies as the result of an accident. Sometimes referred to as "double indemnity."
- Annual Renewable Term Rider—Term life insurance that is "blended" into the policy, which reduces the premium and will reduce the cash value.
- Child Rider—Rider that provides insurance to the insured's child(ren).
- Cost-of-Living Rider—Benefit that can be added to a life insurance policy under which the policy owner can purchase one-year term insurance equal to the percentage change in the consumer price index with no evidence of insurability.
- Disability Income Rider (generally on older policies)—This rider typically pays a monthly benefit of 1% of the death benefit of the coverage, in the event of permanent and total disability.
- Guaranteed Insurability Option—Allows the purchase (optional) of additional coverage at certain intervals without providing evidence of insurability (no underwriting).
- Living Benefits Rider—A rider that allows insureds who are terminally ill or who suffer from certain catastrophic diseases to collect part of their life insurance benefits before they die, primarily to pay for the care they require.

- Other Insured Rider—Rider that provides coverage to an eligible business or family member other than the insured.
- Spousal Rider—Rider that provides coverage to the insured's spouse.
- Terminal Illness Rider—See Living Benefits Rider above.
- Waiver of Cost of Insurance Rider (universal life policies generally)—Waives the cost of insurance in the event the insured becomes totally and permanently disabled during the life of the policy.
- Waiver of Premium Rider (term and whole life policies generally)—Provides that in the event the insured becomes totally and permanently disabled before a specified age, premiums on the contract will be waived during the continuance of the contract.

Keep in mind that many of these riders are more profitable for the insurance carrier. Each carrier only offers certain riders per policy.

Q18 Are There Any Other Types of Life Insurance?

- **Credit life insurance**—This insurance is designed to pay off the balance of a loan if you die before you have repaid it. Credit life insurance is available for many kinds of loans, including student loans, auto loans, farm equipment loans, furniture, and other personal loans, including credit cards. Credit life insurance can be purchased by an individual. Usually it is sold by financial institutions making loans, like banks, to borrowers at the time they take out the loan. If a borrower dies, the proceeds of the policy repay the loan directly to the lender or creditor. Here's what the Federal Trade Commission (FTC) has to say:

  > Before deciding to buy credit insurance from a lender, think about your needs, your options, and the rates you're going to pay. You may decide you don't need credit insurance. If you do, credit insurance can be an expensive form of insurance. For example, it may be less expensive and more practical for you to get life insurance than credit insurance. The FTC has questions that you should ask before deciding to buy credit insurance at https://www.consumer.ftc.gov/articles/0110-credit-insurance.

- **Family income life insurance**—This is a decreasing term policy that provides a stated income for a fixed period of time, if the insured person dies during the term of coverage. These payments continue until the end of a time period, specified when the policy is purchased.
- **Family insurance**—A whole life policy that insures all the members of an immediate family—husband, wife, and children. Usually the coverage is sold in units per person, with the primary wage-earner insured for the greatest amount.
- **Juvenile insurance**—This is life insurance on a child. Coverage is paid for by an adult, usually the parents or guardians. Such policies are not considered traditional life insurance because the child is not producing an income that needs to be protected. However, by buying the policy when the child is young, the parents are able to lock in an extremely low premium rate and allow many more years of tax-deferred cash value buildup.
- **Mortgage insurance**—This decreasing term coverage is designed to pay off the unpaid balance of a mortgage if you die before the mortgage is paid off. Premiums are generally level throughout the term of the policy. The policy is usually independent of the mortgage, meaning that the financial institution granting the mortgage is separate from the insurance company issuing the policy. The proceeds of the policy are paid to the beneficiaries of the policy, not the mortgage company. The beneficiary is not required to use the proceeds to pay off the mortgage.
- **Senior life insurance**—Also known as graded death benefit plans, they provide for a graded amount to be paid to the beneficiary. For example, in each of the first three to five years after the insured dies, the death benefit slowly increases. After that period, the entire death benefit is paid to the beneficiary. This might be appropriate if the beneficiary is not able to handle a large amount of money soon after the death, but would be in a better position to handle it a few years later.

According to consumer organizations, some of these can be the worst types of products in the financial world; so if you are considering one of these products, be sure to compare it with a traditional life insurance product.

Q19 How Do I Make a Cost Comparison Between Life Insurance Policies?

Making a cost comparison between permanent life insurance policies is difficult even for trained professionals because current regulations in most states for most product-types permit insurers to "quote" low premiums and project high account growth while at the same time charging high costs without disclosing the higher risks of under-performance, additional "premiums calls" in the future, or even policy lapse. The good news is that comparing the cost of term life policies is relatively easy because the premium is the cost of a term life policy. First we will address term life insurance coverage, and then we'll look at permanent life insurance coverage. After that you will find different methods of comparing permanent life insurance policies.

CHAPTER 3

CHOOSING AND EVALUATING A LIFE INSURANCE POLICY

Q20 How Do I Choose a Term Life Insurance Policy?

Being human, we crave simplicity because it is, well, simpler that way. Term life is frequently put forward as the easy answer for any person who is not interested in learning the intricacies of various life insurance policies. With term, it is easy for it to be the right answer since term insurance is perfectly adequate in the majority of situations.

So with that being said, how do you evaluate the various term policies available in the marketplace as well as monitor your existing term policy?

Much has been written about how to compare the costs of different life insurance policies. With term life insurance, this is very simple as long as you ensure that you are comparing similar policies. Make sure that you are comparing different policies offering identical coverage. For example, compare the cost of a 10-year level premium term policy only to another 10-year level premium term, not to a 5-year term or decreasing term policy. The policy with

the lowest cost is the one with the lowest premium. The term period is the number of years that premiums remain level until the policy expires or is up for renewal for another term: currently either 1, 5, 10, 15, 20, 25, or 30 years. Again, with term life insurance, the policy with the lowest cost is the one with the lowest premium.

The challenge comes when you are comparing dissimilar term policies, such as comparing an Annual Renewable Term Policy with a Guaranteed Level Premium Term. Then you have the variations among level premium term policies with different guaranteed periods (e.g., 5 years, 10 years, 15 years, etc.), and you have to use your best judgment in determining whether you wish to compare guaranteed or projected rates.

An informed comparison should consider any differences in company ratings from the insurance rating agencies (e.g., AM Best, Standard & Poor's, Fitch and Moody's) as well as such intangibles like how well each company has treated policy owners in the past. It is also helpful to keep in mind that competition for term business has been aggressive in intensity for a number of years, and company actuaries have been aggressively pricing their policies to attract new business, anticipating favorable long-term mortality experience. This premium rate cutting may work out or it may turn out, in retrospect, to have been overly aggressive. In other words, there is no way to know what will happen in the future.

Factors to consider:

- How many years the premium is guaranteed
- Strength of company, as measured by the insurance rating agencies
- Convertibility (option to exchange without evidence of insurability, at the same rate class, to a permanent/cash value policy)
- Length of time convertibility option may be exercised
- Products available for conversion (some companies give you a number of choices, while some limit you to one policy that is typically not a good value compared to other available policies)
- Disability options, if any
- Conversion credit (i.e., reduction in first-year premium as an incentive to convert to permanent insurance)

- Extra cost riders available such as: Disability Waiver, Return of Premium, Family Rider, Accidental Death Benefit, Guaranteed Insurability Option, Child Rider, and Terminal Illness Rider.

Q21 What Are Life Insurance Illustrations and How Can They Help?

Before life insurance illustrations were introduced, life insurance agents (that's what they called themselves in those days—nowadays an agent is more likely to use a title like financial consultant or financial planner) used something called a rate book. The rate book contained virtually everything the agent and the prospective customer needed to know about the proposed life insurance policy. Because there was no such thing as indeterminate premiums and adjustable life in those days, the cash value increased at a rate that could easily be shown as a value per $1,000 of face amount in the rate book. Term insurance was not typically used except for group term life insurance for employee benefit purposes.

Q22 How Do I Read a Typical Term Life Insurance Illustration?

The following term illustration provides information about all facets of this product. The first page shows the factors that the illustration is based on. It continues with renewable period and the conversion period. The next page illustrates the premium.

Sample Term Policy Illustration and Explanation

This illustration is for a renewable and convertible life insurance policy providing a level death benefit with guaranteed level premiums for the first (number of years) years. After (number of years) policy year, premiums will increase annually.

Underwriting Class

Premiums and policy charges illustrated for this coverage are based upon male, age 45 at Preferred Plus. Actual premiums for the insurance coverage may vary from the illustration depending on the outcome of the underwriting process.

Initial Death Benefit

The death benefit illustrated is $500,000. This benefit may be continued to age 95 if appropriate premiums are paid.

Initial Premium

This illustration is based on the premium of $375. The payment frequency selected is annual. Premiums can be paid annually, semiannually, quarterly, or monthly by pre-authorized bank draft. If you elect to pay the premium more frequently than annually, there will a surcharge dependent on the mode, and the total yearly outlay will be greater than the annual premium.

Guaranteed Renewable

This policy may be renewed annually without evidence of insurability to the insured's age 95 provided appropriate premiums for each renewal period are paid.

Guaranteed Conversion

Upon request you have the right to convert all or part of the death benefit to a permanent life insurance plan for the duration of the guaranteed level premium period, or the insured's age 70, whichever comes first. Policies issued at the insured's age 66 or older are convertible during the first five policy years. Evidence of insurability is not required. The conversion must meet company rules at the time of conversion.

This policy does not provide any nonforfeiture benefits (such as cash surrender values) during the level term period. This means that if you fail to pay a premium within a specified time of its due date, this policy will lapse without any value. You should compare this policy to other level premium life insurance policies. Other policies may provide identical coverage with nonforfeiture benefits, however, such policies may have higher premiums than the premiums for this policy. When considering the purchase of this policy, you should compare the value of having nonforfeiture benefits (such as cash values).

Sample Term Life Insurance Policy Illustration Detail

This illustration assumes that premiums are paid at the beginning of each payment period. The payment period for each policy year is annual.

Current Policy Year	Insured Age	Annualized Premium	Death Benefit
1	45	$375	$500,000
2	46	$375	$500,000
3	47	$375	$500,000
4	48	$375	$500,000
5	49	$375	$500,000
6	50	$375	$500,000
7	51	$375	$500,000
8	52	$375	$500,000
9	53	$375	$500,000
10	54	$375	$500,000
11	55	$5,915	$500,000
12	56	$6,525	$500,000
13	57	$7,170	$500,000
14	58	$7,865	$500,000
15	59	$8,655	$500,000
16	60	$9,530	$500,000
17	61	$10,855	$500,000
18	62	$12,385	$500,000
19	63	$14,165	$500,000
20	64	$16,215	$500,000
21	65	$18,540	$500,000
22	66	$21,110	$500,000
23	67	$23,970	$500,000
24	68	$27,125	$500,000
25	69	$31,430	$500,000
26	70	$35,545	$500,000
27	71	$40,905	$500,000
28	72	$45,800	$500,000
29	73	$52,235	$500,000
30	74	$59,585	$500,000

Q23 What Should I Look for in a Term Life Insurance Illustration?

Reading a term life insurance illustration or spreadsheet is not always as straightforward as it may seem. The following factors are important to consider when evaluating and comparing term life insurance illustrations. Usually only a few of these will apply to a particular policy, and some are rarely, if ever used:

- Carrier Ratings and Financial Profile—See Chapter 4, Questions 43-54.
- Cash Value—This policy generates a guaranteed cash value after a certain year.
- Conversion/Exchange Option—Term life insurance policies are usually convertible for a specified number of years or to a specified age. The number of years varies from company to company. Convertible means the policy owner has the right to exchange the policy for a permanent insurance policy regardless of changes in health or finances and with no suicide and contestable periods (a period where the policy is negated if the insured commits suicide or there is fraud). If the policy is converted, the new policy will be issued with the same rate classification as the term policy. Some carriers will give you a number of choices to convert to, while some limit you to one policy (this can sometimes be the company's less competitive policy). Oftentimes there is conversion credit (i.e., reduction in first-year premium).
- Current with Re-Entry Premiums—Assumes the purchase of a brand new policy, with premiums based on then current rates at the insured's attained age, with the insured providing evidence of insurability. Rates shown assume the insured re-qualifies for the same rate classification. Re-entry is assumed to occur at the end of the policy's level period or year 10 for ART/YRT products. Note that there may or may not be a new suicide and contestability period. It is important to understand that, if the policyholder's health declines by the time of re-entry, he/she may have to pay higher premiums than the "With Re-Entry" premiums shown in order to purchase a new policy. In addition, if the

insured's health declines substantially, the insured may not be able to obtain a new insurance policy at any price. Carriers that do not have a re-entry provision will not show any re-entry rates after the initial level period. The right to apply for re-entry may or may not be guaranteed. It is the policy owner's responsibility to initiate the application for re-entry.

- Current Without Re-Entry Premiums—These premiums do not require re-qualification (providing evidence of insurability) after the policy is issued. Future premium rates shown beyond the guaranteed level period are not guaranteed and may be changed by the carrier without notice, subject to the maximum guaranteed premiums. Guaranteed and non-guaranteed rates are shown on the carrier's compliance illustration, along with additional important information.
- Dividends—Dividends illustrated are based upon the current dividend scale and can be changed by the company.
- Guaranteed Premiums—Guaranteed premiums are the carrier's published, guaranteed premiums and are those shown under the heading "Guaranteed" (or "Maximum") premium rates. At the end of the level period, the "Guaranteed" rates shown are the highest premiums that the carrier will charge the policyholder. Actual premiums will be the then current premiums, which may be less than but never more than the guaranteed rates shown.
- Insurance Age—Depending on whether a carrier uses insurance age (your actual age plus six months and one day), age nearest birthday (the typical methods used by almost all carriers), actual age, or age last birthday, it will have an effect on the desired effective date of your policy. The company's pricing reflects its age rating method. This can be offset by backdating a policy to "save insurance age"; i.e., having a policy backdated to just prior to an insurance age change, which would mean a lower premium for the life of the policy. I have never found a reasonable answer as to why insurance carriers all don't simplify this by going with actual age and date of birth.
- Modal Factor (How Often You Pay the Premium)—This is a factor applied to the annual premium to derive the premium due for

semi-annual, quarterly, and monthly bank draft payments. The modal factor for semi-annual premiums ranges from 51% to 53%, which means that you can end up paying an extra 2% to 6% if you don't pay the premium annually. The modal factor for quarterly premiums ranges from 26% to 30%, which means that you will pay anywhere from an extra 4% to 20% by paying quarterly. The modal factor on monthly bank draft premiums ranges from 8.66% to 9%, which means that you will pay anywhere from an extra 3.92% to 8%. The carriers impose these factors because they do not have the use of the money for the entire year, and because they find that, depending on the mode, there is a higher chance that the policy will lapse. This is discussed in greater detail in Question 66.

- Policy Fees—The annual policy fee typically ranges from $45 to $90. The policy fees are added on top of the rate per thousand. The major impact is to the seller of the policy as policy fees are usually non-commissionable. That is, the carrier keeps the policy fee, and the agent's commission is not paid on the fee.
- Premium Level Number of Years—The premium can be for 1, 5, 10, 15, 20, 25, or 30 years; of these options, how many years are guaranteed?
- Rating Bands—Bands are classes of amount of coverage where the higher the amount of coverage, the lower the cost per thousand dollars of coverage.
- Renewability—The policy is guaranteed to be renewable for a certain number of years (or to a specified age), upon timely payment of the premiums, regardless of any changes in health or finances.
- Riders—What optional benefits are available? For example: Disability Waiver, Return of Premium Rider, Family Accidental Death Benefit, Guaranteed Insurability Option, Child Rider, and Terminal Illness Rider? Have these been shown on the illustration? These should be considered separately. Keep in mind that many of these riders are more profitable for the insurance carrier than for the policy owner.
- Risk Class—Companies differentiate not only between smoker and non-smokers. Each of these classes is further divided into four or five classes. Recently, available classes were: Best Available, Preferred

Better Non-Smoker, Preferred Non-Smoker, Standard Better Non-Smoker, Standard Non-Smoker, Tobacco(Non-Cigarette), Preferred Smoker, Standard Better Smoker, and Standard Smoker. What does the designated rate class mean? Are there better rate categories? What qualifications must be met to be qualifying for the class illustrated?

- Suicide and Contestability Clause—Claims are denied for suicide occurring within 1 to 2 years upon issue of the policy (this is the typical range). Claims may also be contested during this period (usually the same number of years). New suicide and contestability clauses may be imposed only if the company requires new evidence of insurability (such as for reinstatement or a request for a lower rate classification, including a request for re-entry rates).

Q24 What Should I Consider in Choosing and Evaluating a Permanent (Cash Value) Life Insurance Illustration and Prospective Policy?

Since there are many unique products available in the marketplace, be sure that you are making a valid, "apples to apples" comparison between policies. Evaluating any type of whole life insurance or other permanent coverage (which encompasses all types of cash value policies) can quickly become a complex and daunting task. Today's permanent life policies are so complex, with so many moving parts, that elaborate, computerized sales illustrations are essential.

Life insurance pricing (i.e., the process of rate setting) is done both prospectively (i.e., making educated guesses about future variables) and retrospectively (i.e., looking back on actual experience and making appropriate adjustments in the premium rate and other factors). Pricing the product requires evaluation of several key factors, which can be summed up under these four basic non-guaranteed risk categories: mortality experience, investment performance, policy lapse rates, and expenses. In the long term, the actual cost of a product will be determined by the company's actual performance in each of these areas. Information on these four factors is typically available from insurance industry resources, such as AM Best, Standard & Poor's, and Veralytic. These also can be found at public libraries and from

the insurance companies themselves. After this next question, we will take a closer look at these categories.

Life insurance companies generally do not like to divulge details about their products in terms of their components.

Q25 What Are the Four Basic Components That Compose and Dictate the Performance of a Life Insurance Policy?

The four basic components that determine how the policy will perform are:

1. Earnings—interest rates, dividends, etc.
2. Mortality—this is the cost of pure life insurance protection—basically, how much the company charges for providing the insurance (i.e., how much they feel there is at risk, how much they can lose).
3. Administrative and overhead expenses.
4. Persistency (sometime referred to as lapse component)—how many policies stay in-force?

Interest rates tend to change the most and can have a greater impact on the performance of a policy than the other components listed above. However, a small change in mortality rates will have a greater impact on the policy performance; though this does not occur very often.

Over the next few questions we will look at each of these components in depth and will be technical in some cases.

Q26 What Is Really Important In an Illustration/Product Analysis?

Permanent cash-value life insurance sales are usually based on illustrations prepared by the company or by the agent using software supplied by the company. The illustration typically highlights projected interest rates and estimates policy values in future years. The illustration is a sales tool, so it naturally accents the positive aspects of the proposed policy. The consumer is naturally led to believe that there is greater assurance that the illustrated values will be achieved than is likely in the real world. There are so many variables that can adversely affect the long-term performance of the policy. Mor-

tality costs, expense, and other charges, future investment experience—all of these are, to some extent, not directly controllable by the insurance company. Results can vary—and they certainly will. So think of the illustration more as a convenient way of showing how the policy works than as a reasonable calculation of premiums required to cover internal policy costs or an estimate of future values.

Understanding how all the components interact is integral to understanding how and why the policy performs as it does. When a policy is issued, the company is at risk for the entire death benefit. That's because the early premium payments go to cover mortality and other expense charges, leaving little or nothing to apply to the cash value. When a cash value starts to accumulate, this gradually reduces the company's net amount at risk.

For example, we'll use a policy issued for $100,000. When it is issued, the entire $100,000 figure is at risk to the insurance company. The cash value of the policy acts as a reserve account, reducing the amount at risk to the insurance company. Therefore, if the cash value in the 30th year of the policy is $60,000 at a certain point, then the net amount at risk to the insurance company is $40,000 ($100,000 of death benefit less the $60,000 of cash value).

The mortality cost is applied to the net amount at risk based on the insured's attained age. With increasing age, the mortality cost per thousand of net amount at risk increases. The theory is that the total mortality cost will decrease as the cash value increases. As long as increases in the cash value (derived from premiums paid in and from investment earnings) are greater than the mortality costs and other expense charges, the policy should continue to grow and remain in-force. When the increases in the policy do not offset the charges, the cash value will commence a rapid descent leading to policy termination with no value.

It is also necessary to understand how the various factors are applied to the policy every month: First, the premium paid is added to the cash value from the end of the prior period. Then mortality costs and other expense charges are subtracted. Interest is credited to this value (after costs). Therefore, the interest credited to the policy is not the actual internal rate of return. The internal rate of return, an important financial yardstick, is always less than the current interest crediting rate.

Q27 What Type of Earnings Are There on a Life Insurance Policy?

There are three basic types of earnings—dividends and credited interest rates on traditional life insurance products. On Equity-Indexed Universal Life, the products have a participation rate in a certain equity index (or indices). On variable life insurance products, there are two types of accounts on a variable life policy. The first is the fixed account, and this account earns interest at the current rate. The other type is a variable account, which has variable accounts whose earnings/loss is the net gain or loss from amounts invested in the variable accounts.

Q28 What Are Dividends?

A "dividend" on a life insurance policy is unlike the dividend you receive on a share of stock or a stock mutual fund. For tax purposes, dividends are considered a return of a portion of the premiums paid for the policy. Basically, the insurance company receives the premium payments and invests them. If mortality and expense experience is favorable (i.e., the company keeps expenses down and the investments do well), the company declares a dividend, which returns a portion of the surplus to policy owners. In this sense, a "dividend" on a life insurance policy is at least in part a refund of over-charged expenses.

Only participating policies pay dividends. Basically, these policies are priced to pay dividends. In effect, the company charges a higher premium, and then returns a portion of it to policy owners. Dividends have always been a controversial topic within the life insurance industry. There is no need to get into the details here, but you should understand what a dividend is and what it is not. In Great Britain, life insurance policies are sold "with profits" (i.e., with dividends), and "without profits" (i.e., no dividends). As you might expect, policies that pay no dividends are less expensive. However, both in the U.K. and in the U.S., over long periods of time the participating policy issued by a reputable company stands a very good chance of outperforming a nonparticipating policy. The key words are "over long periods of time." Although both term and permanent policies can be participating, as a practical matter dividends are suitable only for permanent policies, with their long in-force horizons.

Typically, when the policy is purchased, the policy owner is allowed to elect a form of dividend option, and most insurers allow the dividend option to be changed once the policy is in-force. The policy owner can also elect a combination of options. The most common dividend options are:

1. **Payment in cash—**the insured may choose to receive policy dividend as cash payments like dividends on ordinary corporate stock. If this option is selected, the insurer will pay dividends to the policy owner in cash usually beginning at the end of the first or second policy year. Although life insurance dividends are treated as a tax-free return of premiums (IRC Sec. 72(e) (1), 7702(f)), most policy owners do not choose to take dividends this way because the other options are much more convenient or favorable.
2. **Reducing subsequent premiums—**the policy owner can choose to have the insurer automatically (and at no charge) apply any dividends to reduce future premiums. As dividends increase, the policy owner's required premium payments decrease. If the insurer's investments perform very well, at some point the dividends can equal and even exceed the amount of the premiums. Therefore, if the dividends were high enough to offset future premiums totally, that option could be selected whereby no premiums would be paid out of pocket.
3. **Leaving the dividends with the insurer at interest—**a policy owner can choose to leave the dividend to be retained by the insurer, accumulating and earning interest. The interest rate payable on the policy owner's accumulated account is guaranteed to equal or exceed a specified minimum. Cash can be withdrawn from the dividend accumulation account at any time. When the insured dies or the policy is surrendered, the policy pays the face value or the net cash surrender value plus the value of this account. Interest earned on accumulated and retainer dividends is fully taxable to the policy owner as soon as the policy owner has the right to withdraw it, even if the policy owner elects not to withdraw it. If the policy owner can only withdraw the interest on a specific date (usually the policy anniversary date), the interest is taxable in the policy owner's taxable year with which the date falls.

4. **Buying paid-up additional insurance—**this option allows the policy owner to use dividends to purchase small amounts of completely paid-up (i.e., single premium) additional insurance coverage of the same type as the basic policy. The insurer will add the additional amount of coverage that the dividend can purchase at the insured's attained age. This is purchased at net rates with no commission paid. There is no extra premium. This requires no further evidence of insurability. These paid-up additions can generate dividends of their own.
5. **Buying additional one-year term insurance—**this option allows using the dividends to purchase as much additional one year term life insurance coverage as possible as allowed based on the insured's age. This option also does not have any commission paid, and no evidence of insurability is required. Many insurers limit the amount of coverage that can be purchased to the cash value that year.
6. **Repaying policy loans—**some insurers will allow policy owners to elect to use dividends to be applied directly against any interest and/or principal of a policy loan before being used in one or more other dividend options.

Terminal Dividends—most participating policies will pay a "terminal dividend" at the termination of the contract. The longer the policy has been kept in premium-paying status, the larger the terminal dividend. Although most ordinary level-premium whole life policies have no explicit surrender charges, the terminal dividend is, in a sense, a form of surrender charge, since the insurer is withholding the policy owner's money instead of paying it currently. Those policy owners who terminate their policy in the first few years will receive a relatively small terminal dividend, while those who continue to pay premiums on their policies for a longer period of time receive a larger terminal dividend. The terminal dividend therefore rewards long-term policy holding and discourages early policy lapses. *(Tax Planning with Life Insurance Second Edition 2003/2004 Financial Professionals' Edition—Published by Warren, Gorham and Lamont, RIA by Howard Zaritsky and Stephan R. Leimberg)*

Q29 What Are Interest Rates and How Are Interest Earnings Credited?

Declared Interest Rate (for traditional non-variable policies) is the amount that the investment committee of the life insurance company determines can be credited to its in-force life insurance policies. This means, in effect, that policy owners must accept the rate declared by the company. Interest is usually credited on the accumulated value after policy expenses (mortality/risk charges and overhead expenses) have been deducted, so the actual return is less than the credited rate.

Life insurance companies generally adopt one of two general interest crediting methods that are in widespread use throughout the industry. These are the portfolio method and the banded method. Under the former system, the company credits interest to in-force policies based on a percentage of the earnings on the company's entire investment portfolio. Under the banded system, interest credited is based on the actual performance of specific pools or buckets of money that are received by the company at different times and invested at current market conditions. Since interest rates rise and fall over time, different buckets earn different interest rates. Neither the portfolio nor the banded interest rate system can claim overall superiority.

In fact, over long periods of time, the two systems tend to even out, yielding somewhat similar results. Since a permanent life insurance policy should not be bought for a temporary need, the long-term nature of such contracts tends to make it somewhat less important whether the company uses the portfolio or banded system.

Equity Index Return Rate—The rate of return is dependent upon the performance of the selected index (or indices), the participation rate, and type of crediting method selected (see question 13 for details).

Market Rate—(for variable policies)—The reader will recall that on variable life and variable UL policies the policy owner directly bears the investment risk. That's because the policy owner is in a position to choose specific investment sub-accounts. Usually, funds may be moved between the investment sub-accounts, sometimes with some restrictions.

Q30 What Is the Difference Between Gross and Net Interest Rates?

A company should disclose whether the interest rates credited are:

- gross (before any expenses being subtracted), or
- net of investment expenses, or
- net of investment expense, other company expenses, and profit loads.

Participating products' dividend interest rates are most often net of investment expenses, but prior to other company expenses and profit loads being deducted. Universal life products' declared interest rates, on the other hand, are net of investment expenses, other company expenses, and profit loads. Thus, two companies, both basing their interest rates on equal 9% total investment income returns, both having .5% investment expenses and 1.25% for other expenses and profit loads, might declare interest rates as follows:

- The mutual company would declare an 8.5% dividend interest rate.
- The universal life product would declare a 7.25% net interest rate.

Neither company might say any more regarding how their rates were declared. More importantly, both products will perform identically assuming that both have equal mortality and other charges. Yet the consumer and producer will look more favorably, although incorrectly, on the mutual company with its 8.5% dividend rate. Adequate disclosure by the companies will help remedy this misperception.

Q31 On What Are the Interest Rate Assumptions in an Illustration Typically Based?

1. Interest earned by the company on:
   a) all investments now held,
   b) new investments,
   c) new investments over a certain number of past years, or
   d) other combinations of actual investments.
2. An independent index such as:
   a) Treasury bills,
   b) Moody's long-term bond index, or

c) other indices.

3. Another basis not tied to company results or an index.
4. Interest rates may be the gross interest rate resulting from investments, indices, or other measures, or the gross interest rate reduced by:
   a) investment expenses,
   b) expenses and profit,
   c) a fixed amount or percentage, or
   d) other expenses.

Q32 What Other Questions Should I Consider Regarding Interest Rates and Dividends?

Basically, what you are looking for is whether or not the company is using numbers and facts that are realistic, while also considering the company's history.

Basis for dividends, interest rates, and non-guaranteed factors:

- Are any of the underlying experience factors significantly different from current experience? If so, examine which ones and how they differ.
- If the policy is participating, is there a substantial probability that the current illustrative dividend scale cannot be continued, if current experience holds?
- If the policy is nonparticipating, is there a substantial probability that current illustrations cannot be supported by currently anticipated experience?
- Is the policy of the traditional participating variety, or does it contain non-guaranteed pricing elements using a means other than dividends?
- If the policy is not participating, what are the non-guaranteed elements involved? These are usually non-guaranteed interest crediting rates, mortality charges, loadings, etc.
- If the policy is participating, does the company state that the contribution principle (i.e., aggregate divisible surplus should be distributed in the same proportion, as the policies are considered to have

contributed to the company's divisible surplus) is being followed in the illustrative dividend scale? If it is not, how does it differ?

- If the policy is nonparticipating, what is the company's practice with respect to determination and re-determination of non-guaranteed pricing elements, with particular reference to (a) the degree of discretion reserved by the company and (b) whether any of the elements are guaranteed to follow an outside index?

Q33 How Is a Mortality Charge Determined?

As discussed earlier, the mortality charge is the cost of pure life insurance protection, based on experience tables developed by actuaries and on actual mortality experience. It is the amount the company charges the policy owner periodically for the insurance element in the policy. Other expense charges include a fee for policy administration, company overhead, and taxes.

Each company determines its own mortality charges based on these tables and other factors. Larger companies determine their own mortality charges based on these tables, their experience, and other factors, while smaller companies rely on industry-wide statistics. There are considerable rate variations between companies. At first glance, that might seem curious since the industry uses pretty much the same data to develop their mortality rates. In practice, however, the differences in rates are quite logical. Some companies specialize in writing coverage on those whose health is substandard, while other companies take on specialized risks like smokers and those in hazardous occupations. Even so, there are still some curious anomalies. For example, Company A might be more competitive at issue age 40, while Company B is more competitive at issue age 50. A company's mortality experience is measured (by AM Best) by the rate at which death benefits are paid, compared to the company's own actuarial expectations used to price the premium.

The difference in mortality results among life insurance companies can have a greater impact on a policy's performance than any interest rate return/dividend. Whether disclosed or not, all policy issues are priced for expected cost of insurance charges or COIs. COIs are deductions from permanent life insurance policies to cover anticipated payments by the insurer for death claims. As with most types of insurance, claims are the largest single cost fac-

tor of any insurance policy (If claims are not the largest single cost factor, then is the product really insurance against the risk of death, or something else?). With life insurance, COIs typically account for about 75% of total cost, and, as expected, the higher the claims, the higher the COIs and the higher the premiums. COI charges are calculated year-by-year as the result of the policy death benefit (see net amount at risk below) multiplied by a COI rate provided by the insurance company for each age corresponding to each policy year for each product. These deductions are much like term life insurance premiums in that they are predominantly for claims paid during a given period (typically 1 year).

What should I ask about a company's mortality experience?

- Is the company projecting actual current experience or better-than-current experience?
- Do the mortality rates vary by product, and, if so, why?
- Does the company project an unrealistic increase in mortality expenses, and, if so, is it guaranteed?

The key is to determine which method is being utilized in a particular illustration; however, this is not an easy task. The only method that I currently use is to ask, and then get it in writing if you can.

Q34 What Are Overhead and Administrative Expense Charges, Premium Loads, and Cash-Value-Based "Wrap Fees"?

Overhead expenses include all the operating costs that the life insurance carrier incurs in the course of doing business. These costs fall into four basic categories:

1. Cost of facilities
2. Data processing
3. Employees (labor)
4. Sales expenses (includes commissions, marketing costs, sales offices, etc.)

As with all of the components, these expense factors will vary widely with every life insurance company.

Commissions are a significant part of the overhead expense factor primarily in the first year, and can have a significantly negative impact on the

long-term performance of a permanent life insurance product, especially in the first few years. An agent's first-year commission, including any bonuses or allowances, can exceed 100% of the first-year premium (although this is not always the case). This is why most traditional cash value life insurance policies have almost no cash surrender value for the first few years. Policies typically pay a renewal commission from 2% to 10% for 10+ years.

Most carriers also offer their permanent life insurance policies with the option of adding in term life insurance, which reduces the commission. Some have also lowered the "target" premium, which is the level to which the carrier will pay the maximum commission. In my mind, there is skepticism that this provides additional profits for the company rather than a benefit for the consumer. This will depend on the carrier, and it is always a good idea to get proposals from at least two companies and use the tools in this book. You may want to cap the number of companies that you look at, as the more companies looked, the greater the chance it may become overwhelming.

A consumer also now has the option of a no-load or low-load policy, that is, policies that pay a reduced commission or no commission. Some "no-load" policies do, however, pay a commission, which is usually referred to as a marketing allowance. Low-load and no-load policies tend to be more competitive from the standpoint of a consumer. This is especially true during the first few years, because of the lower surrender charge (than on a traditional, load policy) or lack of any surrender charge. Most such products (there are exceptions) have other built-in charges that tend to make long-term performance and cost more closely approximate traditional "load" policies. Perhaps, one day in the near future, there will be more no-load and low-load life insurance policies from which to choose. Unfortunately, at present there are only a few of these.

Here some other issues to consider in reference to expense charges:

- Are expense charges consistent for new and existing policies of the same type? If they are not, this is an indication that old policyholders are subsidizing the company's attempt to capture new business.
- Do expenses vary by product or underwriting class? This is reasonable only if justified by a company's actual or reasonably anticipated experience. Otherwise, it is an indication of overly aggressive marketing and subsidization of the product with the lower expenses.

- Are expenses, in an illustration that discloses them, adequate and realistic? If not, it is likely they will be subsidized by higher charges for mortality or a lower interest-crediting rate. Conversely, an unrealistic and overly aggressive projection of mortality charges could be offset by higher expense charges, or, again, a lower interest rate.

Premium Loads—Premium loads are calculated as a percent of premiums paid in a given year and typically range between 0% and 35%. Premium-based charges customarily cover state premium taxes that average 2.50%, DAC taxes averaging 1.5%, and sales loads/expenses ranging between 0% and 30%. In addition, while state premium taxes and DAC taxes are generally calculated by the respective government agencies as a percent of premium, and while insurance companies must certainly pay these taxes, insurance companies are not required to assess the charge as a percent of premium. As such, some insurance companies charge no (i.e., 0%) premium charges and collect state and federal taxes from other charges within the policy (usually COIs).

Premium-based charges can also vary depending on either the policy year in which a premium is paid or the level of the premium paid into a given policy. For instance, a higher premium load may be assessed in the early policy years to recover up-front expenses related to underwriting, issue, and distribution of a given policy. After these up-front expenses have been amortized (frequently over a period of ten policy years), premium loads are then often reduced to cover the relatively lower policy owner service and policy administration expenses. In addition, a higher premium load may be charged on actual premiums paid up to a "Base Policy Premium" or "Target Premium" level, while a lower premium load may be charged on actual premiums paid in excess of this "Base Policy Premium" or "Target Premium" amount. This "Base Policy Premium" or "Target Premium" is calculated by actuaries to mature the death benefit as permanent regardless of the age of death of the insured and based on expectation COIs, expenses, and interest/earnings. As such, this "Base Policy Premium" or "Target Premium" is analogous to the "insurance premium" (i.e., that premium typically paid to maintain insurance coverage).

Premium amounts paid into the policy in excess of this "Base Policy Premium" or "Target Premium" can, therefore, be viewed as "excess premium" above and beyond that which is required to support a given insurance death benefit. "Excess premiums" are typically paid to either create a cash value reserve, which can be used to pre-pay future premiums, COIs, and policy expenses (i.e., the minimum planned premium paid for a limited duration to support a defined death benefit), and/or to accumulate wealth in the form of policy cash values that benefit from preferred federal income tax treatment and special protection from the claims of creditors under state law (i.e., under a defined-contribution maximum-accumulation plan design). As such, premiums paid up to the "insurance premium" are typically subjected to "insurance loads" to cover policy expenses unique to the insurance component of the policy, while "excess premiums" are typically subjected to lower "investment-like loads" on those monies contributed toward cash values accumulations. In either case, Veralytic Reports calculate the blended premium load for easy comparison to industry benchmarks and/or peer group products.

Cash-Value-Based "Wrap Fees"—Cash-value-based "wrap fees" are insurance fees charged as a percent of policy account values (e.g., like M&Es found in variable products) similar to Fund Management Fees (FMEs) that are also charged as a percent of assets under management. However, these cash-value-based *insurance fees* are specific to the policy, and separate from and in addition to *investment fees*. The most common policy-specific cash-value-based fee is the M&E charge intended to cover the risks assumed by the insurance company that the actual cost of insurance charges and/or actual expense charges will be greater than expected. Some products can also include policy-specific cash-value-based fees in addition to the M&E, both of which can vary depending on the year of the policy (e.g., 1.00% of cash values during the first 10 policy years and 0.5% of cash values thereafter), and/or the amount of the cash value (e.g., 1.00% of cash values up to $25,000 and 0.5% of cash values above $25,000), and in either case, typically range from 0% to 100 bps (1.00%).

Q35 What Are Persistency and Lapses?

Persistency is a measure of how long a life insurance company's policies are staying in-force (active). This is an important consideration for life insurance companies and has an impact on them. Many policy owners fail to keep their policies in-force long enough to realize the intended benefits. Another word used for a policy that terminates is "lapse." Poor persistency is a perpetual problem for the life insurance industry. When policy owners terminate their coverage prematurely, this can result in a loss to the company, especially on permanent policies that have only been in-force for a short while. Regulators and rating agencies closely monitor company persistency. If a company has a high level of early lapses (the same as a low persistency rate), then there is a problem somewhere. Watch out if this is the case with a company you plan on applying to.

Q36 What Is Lapse Support?

Traditionally, a life insurance product will generate a series of annual gains in policy years after the first year. These gains are used to make up for the loss that the insurance company usually faces in the first year, when expenses are highest (mostly due to commissions, underwriting, and policy issue). It can take 10–20 years for a policy to break even.

Policyholders who lapse in the early years leave the company with unrecovered expenses. This is borne by the existing policyholders.

The technique to watch out for is the lapse support. A lapse-supported product involves shifting expenses between policy owners; however, in this case, the burden is shifted to those who lapse. This generates very large gains for the insurance company in the first ten to fifteen years (the policy's cash value remains artificially low) and very large losses thereafter (by increasing the policy's cash value by more than its interest earnings). Under this pattern, policyholders who lapse early will generate huge profits for the company. These profits are used to offset the losses that will occur when persisting policy holders reach the years when the policy "super performs." The net result is that lapsing policyholders subsidize persisting policyholders, making long-term performance look better for those who never lapse.

Some carriers use a pricing technique wherein the products are designed to recover the initial loss very quickly. This way the products are generally lapse insensitive. It does not matter when policy owners lapse the policy, in this situation.

These products can be identified by an illustration with very low early cash values (the cash surrender value in year 10 is less than the sum of premiums paid), and tremendous annual cash value growth in later years (the annual growth in cash value is consistently greater than what the life insurance company could reasonably earn on its investments, given the assumed policy credit rate).

Q37 Why Should I Watch out for Lapse-Supported Products?

- Additional Risk—The lapse support technique is based on a certain number of lapsing policyholders making contributions to a "pot." The funds in the pot will be distributed to a certain number of persisting policyholders in the later years. If the actual lapse rate is less than the assumption behind the illustration, there will be too few policyholders making contributions into the pot in the early years. There will also be many policyholders looking for distributions, from the pot, in the later years. The company would not be able to afford the illustrated super-performance in the later years.
- Short-term Product Performance—A lapse-supported product shows improved long-term performance only if short-term performance is impaired. If you happen to be one of the unfortunate policyholders who find they must lapse early, your surrender value will be very small, if any at all. And, even with a 3% annual lapse assumption, 46% of all policyholders will have lapsed by the end of the 20th year (ignoring mortality, i.e., dying and using the life insurance).
- Policyholder Service—A policyholder who buys a lapse-supported product will find himself in a strange position—the company will actually prefer that he lapse. This is not a comfortable thought when future dividends, policy enhancements, and other types of policy service are considered. A lapse-supported product creates a catch-22 situation. If the

> insurance company is correct and lapses do materialize at the assumed level, then clients who may have thought they would never lapse, will lapse—at a great cost. If, on the other hand, the clients are right and lapses rarely occur, the company will not be able to afford to live up to the illustration. Unfortunately, the only sure thing with a lapse-supported product is that short-term surrender values will be very low.

In a way, this is similar to gambling.

This is a brief overview of the factors that can affect the performance of a permanent life insurance policy. More detailed information will be featured in upcoming specific reports focusing on maintaining and monitoring specific types of policies. This overview is intended to give you a general idea of what might affect your policy. All of the factors previously discussed help determine the premium you pay for life insurance.

Q38 How Do These Factors Affect the Performance of a Permanent Life Insurance Policy?

This overview is intended to give you a general idea of how all of the factors previously discussed may affect your policy and how they are relevant to the actual premium you pay for life insurance. If you purchase permanent life insurance, the premiums you pay may fluctuate from year to year if any of these four factors change:

- Mortality experience improves or worsens
- Expenses grow or are reduced
- Interest credits rise or fall
- Persistency increases or decreases

Your premium outlay may potentially be reduced if:

- Interest rates rise
- Mortality experience improves
- Persistency is stable
- Expenses drop

Conversely, your premium outlay may potentially increase if:

- Interest rates decrease
- Mortality experience worsens

- Persistency is negative
- Expenses increase

Q39 What Are Some Other Considerations and Situations?

- The surrender charge is the difference between the accumulated value and the surrender value. Depending on the policy, this can be 100% for the first two to five years the policy is in-force, meaning that there would no be no cash value should the policy be surrendered during this period. The surrender charge gradually reduces according to a table included in the policy. Typically, the surrender charge reduces to zero sometime between the 10th and 15th anniversary of the policy.
- Some contracts provide for future benefit increases. It is important to know in advance whether or not such increases are subject to evidence of insurability. If the insured person's health deteriorates in the meantime, and evidence of insurability is required before a scheduled benefit increase occurs, this could present a problem.
- Some disability premium-waiver provisions waive premiums for the pure term cost of insurance, and some waive premiums for the level (permanent) cost. You should know what cost is waived on your policy.
- The mode of premium payment deserves careful consideration. Please see "Question 66: Is There a Difference in How Often I Pay My Premiums" for a full discussion and important information on this topic.
- Premium rating bands are ranges of coverage amount (e.g., $100,000 to $249,999, $250,000 to $500,000, etc.) in which the higher the amount of coverage, the lower the cost per thousand dollars of coverage.
- The annual policy fee ranges from $45 to $90 on the policies surveyed for this book. The policy fees are added on top of the rate per thousand of coverage face amount. As a matter of interest, agents generally do not like policy fees because they are usually excluded for the purpose of determining the agent's commission. The company usually retains 100% of the policy fee to offset expenses, and the agent's commission is not paid on the fee, only on the premium payment itself.

Q40 What Is a Universal Life Insurance Policy Illustration?

Over the last few questions we have discussed the various types of permanent (cash value) life insurance policies along with the various components. An illustration is a projection of how a policy will perform based on those components. With any type of policy, it would be impossible to cover every type of policy and every nuance of each type. An exhaustive review would require volumes of dense text. Keep in mind that there are similarities between coverage types among companies. For example, a universal life policy issued by company A will be similar—but not necessarily identical—to a universal life policy issued by company B, a five-year term will compare to another company's five-year term, and so on. All life insurance policies agree to pay an amount of money when you die. All policies are not the same. A wide variety of plans are available. Some provide permanent coverage and others temporary coverage. Some build up cash values and others do not. Some policies combine different kinds of insurance and others let you change from one kind of insurance to another.

Q41 Is There Any Way to Guarantee the Death Benefit on My Cash Value Life Insurance Policy?

An issue that has always caused concern with universal life (UL) is that the death benefit is not guaranteed for the life of the policy. Insurance companies are now starting to offer policies that continue past age 95/100 and up to age 120. Most insurance policies will terminate (mature) at age 95 or 100 and cash out at that time, leaving the insured to self-insure. This leaves the client with the cash value, which often is lower than the death benefit after years of paying premiums. This payment is also reported to the Internal Revenue Service, on a 1099 form for the amount of cash value, less the basis (typically the sum of premiums paid). This potentially widens the gap further between the cash value at that time and the death benefit of the policy.

A number of carriers are offering and/or deferring the maturity of a life insurance policy beyond age 100. There are two methods that are used—the death benefit guarantee and the no-lapse guarantee. With either method, carriers may charge nothing, expense costs only, or expense charges plus cost of

insurance. At this time, there are no actuarially calculated cost-of-insurance charges for ages greater than 100.

With secondary guarantee-supported universal life, the few carriers that offer the death-benefit extension, as opposed to the cash-value extension, provide an enormous consumer benefit. In the case of our 50-year old male again, his $12,607 premium purchased $1 million of death benefit with cash values in the guaranteed column that zero out at age 71. Cash value at age 100 is obviously still zero. A number of carriers provide a death-benefit extension, though, which supports the death benefit until death actually occurs.

> **No-Lapse Guarantee Clause—**Under a typical clause, the policy would be guaranteed to stay in-force for a number of years, as long as you have paid at least as much as the required premiums. This is called a no-lapse guarantee. Even though it contains the no-lapse guarantee, this policy may provide non-forfeiture benefits (such as cash surrender values) that are less than those that would be provided if the no-lapse guarantee were issued as a separate policy (for example, as a term policy). However, the premiums for the term policy might be higher than those for the no-lapse guarantee in this policy. When considering the purchase of this policy, you should consider the value to you of higher non-forfeiture benefits versus the level of the premiums required to keep your insurance coverage in-force.
>
> **Death Benefit Guarantee—**This is a guarantee that the policy will remain in effect, provided you pay sufficient premiums and you do not take loans. This guarantee will depend on such factors as the amount and timing of premiums paid and withdrawals taken, and changes made to the policy. The premiums shown on an illustration with the death benefit guarantee, which is based on the initial basic insurance amount, will guarantee the contract will remain in effect for the periods shown, if these premiums are paid exactly on the first day of each policy year and no loans or withdrawals are taken. These premium amounts can be affected by policy changes. The premiums for this option are usually not much higher than a policy without a death benefit guarantee.

Q42 Is There Any Oversight of Policy Illustrations?

Policy illustrations have been evolving over the last few years, with new regulations from the National Association of Insurance Commissioners. The following discusses what is being done by regulators in order to assist consumers by providing guidelines for life insurance companies and life insurance advisors. Prior to this regulation, there was a combination of lack of information provided by insurance companies to agents and agents to consumers. Agents were also allowed by the carriers, and by themselves, to provide their own "custom" illustrations that were misleading to consumers. When the National Association of Insurance Commissioners (NAIC) adopts a model regulation, it is up to each State Department of Insurance whether or not to adopt it. Therefore, you would have to check with the NAIC or your State Insurance Department (contact information can be found in Appendix A).

In December 1995, the National Association of Insurance Commissioners (NAIC) adopted the Life Insurance Illustrations Model Regulation #582. Up until this time, there was no oversight for ensuring that the presentation of illustrations was fair and appropriate. Various states have adopted this regulation with certain state-by-state modifications.

The Model Regulation's stated purpose is to provide rules for life insurance policy illustrations that will protect consumers and foster consumer education. Its goals are "to ensure that illustrations do not mislead purchasers of life insurance and to make illustrations more understandable."

The regulation creates standardized procedures that must be followed during the sale of all "life insurance policies except variable life insurance, individual and group annuity contracts, credit life insurance, and life insurance policies with no illustrated death benefits on any individual exceeding $10,000."

The Model Regulation sets standards for initial compliance and for annual reporting. It also sets forth rules for acceptable assumptions that underlie an illustration. Illustration defined: According to the Model Regulation, an illustration is any presentation or depiction that includes non-guaranteed elements of a policy of life insurance over a period of years. In other words, if it assumes an interest rate higher than the guaranteed rate and projects accumulated values based on the higher rate, it contains "non-guaranteed ele-

ments" and is therefore an illustration subject to the Model Regulation. An illustration is further defined as either a basic or supplemental illustration, as defined by the appropriate state's version of the NAIC Life Insurance Illustration Model Regulation.

- Basic Illustration—a ledger or proposal used in the sale of a life insurance policy that shows both guaranteed and non-guaranteed elements. A Basic Illustration must always accompany or precede any Supplemental Illustration. The Basic Illustration consists of the following components:
  - Narrative Summary—describes any policy features, riders, or options (guaranteed or non-guaranteed) shown in the Basic Illustration and the impact that they have on the benefits and values of the policy; in addition, defines the column headings and key terms used in the illustration.
  - Numeric Summary—summarizes death benefits, values, and premiums for three or four particular policy years using guaranteed, midpoint, and current assumptions; includes statements of understanding that must be signed by both the applicant and the agent.
  - Tabular Detail—shows death benefits, values, and premiums for all policy years until age 100, policy maturity, or final expiration.
- Revised Basic Illustration—an updated version of the Basic Illustration, which illustrates the policy as issued.
- Supplemental Illustration—an illustration furnished in addition to a Basic Illustration that may be presented in a format differing from the Basic Illustration, which can only depict the same underlying premiums and a scale of non-guaranteed elements that is not more favorable than these same components in the Basic Illustration. The regulation mandates specific footnotes that must be included in the Supplemental Illustration. The Supplemental Illustration gives the company more flexibility in explaining to the applicant or prospective applicant as to how its product works.

CAVEATS—WHAT AN AGENT CANNOT DO

The NAIC regulation clearly states that, during the sales process, an agent may not do any of the following. Doing so constitutes a violation of these regulations. If an agent violates any of these rules, you should immediately find another agent and, if necessary, contact your State's Insurance Department. When using an illustration in the sale of a life insurance policy, an insurer or its producers or other authorized representatives shall not:

- Represent the policy as anything other than a life insurance policy;
- Use or describe non-guaranteed elements in a manner that is misleading or has the capacity or tendency to mislead;
- State or imply that the payment or amount of non-guaranteed elements is guaranteed;
- Use an illustration that does not comply with the requirements of this regulation;
- Use an illustration that at any policy duration depicts policy performance more favorable to the policy owner than that produced by the illustrated scale of the insurer whose policy is being illustrated;
- Provide an applicant with an incomplete illustration;
- Represent in any way that premium payments will not be required for each year of the policy in order to maintain the illustrated death benefits, unless that is the fact;
- Use the term "vanish" or "vanishing premium," or a similar term that implies the policy becomes paid up, to describe a plan for using non-guaranteed elements to pay a portion of future premiums;
- Except for policies that can never develop nonforfeiture values, use an illustration that is "lapse-supported"; or
- Use an illustration that is not "self-supporting."

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CHAPTER 4

HOW TO CHOOSE A LIFE INSURANCE COMPANY

Q43 Where Do I Start in Choosing a Life Insurance Company?

Choosing a life insurance company is an essential and challenging part of the process. More than 750 life insurance companies offer thousands of life insurance products to residents of the United States. Choosing the right company and right product from this bewildering array is a challenging task. Fortunately, there are some common-sense guidelines that will help you narrow the field to a more manageable selection of companies and products. Let's cover briefly how to evaluate a life insurance company from a financial perspective.

If you think you might need your insurance coverage for more than ten or fifteen years, it is imperative that you choose your insurance carriers carefully and continue to monitor those companies on a regular basis. While no one can accurately predict a company's viability twenty, thirty, or forty years down

the line, you should do everything you can to avoid the time and expense of watching your carrier struggle through receivership and sale.

While those who are making a substantial commitment to invest in a large portfolio may want to consider the services of an insurance analyst or independent consultant, a growing number of consumers are turning to the Internet for their information. Many "net-savvy" consumers are pros when it comes to looking up and analyzing financial data on stocks, bonds, and mutual funds. Performing insurance company due diligence, however, presents a new challenge. Fortunately, many of the leading sources of information have recently made their ratings and "analysis" available to the public online and almost all of it is free. Most likely this will change as the rating services will view this as an income stream.

Don't get caught in the trap of simply comparing two companies and choosing the better one. Instead, hold each company up to a predetermined set of benchmarks. If an insurance agent wants to sell a particular company or product, it is not uncommon for the agent to offer two or three alternatives that look worse than the one the agent wants to sell.

Finally, don't assume that it costs more to purchase insurance from a top-rated company. Remember, product illustrations are poor indicators of how a policy will perform. Since insurance companies generally have comparable expenses, reserve requirements, and overall investment strategies, buying from the best does not necessarily result in higher premiums.

Q44 What Are the Differences Between a Mutual Insurance Company and a Stock Insurance Company?

A life insurance company is typically organized as either a mutual company or a stock company.

A Mutual Life Insurance Company is organized and incorporated under a state's laws and has no stockholders. The policy owner is the customer and, in effect, an owner. A portion of surplus earnings may return to policyholders in the form of dividends.

Stock Life Insurance Company: A life insurance company owned by stockholders who elect a board to direct the company's management. Stock

companies, in general, issue nonparticipating insurance, but may also issue participating insurance. The policy owner is a customer only.

Many insurance companies have demutualized over the years. Demutualization is the process of changing the legal structure of an insurance company from a mutual form of ownership to a stock form of ownership.

A main difference is in how the companies raise money and manage investments. Mutual insurance companies raise funds by issuing debt or borrowing from policyholders. The debt must be repaid from operating profits. Operating profits are also needed to help fund future growth, maintain future debt reserves, offset ratios or premiums, and maintain industry ratings. Stock companies have greater flexibility and more funding channels. They can raise funds by selling debt and issuing additional stocks.

Q45 What Is a Rating?

When selecting or evaluating a life insurance company, a logical place to begin is by reviewing the ratings given by the five major insurance company rating services. In a rating, the rating company or agency expresses its opinion of the life insurance company's financial soundness and creditworthiness. In some cases, the life insurance company will ask one or more rating companies for an evaluation and rating, and the company will then pay a fee ($25,000 to $30,000 is common) to the rating agency. Generally speaking, this fee does not compromise the rating because rating companies are extremely protective of their reputation for objectivity. Without public credibility, a rating is useless, so rating companies strive to maintain their credibility.

Q46 Who Are the Rating Agencies?

Four firms currently rate insurance companies. They are AM Best Company, Standard and Poor's Corporation, Moody's Investors Service, and Fitch Ratings. Each firm employs its own rating system, and some rating agencies are considered to be more stringent than others.

Not all insurance companies are rated by each agency. Each agency employs its own techniques for determining a given insurance company's rating. Areas of consideration may vary and these include financial leverage, management stability, recent performance, and the rated company's overall

financial situation. External factors like competition, diversification, and market presence may also be considered.

Each rating agency provides a description of its analysis and defines the meaning of each rating from the highest to the lowest. Since there are differences between rating agencies, this can make a fair comparison between different ratings somewhat confusing. Information on how to contact each rating service will be found below (including some useful links). The chart at the end of this report compares the ratings given by each agency. To obtain the latest ratings, please check with the appropriate rating service.

The following summary describes each rating service and the rating criteria used, along with a brief explanation of how insurance companies initiate the rating process. It is important to keep in mind that these criteria may change.

Third Party Ratings and Financial Data

There are four major rating firms that analyze life insurance companies on a regular basis, and they offer their ratings and analysis online. As a rule of thumb, only companies that have received one of the top ratings from at least three independent rating companies should be considered. A summary of the four major rating services follows:

- **AM Best Company**—has the most experience rating insurance companies, having been in the business since 1906. A Best's Financial Strength Rating (FSR) is an independent opinion of an insurer's financial strength and ability to meet its ongoing insurance policy and contract obligations. An FSR is not assigned to specific insurance policies or contracts and does not address any other risk, including, but not limited to, an insurer's claims-payment policies or procedures; the ability of the insurer to dispute or deny claims payment on grounds of misrepresentation or fraud; or any specific liability contractually borne by the policy or contract holder. An FSR is not a recommendation to purchase, hold, or terminate any insurance policy, contract, or any other financial obligation issued by an insurer, nor does it address the suitability of any particular policy or contract for a specific purpose or purchaser. In addition, an FSR may be displayed with a rating identifier, modifier, or affiliation code that denotes a unique aspect of the opinion.

You can view the latest Best Ratings and Best Company Reports (which include Best's Ratings) by visiting the AM Best Web site at www.ambest.com. Enter the name of the insurance company under "rating services," then click Go. Registration is required (free). In addition to providing you with an up-to-date financial strength rating, you will find the following: 1) the financial strength rating, 2) outlook, 3) the company address, website, and phone number, 4) the age of the company, 5) the ultimate parent company, 6) the financial size category, and 7) financial strength rating history. In addition to this free data, AM Best offers an in-depth credit report and financial report (for purchase). Unless you're proficient at interpreting insurance company financials, this report may prove rather overwhelming.

- **Fitch's Insurer Financial Strength Ratings—**provide ratings for those insurers who request a rating. Therefore, ratings are not available for all insurance companies. Fitch Ratings uses different criteria for developing its ratings of insurance companies. Some of the determining factors include management style, economic trends, and the historical performance of an insurance company. It also uses data gathered from insurance companies, underwriters, and public financial reports. The ratings measure credit quality and a company's ability to repay its debts. The insurance marketplace is unpredictable, and an insurance company's ratings can change from one year to the next.

  For the latest Fitch Ratings, visit the Fitch Web site at www.fitchratings.com. Enter the name of the insurance company in the search bar on the home page. In addition, you'll find useful insights on the company.
- **Moody's Investor's Services—**provide ratings for those insurers who request a rating. Therefore, ratings are not available for all insurance companies. Moody's Insurance Financial Strength Ratings are opinions of the ability of insurance companies to repay punctually senior policyholder claims and obligations. Specific obligations are considered unrated unless they are individually rated, because the standing of a particular insurance obligation would depend on an assessment of its relative standing under those laws governing both the obligation and the insurance company.

For the latest Moody's Rating, visit the company's Web site at www.moodys.com. Enter the name of the insurance company in the search bar on the home page. In addition, you'll find useful insights on the company.

- **Standard & Poor's Insurer Financial Strength Rating**—is a forward-looking opinion of the financial security characteristics of an insurance organization with respect to its ability to pay under its insurance policies and contracts in accordance with their terms. This opinion is not specific to any particular policy or contract, nor does it address the suitability of a particular policy or contract for a specific purpose or purchaser. Furthermore, the opinion does not take into account deductibles, surrender or cancellation penalties, timeliness of payment, nor the likelihood of the use of a defense such as fraud to deny claims.

  Insurer Financial Strength Ratings do not refer to an organization's ability to meet non-policy (i.e., debt) obligations. Assignment of ratings to debt issued by insurers or to debt issues that are fully or partially supported by insurance policies, contracts, or guarantees is a separate process from the determination of insurer financial strength ratings, and it follows procedures consistent with those used to assign an issue credit rating.

  Insurer Financial Strength Ratings are based on information furnished by rated organizations or obtained by Standard & Poor's from other sources it considers reliable. Standard & Poor's does not perform an audit in connection with any rating and may on occasion rely on unaudited financial information. Ratings may be changed, suspended, or withdrawn as a result of changes in, or unavailability of, such information or based on other circumstances.

  An Insurer Financial Strength Rating is not a recommendation to purchase or discontinue any policy or contract issued by an insurer or to buy, hold, or sell any security issued by an insurer.

  For the latest Standard and Poor's Ratings, visit the agency's Web site at www.standardandpoors.com. To access the Insurer Financial Strength Rating, enter the name of the insurance company in the box under S&P Global Rating, then click Find. Registration is required

(free). Standard & Poor's only publishes the financial strength rating and their credit watch outlook.

The Web site addresses given here are the main home pages for each rating service. It can sometimes be a challenge to find the page on each site; however, keep looking, as the information is there. At the time of the writing of this book, you do need to establish a free account for some of these services.

Q47 How Do I Compare the Ratings from Each of the Four Major Rating Services on a Relative Basis?

Here is a table that does so:

Rank	AM Best	Fitch Ratings	Moody's	Standard & Poor's
1	A++ (Superior)	AAA (Exceptionally Strong)	Aaa (Exceptional)	AAA (Extremely Strong)
2	A+ (Superior)	AA (Very Strong)	Aa (Excellent)	AA (Very Strong)
3	A (Excellent)	A (Strong)	A (Good)	A (Strong)
4	A- (Excellent)	BBB (Adequate)	Baa (Adequate)	BBB (Good)
5	B++ (Good)	BB (Moderately Weak)	Ba (Questionable)	BB (Marginal)
6	B+ (Good)	B (Significantly Weak)	B (Poor)	B (Weak)
7	B (Fair)	CCC	Caa (Very Poor)	CCC (Very Weak)
8	B- (Fair)	CC	Ca (Extremely Poor)	CC (Extremely Weak)
9	C++ (Marginal)	C	C	SD (Selective Default)
10	C+ (Marginal)	D (Default)		D (Default)
11	C (Weak)			
12	C- (Weak)			
13	D (Poor)			
14	E (Under Regulatory Supervision)			
15	F (In Liquidation)			
16	S (Rating Suspended)			

Ratings are useful, but a rating is not a guaranty of an insurer's financial strength or security. These tools are not always foolproof with regard to a specific company. Selecting an insurance company is an exercise in common sense. It is a task requiring research and an understanding of the rating systems and various financial measures. Once you have selected an insurance company, you should continue to monitor the company, because financial data and ratings change.

Q48 What Are the Definitions for Each Rating?

These were current as of the time of the writing of this book.

AM Best Company

Secure Best's Ratings:

A++ and A+ (Superior)—Assigned to companies that have, in our opinion, a superior ability to meet their ongoing obligations to policyholders.

A and A- (Excellent)—Assigned to companies that have, in our opinion, an excellent ability to meet their ongoing obligations to policyholders.

B++ and B+ (Good)—Assigned to companies that have, in our opinion, a good ability to meet their ongoing obligations to policyholders.

Vulnerable Best's Ratings:

B and B- (Fair)—Assigned to companies that have, in our opinion, a fair ability to meet their current obligations to policyholders, but are financially vulnerable to adverse changes in underwriting and economic conditions.

C++ and C+ (Marginal)—Assigned to companies that have, in our opinion, a marginal ability to meet their current obligations to policyholders, but are financially vulnerable to adverse changes in underwriting and economic conditions.

C and C- (Weak)—Assigned to companies that have, in our opinion, a weak ability to meet their current obligations to policyholders, but are financially very vulnerable to adverse changes in underwriting and economic conditions.

D (Poor)—Assigned to companies that, in our opinion, may not have an ability to meet their current obligations to policyholders and are financially extremely vulnerable to adverse changes in underwriting and economic conditions.

E (Under Regulatory Supervision)—Assigned to companies (and possibly their subsidiaries/affiliates) that have been placed by an insurance regulatory authority under a significant form of supervision, control, or restraint, whereby they are no longer allowed to conduct normal ongoing insurance operations. This would include conservatorship or rehabilitation, but does not include liquidation. It may also be assigned to companies issued cease-and-desist orders by regulators outside their home state or country.

F (In Liquidation)—Assigned to companies that have been placed under an order of liquidation by a court of law or whose owners have voluntarily agreed to liquidate the company. Note: Companies that voluntarily liquidate or dissolve their charters are generally not insolvent.

S (Rating Suspended)—Assigned to rated companies that have experienced sudden and significant events affecting their balance-sheet strength or operating performance and whose rating implications cannot be evaluated due to a lack of timely or adequate information.

Not Rated Categories (NR):

NR: Status assigned to insurance companies that are not rated; may include previously rated insurance companies or insurance companies that have never been rated by AM Best.

Rating Modifiers and Affiliation Codes:

Each Best's Financial Strength Rating Category from "A+" to "C" includes a Rating Notch to reflect a gradation of financial strength

within the category. A Rating Notch is expressed with either a second plus "+" or a minus "-."

Fitch Rating Services

Insurance Financial Strength Ratings:

AAA (Exceptional): This is the highest rating assigned by Fitch. Companies with this rating have the strongest ability to meet financial and policyholder obligations. These organizations will most likely not be affected adversely by economic conditions.

AA (Very Strong): Companies are expected to perform well and continue to meet financial obligations. Also, these companies will likely not be affected adversely by economic conditions.

A (Strong): Companies rated "A Strong" are expected to perform well and meet all financial obligations, although they may be more likely to succumb to an economic downturn and market condition than the insurance companies of a higher rating.

BBB (Adequate): This rating indicates insurance companies that are currently meeting all policyholder and financial obligations but could be impacted by negative economic conditions.

BB (Moderately Weak): Moderately weak companies are vulnerable, and changes in the market could make them unable to meet financial obligations. These companies may have alternatives that allow them to improve their financial condition.

B (Significantly Weak): These companies have a strong chance of not being able to meet financial obligations but still have a chance to recover financially.

CCC: These companies have a strong possibility of not being able to meet financial obligations. Such companies have an average chance of recovering.

CC: A "CC" rating indicates that an insurance company is likely to be unable to meet financial obligations or pay claims to its policyholders. There is a below-average chance for recovery for these insurance companies.

C: A distressed rating shows the financial instability is imminent with a strong possibility of not being able to meet financial obligations. Recovery chances are poor.

D (Default): A default rating shows the company is in the process of bankruptcy and/or ceasing business operations.

Notes: "+" or "-" are used with a rating symbol to indicate the relative position of a credit within the rating category. They are not used for the "AAA" category or for ratings below the "CCC" category.

Moody's

Long-Term Insurance Financial Strength Ratings:

Moody's rating symbols for Insurance Financial Strength Ratings are identical to those used to indicate the credit quality of long-term obligations. These rating gradations provide investors with a system for measuring an insurance company's ability to meet its senior policyholder claims and obligations.

Aaa: Insurance companies rated Aaa offer exceptional financial security. While the credit profile of these companies is likely to change, such changes as can be visualized are most unlikely to impair their fundamentally strong position.

Aa: Insurance companies rated Aa offer excellent financial security. Together with the Aaa group, they constitute what are generally known as high-grade companies. They are rated lower than Aaa companies because long-term risks appear somewhat larger.

A: Insurance companies rated A offer good financial security. However, elements may be present that suggest a susceptibility to impairment sometime in the future.

Baa: Insurance companies rated Baa offer adequate financial security. However, certain protective elements may be lacking or may be characteristically unreliable over any great length of time.

Ba: Insurance companies rated Ba offer questionable financial security. Often the ability of these companies to meet policyholder obligations may be very moderate and thereby not well safeguarded in the future.

B: Insurance companies rated B offer poor financial security. Assurance of punctual payment of policyholder obligations over any long period of time is small.

Caa: Insurance companies rated Caa offer very poor financial security. They may be in default on their policyholder obligations or there may be present elements of danger with respect to punctual payment of policyholder obligations and claims.

Ca: Insurance companies rated Ca offer extremely poor financial security. Such companies are often in default on their policyholder obligations or have other marked shortcomings.

C: Insurance companies rated C are the lowest-rated class of insurance company and can be regarded as having extremely poor prospects of ever offering financial security.

Note: Moody's appends numerical modifiers 1, 2, and 3 to each generic rating classification from Aa through Caa. Numeric modifiers are used to refer to the ranking within a group with 1 being the highest and 3 being the lowest. However, the financial strength of companies within a generic rating symbol (Aa, for example) is broadly the same.

Standard & Poor’s

Insurer Financial Strength Ratings:

AAA: An insurer rated AAA has EXTREMELY STRONG financial security characteristics. AAA is the highest Insurer Financial Strength Rating assigned by Standard & Poor’s.

AA: An insurer rated AA has VERY STRONG financial security characteristics, differing only slightly from those rated higher.

A: An insurer rated A has STRONG financial security characteristics, but is somewhat more likely to be affected by adverse business conditions than are insurers with higher ratings.

BBB: An insurer rated BBB has GOOD financial security characteristics, but is more likely to be affected by adverse business conditions than are higher rated insurers.

Note: An insurer rated BB or lower is regarded as having vulnerable characteristics that may outweigh its strengths. BB indicates the least degree of vulnerability within the range; CC the highest.

BB: An insurer rated BB has MARGINAL financial security characteristics. Positive attributes exist, but adverse business conditions could lead to insufficient ability to meet financial commitments.

B: An insurer rated B has WEAK financial security characteristics. Adverse business conditions will likely impair its ability to meet financial commitments.

CCC: An insurer rated CCC has VERY WEAK financial security characteristics, and is dependent on favorable business conditions to meet financial commitments.

CC: An insurer rated CC has EXTREMELY WEAK financial security characteristics and is likely not to meet some of its financial commitments.

SD or D: An insurer rated SD (selective default) or D is in default on one or more of its insurance policy obligations. The D rating also will be used upon the filing of a bankruptcy petition or the taking of similar action if payments on a policy obligation are at risk. A D rating is assigned when S&P Global Ratings believes that the default will be a general default and that the obligor will fail to pay substantially all of its obligations in full in accordance with the policy terms. An SD rating is assigned when S&P Global Ratings believes that the insurer has selectively defaulted on a specific class of policies but will continue to meet its payment obligations on other classes of obligations. An

SD includes the completion of a distressed debt restructuring. Claim denials due to lack of coverage or other legally permitted defenses are not considered defaults.

NR: An insurer designated NR is NOT RATED, which implies no opinion about the insurer's financial security.

Plus (+) or minus (-) signs following ratings from AA to CCC show relative standing within the major rating categories.

Q49 What Would Be of Assistance in a Financial Analysis?

Financial considerations play varying roles in the comparative tools used by the various rating agencies we've discussed over the last few questions. These financial considerations can usually, but not always, be analyzed on a relative basis between carriers and the industry as a whole. Please keep in mind that individual circumstances vary among companies such as size, etc. These are some of the factors you might want to review, but you should keep in mind that there are many more. These factors are provided for those who are comfortable with financial analyses. If you are not comfortable or do not understand these factors, then you should not use them, as they will cause more harm than good.

Asset Analysis

- Total admitted assets: Total assets reported including separate accounts.
- Total liabilities: Funds required for payment of future claims and expenses, including Asset Valuation Reserve (AVR).
- Separate accounts: Assets dedicated and matched to specific liabilities, such as variable life insurance policies.
- Total surplus and AVR: Total capital, surplus, and AVR. AVR is the reserve for potential losses in invested assets.
- Surplus and AVR as percent of general account assets: Total surplus and AVR as a percent of general account assets. Higher numbers represent greater protection for the policyholder.
- Invested assets: Total assets under investment.
- Distribution of invested assets: The percentage of each category of investments to the total invested assets.

- Net yield on mean invested assets: Net investment income divided by the average of the current and prior year's invested assets.
- Asset growth: 1-year and 3-year compound growth for total admitted assets and total surplus and AVR.

Asset Quality Analysis

- Non-investment grade bonds (Class 3-6): The NAIC divides bonds into six categories. Classes 1 and 2 are considered investment grade, classes 3 through 6 are below investment grade.
- Non-investment grade bonds/total bonds: The sum of bonds in classes 3 through 6 divided by total bonds.
- Non-investment grade bonds/surplus and AVR: The sum of bonds in classes 3 through 6 divided by surplus and AVR.
- Non-performing bonds/total bonds: Class 6 bonds are "in or near default." This is the percentage of the bond portfolio that is considered non-performing.
- Non-performing bonds/surplus and AVR: Class 6 bonds divided by surplus and AVR.
- Non-performing mortgages and real estate/total mortgages and real estate: This is the percentage of the mortgage and real estate portfolio that is considered non-performing. This includes mortgages that are 90 days overdue or in foreclosure and real estate acquired through foreclosure.
- Non-performing mortgages and real estate/surplus and AVR: Mortgages 90 days overdue or in foreclosure and foreclosed real estate divided by surplus and AVR.
- Non-performing assets/surplus and AVR: Bonds in or near default (Class 6), mortgages 90 days overdue or in foreclosure, and real estate acquired by foreclosure are each presented as a percent of surplus and AVR.
- Total non-performing assets/surplus and AVR: Total non-performing bonds, mortgages, and real estate as a percent of surplus and AVR, and then as a percentage of invested assets.

Bond Portfolio Analysis

- Total bonds book and market value: The total book value and market value of bonds, and the ratio of market value to book value.
- Bond quality distribution: The percentage of bonds in each of the six NAIC classes.
- Weighted bond class: Indicates the average NAIC class for each dollar invested in bonds.
- Bond maturity distribution: The distribution of bonds by number of years to maturity.
- Weighted bond maturity: Indicates the average number of years to maturity for each dollar invested in bonds.

Operating Income Analysis

- Total income: Total income from all sources.
- Total general expenses: Total general expenses incurred. This includes investment expenses.
- Total general expenses/total income: Total general expenses as a percent of total income.
- Earnings before policy dividends and taxes: Net gain from operations before policy dividends and federal income taxes.
- Policy dividends: Amount paid out as policy dividends, and as a percent of earnings.
- Pretax earnings from operations: Net gain from operations after policy dividends and before federal income taxes.
- Federal income taxes: Amount paid in federal income tax, and as a percent of pretax earnings.
- Net earnings from operations: Earnings before policy dividends and taxes minus policy dividends and federal income taxes.
- Net realized capital gains: The total capital gain (or loss) on assets sold during the year.
- Net income: net earnings plus net realized capital gains.
- Net income as percent of admitted assets: Net income divided by total admitted assets.

- Unrealized capital gains: The total capital gain (or loss) on assets that remain in the investment portfolio.

Premium Growth

- Premium growth: 1-year and 3-year compound growth for total premium income (premiums and annuity considerations only) and ordinary life premium.

Profitability

- Return on assets: Net earnings from operations divided by the prior year's invested assets.
- Return on equity: net earnings from operations divided by the prior year's capital and surplus.
- Lapse ratio: The percentage of ordinary life policies that lapsed during the year and the average for three years.
- Interest margin: Net investment income and required interest are as reported. The interest margin is the net investment.
- Income less required interest as a percent of required interest.
- Ordinary life expenses/premiums: Ordinary life insurance expenses as a percent of ordinary life premiums.
- Total general expenses/total income: Total general expenses as a percent of total income.
- Commissions and general expenses/total income: Commissions and total general expenses as a percent of total income.

Analysis of Face Amount of Insurance

- Total insurance in-force: Total face amount of insurance in-force.
- In-force distribution: Each category (ordinary, group, and other) is presented as a percent of the total amount in-force.
- Total reinsurance ceded: Total face amount of insurance ceded to reinsurers.
- Percent of in-force ceded: Each category (ordinary, group, and other) is presented as a percent of the total face amount of insurance in-force in that category.

- Average policy size: The number of ordinary life policies and the average policy size for total in-force and new policies issued.

Analysis by Line of Business

- Net premiums written: Total premium and annuity considerations plus deposit-type funds.
- Distribution: Each category is presented as a percent of the net premium income.
- Net earnings from operations: Net earnings after dividends and taxes.
- Distribution: Each category is presented as a percent of the net gain from operations.

  (The financial definitions and ratios for this question are based from those used by LifeLink Vitalsigns Software.)

Q50 Who is IRIS (Insurance Regulatory Information Reports)?

Another useful resource are the Insurance Regulatory Information (IRIS) reports issued by the National Association of Insurance Commissioners (NAIC). IRIS reports are comprehensive analyses of the financial status of life insurance companies. The NAIC routes its IRIS reports to the various state insurance commissioners. The IRIS testing process has been used since 1972 to help insurance regulators evaluate the financial condition of insurance companies that they regulate. More than 5,000 companies file their financial statements with the NAIC each year. The IRIS financial ratios serve as an early warning system to spot troubled companies. Ratios measuring such things as profitability, solvency, and liquidity are analyzed in detail. Poorly performing companies are recommended for immediate regulatory action, while others are recommended for less urgent ("targeted") regulatory action. A booklet with more information about IRIS is available on the NAIC Web site at www.naic.org.

There are currently twelve IRIS ratios calculated for life and health companies. The basis for each ratio is reviewed annually to ensure its currency and continued relevance for solvency monitoring. The ratios are revised as

necessary. There is a "usual range of results" that is used as a starting point. The ratios and trends are valuable in identifying companies likely to experience financial difficulties. They are not in themselves indicative of adverse financial condition. The ratios and range comparisons are computer generated.

The IRIS report is available to the public and can be ordered from the NAIC on their Web site. This report lists ratio results for each filing company and includes industry mean and median ("average" and "typical") ratios for comparison. A narrative explanation of each of the ratio formulas, benchmarks, and worksheets is also included.

A useful explanation of the IRIS system is found in the NAIC report. The ratios are grouped into four categories. These include Overall Ratios (ratios numbered 1, 2, and 3), Investment Ratios (4, 5, 6, and 7), Surplus Relief Ratio (8), and Changes in Operation Ratios (9, 10, 11, and 12). The individual ratios are:

Ratio 1: Net change in capital and surplus
Ratio 2: Gross change in capital and surplus
Ratio 3: Net income to total income (including realized capital gains and losses)
Ratio 4: Adequacy of investment income
Ratio 5: Non-admitted to admitted assets
Ratio 6: Total real estate and total mortgage loans to cash and invested assets
Ratio 7: Total affiliated investments to capital and surplus
Ratio 8: Surplus relief
Ratio 9: Change in premium
Ratio 10: Change in product mix
Ratio 11: Change in asset mix
Ratio 12: Change in reserving ratio

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Q51 What Is the Risk Based Capital System?

This is a system used currently only by the State Insurance Regulators, and it is hoped that it will be available to the public soon. It is in the book for the purpose of showing the tool used by insurance commissioners in determining whether or not to act with an insurance company that may be or is at risk.

In 1992, the NAIC developed yet another standard—Risk Based Capital, or RBC for short. RBC was designed as a means of gauging the appropriate minimum amount of capital for a given life insurance company. It was designed to identify inadequately capitalized life and health companies. RBC was intended to provide a uniformly applied guideline for regulatory intervention and to enable regulators to take specific action before a company becomes insolvent.

Risk Based Capital is the amount of capital (assets minus liabilities) deemed to provide a minimum financial cushion in light of a company's size and risk profile. It is calculated by applying factors to various asset, premium, and reserve items found in the company's Annual Statement. The Annual Statement is a voluminous document that each company must file with every state insurance department in which the company has a certificate of authority to do business. RBC factors are higher for items with greater underlying risk and lower for less risky items. For example, some lines of coverage are considered riskier than others, and RBC takes the relative risk into consideration.

The company's calculated RBC is compared to actual capital. RBC is not meant to be a measure of the appropriate amount of capital, but rather the minimum amount with which state insurance regulators feel comfortable.

The RBC standard measures three primary risks—Asset Risk, Underwriting Risk, and Other Risk.

The RBC system is a spectrum or continuum of increasingly stringent regulatory responses for companies that trigger one of the following RBC action levels:

1. Company Action Level: At this RBC level the insurer must submit to the insurance commissioner a comprehensive financial plan. The plan must identify the conditions contributing to the company's financial condition, contain proposals to correct the company's financial problems, and provide projections of the company's financial condition both with and without the proposed corrections.
2. Regulatory Action Level: In addition to requiring the insurer to submit a comprehensive financial plan, the insurance commissioner performs any examinations or analysis of the insurer's business and

operations that are deemed necessary and issues any appropriate corrective orders to address the company's financial problems.

3. Authorized Control Level: In addition, the commissioner may place the insurer under regulatory control.
4. Mandatory Control Level: The insurance commissioner is required to place the insurer under regulatory control.

There are differences in the makeup of Risk Based Capital by asset size. This reinforces the difficulty of making meaningful comparisons between an individual insurer's RBC results and those of the industry. The NAIC stresses that the RBC system is unsuitable for making qualitative comparisons between insurers. Its purpose is to identify undercapitalized companies only, and RBC does not address quality of capital or other related issues. Because of the risk that RBC ratios will be misinterpreted by the general public, they are not released to the general public. In fact, release of RBC data to the public is specifically prohibited. RBC ratings are designed for use by State Insurance Commissioners and affected companies only. Limited information about RBC can be found on the NAIC Web site: https://content.naic.org/cipr_topics/topic_riskbased_capital.htm.

Q52 Are the Carriers Held to any Ethical Standard?

Every carrier does adhere to its own ethical practices as well as to basic guidelines dictated by the Department of Insurance in its state. A list of each state's insurance departments contact information can be found in Appendix A. The Insurance Marketplace Standards Association (IMSA) was formed to promote high ethical standards in the sale and service of individually sold life insurance, annuity, and long-term care products. IMSA member companies are insurers who have agreed to adopt and abide by IMSA's Principles and Code of Ethical Market Conduct in order to earn your trust and gain your confidence.

The Insurance Marketplace Standards Association (IMSA) was created in 1996 in response to a crisis of damaged consumer trust and confidence in the insurance industry. An independent, nonprofit organization, IMSA had more than 200 voluntary members that led the insurance industry in promoting high ethical standards in the sale of individual life insurance, long-term

care insurance, and annuity products. The organization has been superseded by the formation of the Compliance & Ethics Forum for Life Insurers (CEFLI), which can be found online at www.cefli.org.

Here's CEFLI's description from their Web site:

> CEFLI has become a well-recognized industry leader in education and training in life insurance compliance and ethics. CEFLI offers a range of professional training and development opportunities for life insurance compliance and ethics professionals to connect with their peers to discuss various compliance and ethics strategies. CEFLI offers a variety of opportunities to build professional expertise including in-person events such as our Annual Conference, Compliance Fundamentals Training Conference, and Summit Meetings, as well as virtual and online events including Webinars, Benchmarking Surveys, Quick Polls, Web site Resources, Leadership Development Forums, Committees, and other topical Forums to explore current compliance challenges. CEFLI also provides other services to life insurance compliance professionals including its Clearinghouse to obtain compliance certifications.[2]

Unfortunately, CEFLI discontinued IMSA's Principles and Code of Ethical Market Conduct.

Q53 How Do I Find Out About Any Complaints Filed Against My Insurance Company or File My Own Complaint?

Each State Department of Insurance maintains data on the number of complaints filed against an insurance company, as well as pending class action lawsuits. To find your State Department of Insurance, go to the National Association of Insurance Commissioner's (NAIC) Web site—www.naic.org—or Appendix A. Your State Department of Insurance is also where you

2. This language is reprinted from CEFLI's website, all rights reserved. CEFLI's activities are designed solely to provide a forum for the expression of various points of view on compliance and ethics-related topics in the life insurance industry.

can file a complaint if you feel you have gone through your other resources, such as trying to work with your life insurance company, or if there is some reason why you cannot approach them. Other options are many depending on your state, your research, and any other factors. An attorney is always an option if the situation warrants it and the amount at stake exceeds the fees.

Q54 So, What Is the Best Way to Select An Insurance Company?

Ratings are useful, but a rating is not a guaranty of an insurer's financial strength or security. These tools are not always foolproof with regard to a specific company. Selecting an insurance company is an exercise in common sense. It is a task requiring research and an understanding of the rating systems, as well as various financial measures. Once you have selected an insurance company, you should continue to monitor the company, because financial data and ratings change.

Q&A

CHAPTER 5

FINDING A LIFE INSURANCE AGENT

Q55 How Do I Find a Life Insurance Advisor?

Life insurance has traditionally been sold and serviced by a traditional life insurance agent. Over the last few years, this has changed. There are very few traditional life insurance agents who only sell life insurance and other related insurance products. Almost all are now called by such descriptions as financial advisors, financial consultants, and financial planners. The advisors who traditionally had those titles have now expanded more significantly into life insurance. CPAs, also, are now in the life insurance sales business. It has become very difficult to evaluate a life insurance advisor. As with any area, receiving good advice is crucial. The following are some issues to keep in mind.

The agent system has also changed; historically, almost all agents were what are called "captive." This means that they only sold products for the company with which they were affiliated. Today, there are still quite a few "captive agents"; however, the majority are brokers who represent multiple carriers. Some "captive" agents can sell other companies' products; however,

some can only sell their own products. This is important to find out and be aware of. An advisor should represent multiple companies. If they only represent one company they can only offer you that company's products—not necessarily the best products in the marketplace. If your only tool is a hammer, every problem is a nail. This is one more reason for you to shop around.

Use an Advisor Referral Service, though most will provide less than optimal results. The following two services are a good place to start:

1. The American College of Financial Services referral service. The American College grants many financial professional designations including the Chartered Life Underwriter (CLU) designation. A financial professional with the CLU designation possesses expert knowledge in finding the best life insurance solutions for your unique needs. I strongly recommend that you engage someone with the CLU designation, if possible. This service can be found at: https://www.youradvisorguide.com.
2. The National Association of Financial Advisors (NAIFA) offers a referral service. NAIFA members are licensed professionals who work with clients to identify financial needs and provide products and services to secure their future. NAIFA members subscribe to a Code of Ethics. Most NAIFA members hold the CLU designation. This service can be found at: https://security.naifa.org.

Q56 What Are the Regulatory Resources for Researching a Life Insurance Advisor?

Any person selling life insurance (and/or annuities) must be licensed with their State Department of Insurance. Contact information for State Departments of Insurance is located in Appendix A.

With insurance departments, the resources and compliance can sometimes be more lax in some states than others. On most insurance departments' Web sites, you can research whether or not an insurance representative is licensed. The representative has to be licensed in the state where the insured either works or lives. You can also see on some Web sites, their history of

continuing education. As with any field, a practitioner who is up to date on the latest techniques is most likely more proficient.

With Variable Products, they are also overseen by the FINRA (Financial Industry Regulatory Authority—www.finra.org), whom is generally tougher with the representatives that they oversee. On the FINRA Web site, you can research whether or not an insurance representative is licensed. With variable insurance products representatives have to be licensed with both the FINRA and the state insurance department.

The FINRA also maintains the qualification, employment, and disclosure histories of the more than half a million registered securities employees of member firms. For an overview of all the current services that the FINRA provides to investors, you may go directly to http://www.finra.org/Investors/index.htm. The list of services is lengthy.

Q57 What Else Do I Need to Know About My Insurance Advisor?

In addition to their record with their state insurance department, the NAIC and FINRA (if applicable), review the following:

- How long have they been a life insurance advisor?
- What percentage of their practice is life insurance?
- The advisor should gather and discuss your basic personal financial information, such as income, assets, and debt (see Question 3 "How Much Life Insurance Do I Need" for more information). Discuss goals and needs. There is a difference. Needs are necessities and required. Goals are what you would like to have. Sometimes a middle ground will be necessitated due to cost (premiums) and reality. Other sections in this book can help you understand the various issues at play.
- Everything should be in writing. This includes all proposals, illustrations, and any other supporting marketing and advertising material.
- That if they don't know something, they admit it. Either they volunteer to research it themselves or suggest you find a specialist for that area.

- They keep up to date on your life insurance portfolio by continuing education, reviewing your situation, and discussing new products that may be suitable for you.
- Every industry has their own slew of designations, and it's always a challenge to determine which ones have any meaning. The insurance industry and the financial services industry as a whole have been faced with an onslaught of designations. There are basically two types of designations:
    1. Agents may earn such professional designations as Chartered Life Underwriter (CLU) and Life Underwriter Training Council Fellow (LUTCF). Agents who also are financial planners may carry such credentials as Chartered Financial Consultant (ChFC), Certified Financial Planner (CFP), or Personal Financial Specialist (CPA–PF). These designations indicate that the agent has completed advanced training, passed rigorous exams, and is serious about professional development. However, the CLU is the only one that specifically focuses on life insurance only and is by far the most comprehensive in the life insurance area.
    2. Designation for "sale" or a so-called "rogue-designation." These designations can be earned through simplified courses over the Internet or by attending a weekend seminar or off the back of a cereal box (well, not really this last one—at least, not yet). These do not require any level of in-depth studying. However, they may be close enough in name or sound impressive enough to imply mastery of a certain subject. This has become a source of concern for regulators and U.S. legislators. At the time of the writing of this book, this issue was being reviewed in depth, and a couple of State Insurance Departments were beginning to ban some of the biggest offenders. There is nothing formal available at this time for consumers—however, The American College (which awards some of the "real" designations) is providing information and support in this process with their "Your Advisor Guide" Web site, which features a designation check tool to verify a professional's designation at https://www.youradvisorguide.com/designation-check.

This includes tools for companies to use in evaluating the quality of professional designations and for advisors regarding how to use professional designations with the public.

So You've Found an Advisor. What Should You Expect?

It's oftentimes recommended that you meet with at least two or more agents. This may or may not make sense. On the pro side, this will allow you to find a compatible advisor and judge competency. On the flip side, as life insurance is a complex field, it's like anything else—it's hard to make a judgment on something you're unfamiliar with. For instance, if you were to sit down and meet with two attorneys, how do you really know who's best qualified and competent? Doing your homework prior to a meeting will help you make this decision. Keep in mind that if the first advisor you meet comes highly recommended and is well qualified, it's a waste of time to keep looking. The advisor who presents the best may be just the advisor who presents the best—all sizzle and no steak (credit for this saying goes to Bill Hanson—a mentor).

The following questions discuss compensation issues that can play an important role in life insurance purchasing.

Q58 How Is the Agent Compensated and How Will That Affect the Advice You're Given?

For an agent, compensation disclosure is an important issue, which is not currently the case. The current compensation system invites replacement and poor persistency (the percentage of policies that stay in-force—see Question 35). It fails to align the interests of producers and life insurance companies. Consider the producer's perspective: Selling life insurance is a tough job. Few consumers seek out life insurance or annuities; the product must persuade a prospect to buy. Prospecting for business is hard, unpleasant work. Successful producers understandably feel deserving of their financial rewards.

From the opposite side, life insurance companies must write enough business and keep it in-force long enough to make a profit. Since a career agency force is almost prohibitively expensive, most companies are forced to compete for independent producers. This intense competition creates

enormous pressure to pay the highest possible commissions. Unrestricted competition does not always serve the public interest. The present agent-compensation system is based upon the fact that life products are hard to sell. The more difficult the sale, the higher the commission—and the more inefficient the product is from a consumer standpoint.

Keep in mind that salespeople are good at selling. A few things that you can do if you feel pressure:

- A good deal will still be there tomorrow.
- If it looks too good to be true then it probably is.
- Practice saying NO. My former preschooler was an expert. It works well if you're not sure about something.

Inform them that you need to go over this with someone else first. If they discourage you from this or say that it's a special deal, then there's something that probably won't bear further scrutiny.

Q59 How Is the Current Compensation System Harmful to Agents and Consumers?

Regulatory help is needed to facilitate a new compensation model that serves the agents of the insureds as well as the industry. High, or "heaped," first-year commissions are common throughout the industry. Producers then receive smaller commissions, if any, each year, as long as a policy is in-force. This model encourages sales but discourages persistency (keeping policies in-force). While the need for change has been apparent for several years, insurers cannot afford to act unilaterally, and antitrust implications prevent them from acting in concert.

Surely, here is an opportunity for state insurance regulators. Life insurance companies should support a coordinated state regulatory initiative limiting up-front producer compensation. There is no need, however, to limit the ultimate commission payout. Let competition take care of that.

Specifically, producer compensation should be split into a selling fee and a service fee. The selling fee would be whatever amount an insurer deems appropriate, but it would have a ceiling on how much is payable within the first year the policy is in-force. For example, a selling fee may be payable over

five years, contingent on the policy staying in-force and with up-to-date premium payments. A service fee, on the other hand, would be paid to the agent who services the policy— who may not necessarily be the selling agent.

Regulators could also exercise control over the commission structure by limiting product approvals. Companies must design products attractive to the consumer while satisfying producer commission demands. This virtually impossible task produces a competitive landscape in which products are studiously differentiated.

Good product design and pricing lead to persistency—and ultimately, profitability. It is unrealistic, however, to link producer compensation with profitability. The producer does not control these factors. Producers should not be penalized for home-office management failures.

Companies, nonetheless, can tap producers to help encourage persistency. For example, producers could be required to meet with each policy owner at least once each year or forfeit their right to ongoing compensation. Producers who have an assured interest in their in-force business will strive to maximize their compensation by encouraging persistency.

Life insurers should enter into good-faith, profit-sharing agreements with their producers. If producers are expected to forgo heaped first-year commissions, they must be confident of a long-term financial reward commensurate with their contribution and commitment. Permanent life insurance is profitable for companies achieving sufficient sales volume. The same is true for annuities. Producers can make or break persistency; therefore, companies have an incentive to compensate agents based on persistency.

So where do insurance companies begin in aligning their interests with those of their producers? An excellent starting point is mandatory commission disclosure at the point of sale. Making producer compensation and overall marketing allowances transparent to the buyer would help bring about lower first-year commissions and more emphasis on long-term relationships.

It is not that difficult to design a viable commission-disclosure standard. Commission disclosure can and should be made as simple as possible. For example, the producer's first-year compensation should be disclosed as a dollar amount and as a percentage of the first-year premium. Renewal commis-

sions should be disclosed in like manner. All other marketing costs, such as general agent allowances and other selling expenses, should be disclosed to the consumer at the point of sale. If it is administratively difficult to provide these disclosures at the point of sale, they should be mailed to the applicant by the home office. The applicant should then be given the opportunity to ask questions or cancel the application.

Developing a much-needed new producer compensation model will require a cooperative effort between the industry and its regulators. Producers and companies would adapt accordingly, consumers would be better served, and this would enhance the industry's public image.

The point is that the current compensation system has built-in conflicts of interest that a fiduciary should bear in mind in analyzing and/or monitoring a life insurance policy.

Something to keep in mind is that commissions are often quite different than thought of. Often with non-variable life insurance, there are other types of compensation, such as sales conventions and other sales prizes.

Q60 Can an Advisor Accept Both a Fee and a Commission?

Due to the potential conflict of interest involved with commissions, there is little movement towards fee-based planning with no-load/low-load products. In the review of in-force products where a fee is charged, only a properly licensed fee-based planner can be retained. Only some states have a separate license that allows Life Insurance Advisor or other Financial Advisor (anyone who sells life insurance) to charge a fee for their services. Please visit your state's Department of Insurance Web site to see if your state offers such a license. In states that do not, it is a gray area.

For example, my home state, the State of California, issues a little-known license called the "Life and Disability Insurance Analyst," which is discussed in California Insurance Code Sections 1831-1849 and can be found on their Web site. This license was first conceived and introduced into the insurance code in 1984 and, when I attained this license in 1998, I was only the 39th person in the state to attain it.

This is the only section of the State Insurance Code that allows anyone to charge a fee for the analysis of life and disability insurance products.

There are a few exceptions (see below). The code is very clear that when you receive any fee from a client, you are prohibited from receiving any commission for that same client. At one time, I called a compliance attorney at the Department of Insurance and they verified that this is exactly what the code intends. The reality of the matter is that there is currently widespread abuse (most of it unintentional) of this little-known section of the code, and that these are planners who collect a fee from their client, as well as commissions on the sale/implementation of an insurance product. I will not address the ethical issues here, strictly the compliance issues. What is interesting is that most advisors who are exempt under the code, with whom I've met, are so concerned with their liability that they no longer will review a life insurance product. The following are, as examples, the exemptions to the Code in the State of California. This is to give you the idea that if somebody wishes to charge you a fee, make sure that they are properly licensed to do this by checking with your State Department of Insurance and, if there is no such license, then ascertain their qualifications as best you can. This could be a challenge in states where no such license exists.

Exemptions to California Insurance Code Sections 1831-1849—Life Analyst—charging a fee:

- Active members of the State Bar of California
- Any person who has passed all of the qualifying exams necessary to become an associate of the Society of Actuaries
- An officer or employee of any bank or trust company who receives no compensation from sources other than the bank or trust company for activities connected with his employment, which would otherwise subject him to this chapter
- An investment advisor, as defined in Section 25009 of the Corporations Code, when acting in that capacity
- Complex exception—see the code

Fee-only life insurance planners will also be the advisors who will offer you low-load life insurance products. As discussed in Question 16, these products pay no commission; therefore, advisors charge a fee and can be more objective. Some products do pay a minimal marketing fee.

Q61 Is There a Code of Ethics for Life Insurance Agents?

There are many gags both in the movies and by comedians about life insurance agents. Two of the more well-known are the life insurance agents in Woody Allen's *High Anxiety* and the character in Bill Murray's *Groundhog Day*. The most likely reason is that agents, at one point, rated as low as used-car salesmen in consumer confidence ratings (of course, no offense intended to any used-car salespeople). Agents today (for the most part) are professionals and have high standards to which they hold themselves.

To give the reader some idea, a number of professional financial advisor groups have a code of ethics. The following is from the American College, which provides professional designations and the Master of Financial Service degree:

Professional Pledge and Canons of Ethics

All students who matriculate with The American College and earn any of its designations are required to comply with the college's Code of Ethics and Procedures. Included in the Code are the Professional Pledge and the Canons.

The Professional Pledge

"In all my professional relationships, I pledge myself to the following rule of ethical conduct: I shall, in light of all conditions surrounding those I serve, which I shall make every conscientious effort to ascertain and understand, render that service which, in the same circumstances, I would apply to myself."

I. Conduct yourself at all times with honor and dignity.

II. Avoid practices that would bring dishonor upon your profession or The American College.

III. Publicize your achievements in ways that enhance the integrity of your profession.

IV. Continue your studies throughout your working life so as to maintain a high level of professional competence.

V. Do your utmost to attain a distinguished record of professional service.

VI. Support the established institutions and organizations concerned with the integrity of your profession.

VII. Participate in building your profession by encouraging and providing appropriate assistance to qualified persons pursuing professional studies.

VIII. Comply with all laws and regulations, particularly as they relate to professional and business activities.

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An association that I was proud to be a member of is the Society of Financial Service Professionals. The Society of Financial Service Professionals consists of advisors like Chartered Life Underwriters (CLUs), CHFCs, CFPs, CPAs, and others involved with some aspect of financial services. Typically, most of these advisors will have some knowledge and hands-on experience with life insurance. The inclusion of this code of professional responsibility is to give the reader a sense of what they should expect in their life insurance advisor, as this is the expected manner of performance.

CODE OF PROFESSIONAL RESPONSIBILITY OF THE SOCIETY OF FINANCIAL SERVICE PROFESSIONALS

The Code of Professional Responsibility of the Society of Financial Service Professionals is divided into five components, as follows:

Preamble—a brief introduction to the Code of Professional Responsibility, including its history and purpose.

Canons—aspirational model standards of exemplary professional conduct.

Rules—specific standards of a mandatory and enforceable nature.

Applications—practical examples of how the canons and rules apply in given situations.

Disciplinary Procedures—the mechanisms for enforcement of the Code of Professional Responsibility.

PREAMBLE

The Society of Financial Service Professionals is dedicated to setting and promoting standards of excellence for professionals in financial services. In fulfillment of this mission, the Society's Board of Directors has adopted this Code of Professional Responsibility. All Society members are automatically bound by its provisions.

The ultimate goal of enacting the code is to serve the public interest. The path to fulfilling the goal is the fostering of professionalism in financial services. A profession has been defined in the writings of Solomon S. Huebner as possessing four essential traits:

- knowledge or expertise
- service to others
- working with other professionals to enhance the practice and reputation of one who is a member
- self-regulation

Through its Code of Professional Responsibility, the Society strives to improve the level of ethical behavior among its members by articulating standards that are aspirational in nature, that is, by identifying the lofty, altruistic ideals that define a true profession, and by delineating and enforcing minimum standards of ethical conduct.

This Code of Professional Responsibility has its origin in the code of ethics of the American Society of CLU & ChFC, the predecessor organization of the Society of Financial Service Professionals. The members of the Society created and adopted a code of ethics in 1961. With a name change in the fall of 1998, and a broadened membership constituency, it became appropriate to create this new Code of Professional Responsibility.

The Society acknowledges the diversity of its membership—from those that serve the public directly, as advisors, to those that serve indirectly through companies, educational organizations, and the like. Whatever role he or she plays within the financial services industry, it is the responsibility of each Society member to understand and adhere to the Code of Professional Responsibility.

From time to time, a Society member may be unclear about the ethical implications of a given course of action. In such cases, a Society member may request an advisory opinion from the Society or may seek confidential advice through the Society's Ethics Information Line. Advisory opinions will be unpublished and specific to the inquiring member. However, there may be instances in which the subject matter of the advisory opinion has broad, general application and in such cases, at its discretion, the Society may chose to publish a given opinion for the benefit of all members, preserving the anonymity of those involved.

An alleged violation of the Society's Code of Professional Responsibility will result in an enforcement action, carried out in accordance with the disciplinary procedures. The procedures ensure that any member charged with ethical misconduct is afforded appropriate due process. The procedures also provide for appropriate sanctions, such as reprimand, censure, and revocation of membership, should a member be found to have acted in violation of the code.

True enforcement of ethical behavior must come from the personal conscience of each individual, rather than external forces. Nevertheless, as an organization that promotes its members' education and expertise to the consumer, the Society believes it is essential that it act in an enforcement capacity.

CANONS

CANON 1: *Fairness*

A member shall perform services in a manner that respects the interests of all those he/she serves, including clients, principals, partners, employees, and employers. A member shall disclose conflicts of interests in providing such services.

Fairness requires that a professional treat others as he/she would wish to be treated if in the other's position. A professional also strives to avoid unfairness by inflicting no unnecessary harm on others and, when possible, shielding others from harm.

RULES

R1.1 A member shall not engage in behavior involving concealment or misrepresentation of material facts.

Applications for Rule 1.1

A1.1a. In the sale of financial products, the use of product projections that are more aggressive than the company's current assumptions—without offering alternate illustrations/projections using more conservative assumptions—is a form of misrepresentation. It is best to show a range of assumptions for each product to illustrate the impact of changes on the rate of return and other expenses.

A1.1b. To avoid misrepresentation, the financial services professional is advised to use unbiased historical illustrations, show past performance, and to educate the consumer on the difference between past results and projections, and actual future results.

A1.1c. Improper replacement is a form of misrepresentation. When considering the replacement of one insurance, annuity, or other financial product for another, a thorough comparison of both products, including surrender charges, incontestable clauses, expenses, fees, and tax consequences, should be completed. The Society's Replacement Questionnaire (RQ) provides a tool for the thorough analysis of replacement issues.

A1.1d. Failing to note a preexisting medical condition on an insurance application is a form of concealment.

R1.2 A member shall respect the rights of others.

R1.3 A member shall disclose to the client all information material to the professional relationship, including, but not limited to, all actual or potential conflicts of interest. In a conflict of interest situation, the interest of the client must be paramount.

Applications for Rule 1.3

A1.3a. A potential conflict of interest is inherent in the relationship between the client and the financial service professional when the professional is compensated by commissions on the sale of financial

products. In such circumstances, if asked by the client or prospect, the professional should disclose, to the best of his/her knowledge, all forms of compensation, including commissions, expense allowances, bonuses, and any other relevant items.

A1.3b. The potential for a conflict of interest exists when a financial service professional receives fees for referring business to another practitioner. The referring professional should disclose this information.

A1.3c. A member who serves as a director or trustee of an organization/business faces a conflict of interest when competing to provide products or services to this organization for compensation. For example, Jackie Jones, ChFC, a professional money manager, is on the board of XNet Corporation. XNet is currently interviewing candidates to manage its $10 million investment portfolio. If Jackie decides to seek XNet's account, she is in a conflict-of-interest situation. Under these circumstances, Jackie should disclose the conflict to all relevant parties and have the parties acknowledge and accept the conflict. Additionally, Jackie should consider recusing herself from all discussions and decision-making regarding the selection of XNet's money manager. She may also consider resigning from the board or taking her name out of consideration for the money manager position.

R1.4 A member shall give proper respect to any relationship that may exist between the member and the companies he or she represents.

Application for Rule 1.4

A1.4a. Society members frequently have contractual relationships with the company whose products they sell. Honoring the terms of these contracts and refraining from negative statements about such companies are examples of giving proper respect to the relationship. Note, however, the need to balance the requirements of Rule 1.4 with the duty to act in the best interest of the client.

R1.5 A member shall make and/or implement only recommendations that are appropriate for the client and consistent with the client's goals.

Applications for Rule 1.5

A1.5a. Compliance with Rule 1.5 requires the financial service professional to use his/her best efforts to (1) understand the client's/prospect's personal and financial background and experience; (2) understand the client's/prospect's risk tolerance; and (3) educate the client about the various options available to meet identified needs and goals. This may include utilizing a fact-finding and/or risk-assessment tool, one-on-one educational/counseling sessions, sharing newspaper or magazine articles, etc. In these circumstances, the financial service professional is cautioned against providing advice if he or she is not properly licensed or authorized to do so. See also Rule 2.2 and the Application A2.2a.

A1.5b. Appropriateness of the recommendation to the client's needs must take precedence over any sales incentives available to the financial service professional, such as conventions, trips, bonuses, etc. For example, Bob Bucks needs to sell just one more policy to qualify for MDRT. He knows he can convince his best client to purchase additional insurance coverage even though Bob knows the current coverage is more than adequate. If Bob makes this sale, he has violated Rule 1.5.

R1.6 In the rendering of professional services to a client, a member has the duty to maintain the type and degree of professional independence that (a) is required of practitioners in the member's occupation, or (b) is otherwise in the public interest, given the specific nature of the service being rendered.

Application for Rule 1.6

A1.6a. The requirement of professional independence mandated by Rule 1.6 presents a special challenge for Society members who are contractually bound to sell the products of only one company, or a select group of companies. In such cases, the member must keep paramount his/her ethical duty to act in the best interest of the client, even if this means forgoing a sale.

CANON 2: *Competence*

A member shall continually improve his/her professional knowledge, skill, and competence.

Professionalism starts with technical competence. The knowledge and skills held by a professional are of a high level, difficult to attain, and, therefore, not held by the general public. Competence not only includes the initial acquisition of this specialized knowledge and skill, but also requires continued learning and practice.

RULES

R2.1 A member shall maintain and advance his/her knowledge in all areas of financial service in which he/she is engaged and shall participate in continuing education programs throughout his/her career.

Application for Rule 2.1

A. 2.1a. Compliance with Rule 2.1 requires, at a minimum, meeting the applicable continuing-education standards set by state licensing authorities, the Society of Financial Service Professionals, The American College, the CFP Board of Standards, and any other entity with appropriate authority over the member's license(s) or other credentials. For example, PACE, the joint CE program of the Society and of The American College requires 30 hours of CE every 2 years. The CFP Board of Standards also requires 30 hours of continuing education every 2 years for CFP™ licensees.

R2.2 A member shall refrain from giving advice in areas beyond the member's own expertise.

Applications for Rule 2.2

A2.2a. A member shall not give tax, legal, insurance, accounting, actuarial, investment, or other advice unless the member has professional training and is properly licensed in these areas. For example, to avoid the unauthorized practice of law, the financial service professional will clearly mark specimen documents, such as living or testamentary

trusts or buy-sell agreements, as samples and inform the client that the documents must be reviewed by a licensed attorney.

A2.2b. Billy Burke, CFP, has a specialized financial planning practice that focuses on assisting clients with funding college for their children. When Billy's long-time client and friend, Margaret Hamilton, asks for help in managing the distribution of funds from her defined benefit plan, Billy knows this is beyond his area of expertise, but he doesn't want to let his friend down. Billy proceeds to recommend several investment options to Margaret, but neglects to mention the early-withdrawal taxes and penalties. Billy has violated Rule 2.2.

CANON 3: *Confidentiality*

A member shall respect the confidentiality of any information entrusted to, or obtained in the course of, the member's business or professional activities.

A financial service professional often gains access to client records and company information of a sensitive nature. Each Society member must maintain the highest level of confidentiality with regard to this information.

RULES

R3.1 A member shall respect and safeguard the confidentiality of sensitive client information obtained in the course of professional activities. A member shall not divulge such information without specific consent of the client, unless disclosure of such information is required by law or necessary in order to discharge legitimate professional duties.

Application for Rule 3.1

A3.1a. Examples of sensitive client information include, but are not limited to, medical data, information about financial status, Social Security or credit card numbers, information about personal relationships, etc. In determining whether information is sensitive, the Society member should take a cautious approach, and if in doubt, discuss the issue with the client.

R3.2 A member shall respect and safeguard the confidentiality of sensitive company/employer information obtained in the course of professional activities. A member shall not divulge such information without specific consent, unless disclosure of such information is required by law or necessary in order to discharge legitimate professional duties.

R3.3 A member must ensure that confidentiality practices are established and maintained by staff members so that breaches of confidence are not the result of intentional or unintentional acts or omissions.

Application for Rule 3.3

A3.3a. A member who employs others who work with sensitive, confidential client information has the responsibility to train these employees in the handling of such information. These employees must be instructed that they will be held responsible for unauthorized disclosure of confidential data. For example, Judy Parker has set up detailed procedures for her staff to follow in safeguarding confidential client information. On three separate occasions, Judy overhead her office manager gossiping with friends about the size of Client X's investment portfolio. Judy has not taken any action in regard to the office manager's behavior. Judy has violated Rule 3.3.

CANON 4: *Integrity*

A member shall provide professional services with integrity and shall place the client's interest above his/her own.

Integrity involves honesty and trust. A professional's honesty and candor should not be subordinate to personal gain or advantage. To be dishonest with others is to use them for one's own purposes.

RULES

R4.1 A member shall avoid any conduct or activity that would cause unnecessary harm to others by:

Any act or omission of a dishonest, deceitful, or fraudulent nature.

Pursuit of financial gain or other personal benefits that would interfere with the exercise of sound professional judgments and skills.

R4.2 A member shall establish and maintain dignified and honorable relationships with those he/she serves, with fellow practitioners, and with members of other professions.

Application for Rule 4.2

A4.2a. A member needs to be respectful in all dealings with another financial service professional in competitive engagements and avoid at all costs defamatory remarks to the client or other professionals. This does not mean a member cannot provide impartial factual information about a competitor. For example, in trying to help a friend make a decision about which long-term care policy to purchase, Joe Carter, CLU, reviews the features of each contract and accurately notes that his competitor's policy fails to provide coverage for home care. Joe recommends that his friend review this information with his agent.

R4.3 A member shall embrace and adhere to the spirit and letter of laws and regulations governing his/her business and professional activities. See also Rule 6.1.

R4.4 A member shall be truthful and candid in his/her professional communications with existing and prospective clients, and with the general public.

Applications for Rule 4.4

A4.4a. Financial service professionals will not use words or make statements in brochures or advertising materials or in any client communication that create false impressions or have the potential to mislead. For example, product salespersons should not refer to themselves as financial/estate planners/consultants, if they do not provide these services. Words such as deposits or contributions should not be used to describe life insurance premiums. Life insurance policies should not be referred to as retirement plans. Discussion of vanishing premiums and guaranteed performance should be avoided. Financial service professionals must avoid creating the impression that they represent a

number of companies when they place business with only a few companies. See also Rule 1.6.

A4.4b. Candid communication is required when a client is acting or intends to act outside the law. In such cases, the member should terminate the professional relationship and seek the advice of appropriate advisors. For example, Lisa Long, CLU, CFP, an investment advisor, has been asked by her client to effect a transaction based on insider information. Lisa must immediately advise her client that insider trading is a violation of SEC rules and could result in criminal charges. Lisa should also document what has happened; and, if the client plans to proceed with the transaction, Lisa should terminate the relationship. Lisa should also consult her own legal and ethical advisors as to whether she has additional legal obligations under these circumstances. Lisa's legal obligations will impact her ethical obligations.

R4.5. A member shall refrain from using an approved Society designation, degree, or credential in a false or misleading manner.

Application for Rule 4.5

A4.5a. A member must not use Society-recognized professional designations in his/her company name, tagline, or brochures in a manner which would be misleading. For example, John Smith, ChFC, and Associates is acceptable. John Smith and Associates, Chartered Financial Consultants is not because it creates the impression that everyone associated with the firm is a Chartered Financial Consultant. See also Rule 7.7.

CANON 5: *Diligence*

A member shall act with patience, timeliness, and consistency in the fulfillment of his/her professional duties.

A professional works diligently. Knowledge and skill alone are not adequate. A professional must apply these attributes in a prompt and thorough manner in the service of others.

RULES

R5.1 A member shall act with competence and consistency in promptly discharging his/her responsibilities to clients, employers, principals, purchasers, and other users of the member's services.

R5.2 A member shall make recommendations to clients, whether in writing or orally, only after sufficient professional evaluation and understanding of the client's needs and goals. A member shall support any such recommendations with appropriate research and documentation.

R5.3 A member shall properly supervise subordinates with regard to their role in the delivery of financial services, and shall not condone conduct in violation of the ethical standards set forth in this Code of Professional Responsibility.

CANON 6: *Professionalism*

A member shall assist in raising professional standards in the financial services industry.

A member's conduct in all matters shall reflect credit upon the financial services profession. A member has an obligation to cooperate with Society members, and other financial service professionals, to enhance and maintain the profession's public image and to work together to improve the quality of services rendered.

RULES

R6.1 A member has the duty to know and abide by the local, state, and national laws and regulations and all legal limitations pertaining to the member's professional activities.

Applications for Rule 6.1

A6.1a. The financial service profession is subject to state and federal laws and regulation in the areas of securities, insurance, banking, and unfair trade practices, among others. Society members must understand these laws and regulations and their applicability to their practices. For example, Susan Short, CLU, just earned her CFP license,

and is planning on expanding her practice to include comprehensive financial planning services. Does Susan need to register as an investment advisor? Must she be licensed with the National Association of Securities Dealers? What about state insurance laws? Susan must answer these questions and comply with the appropriate requirements for her business activities.

A6.1b. Jon Planner receives equity commissions throughout the year. As part of a prearranged agreement, he transfers these commissions to the corporation for whom he works. Jon later learns that this is a violation of FINRA rules and that commissions cannot be split with corporations. Jon is ethically obligated to correct this situation and to further educate himself on the rules and regulations applying to his business.

R6.2 A member shall support the development, improvement, and enforcement of such laws, regulations, and codes of ethical conduct that foster respect for the financial service professional and benefit the public.

Application for Rule 6.2

A6.2a. Suppose Congress is contemplating a measure that would increase the regulatory burden on financial service professionals by requiring increased documentation of specific client transactions. There is firm evidence that enactment of this measure would substantially reduce the likelihood of client's being misled or confused about such transactions. Rule 6.2 would require Society members to support such a measure.

R6.3 A member shall show respect for other financial service professionals and related occupational groups by engaging in fair and honorable competitive practices; collegiality among members shall not impede enforcement of this Code.

R6.4 A member shall cooperate with regulatory authorities regarding investigations of any alleged violation of laws or regulations by a financial service professional.

CANON 7: *Self-regulation*

A member shall assist in maintaining the integrity of the Society's Code of Professional Responsibility and of the professional credentials held by all Society members.

Every professional has a responsibility to regulate themselves. As such, every Society member holds a duty of abiding by his/her professional code of ethics. In addition, Society members have a duty to facilitate the enforcement of this Code of Professional Responsibility.

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Q62 What Is the History, Purpose, and Structure of State Insurance Regulation?

A Brief History

Benjamin Franklin helped found the insurance industry in the United States in 1752 with the Philadelphia Contributionship for the Insurance of Houses from Loss by Fire. The current state insurance regulatory framework has its roots in the 19th century with New Hampshire appointing the first insurance commissioner in 1851. Insurance regulators' responsibilities grew in scope and complexity as the industry evolved. Congress adopted the McCarran-Ferguson Act in 1945 to declare that states should regulate the business of insurance and to affirm that the continued regulation of the insurance industry by the states was in the public's best interest.

The Financial Modernization Act of 1999, also called Gramm-Leach-Bliley, established a comprehensive framework to permit affiliations among banks, securities firms, and insurance companies. Gramm-Leach-Bliley once again acknowledged that states should regulate the business of insurance. However, Congress also called for state reform to allow insurance companies to compete more effectively in the newly integrated financial service marketplace and to respond with innovation and flexibility to evermore demanding consumer needs all while continuing to protect consumers, which is the hallmark of state regulation.

The Role of the State Legislatures

State legislatures set broad policy for the regulation of insurance. They establish and oversee state insurance departments, regularly review and revise state insurance laws, and approve regulatory budgets. State insurance departments employ 12,500 regulatory personnel. Increases in staff and enhanced automation have allowed regulators to substantially boost the quality and intensity of their financial oversight of insurers and expand consumer protection activities. State regulation of insurance provides a major source of state revenue. In 2000, states collected more than $10.4 billion in revenues from insurance sources. Of this amount, $880 million—roughly 8.4%—went to regulate the business of insurance while the remaining $9.6 billion went to state general funds for other purposes.

National Association of Insurance Commissioners (NAIC)

The NAIC serves as a vehicle for individual state regulators to coordinate their activities and share resources. Established in 1871, the NAIC functions as an advisory body and service provider for state insurance departments. Commissioners use the NAIC to pool scarce resources, to discuss issues of common concern, and to align their oversight of the industry. Each state, however, ultimately determines what actions it will take.

The Purpose and Structure of Insurance Regulation

The fundamental reason for government regulation of insurance is to protect American consumers. State systems are accessible and accountable to the public and sensitive to local social and economic conditions. State regulation has proven that it effectively protects consumers and ensures that promises made by insurers are kept. Insurance regulation is structured around several key functions, including company licensing, producer licensing, product regulation, market conduct, financial regulation, and consumer services.

Company Licensing

State laws require insurers and insurance-related businesses to be licensed before selling their products or services. Currently, there are approximately 7,200 insurers in the United States. All U.S. insurers are subject to regulation in their state of domicile and in the other states where they are licensed to sell insurance. Insurers who fail to comply with regulatory requirements

are subject to license suspension or revocation, and states may exact fines for regulatory violations. In 2000, nearly 300 companies had their licenses suspended or revoked.

The NAIC's Uniform Certificate of Authority Application (UCAA), a company licensing system, helps states expedite the review process of a new company license. In addition, an NAIC database has been developed to facilitate information sharing on acquisition and merger filings. Theses databases assist insurance regulators by creating a streamlined and more cost-efficient regulatory process.

Producer Licensing

Insurance agents and brokers, also known as producers, must be licensed to sell insurance and must comply with various state laws and regulations governing their activities. Currently, more than 3.2 million individuals are licensed to provide insurance services in the United States. State insurance departments oversee producer activities in order to protect insurance-consumer interests in insurance transactions. The states administer continuing-education programs to ensure that agents meet high professional standards. Producers who fail to comply with regulatory requirements are subject to fines and license suspension or revocation. In 2000, nearly 16,000 insurance producers had their licenses suspended or revoked. When producers operate in multiple jurisdictions, states must coordinate their efforts to track producers and prevent violations. Special databases are maintained by the NAIC to assist the states in this effort. The National Insurance Producer Registry (NIPR)—a non-profit affiliate of the NAIC—was established to develop and operate a national repository for producer licensing information.

Product Regulation

State regulators protect consumers by ensuring that insurance policy provisions comply with state law, are reasonable and fair, and do not contain major gaps in coverage that might be misunderstood by consumers and leave them unprotected. The nature of the rate review, rating rules, and forms varies somewhat among the states depending on their laws and regulations. For personal property-casualty lines, about half of the states require insurers to file rates and to receive prior approval before they go into effect. With the excep-

tion of workers' compensation and medical malpractice, commercial property-casualty lines in many states are subject to a competitive rating approach. Under such a system, regulators typically retain authority to disapprove rates if they find that competition is not working. Premiums for life insurance and annuity products generally are not subject to regulatory approval, although regulators may seek to ensure that policy benefits are commensurate with the premiums charged. Many states subject health insurance rates to prior approval—with all other lines using a "file and use" system or no provisions for review.

Financial Regulation

Financial regulation provides crucial safeguards for America's insurance consumers. The states maintain at the NAIC the world's largest insurance financial database, which provides a 15-year history of annual and quarterly filings on 5,200 insurance companies. Periodic financial examinations occur on a scheduled basis. State financial examiners investigate a company's accounting methods, procedures, and financial-statement presentation. These exams verify and validate what is presented in the company's annual statement to ascertain whether the company is in good financial standing. When an examination of financial records shows the company to be financially impaired, the state insurance department takes control of the company. Aggressively working with financially troubled companies is a critical part of the regulator's role. In the event the company must be liquidated or becomes insolvent, the states maintain a system of financial guaranty funds that cover consumers' personal losses.

Market Regulation

Market regulation attempts to ensure fair and reasonable insurance prices, products, and trade practices in order to protect consumers. With improved cooperation among states and uniform market conduct examinations, regulators hope to ensure continued consumer protections at the state level. Market conduct examinations occur on a routine basis, but also can be triggered by complaints against an insurer. These exams review agent-licensing issues, complaints, types of products sold by the company and agents, agent sales practices, proper rating, claims handling, and other market-related aspects of an insurer's operation. When violations are found, the insurance department makes recommendations to improve the company's operations and to bring

the company into compliance with state law. In addition, a company may be subject to civil penalties or license suspension or revocation.

Consumer Services

The states' single most significant challenge is to be vigilant in the protection of consumers, especially in light of the changes taking place in the financial services marketplace. States have established toll-free hotlines, Web sites, and special consumer-services units to receive and handle complaints against insurers and agents. The states also have launched an interactive tool to allow consumers to research company complaint and financial data using the NAIC Web site. During 2000, state insurance departments handled 4.5 million consumer inquiries and complaints. As needed, state insurance departments worked together with policyholders and insurers to resolve disputes. In addition, many states sponsor educational seminars and provide consumer brochures on a variety of insurance topics. Some states publish rate-comparison guides to help consumers get the best value when they purchase insurance.

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Q63 Why Do States Currently Regulate Insurance?

Why is insurance regulated?

Government regulation of insurance companies and agents began in the states more than 100 years ago for one overriding reason—to protect consumers. State regulators' most important consumer protection is to ensure that insurers remain solvent so they can meet their obligations to pay claims. States also supervise insurance sales and marketing practices and policy terms and conditions to ensure that consumers are treated fairly when they purchase insurance products and file claims.

What is the first priority of insurance regulators?

The fundamental purpose for government regulation of insurers and agents is to protect American consumers. Effective consumer protection that focuses

on local needs is the hallmark of state insurance regulation. State regulators understand local and regional markets and the needs of consumers in these markets. State policymakers recognize that consumer protection is their highest job priority. Meaningful evaluation of the existing state regulatory system or any federal alternative must begin with a hard look at its impact on current protections that the public expects.

How is insurance different from banking?

Insurance is a commercial product based upon subjective business decisions: Will an insurance policy be offered to a consumer? At what price? What are the policy terms and conditions? Is a claim filed by a policyholder valid? If so, how much should the customer be paid under the policy's terms? Unlike most products, the purchaser of an insurance policy will not be able to fully determine the value of the product purchased until after a claim is presented—when it is too late to decide that a different insurer or a different product might make a better choice. All of these subjective aspects add up to one big certainty—insurance products can generate consumer backlash and dissatisfaction that require a high level of regulatory resources and responsiveness.

What is the cost of state insurance regulation?

In 2000, state insurance departments employed 12,500 regulatory personnel nationwide and spent $880 million to be the watchful eyes and helping hands on consumer insurance problems. States also maintain a system of financial guarantee funds that cover personal losses of consumers in the event of insurer insolvency. The entire state insurance system is authorized, funded, and operated at no cost to the federal government.

What is Gramm-Leach-Bliley?

The Financial Modernization Act of 1999, also called Gramm-Leach-Bliley, established a comprehensive framework to permit affiliations among banks, securities firms, and insurance companies. Gramm-Leach-Bliley once again acknowledged that states should regulate the business of insurance. However, Congress also called for state reforms to allow insurance companies to compete more effectively in the newly integrated financial service marketplace

and to respond with innovation and flexibility to evermore demanding consumer needs.

States already have taken action to meet the specific requirements of Gramm-Leach-Bliley. Forty-six states have enacted a model law to establish a system of reciprocity to license out-of-state insurance agents and brokers. This already exceeds the 29 states required by federal law to prevent establishment of the National Association of Registered Agents and Brokers—a quasi-governmental entity that would preempt state laws. In response to another provision that requires states to set minimum standards to keep insurance information private, the NAIC drafted model privacy regulations, and 49 states and the District of Columbia now meet or exceed the federal privacy requirement.

What are states doing to modernize insurance regulation?

States are committed to streamline and simplify state insurance regulation while continuing to protect consumers. The nation's insurance commissioners announced their commitment to modernize the state system in specific areas by endorsing an action plan, the Statement of Intent—The Future of Insurance Regulation, which was adopted in March 2000. Working in their individual states and collectively through the NAIC, the commissioners have made tremendous progress on their goal of creating an efficient, market-oriented regulatory system for the business of insurance. The Statement of Intent set forth goals for improvement in producer licensing, product speed to market, privacy of consumer information, and company licensing. State legislatures working through the National Conference of State Legislatures (NCSL) and the National Conference of Insurance Legislators (NCOIL) also are committed to reform state insurance regulation. In September 2001, the NCSL Executive Committee established the Task Force to Streamline and Simplify Insurance Regulation—co-chaired by Senator Kemp Hannon of New York and Representative David Counts of Texas—to lead state legislative efforts to modernize state insurance regulation. The Task Force is charged by the NCSL Executive Committee to explore the issues that confront state insurance regulation in the integrated financial marketplace and, if necessary, to recommend specific measures to the states for legislative

consideration. Moreover, for many years NCOIL has served as a forum for legislators to discuss the many issues confronting state insurance regulation and has recommended to states model laws to promote market-based regulatory structures.

How do regulators promote competitive markets?

The purpose of government supervision is to make sure the critical personal interests of consumers are not lost in the arena of commercial competition. Once the consumer protection responsibilities of government insurance regulators are satisfied, it is fair to ask how the system of regulation can be made most compatible with the demands of commercial competition without sacrificing the needs of consumers. Regulators continue to give this matter our highest attention, as evidenced by our speed-to-market initiatives.

What are states doing to keep insurance markets competitive with other financial services products, especially with regards to life insurance and annuities?

Insurers, especially in the life insurance and annuities market, increasingly face direct competition from products offered by other financial services entities. State insurance regulators have worked diligently over the past two years to identify the issues in this area and come up with possible solutions to reflect the new market realities. Regulators now believe that a more efficient review process for these products is possible and could help insurers better compete in the marketplace while maintaining a high level of protection for insurance consumers. To accomplish this goal, regulators have endorsed the idea of an interstate insurance compact. The NAIC has drafted an interstate compact proposal and currently is discussing it with state legislators and interested parties for possible legislative consideration during the 2003 legislative sessions.

Why are the states' modernization efforts taking so long?

Insurance regulation is a complex matter and any change to the process should not be undertaken without thorough review and analysis of the impact of change to the business, companies, and agents, and also to the consumers and policyholders the industry serves. However, the states have established aggressive timelines in order to meet their modernization objectives. They

have come to a point where a number of the goals set out in the Statement of Intent have worked their way through the state legislative process. From the Producer Licensing Model Act to privacy regulations, the states have proven a commitment to modernizing insurance regulation and protecting consumers—as states have done for the past 130 years.

Isn't this really just about states protecting their turf?

Modernization efforts are not just about the survival of the state system. It is about responding to change and, in turn, making the best insurance regulatory system in the world even better. State policymakers believe consumers are—and will continue to be—best served by the states. Regulators and legislators have accepted the challenge to make the state system of insurance regulation better, and they will continue to make progress in implementing this vision.

When state regulators say there is a need for more uniformity, aren't they making a case to get rid of the 50-regulator system?

Having similar processes with local control and application is really the best of both worlds. Consumers need to have the confidence that the people regulating their policies understand the area market. For example, Iowa consumers do not buy much hurricane insurance, and there is little need for crop insurance in New York City. However these types of insurance are very important in the regions in which they are sold.

Wouldn't it be better to create a federal agency like the SEC to oversee regulation?

Clearly—since the Gramm-Leach-Bliley Act passed—conglomerates are being formed and banks and insurance and securities firms are converging. But there are still fundamental differences between banking, securities, and insurance. Insurance is a product with which consumers have many issues and questions. State insurance regulators need to be there on a local basis to deal with them. The state system has the expertise and has demonstrated that it can be responsive to these situations. When consumers have a problem with their insurance, it is often at a time of tragedy—when a child needs an operation and the insurance company won't pay for it, or a house just burned down and the insurance company is not coming through. So, insurance is very dif-

ferent from banking and securities products. Insurance also involves extremely complex contracts—so there is greater potential for consumer abuse.

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CHAPTER 6

OTHER ISSUES BEFORE BUYING A POLICY

Q64 Okay, I'm Ready to Buy Some Life Insurance. What Should I Expect?

The first step will be to complete a written application. This is necessary whether you apply through an advisor or directly to the company. There are three newer methods at the time of the writing of this book. The first is called tele-underwriting, which is where you are asked all the questions over the phone and then you sign an application at some later time. The second is similar; with this method the application is done online, additional questions are asked over the telephone, and then the paperwork (including an application) are signed when the policy is delivered. These methods are designed to reduce the processing time of applying for life insurance, which can take several weeks under the traditional method. The third is when you complete the application online or through an app and there is no human interaction.

An application is a form with a series of questions that will range from your identification information (address, phone number, drivers license,

etc.), to personal financial information, as well as medical questions and avocation questionnaires (where appropriate). Avocations are hobbies, such as rock climbing, scuba diving, etc.

Q65 How Will I Know That This Is the Right Policy for Me; In Other Words, Is It Suitable?

This question is complex and depends on whether or not you have an advisor, how knowledgeable they are on this subject, what state you live in, and how comfortable you feel with the methods in this book and with any other resources you may have consulted. Suitability is a term that basically means that a certain product is appropriate for a certain individual.

The difficult part of suitability with regard to life insurance is that there is no clear-cut answer for professional advisors either. Currently, there are suitability regulations for the sale of variable insurance products as these are under the purview of the FINRA/SEC. In reviewing suitability regulations from the perspective of (non-variable) life insurance rather than securities regulation, there are significant differences. Existing suitability regulations for registered products are adaptations of the regulations for any/all investment products and are not always applicable to life insurance products. State suitability rules exist in only a small percentage of the states and vary in terms of requirements, terms, and enforcement. The actual number of life insurance sales for non-registered products, which come under the purview of states that have suitability regulations, is very low for life insurance (a couple of years ago, it was approximately 10%). Approximately 30 states have suitability rules for annuities. So life insurance suitability rules may not be far behind.

For years the mantra in the life insurance industry is that it is not bought, it is sold. It has also been taught by carriers and passed from agent to agent that life insurance is a unique product that can be a one-size-fits-all miracle tonic that will cure whatever ails you. Life insurance, for the most part, has never been viewed as a part of an overall financial plan—rather it has been viewed as a financial plan in and of itself. We need to recognize that life insurance is a financial asset rather than property and that, as a financial asset, it needs to be measured on its own strength.

It is important to look at the history of how field representatives have determined life insurance needs. The word "agent" is important here since agents act on behalf of a principal, in this case, a life insurance company. Over the years, life insurance companies have been seeking to distance themselves from their agents (their distributors) and claim to bear no responsibility for the abuses carried out by some of their agents.

Suitability necessitates that agents and brokers fully understand their product. If sellers do not understand what they are selling, they cannot make a reasonable recommendation. For years, agents were asked to distribute products that were to some degree "black boxes." In other words, the agents had no idea what they were really distributing. The components of the products were a mystery in terms of the mortality costs, dividend determination, and overhead expenses. This started to change with the introduction of universal life; however, until the American Society of CLUs and ChFCs (now the Society of Financial Service Professionals) introduced the Illustration Questionnaire (IQ), the agents had neither knowledge nor ability to gain knowledge about the actual construction of the life insurance contracts. Added to that was the fact that agents and carriers were, until the introduction of the 1995 NAIC Life Insurance Illustrations Model Regulation, able to illustrate anything they wanted.

Another factor in determining suitability is the recognition that life insurance is indeed a financial asset and that it must stand up as such. A number of life insurance policies inherently do not. For example: In a case in which I was involved, the goal was to use life insurance to increase the future wealth of the beneficiaries. The clients' trust owned a $2 million, second-to-die policy (which pays a death benefit at the second death) life insurance and the insureds were, at the time, a 72-year-old couple. The policy had a planned annual premium of $50,000 for life. The rate of return at age 100 on death is only 2.4% (estate and income tax free), which is low considering there is a 20% chance that at least one person will live that long. Under FINRA regulations, this would most likely not be a suitable investment, due to the low rate of return. However, based on the risk factor, there could always be an argument that, if the clients were to die early (soon), it would be a good invest-

ment. This illustrates how the mix of life insurance into the planning process can make it a complex topic.

There is no shortage of abuses—for example, a case reviewed by the author involved the sale of a variable universal life policy with a face amount of $570,000 to a 33-year-old woman who had no dependents or any other discernible reason for life insurance. This woman receives a significant annual income stream from the estate of her father, and will receive a significant distribution from the trust when she reaches age 40. The trust also provides her with a residence at no cost and pays for all medical bills and unforeseen circumstances. Her children will be treated similarly upon her death. The life insurance policy that was sold to this woman was sold as a cash accumulation vehicle, not as a life insurance policy.

Due in part to the history of abusive life insurance industry practices, a majority of households remain underinsured. For some of these people, it has been the author's experience that they are turned off by the thought of life insurance, due to prior negative experiences with life insurance salespeople. Another cause is the failure to provide a coherent basis for life insurance recommendations.

Following is a summary of the FINRA Suitability Rules to give a sense of what factors you should consider:

- Collect and document comprehensive information about the customer's background, financial assets, investment goals, and risk tolerance. (FINRA Rule 2310(b), Recommendations to Customers [Suitability] [FINRA Manual 2001].)
- Only recommend policies that are appropriate for the customer's investment objectives and risk tolerance. (The FINRA reminds members of their responsibilities regarding the sale of variable life insurance in FINRA Notice to members 00-44 2000 [www.finra.org].)
- Consider whether the customer wants and needs life insurance, and whether the investor has the financial wherewithal to make the necessary payments. (The FINRA reminds members of their responsibilities regarding the sale of variable life insurance, supra.)

- Adopt procedures to ensure that replacement policies are suitable. (The FINRA reminds members of their responsibilities regarding the sale of variable life insurance, supra.)
- Transactions whereby a customer finances a new variable life insurance policy or annuity through the use of cash values from an existing policy are presumed unsuitable. (The FINRA reminds members of their responsibilities regarding the sale of variable life insurance, supra.)

The NASD recently changed their name and organization to FINRA. However, some of the rules have not been transitioned yet and some have, so the references may change.

One of the major issues in enforcing a suitability regulation is the long-term nature of life insurance. Often by the time a customer realizes he or she has been sold an unsuitable policy, many years have passed and the statute of limitations has expired. For this reason, it is essential that a life insurance suitability regulation contain a discovery rule to toll the statute of limitations. This ensures that customers will be protected from abuses that may take many years to unfold.

Under current state laws, life insurance agents and brokers have a duty of good faith and fair dealing. They do not currently have a duty to advise. It is time to recognize that, contrary to the mantra, life insurance is bought, and is bought as an investment product. Often customers do not understand what they are buying and rely upon their brokers to recommend appropriate products. The representatives and insurers oftentimes either do not understand what they are selling or recommend products for the primary benefit of themselves rather than for the benefit of their customers. The results are the abuses discussed earlier in this question.

Changing these approaches will especially be difficult in an industry where the most respected agents/producers are those who sell the most life insurance. These are some of the individuals whose names and pictures are on the walls at the life insurance company and who qualify for special trips and recognition. There are no rewards or recognition for ethical issues. So consider your advisor's background. A majority of agents/producers do have their client's best interests at heart.

Q66 Is There a Difference in How Often I Pay My Premium?

Changing how often you pay your premium could save you money (it may be a lot!). Almost always, you have a choice of whether to pay premiums monthly, quarterly, semi-annually, or annually. Insurance companies typically charge extra when you pay other than annually.

This is a factor applied to the annual premium to arrive at the premium if you elect to pay on a semiannual, quarterly, or monthly bank-draft basis. The mode premium factor for semi-annual premiums ranges from 51% to 53%, which means that you pay an extra 2% to 6% if you don't pay the premium annually. The mode factor for quarterly premiums ranges from 26% to 30%, which means that you pay an extra 4% to 20% by paying quarterly. The mode factor on monthly bank draft premiums ranges from 8.66% to 9%, meaning that you pay an extra 3.92% to 8%. The reason the monthly bank-draft mode premium factor is more economical than the quarterly mode factor is because monthly bank-draft persistency is better than quarterly mode persistency. (Companies charge these mode premium factors because when premiums are paid more often than annually, the company does not have the use of the premium dollars for the entire year. In addition, depending on the mode of payment selected, there is a higher probability that the policy will lapse.)

However, that's not the whole story. The actual charge is higher as is illustrated by the calculation and usage of an "Annual Percentage Rate (APR)" as defined under the "Federal Truth In Lending" law. This calculation illustrates a higher percentage rate than shown in the paragraph above. This is due to the fact that the policy owner does not have usage of the entire annual premium for the entire year.

You can judge whether you are willing to pay the extra cost by calculating the annual percentage rate (APR). Unfortunately, insurance companies are not required to disclose the APR, so you have to calculate it yourself. You can produce a good approximation with one of the formulas below. The first is for monthly premiums, the second is for quarterly, and the third is for semi-annual.

For example, if the monthly premium is $95 and the annual premium is $1,000, the first of the formulas would produce an annual percentage rate of about 29.7 percent, and it would clearly be in your interest to pay it annually. The calculation is shown below; the factors are below the formulas.

Sample calculation of APR—monthly premium is $95; annual premium is $1,000:

$$APR=\frac{3{,}600((12*\$95)-\$1{,}000)}{(13*\$1{,}000)+(42*\$95)}=\frac{3{,}600(\$1{,}140-\$1{,}000)}{\$13{,}000+\$3{,}990}=\frac{3{,}600(\$140)}{\$16{,}990}=29.7\%$$

Formulas for calculation of APR:

For Monthly Premiums: $$APR=\frac{3{,}600(12M-A)}{13A+42M}$$

For Quarterly Premiums: $$APR=\frac{1{,}200(4Q-A)}{5A-2Q}$$

For Semi-Annual Premiums: $$APR=\frac{200(2S-A)}{A-S}$$

Where:
M = Monthly Premium
Q = Quarterly Premium
S = Semi-Annual Premium
A = Annual Premium

The formulas and example are from *The Insurance Forum*, published by Dr. Belth and appeared in its April 1997 newsletter. On Dr. Belth's Web site you can find a calculator that will allow you to solve for the annual percentage rate as both a percentage and in dollar terms.

The reason the monthly bank-draft mode premium factor is more economical than the quarterly mode factor is because monthly bank-draft persistency is better than quarterly mode persistency. Companies charge these mode premium factors because when premiums are paid more often than annually, the company does not have the use of the premium dollars for the entire year. In addition, depending on the mode of payment selected, there is a higher probability that the policy will lapse. Also, this is oftentimes a profit center for the company.

It's important to keep in mind that the premiums on universal life policies are designed to be flexible. As such, the policy owner has the option when of and when to pay. Therefore, the application of the APR concept may arguably not apply, as life insurance premiums are not a debt (loan). Please note that as discussed in other parts of this book, missing premium payments can cause a policy to lapse, especially when they are non-scheduled, less than scheduled, or the policy is underfunded.

There has been some litigation in this area as to whether companies should disclose annual percentage rates (APRs). There are a few companies who have settled suits in this area and have added calculators to their Web sites. They are not listed in this book, as I feel that it would be inappropriate to send readers to a specific company. A calculator can be found on Dr. Belth's Web site at http://www.insuranceforum.com/pages/aprcalc.html.

Q67 What Is Insurable Interest?

Insurable interest means that the person who is purchasing the policy has more to lose than to gain by insured's death and therefore may purchase a life insurance contract on somebody else's life. This is intended to prevent a person purchasing a policy unknowingly on another person for purposes of wagering, planned murder, or any other reason.

An individual is deemed to have unlimited insurable interest in themselves and can purchase as much life insurance as they want (with no state restrictions), subject to the willingness of insurance companies to issue an applied-for amount of coverage. Otherwise, it is any instance where the insured carries an economic responsibility to a beneficiary.

Insurable interest is typically only required at the inception of the policy. After that, most states will allow that the beneficiary can be changed or the policy assigned without regard to insurable interest.

There are exceptions to these statements that vary on a state-by-state basis. Please contact your state insurance department (listed in Appendix A).

Recently there are concerns regarding questionable uses of life insurance, and insurable interest has become a hot topic. Life insurance up until recently has been used for the long-accepted purpose of providing a beneficiary with

a sum of money to replace some type of income loss. The usual needs on the personal side covered income protection for the family, mortgage, etc., and could be used to pre-fund a potential estate-tax liability. Other uses were for business purposes like key-person indemnification, buy-sell funding, etc. There are many different needs, though this covers the basics.

Over the last fifteen to twenty years, life insurance has entered into some very strange and complex uses. This is not altogether new. Some of these uses had roots in sound principles while others did not. Stretching the limits of usage for life insurance is nothing new. As mentioned in the opening of the book (Question 1), a concept known as the tontine annuity system was founded in Paris by the 17th-century Italian-born banker Lorenzo Tonti. Although essentially a form of gambling, this system has been regarded as an early attempt to use the law of averages and the principle of life expectancies in establishing annuities. Under the tontine system, associations of individuals were formed without any reference to age, and a fund was created by equal contributions from each member. The sum was invested, and, at the end of each year, the interest was divided among the survivors. The last remaining survivor received both the year's interest and the entire amount of the principal.

This eventually led to some not-so-desired ends resulting in the practice of taking out life insurance on strangers and having them murdered for profit. This was common in England in the 1700s and helped lead to the establishment of the British Life Assurance Act of 1774, wherein a policy of life insurance can only be procured by a party that has an insurable interest in the life of the insured. Recently, however, a variety of situations has arisen in which the party seeking a life policy does not have an insurable interest, yet is not engaging in a wagering transaction of the kind the Life Assurance Act and its progeny sought to forbid.

Understanding the concept of insurable interest will help in understanding some of the prevalent issues with the life insurance secondary marketplace and especially with a newer form generalized as Stranger-Owned Life Insurance.

This marketplace has pros and cons (see Question 132). Those in favor state that it will give the elderly, and their advisors, an additional financial

asset and additional leverage in terms of life insurance policy value. Those against the concept—aside from just the fact that the entire concept is considered "creepy" (my technical term)—state that it could ultimately (though not realistically) lead to murder for hire as in old England, though most likely result in financial havoc for the life insurance industry.

There are many issues of concern regarding the secondary life insurance marketplace. There are also the other uses of life insurance that stretch the intent of the tax rules and the meaning of "insurable interest." The only thing that is clear is that, for now, it is here and will need to be considered in planning situations. However, the different types of transactions and risks need to be carefully considered.

The transactions range from the fairly benign to highly malignant, and as is often the case, all might face the same treatment, as they cannot be sorted apart. The "insurable interest" concept and the unintended usages of life insurance will have an impact—the question is of what type and how much. Greed and abuse are fueling the debate and challenges brought on by the secondary marketplace. Remember that once a policy is sold, a third party gains a financial interest in the insured's early death and that the policy can be resold multiple times.

The future of the life insurance industry and a number of companies may be affected by the handling of the secondary marketplace. Despite all of the arguments, there are always facts and figures. Life insurance policies are priced based on mortality costs and expenses. The secondary marketplace and these other concepts introduce a new stress point on the pricing and there is no way that this cannot have an impact.

It's important to keep in mind that using life insurance for other purposes than intended could have dire consequences. Life insurance is for insuring lives rather than investing. The long-term effects and the interpretation of insurable interest will have a significant impact on the future of the life insurance industry and will bear continued monitoring.

As an example of insurable interest, the following is how the state of California defines insurable interest (as mentioned above, each state's insurance code has it's own specific definition for insurable interest (please see Appendix A for a listing of state insurance departments). This is included

because this provides a good representation of insurable interest rules. The State of California Insurance Code §10110 states that:

Every person has an insurable interest in the life and health of:

(a) Himself.

(b) Any person on whom he depends wholly or in part for education or support.

(c) Any person under a legal obligation to him for the payment of money or respecting property or services, of which death or illness might delay or prevent the performance.

(d) Any person upon whose life any estate or interest invested in him depends.

This is continued in Insurance Code § 10110.1:

(a) An insurable interest, with reference to life and disability insurance, is an interest based upon a reasonable expectation of pecuniary advantage through the continued life, health, or bodily safety of another person and consequent loss by reason of that person's death or disability or a substantial interest engendered by love and affection in the case of individuals closely related by blood or law.

(b) An individual has an unlimited insurable interest in his or her own life, health, and bodily safety and may lawfully take out a policy of insurance on his or her own life, health, or bodily safety and have the policy made payable to whomsoever he or she pleases, regardless of whether the beneficiary designated has an insurable interest.

(c) Except as provided in Section 10110.4, an employer has an insurable interest, as referred to in subdivision (a), in the life or physical or mental ability of any of its directors, officers, or employees or the directors, officers, or employees of any of its subsidiaries or any other person whose death or physical or mental disability might cause financial loss to the employer; or, pursuant to any contractual arrangement with any shareholder concerning the reacquisition of shares owned by the shareholder at the time of his or her death or disability, on the life or physical or mental ability of that shareholder for the purpose of

carrying out the contractual arrangement; or, pursuant to any contract obligating the employer as part of compensation arrangements or pursuant to a contract obligating the employer as guarantor or surety, on the life of the principal obligor. The trustee of an employer or trustee of a pension, welfare benefit plan, or trust established by an employer providing life, health, disability, retirement, or similar benefits to employees and retired employees of the employer or its affiliates and acting in a fiduciary capacity with respect to those employees, retired employees, or their dependents or beneficiaries has an insurable interest in the lives of employees and retired employees for whom those benefits are to be provided. The employer shall obtain the written consent of the individual being insured.

(d) An insurable interest shall be required to exist at the time the contract of life or disability insurance becomes effective, but need not exist at the time the loss occurs.

(e) Any contract of life or disability insurance procured or caused to be procured upon another individual is void unless the person applying for the insurance has an insurable interest in the individual insured at the time of the application.

(f) Notwithstanding subdivisions (a), (d), and (e), a charitable organization that meets the requirements of Section 214 or 23701d of the Revenue and Taxation Code may effectuate life or disability insurance on an insured who consents to the issuance of that insurance.

(g) This section shall not be interpreted to define all instances in which an insurable interest exists.

Q68 What Should I Consider in Choosing a Beneficiary?

This really will depend on your personal situation, as well as on the laws of your state. As I am not an attorney, I can only give you some basic guidance. A beneficiary is the person who will receive the funds in your policy when you die. You can name a primary and a contingent beneficiary, as well as naming multiple primary and contingent beneficiaries.

The proceeds from a life insurance policy usually go directly to the beneficiary, thus avoiding probate. Life insurance proceeds are usually not subject to income tax. If there is still an estate tax and your estate is subject to this tax, then the life insurance proceeds may be subject to the estate tax. There are methods using a "trust," which can assist in this situation. It is advisable to work with an estate planning attorney and have a will drawn up—and a trust, if the attorney feels that it a benefit to you. When you do meet with the estate-planning attorney, you should discuss your life insurance. If you already have drawn up a will or trust, you should call your attorney prior to applying for insurance. If you do not have either document, you can change the owner and beneficiary of your life insurance policy at any time.

If you have multiple beneficiaries, you can add one of the following definitions to further direct the distribution of the death benefit:

- Per Capita—this means that if a beneficiary dies before the insured, the remaining beneficiaries will equally divide that share of the proceeds in addition to receiving their own shares when the insured dies either (1) by head or by individual or (2) to share equally.
- Per Stirpes—this means that if a beneficiary dies before the insured, that beneficiary's share of the proceed will pass upon that beneficiary's heirs rather than going to the remaining beneficiaries when the insured dies. It means by family branches, i.e., a method of dividing benefits among living members of a class of beneficiaries and the descendants of deceased members. It is very important to make sure that all documents are clear and concise, because you will not be around to clarify them. Make sure that there are no spelling errors and full names are used. If you have a child under the age of 18 and you name them as a beneficiary, whoever has physical guardianship will typically have financial guardianship. That may not be how you wish for it to be. Again, that's why it is a good idea to have estate planning done with an estate planning attorney.

In my opinion, only an estate-planning attorney should handle estate planning. Beware of living-trust seminars and non-attorneys peddling living trusts.

Another issue to consider is a simultaneous death, where the insured and primary beneficiary die together, such as in a car crash and it cannot be determined who died first. Some states have enacted the Uniform Simultaneous Death Act, which provides that, in such a case, the proceeds are paid as if the primary beneficiary died first. Therefore, the proceeds would be received by the contingent beneficiary. If there were no contingent beneficiary, the insured's estate would receive the proceeds. Therefore, it's important to consider this in your estate planning and address it.

Q69 Who Should I Name as the Policy Owner?

For the most part, the same issues that apply in choosing a beneficiary apply here as well. Typically, the insured is the owner (at least in community property states). I am not familiar as to whether or not this is the case in separate property states, since my practice has been limited to community property states. Separate property states have different estate-planning practices. You may want to research this. A good place to start is with Nolo Press and their Web site at www.nolo.com. When the insured is not the owner, it is generally for specific reasons, such as for estate-planning purposes. As discussed in the previous question, you should strongly consider having at least a will drawn up. You may wish to discuss this with your attorney, if you have one.

It is not always necessary to engage an attorney if you wish to research the ownership and beneficiary issues yourself and are aware of the pros and cons.

Q70 What Are Life Insurance Survivor Options?

On fewer and fewer new policies and almost all older ones, the insurer offers a variety of survivor options when the insurer passes away. The following is a list of the more common settlement options:

- Lump Sum Payment
- Income for a Fixed Period from 5 to 25 Years—if you should die before the payments are complete, your beneficiary will get the remainder in the same time intervals.

- Life Income with a Guaranteed Payment—You collect a payment for the rest of your life at least equal to a guaranteed amount (calculated by the insurance company). If you should die before the guaranteed amount is paid, your beneficiary will receive the difference at your death.
- Joint and Survivor Life Income—Payments are made for your life and the life of your selected survivor. Your survivor does not have to get the same amount—it may be preselected at 33%, 66%, 100%, etc.
- Lifetime Income—This provides income for your life ONLY. When you die, payments cease altogether.
- Installment Refund with Life Income—You will receive income for life. Should you die before you have received total payments equal to your initial contribution, your beneficiary will receive the difference.
- Income of a Specific Amount—You can select an amount to be paid until the principal is exhausted.

The decision of which option to take is complicated. Keep in mind that the rate of return on the various options (except the lump sum) is low—so you may not be maximizing the rate of return. Another consideration is that, except for the lump-sum option, access to the fund will be lost.

Currently, most carriers, upon presentation of a death certificate (and any required paperwork), deposit the proceeds into a money-market account and send the beneficiary a checkbook. The checkbook can then be used to write checks up to the total amount of the death benefit (plus any interest).

Q&A

CHAPTER 7

UNDERSTANDING UNDERWRITING

Q71 What Is Underwriting and Why Is It Important to Me?

You've looked at various life insurance policies, you've compared companies, and now you're ready to apply for a policy. You may be about to embark on a long and winding path before that newly issued policy is in your hands. This is especially so if you have a significant health condition ranging from minor (e.g., height and weight, blood pressure) to major (e.g., cancer, heart disease). To get your policy issued, you must successfully pass the company's underwriting process. Choose your company with care: There are differences in underwriting philosophy from company to company.

Q72 How Do I Begin to Understand the Underwriting Process?

To understand the underwriting process, first recognize that insurance medicine differs from clinical medicine. The latter is about diagnosis and treatment; your doctor's job is to keep you well, and to make you well again if you

get sick. That is clinical medicine. In contrast, insurance medicine seeks to determine the level of risk assumed by the insurance company if it issues a policy, and to set an appropriate premium to cover that risk.

Company A may react differently to a given medical condition than Company B. One company's "standard" risk is another carrier's rated (i.e., issued at a higher-than-standard premium rate) risk. While modern life underwriting is a sophisticated process, with elaborate point rating systems and complex underwriting manuals that vary from company to company, it is still more art than science.

Take the time to discuss the underwriting process with your insurance advisor so you will know what to expect. Make sure that your advisor is experienced enough to get you the best offer from a suitable company. A lot of agents will wait until the company makes an offer. Only at that point, and sometimes only when the client persists, will the agent seek quotes from other companies. My philosophy is to do this ahead of time, in the hope and expectation that the company, with whom we start the process, will issue a policy. This involves an informal, advance discussion of the case, with an underwriter, to reduce or eliminate any surprises.

In insurance medicine, the underwriter works with the company's medical director to make a mortality assessment (i.e., determine the applicant's life expectancy with reference to a mortality table), considering all relevant factors, such as disease or medical problems present at the time of application. The underwriter considers all the available information and then renders an expert opinion of the applicant's insurability and the premium to be charged. Some weight may be given to the quality of care being received from a physician.

Q73 How Does the Underwriting Process Work?

At this point, you have selected the company to which you are going to apply for a policy, and also, your life insurance advisor. If your advisor is on the ball, he or she should have prepared a proposal based on the pre-underwriting issues described in the previous section. Caution—if you think there might be pre-underwriting issues and you have not disclosed them to your advisor, this could very well come back to haunt you.

The next step is completing the application. Answer the questions as completely, truthfully, and accurately as you can. Your advisor should be able to help you with any questions about the application. Your advisor is, in most cases, an independent broker and not an employee of the insurance company. The advisor is not authorized to make or modify contracts, waive any requirements, or advise you to omit any information that may be requested by the insurance company. You must make a good-faith full disclosure to the company of any and all information that may affect the underwriting of your application.

Q74 What Are Some Tips for My Life Insurance Examination?

Please note that I am not a physician, and I cannot guarantee the effectiveness of these tips. But they are a result of long experience and many discussions with home office underwriters and other involved people over the years:

- Insurance companies are looking for average people, not supermen, so relax as much as possible during the examination. Underwriting is done on the basis of your medical history, as well as on the results of your current exam.
- It is better not to eat for eight hours prior to the examination and take little or no caffeine. Schedule a morning examination if at all possible, when you're more likely to be relaxed.
- Alcohol tends to elevate blood pressure for twelve to twenty-four hours. I suggest no alcohol for twenty-four hours prior to the examination.
- One key factor is a good night's rest before the exam.
- If possible, give a urine specimen before a blood pressure check, since the elimination of fluids tends to moderately lower blood pressure.
- If you are a smoker, we suggest that you do not smoke at all within thirty minutes of the exam. Smoking tends to elevate blood pressure by constricting the artery walls.
- Salt retains fluids. Avoid salt or use it very lightly for three or four days prior to the examination. This can have a beneficial effect on your blood pressure.

- To the best of your knowledge, give your complete medical history or important items. Be certain the examiner correctly lists the location of doctors and hospitals that you have seen in the past, since the insurance company will most likely request their reports. Do not try to hide any of your medical history, since this tends to make it look worse than it probably is.
- You should discuss any potential problems with your advisor prior to the examination. This can affect your advisor's recommendations, such as which company or companies to apply to and how to prepare for the underwriting process. The advisor might want to discuss your case informally with the underwriter before you apply. In some cases, this can be beneficial.
- For the EKG (electrocardiogram) test, which is a graph of the electrical activity of the heart, be relaxed and comfortable prior to it. Do not use coffee or other stimulants. If you are aware of EKG changes that have been noted and evaluated in the past, then it is most helpful to bring those to the examiner's attention as well as to your advisor. Some people have an abnormal-looking EKG, but it is normal for them.

An employee of a third-party firm (contracted by the company) may be contacting you, your advisors, or acquaintances as part of a routine inspection regarding your preliminary insurance application. This is a traditional part of the application process. Usually, these questions are handled efficiently and in a professional manner. Please let your advisor know if there are any problems. This is known in the industry as an inspection report. It will seem as if you have been asked these questions before, and you probably have. Insurance companies try to corroborate information from different sources.

Q75 Who Is the Medical Information Bureau (MIB)?

The Medical Information Bureau—known in the industry as MIB—was established in 1902. For most people, MIB remains a mysterious component in the life insurance underwriting process. If you have ever applied for life, health, or disability insurance, chances are you're in the MIB database. MIB is a valuable asset to both the life insurance industry and the insurance-buying public. MIB keeps premium costs low by helping to detect insurance fraud.

Fraud runs up claim costs, which are borne by everyone who pays life insurance premiums.

According to the MIB Web site (located at www.mib.com)—"The vast majority of persons who apply for life, health, disability, and long-term care insurance are honest and forthright in their answers to questions on insurance applications and medical exam forms concerning any medical conditions they currently have as well as their health histories. That would additionally include information on any other hazards to which they may have been exposed at work or at play. Unfortunately, a relatively few attempt to circumvent the process. In doing so, they increase the costs of the insurance company, which, in turn, may result in reduced dividends for existing policyholders and increased premiums for applicants."

MIB is nothing more than an information clearinghouse that stores information, gathered by over 600 insurers, in processing and underwriting cases. Member companies send an inquiry to MIB and receive a short, coded report with information on the applicant's medical history and other relevant underwriting information. MIB carefully guards the privacy of the information in its database, and only member companies may access it. All MIB member companies must agree to a strict set of standards for use of the data provided.

An MIB inquiry often guides insurers to information that is valuable in assessing risks. MIB is a taxpaying organization, supported by assessments from member insurance companies based on their total insurance in-force and business written in the previous year. Additional revenue comes from user fees based on the number of inquiries a member company submits to MIB. It is estimated that over 90% of the individual life insurance policies and 80% of the health and disability policies issued in the United States and Canada are subject to the MIB system. This is done through member companies and reinsurance treaties that nonmember companies have with member companies.

The MIB will also provide you with an annual record disclosure without charge. To request the free disclosure (according to the MIB Web site as of 8/22/2006), you must call MIB's toll-free phone number, 866-692-6901. (TTY 866-346-3642 for hearing impaired.)

Here are details from the Web site http://www.mib.com/html/request_your_record.html:

A few things to bear in mind before you call—

> If you have not applied for individually underwritten life, health, or disability insurance during the preceding seven-year period, MIB will not have a record on you.
>
> We will ask you for personal identification information to assist us in locating a record, if one exists. We may validate the identification information that you provided with other consumer reporting agencies.
>
> You will be asked to certify under penalty of perjury that the information you provided about yourself to request MIB disclosure is accurate and complete, and you represent that you are the person that is requesting disclosure.
>
> Upon receipt of your (a) request for a Record Search and Disclosure, and (b) proper identification, MIB will initiate the disclosure process and provide you with:
>
> - the nature and substance of information, if any, that MIB may have in its files pertaining to you;
> - the name(s) of the MIB member companies, if any, that reported information to MIB; and,
> - the name(s) of the MIB member companies, if any, that received a copy of your MIB record during the twelve (12) month period preceding your request for disclosure.

MIB is committed to the philosophy that every consumer should be entitled to know the contents of his or her record maintained by MIB and has the right to correct any inaccurate or incomplete information in the record.

Q76 What Is a Rated Premium (and/or Do I Have a Known or Unknown Medical Condition)?

Once the insurance company receives your application, the underwriting department will begin the evaluation process—this is known as underwriting the case—to determine whether or not you qualify for the insurance and, if so,

what is the appropriate rate classification (discussed previously). The company may determine that insurance coverage cannot be issued as applied for. In that case, the company is likely to offer you insurance on a modified (rated) basis.

Life insurance companies employ a medical director, who advises the underwriting department on difficult or borderline applications. The medical director will be an M.D., and may be a full-time employee or a part-time consultant.

If your application is a borderline case, chances are the medical director will have been consulted. In many cases you can negotiate with the company. This may call for furnishing additional detailed information about the condition or conditions that concern the underwriter. That is why it is important to find out the exact reason why your application was declined or rated. With that information in hand, you should then consult your personal physician. Always bear in mind that the insurance company is taking on a risk by offering you insurance, so that their view of your medical situation will necessarily be more conservative than your doctor's opinion. If your physician does not agree with the insurance carrier's decision, one of two things may be occurring.

First, your physician may not have been fully forthcoming with you regarding a health condition or you may have a new condition. Second is that the insurance carrier does not know the full details. This may be due to incomplete medical records or some other reason. This is where your choice of advisor can play a major role. Your advisor should act as your advocate in case your application is declined or modified, to see if furnishing additional information will allow the company to make a more favorable offer.

I have found that in about 50% of the cases where the initial offer is not favorable, this is due to poor communication. Your advisor will find out as much as possible about the company's reasoning for the declination or modified offer. Then you can discuss the situation with your own doctor. After assessing the situation in this way, your advisor may suggest further negotiations with the insurance company in an attempt to get a better offer. Alternatively, your advisor may suggest shopping around for a life insurance company with more experience in underwriting and issuing policies for cases similar to yours.

Underwriting departments tend to become specialists and to develop their own comfort levels with certain types of medical conditions. This is also true of life insurance companies, whose experience with different ailments will find its way into the company's underwriting criteria. After many years of working with these conditions, companies compile reliable statistics that may allow them to make a more favorable offer. Two very important underwriting variables are the company's risk tolerance for a given medical condition, and how it sets an appropriate rating and premium for that condition. These factors vary from company to company. Again, underwriting is more art than science, and different companies may view a given medical condition or lifestyle consideration differently.

Occasionally—perhaps 10% to 15% of the time—the applicant will be offered a rated policy. This means that the applicant does not meet the company's standard rating criteria and the company must therefore charge a higher premium to cover the increased risk. Ratings are assigned based on health history and lifestyle considerations. Here are some examples of situations that may result in a rated policy: (a) family history of cancer or heart disease; (b) multiple moving traffic violations within a certain period of time; (c) hazardous avocation (e.g., deep scuba diving, parachute jumping, mountain climbing); (d) height and weight outside the company's standard criteria; (e) tobacco usage or any health issue that is not under control or otherwise being dealt with; (f) history of certain conditions, such as cancer or heart disease; and many other conditions. The underwriter is looking for anything that might affect mortality.

Some companies offer an impaired risk program. These are designed to provide insurance to those who have health issues that caused them to be declined coverage elsewhere. There is a considerable number of such companies, and typically, it will be a large, respected company offering a full range of life insurance products. A few companies offer guaranteed issue or simplified underwriting programs. There are even some "impaired risk" products (i.e., for those with significant medical conditions) available with no extra premium over the company's standard rate. All rated and declined applications should at least be considered for impaired risk underwriting. It's worth a try in most cases. Appendix D has a list of a number of conditions and

lifestyle considerations plus what to expect and assistance that can be given in underwriting. Your advisor is a valuable resource in determining options for your specific background.

Don't give up hope—there may be life insurance available to you at an affordable cost. The best way to find out is to check around. Your advisor can help you to do this.

Even with a rated premium, the applicant may have a life expectancy well into the 70s or 80s. Only about 5% to 6% of the time will the application be declined. Declined applications are comparatively rare and are reserved for the most serious medical conditions, such as cancer (currently under treatment) or advanced heart conditions.

Tobacco usage is another factor that can vary greatly from company to company. Smokers should take special care in selecting the right companies to apply to for coverage. (See Question 79).

Rate classifications: Since each applicant's circumstances are unique, the risk-assessment process must be tailored to each applicant's situation. Underwriting requires good judgment, for there is no one magical solution to every underwriting problem. Here is where an independent life insurance advisor can pay off for you. Your advisor works with several different life insurance companies on a regular basis, and is therefore in a position to choose the company most likely to issue the sought-after policy on the most favorable terms.

A life insurance policy is a financial asset, just like stocks and bonds. The key to successfully getting through the underwriting process is finding a company that will invest in your life. The company wants you to live long and prosper.

Q77 How Will My Build Affect My Insurance Premium?

This can often depend on the life insurance company. Your height and weight can have a significant impact on your life insurance premium. As your doctor probably reminds you each year, the more you weigh, the greater your chances are of certain health conditions.

And with life insurance companies, the more you weigh, the more you will pay. This extra amount of premium is incremental and increases as your weight increases over the desired weight. Even a slight amount of extra weight can change your rate class from an insurance company's best rate.

The tables below contain height and weight guidelines from one life insurance company.

Build Chart (Female):

Height	Weight	Height	Weight	Height	Weight
5'0"	145	5'7"	176	6'2"	216
5'1"	149	5'8"	182	6'3"	222
5'2"	153	5'9"	188	6'4"	227
5'3"	158	5'10"	193	6'5"	233
5'4"	162	5'11"	199	6'6"	238
5'5"	166	6'0"	205	6'7"	243
5'6"	170	6'1"	211	6'8"	249

Build Chart (Male):

Height	Weight	Height	Weight	Height	Weight
5'0"	154	5'7"	192	6'2"	234
5'1"	159	5'8"	197	6'3"	240
5'2"	164	5'9"	203	6'4"	246
5'3"	169	5'10"	209	6'5"	253
5'4"	175	5'11"	215	6'6"	260
5'5"	180	6'0"	221	6'7"	266
5'6"	186	6'1"	227	6'8"	273

Q78 What Are Some Sample Guidelines to Qualify for Preferred Rates?

The table on the following page shows samples from one life insurance company's underwriting guidelines as of 2008. These guidelines are for this carrier's best available rates and their next two higher rate categories, so that you can see the difference. This is not a guarantee of any current guidelines.

Q79 How Will Tobacco Usage Affect My Premiums?

This will depend on the carrier. Carriers also treat the different forms of tobacco, such as cigarettes, cigars, and chewing tobacco, in their own fashion. In any event, the usage of tobacco will increase your premium; the only question is how much. Rate classification for tobacco usage will depend on the type of tobacco. For non-tobacco classes, it will depend on the date of the last usage of tobacco. There is a wide range of how life insurance companies treat those who use tobacco. A couple of considerations are the type of tobacco used and, if no longer using tobacco, the last date of usage. This is an area that you need to have a representative who has access to a number of carriers and will get you quotes from multiple carriers.

	Tier 1 (Best Available):	**Tier 2:**	**Tier 3:**
Impairments/personal history:	No diseases, disorders, or activities that would affect mortality	No diseases, disorders, or activities that would affect mortality	No diseases, disorders, or activities that would affect mortality
Blood Pressure:	No current, or history of, blood pressure treatment or medication. Current and past readings cannot exceed: * 140/85 (age 60 or younger) * 150/90 (age 61 or older)	Currently controlled and average reading in last 2 years (including treatment) does not exceed: * 140/90 (age 60 or younger) * 150/90 (age 61 or younger)	Currently controlled and average reading in last 2 years (including treatment) does not exceed: * 150/90 (age 60 or younger) * 155/90 (age 61 or younger)
Family History:	No cardiovascular or cancer disease (except basal cell carcinoma) in either parent or siblings on or before age 60	No cardiovascular or cancer death in either parent on or before age 60	Not more than one cardiovascular death in or before age 60
Driving History:	No DWI, DUI, reckless driving, license revocation, or suspension in last 5 years	No DWI, DUI, reckless driving, license revocation, or suspension in last 5 years	No DWI, DUI, reckless driving, license revocation, or suspension in last 3 years
Nicotine:	No use of nicotine or nicotine substitutes in last 5 years (occasional cigar use may be okay if minimal and current nicotine test is negative)	No use of nicotine or nicotine substitutes in last 3 years (occasional cigar use may be okay if minimal and current nicotine test is negative)	No use of nicotine or nicotine substitutes in last 2 years (occasional cigar use may be okay if minimal and current nicotine test is negative)
Cholesterol:	240 mg/dl (treated or untreated–maximum reading)	270 mg/dl (treated or untreated–maximum reading)	285 mg/dl (treated or untreated–maximum reading)
Cholesterol/ HDL Ratio:	5.0 (maximum)	6.0 (maximum)	7.0 (maximum)
Alcohol/Substance Abuse:	No history or treatment for alcohol or substance abuse: ever	No history or treatment for alcohol or substance abuse: last 10 years	No history or treatment for alcohol or substance abuse: last 7 years
Aviation:	Flat extra premium (usually available) or excluded	Flat extra premium (usually available) or excluded	Flat extra premium (usually available) or excluded
Hazardous Occupation or Avocation:	May require flat extra premium	May require flat extra premium	May require flat extra premium

A special note for cigar smokers is that some companies will consider you a non-smoker if you smoke cigars only occasionally (less than 10 a year—typically) and test negative for nicotine on your lab tests.

If a carrier finds out, at any time, that an insured misrepresented information regarding tobacco usage, they will rescind the policy as a material misrepresentation. In other words, they will cancel the policy, thus defeating the entire purpose of obtaining coverage. Some carriers will pay the death benefit based on the amount of coverage that the premiums paid would have purchased on a smoker basis; however, the majority do not, as this is not fair to the truthful applicant.

Q80 How Do I Find Out Why My Life Insurance Application Was Not Approved or Modified?

An option is to write a letter to the insurance company asking for the results of any exams and any other reasons for their decision. They will require the name and address of your physician and will send the information there. (note: If your application was approved, you can also request the results of your exams.)

This is required under the U.S. Fair Credit Reporting Act, which states that life insurance companies must inform you why an "adverse decision" was made on your life insurance application (meaning why it rejected you or placed you in a higher-risk class).

Insurers are not required to go into great detail on exactly what medical condition led to an adverse decision. The concept is that insurers do not like to "intrude" on the relationship between applicants and their physicians, and insurers do not want to be in the position of giving an applicant a detailed diagnosis of his or her condition.

If the life insurance company has acquired medical information from your doctor, you can ask your doctor for the same information, along with an explanation of your condition.

Occasionally, in the exams performed for the insurance company, a new condition is found that your physician is not aware of or has chosen not to discuss with you. When this happens, you have to really press your physician to find out the truth.

Q81 What Is Financial Underwriting?

An often overlooked but critical consideration is financial underwriting. This is especially important in larger cases and some business situations. You, as an individual applicant, may have to justify to the insurance company the amount of coverage applied for. Life insurance companies are sensitive to the over-insurance problem—where someone is insured for more than an insurable interest. When someone applies for a large amount of life insurance, there is reason why. Financial underwriting seeks to find out why, and to ensure that the amount of coverage can be justified. Therefore, the amount of coverage bears a definite relationship to the applicant's net worth and income. The underwriter needs to know the purpose of the coverage applied for. This helps the underwriter determine if the beneficiary's economic loss—in the event of the insured person's death—is in line with the total amount of insurance in-force.

Other factors considered during the financial underwriting process, are a growth rate and duration variables. Forecasting the future value of financial and other assets is guesswork, and there is no reliable way to predict the future. Underwriters are trained to take future value into consideration. Future value is today's value plus compound interest and/or other growth in value over time, to a specific point in the future. It is calculated by using an assumed interest rate or rate of appreciation during the desired time horizon.

More sophisticated analyses of future value employ a very complex statistical technique, known as stochastic modeling. This takes variability of future possible outcomes into consideration. There is very little published information available to help in predicting how much net worth increases over time.

While medical underwriting is more art than science, the opposite is true of financial underwriting. Many tools and techniques have been developed over the years, such as income multiples, capitalization formulas, and the future-value approach. The underwriter is looking for evidence of anti-selection (where the risks are not evened out; i.e. lopsided). This is also known as "selection against the company." It means that the applicant and/

or the intended beneficiary is especially claims-conscious and thereby more likely to anticipate a death claim than the average insured risk. To help minimize the impact of financial anti-selection, underwriters commonly apply four tests:

1. Vulnerability—Is insurance the best method for protecting the financial objective?
2. Attainability—Is the forecasted asset or value growth realistic?
3. Normalcy—Is the financial objective normal or speculative?
4. Desirability—How strongly motivated is the applicant to achieve the stated objective?

The risks considered during the financial underwriting process include:

- Inflation, which reduces purchasing power over time
- Family or partnership situations—divorce or the possible breakup of a business partnership
- Financial uncertainty—e.g., job loss, disability, or reduction of future profits/earnings
- Tax law changes, which affect future projections
- Market risks, which affect future values
- Interest rate changes, which affect asset valuations

Q82 How Does the Conditional Receipt Work?

The conditional receipt: In most cases, when your application is taken, you will tender the initial premium payment with the application and you receive a conditional receipt. The conditional receipt binds your life insurance coverage effective on the date of your application (the exact conditions vary a bit from company to company), provided that you are eligible for the coverage applied for. An example will help you understand how a conditional receipt works: Suppose you apply for a $1 million face amount life insurance policy, you are in excellent health on the date you applied for the coverage, and you received a conditional receipt. Then suppose you are run over by a truck the next day in an unfortunate accident. Even though the insurance company has not even received your application, your beneficiary will receive the $1 million, once the company underwrites the case and determines that you were eligible

for the coverage applied for. In this case, you paid just one premium payment and your beneficiary collects the proceeds.

Now suppose you have a serious heart condition, of which you are unaware. Otherwise, your situation is identical to that described above. You apply for the coverage, get your conditional receipt, and take a medical examination the next day. On the way home, the truck runs over you and you are killed. Since you were not eligible for the coverage as applied for, the company underwrites the case, discovers your heart condition, declines the claim and returns your premium payment to your beneficiary. That's how a conditional receipt works. It is, in effect, a limited life insurance agreement, good until the company can underwrite the case and make a final determination of your eligibility for the coverage you applied for.

Q83 Why is Honesty the Best Policy and/or Can What the Insurance Company Doesn't Know Hurt You?

Keep in mind that a life insurance policy is a unilateral contract. One party makes an offer and the other party accepts it "as is." This differs from most contracts, which are bilateral.

Most policies are issued with a two-year "incontestability" clause. A typical such clause reads: "Except for non-payment of premium, we will not contest this contract after it has been in-force during the insured's lifetime for two years from the date of issue." During the first two years, the company can challenge (contest) the policy if there is any reason to do so, such as suspicion that the applicant lied.

One commonly asked question is what if I smoke and don't admit it? Most likely the application will not make it through the underwriting process, because nicotine will show up in the urinalysis or in the medical records. Even if a smoker makes it through the underwriting process and gets a policy issued without disclosing tobacco use, if he or she dies during the contestable period, the company can rescind the policy (cancel it retroactively) and deny the claim. In that case, the company's sole obligation to the beneficiary would be to return the premium payments that have been made, with interest. In case of outright fraud, a company may choose to contest a claim for longer than the two-year contestable period.

Q84 Is There Anything Else That I Need to Know About Underwriting?

This section is an overview of the life insurance underwriting process. Each company has its own individual procedure and requirements. Most companies will look at the state Department of Motor Vehicle reports. You may be asked to fill out a supplementary questionnaire, such as a travel or aviation form.

A note on genetic testing. There is currently no federal law that limits the use of genetic information by life insurance companies. A few states have proposed legislation. Insurance companies will usually only consider genetic tests ordered by medical providers. These tests are typically done when there is a family history of a disease or as a diagnostic tool. Your medical records will include any such test results. A 2018 study published in Genetics in Medicine found that 40% of gene variants identified by direct-to-consumer kits were false positives. And some genetic variants that were called "increased risk" by the DNA companies were classified as benign and common by clinical labs.[3]

The life insurance company retains (keeps or underwrites) the risk, up to the company's specified retention level. For example, a life insurance company might retain up to $1 million on any one insured life. Above the retention level, the case is reinsured with one or more other companies. The reinsurance process is invisible to the insured person, and the original writing company is solely responsible for paying the death benefit in the event of a claim. If yours is a very large case, your advisor will help coordinate the underwriting and reinsurance process and this can smooth the issuance of your policy.

Your advisor and your approach to and attitude towards the underwriting process can have a significant impact on a favorable outcome. Life insurance companies are in business to serve the public and make money. They are vitally interested in a deal that amounts to a win-win situation for both parties to the contract.

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3. Stephany Tandy-Connor, Jenna Guiltinan, Kate Krempely, Holly LaDuca, Patrick Reineke, Stephanie Gutierrez, Phillip Gray, Brigette Tippin Davis, "False-positive results released by direct-to-consumer genetic tests highlight the importance of clinical confirmation testing for appropriate patient care," *Genetics in Medicine*, December 2018, https://pubmed.ncbi.nlm.nih.gov/29565420/.

CHAPTER 8

MONITORING YOUR IN-FORCE LIFE INSURANCE POLICY

Q85 How Do I Monitor and Evaluate an In-Force Policy?

As we've seen, there are many components that can affect the performance of a life insurance policy. The key in monitoring and evaluating a life insurance policy is determining how and if these components have changed and are affecting its performance. There are differences if you are monitoring a policy purchased recently and monitoring (or evaluating) an older policy. I will make that distinction where it is possible.

Q86 What Areas Should I Review for Potential Changes?

Life insurance is an asset that must be purchased and monitored with care. The following questions cover areas where attention to detail can add value for the beneficiaries and prevent trouble in the future. The focus is on existing policies, however, many of these items also apply to new policies.

- Face amount—every two to three years, you should review your term life insurance needs.
- Policy type (discussed in Chapter 2, Questions 4 through 19)— such as whether the policy is term, whole life, universal life, variable life, etc.
- Riders—are they still needed?

The following is a summary that I prepare annually for each client to ensure that all information is updated and the owner and/or trustee is fully informed. The summaries are based on information provided by the insurance carriers. It does not cover every potential issue; it is designed for policy owners to have the basics of their policy and it is always used in conjunction with the carrier's most recent annual statement and the following guide. Not all of the categories are applicable in every instance. This may be useful to you in reviewing some of the more important factors of your policy.

Term Policy Information:

Insured:
Carrier:
Policy Number:
Type of Coverage:
Face Amount:
Issue Date:
Premium Mode:
Modal Premium:
Premium (if switched to Annually):
Annualized Current Premium:
Annual Savings if Switched to Annual:
Re-entry Date:
Last Conversion Date:
Primary Beneficiary:
Contingent Beneficiary:
Owner:
Riders:
Notes/Comments:
Outstanding Items:

The following is a guide to the terms used above. Other terms specific to your term policy may be found in the glossary section:

- **Type of Coverage:** This is the type of term life insurance coverage insuring your life.
- **Face Amount:** This is the amount your beneficiaries would receive in the event of your death (less any policy loans outstanding).
- **Premium:** This is your premium and how it is paid.
- **Issue Date:** The date your policy became effective and was issued by the insurance company.
- **Re-entry Year:** If applicable, this is the year that you will need to requalify for preferred rates. Please read your policy for further information or contact my office.
- **Last Conversion Year:** This is the last year that you can convert your term life insurance to permanent life insurance without evidence of insurability.
- **Primary Beneficiary:** This is your primary beneficiary.
- **Contingent Beneficiary:** If applicable, this is your contingent (or secondary) beneficiary who would receive the proceeds of your policy should your primary beneficiary predecease you.
- **Riders:** If applicable, what riders you have elected on this policy.

Q87 Is My Current Permanent Life Insurance Policy in Good Health?

If you have a life insurance advisor, then they should have been reviewing the policy with you. You should have also been presented with an in-force illustration, which will tell you how the policy is projected to perform into the future, based on current values and assumptions. These in-force illustrations are critical to you as a policy owner.

However, before we discuss in-force illustrations, you may wish to use the following list to help gather information about your policy.

Whole Life Policy Information:

Insured:
Carrier:
Policy Number:

Type of Coverage:
Face Amount:
Issue Date:
Premium Mode:
Modal Premium:
Premium (if switched to Annually):
Annualized Current Premium:
Annual Savings if Switched to Annual:
Primary Beneficiary:
Contingent Beneficiary:
Policy Owner:
Premium Payer:
Riders:
In-force Illustration Dates: Last: Next:
Gross Cash Value:
Surrender Charge:
Policy Loan:
Net Cash Value:
Participating or Non-Participating:
Paid Up Additions:
Crediting rate, loan rates, etc.:
Notes/Comments: This section would include notes about the results of the most recent in-force illustration, which is typically requested from the carrier every 3 years or upon request from the policy owner.
Outstanding Items:

The following is a guide to terms for whole life insurance (further terms are found in the glossary).

Your guide to your whole life insurance summary

This brief guide may be helpful to you in understanding your whole life insurance annual statement. This guide covers only the most commonly used terms and is generic in the sense that it is not specific to any particular whole life policy or issuing company. Some terms will not apply to your policy, and your policy may contain terms not listed here. Please consult your policy or policies

for definitions and terms specific to each policy, and please call or e-mail me with any questions.

- **Death Benefit**—This is the amount—minus any outstanding policy loan(s)—that your beneficiary or beneficiaries would receive in the event of your death.
- **Interest Rate**—The interest rate credited on your policy by the insurance company, which is applied to the accumulation value less any policy loans. Interest is compounded monthly. The more frequently interest is compounded, the higher the effective annual rate, but the difference between, for example, monthly and quarterly compounding is small.
- **Interest Credited/Charge on Loan Account**—The net interest credited or charged by the company on any loan debt for the specified period.
- **Issue Date**—The effective date of your policy and the date it was issued by the insurance company.
- **Loan or Loan Debt**—An amount borrowed against the accumulated value.
- **Loanable Value**—The amount you may borrow against your accumulated value, as of the report date.
- **Loan Repay**—A payment applied to reduce your loan debt.
- **Net Cash Surrender Value**—This is the amount payable if you surrender your policy as of the report date.
- **Paid-up Insurance**—Insurance on which all required premiums have been paid and no further premiums will ever become due and payable. This term is frequently used to mean the reduced paid-up insurance that is available as a non-forfeiture option on most whole life policies.
- **Premium Payment**—The sum of all premiums received on your policy during the period covered by the statement.
- **Surrender Charge**—The charge for early surrender of the policy. This is the difference between the accumulation (or account) value and the net cash surrender value. The surrender charge typically decreases each year and disappears after a certain number of years.

Universal Life Policy Information:

Insured:
Carrier:
Policy Number:
Type of Coverage:
Face Amount:
Issue Date:
Premium Mode:
Modal Premium:
Premium (if switched to Annually):
Annualized Current Premium:
Annual Savings if Switched to Annual:
Primary Beneficiary:
Contingent Beneficiary:
Policy Owner:
Premium Payer:
Riders:
In-force Illustration Dates (next and last):
Gross Cash Value:
Surrender Charge:
Policy Loan:
Net Cash Value:
Crediting rate, loan rates, etc.:
Notes/Comments: This section would include notes about the results of the most recent in-force illustration, which is typically requested from the carrier every 3 years or upon request from the policy owner.
Outstanding Items:

The following is a guide to terms for universal life insurance (further terms are found in the glossary).

Your guide to your universal life insurance summary

This is a guide to your universal life insurance annual statement. Please note that this is a generic guide and is for the most commonly used terms. Some terms will not apply to your policy, and your policy may contain terms not

listed here. Please consult your policy(ies) for definitions and terms specific to your policy(ies). Please call or e-mail me with any questions.

- **Policy Issue Date**—The date your policy became effective and was issued by the insurance company.
- **Current Specified Amount/Death Benefit**—This is the amount your beneficiaries would receive in the event of your death (less any policy loans outstanding).
- **Premium Payment**—The sum of all premiums received on your policy during the summary period.
- **Premium Expense, Fees, and Other Expenses**—Policy fees and other costs associated with the setup and administration of your policy.
- **Cost of Insurance/Mortality Costs**—The amount deducted each month from the accumulated value to cover charges for the cost of insurance.
- **Interest Credited**—The amount of interest credited on your policy.
- **Interest Rate**—The interest rate credited on your policy, applied to the accumulation value, minus any policy loans. Interest is compounded monthly.
- **Withdrawals**—A full or partial withdrawal of the net cash surrender value.
- **Loan or Loan Debt**—An amount borrowed against the accumulated value.
- **Loanable Value**—The amount you may borrow against your accumulated value as of the date reported.
- **Loan Repay**—A payment applied to reduce your loan debt.
- **Interest Credited/Charge on Loan Account**—The net interest credited/charge on any loan debt for the specified period.
- **Accumulation/Account Value**—Your account balance; this is the amount upon which interest is credited and will generally include any amount set aside, in the loan account, to secure any loan debt.
- **Surrender Charge**—The charge for early surrender of the policy. This is the difference between accumulation/account value and the net cash surrender value. This value will typically decrease each year and will disappear entirely after a certain number of years.

- **Net Cash Surrender Value**—This is the amount payable if you surrender your policy on the date reported.

Q88 What Is an In-Force Illustration?

An in-force illustration is the only way to gauge the potential future performance of a policy. An in-force illustration/ledger is an illustration produced from a certain point (as current as possible) using the actual values and using current assumptions (the actual interest rate the company is crediting and the current mortality and expense factors). It allows you to compare past (actual) performance with anticipated performance. In other words, you are using actual performance as a measure rather than the original projections in the sales illustration generated at the time of issue. This applies to all permanent (cash value) life insurance policies, where the policy and its values are not fully guaranteed.

Q89 How Do I Order an In-Force Illustration?

These can be requested from the life insurance company; it can take anywhere from a couple of days to a few weeks to receive them. You can order in-force illustrations from your life insurance company by sending a letter, calling them, or via their online portal (not offered by all companies).

On the following page is a sample request form for an in-force ledger illustration for a universal life policy. If you are requesting information for a whole life policy, substitute dividend-crediting rate for interest rate.

Q90 What Will the In-Force Illustration Tell Me?

An in-force illustration will tell you if your policy will continue to its maturity (the longest it can continue to). You can always use the original sales illustration as your benchmark.

The first illustration requested in the letter above will show you for how many years the policy will continue, using the current cash value, death benefit, premium payment, mortality costs, expenses, and interest rates. If the policy will terminate before the maturity age, the second illustration will show

-----------------------------START LETTER----------------------------

Date

Attn: Policy Owner Services
Carrier Name and Address

Re: Policy Number, Insured Name, Owner Name

To Whom It May Concern:

My life insurance policy number is listed above. Please provide two in-force proposals (Note: depending on your situation, you may need additional in-force proposals):

1. Illustrate to maturity with current premiums, based on current interest rate and mortality assumptions.
2. Illustrate to maturity the minimum premium required to endow the policy at maturity based on current interest rate and mortality assumptions.

Please also indicate the current surrender value, loan value, and the cost basis in the policy to date. Please call me if you have any questions and thank you for your prompt attention to this matter.

Sincerely,

Policy owner's name and signature

------------------------------END LETTER-----------------------------

you what the minimum premium is that needs to be paid in order to continue the policy to the maturity of the contract.

Depending on your situation, you can ask for other in-force illustrations. For example, if the policy was originally designed on a limited premium payment schedule, you can request the company to furnish an in-force

illustration to determine how many more years the premium will actually need to be paid.

As discussed in the policy loan chapter (10, Questions 106-109) a loan will most likely cause your policy to implode over the long run depending on its size and all the components that affect a life insurance policy.

For the purposes of this book, we will take a look at how a universal life policy issued in 1971 by a large, well-rated (see Questions 44-48) life insurance company has performed. Each company's format is different. Also, over the last few years, due to many abuses and to provide a greater degree of consumer protection, an illustration is lengthier and provides significantly more detail (see Question 40) than in prior years. Please keep in mind that for the most part, every company's illustration is different, as is each of their products by necessity.

On this, the original illustration, the proposed insured's name would be in the upper left hand corner along with his or her personal information. The company's name would be at the top. The basic design information is at the top right hand corner—a death benefit of $750,000 with a proposed annual premium payment of $5,661. The first two columns indicate the policy year and the policy age at the end of that year. Policy (insurance) age changes six months and one day before one's actual birthday, for most companies. I have yet to find a logical reason for this, except that it benefits the life insurance companies. Column 3 shows the annualized premium and/or withdrawals. Columns 4, 5, and 6 show the guaranteed values, based on the guaranteed interest rate of 5.5% and guaranteed mortality and expense charges. Column 4 is the cash accumulation value, Column 5 is the net cash surrender value and Column 6 is the death benefit. Columns 7, 8, and 9 show the same values based on current interest rate, mortality, and expense charges.

Once you have this, you can gauge how the policy is actually performing. For our case study, we will use a client of mine who was policy age 47 at issue. At the time in-force illustrations were run, he was age 56. So only nine years had elapsed since he purchased a $750,000 universal life insurance policy with XYZ Life. Due to the assumptions at that time he was projected to pay a premium of $5,661 annually, which would endow the policy at his age 95. We ran an in-force proposal and found that, to still have the policy endow at his age

95, and based on the now current assumptions, he would need to increase his premium to $10,800 annually. XYZ has not given him any indication that the policy is so far off the original marks and they are not alone in their failure to do so. Only a few carriers now have added a line on the annual report, stating the client age at which the policy will lapse, or mail in-force illustrations on their own volition.

Original Sales Illustration—page 1 of 3

Any Life Insurance Company

Male Age: 47 Rate Class: Non-smoker
Initial Face Amount: $750,000
Annual Premium: $5,661
Payable: Annually

			Guaranteed Interest Rate and Non-Guaranteed Projected Values			Guaranteed Monthly Deductions at Illustrated Guaranteed Interest Rates and Monthly Deductions		
Policy Year End	and Age	Annualized Premium Outlay and/or Withdrawals	Accumulated Value	Net Cash Surrender Value	Death Benefit	Accumulated Value	Net Cash Surrender Value	Death Benefit
1	48	5,661	3,312	0	750,000	3,433	0	750,000
2	49	5,661	4,981	0	750,000	7,162	0	750,000
3	50	5,661	6,384	0	750,000	11,211	0	750,000
4	51	5,661	7,507	0	750,000	15,607	0	750,000
5	52	5,661	8,244	0	750,000	20,381	881	750,000
6	53	5,661	8,478	0	750,000	25,565	6,815	750,000
7	54	5,661	8,180	0	750,000	31,194	12,444	750,000
8	55	5,661	7,224	0	750,000	37,306	18,556	750,000
9	56	5,661	5,476	0	750,000	43,943	25,943	750,000
10	57	5,661	2,879	0	750,000	51,150	33,150	750,000
11	58	5,661	0	0	0	58,627	43,627	750,000
12	59	5,661	0	0	0	66,492	53,742	750,000
13	60	5,661	0	0	0	74,699	64,199	750,000
14	61	5,661	0	0	0	83,285	75,035	750,000
15	62	5,661	0	0	0	92,375	85,625	750,000
16	63	5,661	0	0	0	101,939	97,439	750,000
17	64	5,661	0	0	0	112,026	109,026	750,000
18	65	5,661	0	0	0	122,775	120,525	750,000
19	66	5,661	0	0	0	134,173	133,423	750,000
20	67	5,661	0	0	0	146,289	146,289	750,000

Cash Value Accumulation Test: This illustration assumes that the definitional requirements for a life insurance contract under Internal Revenue Code Section 7702 have been satisfied by complying with the cash value accumulation test.

This is an illustration, not a contract. Presented by Jane Agent on Date.

Original Sales Illustration—page 2 of 3

Any Life Insurance Company

Male Age: 47 Rate Class: Non-smoker
Initial Face Amount: $750,000
Annual Premium: $5,661
Payable: Annually

			Guaranteed Interest Rate and Non-Guaranteed Projected Values			Guaranteed Monthly Deductions at Illustrated Guaranteed Interest Rates and Monthly Deductions		
Policy Year End	and Age	Annualized Premium Outlay and/or Withdrawals	Accumulated Value	Net Cash Surrender Value	Death Benefit	Accumulated Value	Net Cash Surrender Value	Death Benefit
21	68	5,661	0	0	0	158,825	158,825	750,000
22	69	5,661	0	0	0	171,772	171,772	750,000
23	70	5,661	0	0	0	185,085	185,085	750,000
24	71	5,661	0	0	0	198,963	198,963	750,000
25	72	5,661	0	0	0	213,373	213,373	750,000
26	73	5,661	0	0	0	228,243	228,243	750,000
27	74	5,661	0	0	0	243,477	243,477	750,000
28	75	5,661	0	0	0	259,111	259,111	750,000
29	76	5,661	0	0	0	274,705	274,705	750,000
30	77	5,661	0	0	0	290,242	290,242	750,000
31	78	0	0	0	0	299,708	299,708	750,000
32	79	0	0	0	0	308,346	308,346	750,000
33	80	0	0	0	0	316,078	316,078	750,000
34	81	0	0	0	0	322,867	322,867	750,000
35	82	0	0	0	0	328,548	328,548	750,000
36	83	0	0	0	0	333,034	333,034	750,000
37	84	0	0	0	0	336,157	336,157	750,000
38	85	0	0	0	0	337,607	337,607	750,000
39	86	0	0	0	0	337,112	337,112	750,000
40	87	0	0	0	0	334,227	334,227	750,000

Cash Value Accumulation Test: This illustration assumes that the definitional requirements for a life insurance contract under Internal Revenue Code Section 7702 have been satisfied by complying with the cash value accumulation test.

This is an illustration, not a contract. Presented by Jane Agent on Date.

Original Sales Illustration—page 3 of 3

Any Life Insurance Company

Male Age: 47 Rate Class: Non-smoker
Initial Face Amount: $750,000
Annual Premium: $5,661
Payable: Annually

			Guaranteed Interest Rate and Non-Guaranteed Projected Values			Guaranteed Monthly Deductions at Illustrated Guaranteed Interest Rates and Monthly Deductions		
Policy Year End	and Age	Annualized Premium Outlay and/or Withdrawals	Accumulated Value	Net Cash Surrender Value	Death Benefit	Accumulated Value	Net Cash Surrender Value	Death Benefit
41	88	0	0	0	0	328,354	328,354	750,000
42	89	0	0	0	0	318,794	318,794	750,000
43	90	0	0	0	0	304,662	304,662	750,000
44	91	0	0	0	0	284,658	284,658	750,000
45	92	0	0	0	0	257,153	257,153	750,000
46	93	0	0	0	0	219,520	219,520	750,000
47	94	0	0	0	0	169,008	169,008	750,000
48	95	0	0	0	0	101,794	101,794	750,000

Cash Value Accumulation Test: This illustration assumes that the definitional requirements for a life insurance contract under Internal Revenue Code Section 7702 have been satisfied by complying with the cash value accumulation test.

This is an illustration, not a contract. Presented by Jane Agent on Date.

In-Force Illustration—Current Assumptions

This excerpt from an in-force illustration shows the current premium and current assumptions—the policy will lapse without value at the insured's age 81. At the bottom of the first page, we can see where the policy's cash-value annual increase starts to slow down and then starts decreasing rapidly.

Universal Life In-Force Illustration—Sample

Current Premiums and Assumptions

PAGE 1 of 2

Initial Face Amount: $750,000
Current Account Value Balance: $xxxxxxxx
% Accumulated Value Balance Projected to: DATE
Current Weighted Interest Rate: 05.68%
Cash Value Accumulation Test: @ 01881

Policy #xxxxxxxxx
Male Issue Age 47
Premiums Payable: Annually
Table Rating: None

Premiums Paid To Date: $45,288

End-of-Year Policy Values

			Guaranteed Interest Rate and Non-Guaranteed Projected Values			Guaranteed Monthly Deductions at Illustrated Guaranteed Interest Rates and Monthly Deductions		
Policy Year End	and Age	Annualized Premium Outlay and/or Withdrawals	Accumulated Value	Net Cash Surrender Value	Death Benefit	Accumulated Value	Net Cash Surrender Value	Death Benefit
9	56	5,661	31,462	13,462	750,000	36,987	18,987	750,000
10	57	5,661	30,148	12,148	750,000	42,219	24,219	750,000
11	58	5,661	27,974	12,974	750,000	47,366	32,366	750,000
12	59	5,661	24,892	12,142	750,000	52,531	39,781	750,000
13	60	5,661	20,758	10,258	750,000	57,168	47,118	750,000
14	61	5,661	15,416	7,166	750,000	62,635	54,385	750,000
15	62	5,661	8,695	1,945	750,000	67,668	60,918	750,000
16	63	5,661	409	0	750,000	72,631	68,131	750,000
17	64	5,661	0	0	0	77,533	74,533	750,000
18	65	5,661	0	0	0	82,457	80,207	750,000
19	66	5,661	0	0	0	87,327	86,577	750,000
20	67	5,661	0	0	0	92,139	92,139	750,000
21	68	5,661	0	0	0	96,442	96,442	750,000
22	69	5,661	0	0	0	100,120	100,120	750,000
23	70	5,661	0	0	0	102,970	102,970	750,000
24	71	5,661	0	0	0	105,212	105,212	750,000
25	72	5,661	0	0	0	106,544	106,544	750,000
26	73	5,661	0	0	0	106,731	106,731	750,000
27	74	5,661	0	0	0	105,422	105,422	750,000
28	75	5,661	0	0	0	102,367	102,367	750,000

Percent accumulated value projected to DATE assumes that policy owner will pay premiums totaling $0 in addition to premiums paid to date shown above. This projected value is based on the current weighted interest rate as described in explanatory notes. If a recent payment has been made, it may not be reflected on this illustration.

Please refer to the last page for important explanatory notes.
This is an illustration not a contract.

Universal Life In-Force Illustration—Sample

Current Premiums and Assumptions

PAGE 2 of 2

Initial Face Amount: $750,000
Current Account Value Balance: $xxxxxxxxx
% Accumulated Value Balance Projected to: DATE
Current Weighted Interest Rate: 05.68%
Cash Value Accumulation Test: @ 01881

Policy #xxxxxxxxxx
Male Issue Age 47
Premiums Payable: Annually
Table Rating: None

Premiums Paid To Date: $45,288

End-of-Year Policy Values

			Guaranteed Interest Rate and Non-Guaranteed Projected Values			Guaranteed Monthly Deductions at Illustrated Guaranteed Interest Rates and Monthly Deductions	
Policy Year End and Age	Annualized Premium Outlay and/or Withdrawals	Accumulated Value	Net Cash Surrender Value	Death Benefit	Accumulated Value	Net Cash Surrender Value	Death Benefit
29 76	5,661	0	0	0	96,671	96,671	750,000
30 77	5,661	0	0	0	87,899	87,899	750,000
31 78	5,661	0	0	0	75,548	75,548	750,000
32 79	5,661	0	0	0	58,928	58,928	750,000
33 80	5,661	0	0	0	37,409	37,409	750,000
34 81	5,661	0	0	0	10,315	10,315	750,000

Percent accumulated value projected to DATE assumes that policy owner will pay premiums totaling $0 in addition to premiums paid to date shown above. This projected value is based on the current weighted interest rate as described in explanatory notes. If a recent payment has been made, it may not be reflected on this illustration.

Please refer to the last page for important explanatory notes.

This is an illustration not a contract.

The following explanatory notes apply to both in-force illustations:
The current interest rate is 5.5%. It is not guaranteed. The company may declare a higher or lower current interest rate, but it will never be less than the guaranteed rate.

The guaranteed values shown are calculated using the guaranteed maximum monthly deductions and the guaranteed cumulative interest rate of 5.5% for the duration of the policy.

The non-guaranteed values are based on the lesser of the current interest rate and the current weighted interest rate. The current weighted interest rate is the average interest rate currently being earned by the various unloaned portions of your accumulation value as shown in the table of accumulation values in your annual statement. It is not a guaranteed rate.

The non-guaranteed interest rate shown in the fourth and subsequent policy years may be different from the current interest rate or current weighted interest rate.

Withdrawals are the amounts taken from the policy's cash value and payable to you. Applicable surrender charges have been deducted from the policy's values. Certain types of withdrawals may be subject to tax. You should consult your tax advisor as to the taxability of any planned withdrawal. A penalty-free withdrawal can be requested in policy years two and after an amount not to exceed 10% of the current accumulation value or 100% of the cash value—whichever is less. Withdrawals in excess of the penalty-free withdrawal will be charged applicable surrender charges.

The accumulation value is the policy value before the application of surrender charges. The cash value is the accumulation value less any applicable surrender charges and is the amount actually available to you upon surrender (less any outstanding policy loans).

In-Force Illustration—Assumptions to Endow Policy
This in-force illustration shows that to continue the policy and have it endow (cash value equal the death benefit at age 100), would now require an annual premium of $10,711 based on the interest rate and mortality charges at the time this illustration was run.

Universal Life In-Force Illustration—Sample

Solve for Premium to continue policy to maturity
based on current assumptions

Page 1 of 3

Initial Face Amount: $750,000
Current Account Value Balance: $xxxxxxxx
% Accumulated Value Balance Projected to: DATE
Current Weighted Interest Rate: 05.68%
Cash Value Accumulation Test: @ 01881

Policy #xxxxxxxxx
Male Issue Age 47
Premiums Payable: Annually
Table Rating: None

Premiums Paid To Date: $45,288

End-of-Year Policy Values

			Guaranteed Interest Rate and Non-Guaranteed Projected Values			Guaranteed Monthly Deductions at Illustrated Guaranteed Interest Rates and Monthly Deductions		
Policy Year End	and Age	Annualized Premium Outlay and/or Withdrawals	Accumulated Value	Net Cash Surrender Value	Death Benefit	Accumulated Value	Net Cash Surrender Value	Death Benefit
9	56	10,711	36,609	18,609	750,000	42,208	24,208	750,000
10	57	10,711	40,707	22,707	750,000	52,967	34,967	750,000
11	58	10,711	44,237	29,237	750,000	63,973	48,973	750,000
12	59	10,711	47,176	34,426	750,000	75,350	62,600	750,000
13	60	10,711	49,415	38,915	750,000	87,032	76,532	750,000
14	61	10,711	50,836	42,586	750,000	99,058	90,808	750,000
15	62	10,711	51,311	44,561	750,000	111,541	104,791	750,000
16	63	10,711	50,704	46,204	750,000	124,435	119,935	750,000
17	64	10,711	49,510	46,510	750,000	137,785	134,785	750,000
18	65	10,711	46,760	44,510	750,000	151,709	149,459	750,000
19	66	10,711	42,150	41,400	750,000	166,182	165,432	750,000
20	67	10,711	35,838	35,338	750,000	181,246	181,246	750,000
21	68	10,711	26,111	26,111	750,000	196,567	196,567	750,000
22	69	10,711	14,041	14,041	750,000	212,119	212,119	750,000
23	70	10,711	0	0	0	227,816	227,816	750,000
24	71	10,711	0	0	0	243,934	243,934	750,000
25	72	10,711	0	0	0	260,334	260,334	750,000
26	73	10,711	0	0	0	276,954	276,954	750,000
27	74	10,711	0	0	0	293,676	293,676	750,000
28	75	10,711	0	0	0	310,476	310,476	750,000

Percent accumulated value projected to DATE assumes that policy owner will pay premiums totaling $0 in addition to premiums paid to date shown above. This projected value is based on the current weighted interest rate as described in explanatory notes. If a recent payment has been made, it may not be reflected on this illustration.

Please refer to the last page for important explanatory notes.

This is an illustration not a contract.

Universal Life In-Force Illustration—Sample

Solve for Premium to continue policy to maturity
based on current assumptions

Page 2 of 3

Initial Face Amount: $750,000
Current Account Value Balance: $xxxxxxxx
% Accumulated Value Balance Projected to:
DATE
Current Weighted Interest Rate: 05.68%
Cash Value Accumulation Test: @ 01881

Policy #xxxxxxxxx
Male Issue Age 47
Premiums Payable: Annually
Table Rating: None

Premiums Paid To Date: $45,288

End-of-Year Policy Values

			Guaranteed Interest Rate and Non-Guaranteed Projected Values			Guaranteed Monthly Deductions at Illustrated Guaranteed Interest Rates and Monthly Deductions		
Policy Year End	and Age	Annualized Premium Outlay and/or Withdrawals	Accumulated Value	Net Cash Surrender Value	Death Benefit	Accumulated Value	Net Cash Surrender Value	Death Benefit
29	76	10,711	0	0	0	326,951	326,951	750,000
30	77	10,711	0	0	0	343,077	343,077	750,000
31	78	10,711	0	0	0	358,841	358,841	750,000
32	79	10,711	0	0	0	374,187	374,187	750,000
33	80	10,711	0	0	0	389,170	389,170	750,000
34	81	10,711	0	0	0	403,898	403,898	750,000
35	82	10,711	0	0	0	418,395	418,395	750,000
36	83	10,711	0	0	0	432,785	432,785	750,000
37	84	10,711	0	0	0	447,157	447,157	750,000
38	85	10,711	0	0	0	461,536	461,536	750,000
39	86	10,711	0	0	0	476,046	476,046	750,000
40	87	10,711	0	0	0	490,756	490,756	750,000
41	88	10,711	0	0	0	505,732	505,732	750,000
42	89	10,711	0	0	0	521,112	521,112	750,000
43	90	10,711	0	0	0	537,081	537,081	750,000
44	91	10,711	0	0	0	553,793	553,793	750,000
45	92	10,711	0	0	0	571,511	571,511	750,000
46	93	10,711	0	0	0	590,407	590,407	750,000
47	94	10,711	0	0	0	611,078	611,078	750,000
48	95	10,711	0	0	0	634,254	634,254	750,000

Percent accumulated value projected to DATE assumes that policy owner will pay premiums totaling $0 in addition to premiums paid to date shown above. This projected value is based on the current weighted interest rate as described in explanatory notes. If a recent payment has been made, it may not be reflected on this illustration.

Please refer to the last page for important explanatory notes.

This is an illustration not a contract.

Universal Life In-Force Illustration—Sample

Solve for Premium to continue policy to maturity
based on current assumptions

Page 3 of 3

Initial Face Amount: $750,000
Current Account Value Balance: $xxxxxxxx
% Accumulated Value Balance Projected to: DATE
Current Weighted Interest Rate: 05.68%
Cash Value Accumulation Test: @ 01881

Policy #xxxxxxxxx
Male Issue Age 47
Premiums Payable: Annually
Table Rating: None

Premiums Paid To Date: $45,288

End-of-Year Policy Values

			Guaranteed Interest Rate and Non-Guaranteed Projected Values			Guaranteed Monthly Deductions at Illustrated Guaranteed Interest Rates and Monthly Deductions	
Policy Year End and Age	Annualized Premium Outlay and/or Withdrawals	Accumulated Value	Net Cash Surrender Value	Death Benefit	Accumulated Value	Net Cash Surrender Value	Death Benefit
49 96	10,711	0	0	0	660,784	660,784	750,000
50 97	10,711	0	0	0	691,371	691,371	750,000
51 98	10,711	0	0	0	725,303	725,303	750,000
52 99	10,711	0	0	0	761,132	761,132	750,000
53 100	10,711	0	0	0	799,583	799,583	750,000

Percent accumulated value projected to DATE assumes that policy owner will pay premiums totaling $0 in addition to premiums paid to date shown above. This projected value is based on the current weighted interest rate as described in explanatory notes. If a recent payment has been made, it may not be reflected on this illustration.

Please refer to the last page for important explanatory notes.

This is an illustration not a contract.

The policy's performance was affected not only by the decreased interest rate but also by an increase in the mortality costs. The increase in the mortality costs was not shown anywhere in the in-force illustration. If you see a dramatic difference in the potential performance of your policy as shown here with the close to doubling of the premium, there may be more than meets the eye. Your agent may not always know—the front-line customer service representative might not know either. So either press your agent or someone at the company. For me, it took using a software package designed for this purpose and ultimately a letter by an attorney involved with the case to a vice-president of the company to confirm that they had raised the mortality costs. This is not always an easy matter when there is a large discrepancy. If you're hitting a brick wall with your agent and/or the insurance company, use one of the resources discussed throughout this book, such as a life insurance analyst/consultant or the Department of Insurance (in your state).

Q91 Are There Other Issues If I Purchased a Limited Premium-Payment Policy?

Limited premium-payment period policies almost always have not lived up to their promises. These were referred to, at one time, as "vanishing premium policies" (this term is now not allowed by the insurance code, due to its misleading nature). At one point, agents and carriers could formulate an illustration (within some parameters) to make a policy attractive to a potential policy owner. Especially (in most cases) for these policies, an in-force illustration will show a much longer anticipated premium-payment period.

These policies were sold under the concept of a vanishing premium, using illustrations and based on current assumptions at the time. When this was popular, the illustrated interest rates or dividend scales (perhaps coupled with a surrender of dividend additions) showed that the premium would "vanish" after a certain number of years. In other words, no further premiums would be due. At that time, there was no emphasis on guaranteed assumptions by either the carrier or the agent. In fact, the agent could generate an illustration using their own format that did not show the guarantees.

A distinction to be made is that this misleading term of "vanishing premium" is actually a non-guaranteed projection of a limited premium-payment

period. One of the problems with the term "vanishing premium" is the ease of confusing it with paid-up life insurance, a similar concept but featuring a guaranty. Once a policy is paid up, continuation of coverage is guaranteed regardless of future dividends. The truth is that a limited premium payment design can be useful, as long as it is understood that premium payments may be due for a longer period or may need to start again at some point, if this is indicated. A good number of companies and agents have not taken any action to warn their clients. Again, this is where an in-force illustration is extremely useful.

Another sign of these policies is that they will almost always have a significant amount of term insurance mixed into them, and the non-guaranteed returns from the policy are required to replace the term portions of the policy with permanent insurance. When this does not happen, because of declining interest rates and perhaps other unmet projections, three related developments threaten the future of the policy. Reduced non-guaranteed returns leave fewer investment dollars inside the policy to generate additional dividends and cash value growth. With poorer investment results and lower dividends, additional permanent insurance, which must be acquired with these dividends, is not purchased at a fast enough rate to replace the term insurance on the planned schedule. In turn, the continuing presence of too much term insurance, as the insured ages, increases the policy's mortality charges and leaves less money left over to accumulate as the cash value reserve inside the policy. As that reserve fails to build fast enough because of reduced investment returns and is, at the same time, depleted with higher than projected insurance costs, there is a good chance that the policy will fall apart before the insured dies.

Some policies, from what are generally regarded as reputable companies, have gone so far as to offer step-rated or "graded" premiums, which depend on dividends to avoid an additional out-of-pocket cost to the policyholder when the future premium increase occurs. In some cases, the premiums do not increase for the first ten years. However, when interest or dividend rates fall or insurance costs go up, dividends will be insufficient to pay the increased premium, and the risk of policy lapse is especially high. This is just an example of the lengths to which life insurers will go to try to appear competitive price-wise.

The danger with a good number of these policies is that they can terminate very quickly. The other type of policy that can be worse is a "lowball"

premium policy. These policies have premiums that are too low to support the policy if there are any changes from the current assumptions at time of purchase. The chance of this occurring is less than winning the lottery.

If you are considering a policy with a limited premium-payment period, you should request an illustration with a dividend scale reduced by 200 basis points or an interest rate 2% below the current projected rate, respectively. Considering the last few years, this still may not be sufficient. Keep in mind that you can continue to pay the premium or increase it to meet the originally planned payment period, if you would like to.

Q92 How Do I Measure a Life Insurance Policy's Internal Performance and Compare It with Another Policy?

There are many ways to compare life insurance policies and measure their internal performance. We will take a look at a few of the various methods. Each has its pros and cons; also, some are easier to use than others. It can be difficult to compare similar types of policies, let alone different types of policies.

There are many different methods of determining the performance of a policy and to use these methods in a replacement situation. Please note that these are applicable to permanent (cash value) life insurance policies only and not to term life insurance.

For the most part, comparing term insurance is comparing premiums. Another consideration, with term life insurance, is the conversion factor (are there policies that you can convert to limited or can you convert to any of the company's permanent policies?). (Ben Baldwin—Life Insurance Investment Advisor, Probus Publishing Company, ©1988).

INTEREST-ADJUSTED INDICES

These indices were adopted by the National Association of Insurance Commissioners (NAIC), in 1976, as a life insurance solicitation model regulation, and were then recommended to each state for their adoption. This regulation has been adopted in almost every state. This regulation requires that insurers provide buyers with an interest-adjusted surrender cost index and an interest-adjusted net payment cost index for the 10th and 20th policy years, using a 5% interest assumption.

Keep in mind that this is automatically calculated on a proposal for a new policy. However, you can calculate it yourself for any reason or understand the numbers better than shown on the initial illustration. The inputs required for the interest-adjusted methods are:

1. The annual level premiums accumulated at 5%.
2. The face amount.
3. The time period over which the analysis is to be made (the model regulation requires it for 10 and 20 years).
4. The interest rate. The NAIC chose 5% net after-tax as an acceptable long-term interest rate, from personal investments of comparable security and stability as a life insurance policy.
5. Dividends are to be accumulated at 5% interest, if dividends are available in the contract.
6. The cash surrender value.

The NAIC requires the use of two indices. The interest-adjusted net payment cost index assumes that the policy is continuing in-force, and therefore only the dividend values plus 5% interest earnings (if the policy in question pays dividends) are available to the policy owner to reduce cost. The cash surrender value is not available and therefore not included in the interest-adjusted net payment cost index. The interest-adjusted surrender cost index assumes the policy is terminated; thus the cash value is available to reduce cost and is included in the calculation of the surrender cost index. (Ben Baldwin—Life Insurance Investment Advisor, Probus Publishing Company, ©1988).

INTEREST-ADJUSTED NET PAYMENT COST INDEX

This index is based upon the continuation of the policy. Since the policy is continuing in-force, it assumes that the cash value of the policy is not available to the policy owner. Dividends and 5% interest on those dividends are assumed to be available to the policy owner in participating policies.

This index is calculated by accumulating the annual dividends, if available, plus the 5% interest earnings on those dividends for the period of time in question. In order to convert those dividend credits and their interest earnings to a level amount for the period of time in question, the amount is divided by the future value of $1 at 5% for the period. The payment of $1 per year, assuming a

5% interest rate and a 20-year time period, results in a future value of $34.72 in 20 years. By dividing the insurance-company-provided future dividend income value by this 20 year divisor, you will find out what number of dollars would have had to have been deposited annually to arrive at this amount. The ten-year divisor is $13.21; that is $1 per year, deposited at the beginning of the year into an account earning 5%, and would accumulate $13.21 in 10 years. If you do not have a calculator, use these factors to change the total value of the dividends, available at the end of the period of time, to the level annual equivalent credit that can be used to offset the adjusted premium.

The adjusted premium is the level annual premium accumulated at 5%. For example a $1,000 annual premium accumulated at 5% for 20 years would be $34,719.30. If the 20th year accumulation of dividends was $12,000, you would calculate the 5% interest-adjusted dividend value by dividing the $12,000 by 20 years ($600), then calculating the future value of that average annual dividend of $600 compounded at 5% for 20 years for 20 years and arrive at an adjusted dividend value of $20,831.60. The difference between the adjusted dividend premium ($34,719.30), and the interest-adjusted dividend ($20,831.60), $13,887.70 is the interest-adjusted cost for this $100,000 policy. To calculate what this $13,887.70 total cost is as an equivalent to a 20-year interest-adjusted annual premium, you can use your calculator or the 20-year factor of 34.72 described above. $13,887.70 divided by 34.72 is $400. Dividing this amount by 100 gives us the per $1,000 interest-adjusted net payment cost index of $4.00. (Ben Baldwin—Life Insurance Investment Advisor, Probus Publishing Company, ©1988).

INTEREST-ADJUSTED SURRENDER COST INDEX

The interest-adjusted surrender cost index assumes that the cash surrender value of the policy, and any termination dividend available at the termination of a policy, will be available, as well as the dividends and their interest earnings.

If, in the example above, the total cash available upon surrender amounted to $10,000, you would then subtract the $10,000 from the $13,887.70 insurance cost determined without considering the cash surrender value, and arrive at $3,887.70 for the $100,000 policy. Dividing that amount by the 20-year 5% factor of 34.72 results in the amount of $112. Dividing this amount by

100 gives you the per $1,000 interest-adjusted surrender cost index of $1.12. This can then be used to compare this policy to others of comparable size and type.

According to the Report of the Joint Special Committee on Life Insurance Costs (Footnote—Report to American Life Convention, Institute of Life Insurance and Life Insurance Association of America (New York: Institute of Life Insurance, May 4, 1970), page 6), the advantages of these two interest-adjusted methods are as follows:

1. They take the time value of money into account.
2. They are easy to understand.
3. They do not require recourse to advanced mathematics.
4. They do not suggest a degree of accuracy that is beyond that justified by the circumstances.
5. They are significantly similar to the traditional methods, so that transition could be accomplished with a minimum of confusion.

Although these indices do take the time value of money into consideration, neither the public nor insurance agents have found them easy to understand or communicate. The public does regard these devices as having a degree of accuracy beyond that which is justified. This is due to the facts that are on each illustration and, as such, are given a high degree of credibility.

As with a lot of things in life, the lowest price may not always be the best. Life insurance companies can manipulate the internal design of their policies to wind up with a low index. The interest-adjusted indices then, although they do take the time value of money into consideration, fail because you cannot rely on assumed policy values 10 and 20 years hence. Strict reliance on the indices, and the potential misuses of indices, can mislead rather than help the consumer.

The ledger statements from which the indices are derived are becoming less and less accurate due to the degree of complexity and types of products, the volatility of the economy, and the many changes in the life insurance industry. Due to these factors, the indices will become less and less useful as an appropriate tool for comparing life insurance products. (Ben Baldwin—Life Insurance Investment Advisor, Probus Publishing Company, ©1988).

LINTON YIELD METHOD

This is most likely the oldest method, named after Mr. Albert Linton (President of Provident Mutual, with a background as an actuary) who, in the 1930s, demonstrated that a whole life insurance policy or an endowment life insurance policy could be analyzed as equivalent to a combination of decreasing term insurance and a savings fund. Basically, it derives estimated investment returns on cash value policies and can be used to determine policy returns on a year-by-year basis—so-called one year RORs (rates of return). There are many slight variations on this method. There are many variations of the Linton Yield to assist with different tasks.

This is the basic method and is the method used by Mr. James Hunter at the Consumer Federation of America. As he describes it, the starting point is the next policy anniversary; the numbers come from a current illustration (either new for a proposed policy or an in-force illustration for an existing policy). Assume that a person surrenders their policy for the year-end surrender value (not accumulation/cash value prior to the surrender charge), and then changes their mind and asks to reinstate immediately. The cost to reinstate is the surrender value plus the next annual premium. (Rider costs not providing insurance on the insured must be excluded.)

Here is how to calculate an annual rate of return (ROR). You may wish to do this for several future years to see any trends.

DBt = Death benefit, policy year t. Use the average death benefit during the year, if changing.

Pt = Annual premium for year t. Divide other premium frequencies by appropriate factors from VII above to convert non-annual premiums to annual premiums.

CSVt = Cash surrender value end of year t, including cash value of any paid-up additional insurance (PUAs). (If dividends are held at interest, exclude them from the calculation; but, in this case add the year end dividend, but not interest, to CSVt. If the dividend option is cash or "reduce premium," do not use the prior-year dividend; add the year-end dividend to CSVt.)

TCt = Term cost for risk amount in year t.

TRt = Assumed market term rate for alternative policy.

PFt = Any annual term policy fee.

Basic Concept: BVt * (1 + RORt/100) = EVt. Solve for RORt where, BVt = beginning-of-year policy value = CSVt-1 (prior year surrender value) + Pt - TCt; EVt = end-of-year surrender value, including Dt for any dividend not used for PUAs.

TCt = (DBt - BVt) * TRt + PFt, or TCt = (DBt - (CSVt-1 + Pt - TCt)) * TRt + PFt. Or TCt = [(DBt - CSVt-1 - Pt) * PR + PF]/(1-TR), from 8th grade algebra.

Finally, **RORt** = [(EVt / BVt) - 1] * 100.

Example—Suppose you want the 11th policy year ROR for a policy whose 10th year surrender value is $8,938, whose 11th year surrender value is $10,538, and whose annual premium is $1,159. (Dividends buy PUAs.) The death benefit during the next year averages $107,600. The cost of one-year term insurance for this person in his or her risk class and age is $1.22 per $1,000 per year plus $50. (It is not appropriate, at least not without an "apples to apples" warning, to use 10-year or 20-year term rates because these policies may not be renewed without evidence of insurability.) We have:

TC11 = [(107,600 - 8,938 - 1,159) * 1.22/1,000 + 50] / (1 - .00122) = 169

RORt = [(10,538 / (8,938 + 1,159 - 169)) - 1] * 100 RORt = 6.1%.

This section taken from notes from a talk by Mr. James Hunter, FSA, on September 28, 2001.

THE JOSEPH M. BELTH METHOD

Joseph M. Belth, Ph.D., Professor of Insurance at Indiana University, is the publisher of *The Insurance Forum*. This publication is provocative and features his work on getting at the truth from life insurance companies. Part of that work is determining the true costs of life insurance policies.

The method he came up with is a level-price approach, and is based on the premise that the protection provided by an insurance policy was not the

full face amount of the policy, but is the face amount of the policy minus its cash surrender value. As discussed previously, this would be the amount at risk to the carrier; in other words, the protection.

Professor Belth used the level-cost method to attempt to measure the average cost to policy owners of this amount at risk. Professor Belth also developed a price per thousand dollars, for each age, for this net amount of protection. These were then converted, as yearly prices, into amounts that represented a level price per thousand, for each age, for this net amount of protection, provided by the policy for a particular time period. Professor Belth has referred to them as benchmark life insurance costs that represent a base value of the protection provided by a policy.

In June and October of 1982 issues of *The Insurance Forum*, Professor Belth published an updated method of determining costs and/or rates of return within life insurance policies that was more easily adapted by the individual in determining the cost efficiency of his individual policy.

His formula is as follows, with the following inputs:

1. Death benefit (F)
2. Policy cash surrender value as of the last previous anniversary date (CVP)
3. Policy cash surrender value as of the current anniversary date (CSV)
4. Most recent annual premium (P)
5. Most recent annual dividend or credited interest or a combination—whichever is applicable (D)
6. Insured's insurance age (six months and one day prior to next actual birthday)
7. Assumed alternative use of funds interest rate (i). This is the rate of interest that the policy owner (or whoever is doing the calculation) feels could be earned in an investment with liquidity equivalent to that within the life insurance policy.
8. Benchmark rates per $1,000 of life insurance (net amount at risk)

The table used by Dr. Belth for the cost of term insurance for the policy owner is derived as he describes it in *The Insurance Forum* of June 1982, Volume 9, Number 6. Due to the time elapsed since then, we are using more current figures.

The term costs that we will use are from the 2003 edition of *Tax Facts* (published by the National Underwriter Company). The table is for one-year term rates, used in the calculation of the "cost" of pure life insurance protection, which may be taxable to an employee in certain situations.

What we are saying is that, if the price of your life insurance protection per $1,000 is in the vicinity of the "raw material cost" (that is the amount needed just to pay death claims based on population rates), your life insurance protection is reasonably priced.

One-Year Term Premiums for $1,000 of Life Insurance Protection–One Life

Age	Premium	Age	Premium	Age	Premium
0	$0.70	34	$0.98	67	$15.20
1	0.41	35	0.99	68	16.92
2	0.27	36	1.01	69	18.70
3	0.19	37	1.04	70	20.62
4/5	0.13	38	1.06	71	22.72
6	0.14	39	1.07	72	25.07
7	0.15	40	1.10	73	27.57
8	0.16	41	1.13	74	30.18
9	0.16	42	1.20	75	33.05
10	0.16	43	1.29	76	36.33
11	0.19	44	1.40	77	40.17
12	0.24	45	1.53	78	44.33
13	0.28	46	1.67	79	49.23
14	0.33	47	1.83	80	54.56
15	0.38	48	1.98	81	60.51
16	0.52	49	2.13	82	66.74
17	0.57	50	2.30	83	73.07
18	0.59	51	2.52	84	80.35
19	0.61	52	2.81	85	88.76
20	0.62	53	3.20	86	99.16
21	0.62	54	3.65	87	110.40
22	0.64	55	4.15	88	121.85
23	0.66	56	4.68	89	133.40
24	0.68	57	5.20	90	144.30
25	0.71	58	5.66	91	155.80
26	0.73	59	6.06	92	168.75
27	0.76	60	6.51	93	186.44
28	0.80	61	7.11	94	206.70
29	0.83	62	7.96	95	228.35
30	0.87	63	9.08	96	250.01
31	0.90	64	10.41	97	265.09
32	0.93	65	11.90	98	270.11
33	0.96	66	13.51	99	281.06

Professor Belth's Formula:

$$\frac{(P + CVP)\,(1 + i) - (CSV + D)}{(F - CSV)\,(.001)}$$

P = Premium

CVP = Cash Value Previous Year

i = Alternate use of Funds Interest Rate (Net after Taxes)

CSV = Cash Surrender Value this year

D = Dividend or Interest Credited

F = Death Benefit

This method is suitable for comparing policies specifically for a replacement situation. (Ben Baldwin—Life Insurance Investment Advisor, Probus Publishing Company, ©1988)

THE BEN BALDWIN SYSTEM

This is an alternative system devised by Ben Baldwin: "An Alternative Method—The Baldwin System for the financial analysis of life insurance on an individual basis." It seeks to cure the previously stated defects in all of the previously discussed systems.

According to Mr. Baldwin, in testing and evaluating this system on the financial evaluation of life insurance, a computer program was developed. This has been used to test the system with all types of life insurance: term, whole life, single premium life, universal life, variable life, and universal variable life. The program gives simultaneous results of Professor Belth's system of evaluating the cost effectiveness of life insurance policies, the cash-on-cash rate of return, and cash and life insurance value rate of return. The Baldwin System has proved to be valuable in making individual decisions regarding existing life insurance and potential purchases. Although it takes a bit of effort to understand, you should be able to understand the data that is used in coming up with the conclusions, and then you are in a good position to evaluate the results.

The step-by-step procedure follows:

STEP 1

Determine how much life insurance is provided by the policy.

Total Death Benefit ________________

Less Total Current Asset Value -________________

Equals "Life Insurance" =________________

Total Death Benefit

Total death benefit is the face amount of the policy plus any policy provisions that increase the death benefit in the event of a natural death, i.e., term insurance riders or paid-up additional life insurance as a result of dividends being left in your policy.

Total Current Asset Value

Total current asset value is what you would get for your policy if you went to the insurance company and cashed it in today. It includes the amount of any loans, which you would not have to pay back as a result of cashing in the policy. The objective of this calculation is to determine how much of the total death benefit is your money and how much is life insurance company money, "life insurance."

STEP 2

Determine what you have paid to maintain the life insurance in-force this year.

Premium	____________
Plus Net After-tax Loan Interest Cost	+____________
Plus Net After-tax Cost of Cash Left in the Policy	+____________
Equals Total Current Year's Cost	=____________

Premium

The premium portion of what you have paid to maintain the life insurance is the billed gross premium for the policy or what you have chosen to pay if the policy is a universal life type of contract without a stated premium.

Loan Interest Costs

The net after-tax loan interest cost is calculated first by determining the gross loan interest paid for the year. For example, if the policy had an outstanding loan of $1,000 at a 5% interest rate, the gross loan interest would be $50. For tax year 1987, assuming this is considered consumer interest, this interest would be 65% deductible (40% in 1988, 20% in 1989, 10% in 1990, and zero % deductible thereafter). Assuming this is a 1987 calculation, 65% of the $50 interest charge is deductible, or $32.50 ($50 x 65% = $32.50). We will assume that you are in the 28% federal tax bracket, and that the state income tax bracket adds percent to that, bringing your total marginal tax bracket to 30%. Thus, the $32.50 income-tax deduction would reduce your tax liability by $9.75 tax reduction = $40.25).

Personal life insurance policy loans are becoming more expensive as a result of the provisions of the Tax Reform Act of 1986. Life insurance policy loans are more expensive for lower-bracket taxpayers than they are for high-bracket taxpayers.

There are further unseen costs for life insurance policy loans. In the last few years, most life insurance companies have offered enhancements to their participating whole life insurance policies. If the policy owner accepts a higher interest charge on policy loans, he will be rewarded with high dividends. Conversely, if the policy owner refuses the enhancement in order to maintain his low policy loan interest rate, he will receive lower dividends. See Chapter 10, Questions 106-109 for more information on policy loans.

This dividend credit differential between borrowers and non-borrowers is effectively an increase in the cost of life insurance policy loans. The precise dividend differential and loan interest-rate alternatives offered to an individual policy owner in an enhancement or upgrade offer can be used to determine the impact on a specific policy.

The wisdom of leveraging life insurance—borrowing to pay premium, the so called "minimum deposit plans"—are questionable at best today. What loan interest has to be paid? What effect does it have on dividends? What are the loan proceeds to be used for? For example, if the money is to be used to finance investments, you would expect the interest expense to be deductible up to an amount equal to the annual portfolio investment income. However, if it is used to make consumer purchases (such as an automobile) or to carry life insurance, it will be subject to the phase out of deductibility, which will make it a less economical strategy. As stated in *Forbes*, June 29, 1987, "if you own a minimum-deposit life insurance policy, condolences are in order."

Opportunity Costs

The net after-tax cost of cash left within an insurance policy may be considered an "opportunity" cost. If you are able to borrow on your life insurance policy at 5% and are able to invest that money at an amount more than 5%, it makes no sense to borrow on the policy and reinvest. If you choose not to do that, and leave the cash within your life insurance policy, you are sacrificing the opportunity.

That lost opportunity is a cost that could be added to your cost of holding a life insurance policy.

Economic conditions in 1987 made it difficult to borrow from a policy, pay loan interest, and profitably reinvest the money to earn an easy profit. The increased costs for policy loan interest, and reduced dividends for policies that retained their low interest rate on policy loans, combined with the lower interest rates available on alternative safe investments, provided little opportunity for gain.

For example, we have just established that if you as an individual in the 30% combined marginal tax bracket borrowed from your policy at 5%, the net after tax deduction cost of the loan would be as follows:

Interest charge on $1,000 loan:	$50.00
Amount of loan interest deductible:	65%
Deductible interest (65% x 50):	$32.50
Amount of deduction in 30% tax bracket (30% x $32.50) equals:	$ 9.75
Net cost of $50 interest charge ($50 - $9.75):	$40.25

If you were then to reinvest the $1,000 at 5.5% taxable outside of the policy, the following would be the result:

Interest earnings:	$55.00
Income tax on interest earnings (30 % x $55):	-$16.50
Net after tax gain:	$38.50

Net benefit realized by borrowing and reinvesting:

Cost:	$40.25
Benefit:	$38.25
Gain (Loss):	($ 1.75)

In addition to this loss, you may also have lost the opportunity to receive higher dividends.

The situation in the early 1980s was far different. You would have found that if you had $1,000 at a 5% interest cost, and paid a total of $50 in interest for the year, your net after-tax cost for that $50-a-year deductible loan interest would have been $25, assuming the 50% tax bracket. You could then have put those funds in a money-market account, earned 10% on the $1,000 (gross interest return of $100 per year), paid 50% tax on those earnings, and netted $50 per year. You could, therefore, have earned a 100% profit on the net $25

after-tax cost of your policy loan. Had you not borrowed on this policy and left the $1,000 within the policy during that period of time, you would have been sacrificing these earnings. This lost opportunity cost may be considered an additional cost for maintaining your life insurance policy.

STEP 3

What cash benefits did you receive as a result of maintaining the policy in force for the current year?

Current Year's Increase in Cash Value, Account Value, or Asset Value	______________
Plus Current Year's Dividend, if any	+______________
Equals Total Policy Owner Credit	=______________

Critics will find weaknesses and advocates will find strengths in this particular section of this system for the financial analysis of life insurance. The critics will say that you are looking at the policy for only one particular year. They will question whether the financial results for any particular year are an accurate report on what has happened in the past, or a predictor of what will happen in the future. The criticism is valid because the policy under analysis could be a variable life insurance policy with its investment in a common stock account in a year when the common stock fund has taken a substantial beating. If that were the case, current-year return could easily be negative. If you concluded that one year's negative return meant that you should get rid of the policy, that may certainly be an erroneous conclusion. You should perform further evaluation by re-entering your numbers in the formula using the average annual increase in account value and the average annual dividend received since the policy's inception as the credits received as a result of maintaining the policy in-force. For inputing into the policy, you could use average annual premium, average policy loan costs, and the average net after-tax costs for maintaining cash within the policy. This would give you an indication of average return from policy inception. From the standpoint that each policy owner is trying to make a "Where do we go from here?" decision, the current year's actual return will be far more important than such averages.

If you are considering an upgrade or enhancement offer, you can use the formula by entering assumptions, such as the elimination of the policy loan

and the acceptance of the higher dividend yields, to determine the impact of the offer.

Advocates of this system of financial analysis of life insurance will appreciate the fact that it can tell them what is going on within a life insurance policy in the current year and, by using other inputs, what has gone on since policy inception. It can also be used to evaluate the financial result of accepting upgrade offers and increasing, decreasing, or eliminating policy loans.

STEP 4

Determine your investment in the contract.

Total Asset Value	____________
Less (Subtract: Loan Outstanding)	-____________
Equals Investment Remaining in Contract	=____________

The investment capital in the contract is extremely important, as it is the investment upon which you are going to calculate your investment return. It is the investment at the moment of your evaluation. Some users of this system will wish to refine this figure to make it closer to the policy owner's average investment in the contract during the year in question. That is, you could calculate your investment in the contract at the beginning and at the end of the year and then add the two together, subtract any policy loan, and divide by two to come up with the average investment in the contract for that year.

Others may wish to decrease the investment in the contract by the amount of ordinary income tax they would have to pay on the gain within the policy if they surrendered it and/or any back-end load. The gain in the contract is total policy value less the policy owner's basis. This is subject to ordinary income tax upon policy surrender. This is valid if the policy is to be dropped and the income tax paid; however, it is invalid if this tax liability is to be avoided by using a 1035 tax-free exchange into either another life insurance policy or an annuity contract or continue the policy.

For our purposes, it is better that you understand the logic in the procedure, using the current existing investment in the contract.

When entering the figure for the outstanding policy loan, the unpaid outstanding interest on the policy loan at the time of the evaluation should be added to the policy loan amount.

STEP 5

Determine the dollar amount of return you have earned in the current policy year.

From step 3 above, take your increased value for the current policy year and subtract step 2, your current input into the contract for the current year.

Policy Owner Credit (Step 3)	______________
Minus Policy Owner Costs (Step 2)	-______________
Equals Policy Owner Net Gain (Loss)	=______________

STEP 6

Determine your cash-on-cash return for the current year.

In order to determine your cash-on-cash annual percentage rate of return for the current year, take the amount of the credit from step 5, and divide it by your investment remaining in the contract from step 4.

Amount of Credit (Step 5)	______________
Divided by Amount Invested (Step 4)	÷______________
Equals % Cash-on-Cash Return	=______________

STEP 7

Determine your policy owner's equivalent taxable return.

The cash-on-cash return varies in value for high- and low-bracket taxpayers. This is easier to communicate if you have the number that represents the pre-tax rate of return that you would have to obtain on a taxable investment outside of the life insurance contract in order to match that non-taxable return within the policy. In order to accomplish this, take your tax-free rate of return as calculated in step 6 above and divide it by one minus your tax bracket.

Policy owner's Untaxed Cash-on-Cash Rate of Return (Step 6)		______________
Divided by (1 minus Tax Bracket)	÷	______________
Equals Equivalent Taxable Return	=	______________%

STEP 8

Determine the value of your life insurance.

This is a very important question these days, when life insurance policies are being touted as competitive investments regardless of the life insurance protection they provide. If you are not in need of life insurance protection and place no value on the life insurance protection provided by the contract, then you need go no further in the financial evaluation of the life insurance contract. Step 7, the cash-on-cash return, is all that is the value, and the viability of the life insurance contract as an investment depends upon the competitiveness of this cash-on-cash return with other investment alternatives available.

Other individuals will place varying values on the life insurance protection provided by the contract. The young non-smoker who has an opportunity to purchase term insurance at discounted rates through his association, his employer, or some other advantageous source would put one value on the life insurance that he could obtain in his preferred status. An individual who is older, has a great personal need for life insurance, and has just had a heart attack—so that existing life insurance could not be replaced—would place a much higher value on the net amount at risk. In some cases the insurance protection will have so much value to the policy owner that the cash-on-cash return or investment return of the policy would be irrelevant.

Life insurance does have value, and that value has to be individually determined. The most accurate cost per thousand to be entered in this section of the formula would be the figure you obtained as a result of applying to an insurance company for an equivalent amount of term life insurance, submitting to medical examination, and receiving an offer for term insurance at a contractually guaranteed rate. All other entries are estimates, and the financial analysis is only as good as that estimate is accurate.

Once the equivalent retail value of term life insurance is determined, it is multiplied by the amount of life insurance protection provided by the contract (face amount of the policy minus asset value of the policy as determined in step 1) to determine the value of the life insurance within the contract.

Some would argue that your retail cost of the term insurance divided by one minus your current marginal tax bracket is the figure that should be entered. This figure would represent the amount that you would have to earn

in total to service a retail term insurance policy. For example, for every $100 a policy owner in the 30% marginal state and federal tax bracket must pay for term insurance, that policy owner must earn $142.86 (100 ÷ (1 - .30) = $142.857). This communicates that in order to send a check to an insurance company for $100, you must earn $142.86, pay the 30% tax ($42.86 [$142.06 x .30 = $42.86]) and send the balance, $100, to the insurance company.

This method of valuing the cost of retail term insurance would be accurate if the untaxed earnings on an investment within the life insurance policy were entirely sufficient to cover all mortality and expense charges within the policy. We have taken the more conservative approach using just the equivalent retail cost of term insurance for the policy owner.

Value of Life Insurance:
Life Insurance in Thousands (Step 1)
Multiplied by Policy owner's Cost ______________
Per $1000 of Life Insurance ÷______________
Equals Value of Life Insurance =______________

STEP 9

Determine the total value you receive as a result of continuing this life insurance contract.

The total value you receive as a result of continuing the life insurance contract is the cash-on-cash return plus the value of the life insurance protection. Add the life insurance value determined in step 8 to the cash return of step 5 to come up with the total dollar amount of benefit you receive from the contract.

Policy owner Net Gain (Loss) (Step 5) ______________
Plus Life Insurance Value (Step 8) +______________
Equals Total Benefit Received =______________

STEP 10

Determine the percentage return on the contract when the cash-on-cash return is added to the life insurance value.

Value Received ÷ Amount Invested = _____________ % Rate of Return
(Step 9) (Step 10)

STEP 11

Determine the equivalent taxable return that you must earn to match this tax-deferred/tax-free return from the life insurance contract.

Percent Rate of Return (Step 10) ÷ (1 Minus Tax Bracket) = _______ %

(Ben Baldwin—Life Insurance Investment Advisor, Probus Publishing Company, ©1988).

THE VERALYTIC SYSTEM

The Veralytic System was invented by Barry D. Flagg as a tool for measuring internal policy costs and actual historical performance of life insurance. The Veralytic System evaluates any in-force policy or proposed permanent life insurance product on the following five considerations:

- Insurer financial strength
- Competitiveness of internal policy costs
- Illustration reliability
- Access to/restrictions on policy account values
- Actual historical performance of invested assets underlying policy account values

The Veralytic System rates each consideration against benchmarks for the universe of peer-group alternatives and assigns a star rating to the policy under evaluation. Each consideration is measured independently, given equal weight, and totaled for an overall Star Rating.

See page 360 for a special offer on Veralytic reports.

Q&A

CHAPTER 9

WHAT SHOULD I KNOW ABOUT LIFE INSURANCE REPLACEMENTS?

Q93 Why Would I Consider a Life Insurance Replacement?

A life insurance policy is a financial asset. It is a good idea to review it on a regular basis to make sure you are getting the value you expected, in exchange for the premium dollars you pay the life insurance company. Things change in the real world, and your life insurance policy can be affected by such things as changes in the issuing company's financial condition and by competition.

Life insurance is also a financial tool, a complex tool that provides you with financial leverage. There is no substitute for life insurance, for it is unique in its ability to provide a self-completing financial plan, should the insured person die unexpectedly. Life insurance can be used to replace lost income, pay the federal estate tax, and provide money for many other worthwhile purposes.

Replacing an in-force life insurance policy can be a very good idea or a very bad one. It depends on many factors. Traditionally, the viewpoint within

the life insurance industry is that replacing an existing life insurance policy with a new one is generally not in the policy owner's best interest. This statement is ambiguous in the sense that it can be both true and false at the same time. Dealing with the complexities of the life insurance replacement issue is like peeling away the layers of an onion. Remove several layers and there are still many layers remaining.

This section is intended to aid you in the replacement decision-making process. It is not an exhaustive treatment of the subject, because your individual situation is unique and there is no one-size-fits-all solution. Our purpose here is to help you evaluate the pertinent facts and circumstances when considering whether or not to replace an existing life insurance policy. A replacement may be internal (i.e., replacing it with a new policy from the same company) or external (i.e., replacing it with a policy from a different company).

Q94 How Is Replacement Defined?

Simply stated, replacement means discontinuing one life insurance policy to purchase another. A very fine line divides replacement (which is permissible under state insurance law) from twisting (which is prohibited by state law). Twisting is like churning—replacing a life insurance policy primarily for the agent's benefit, to earn a new agent commission. Twisting is defined as the practice wherein an agent induces a policy owner through misrepresentation to discontinue an existing life insurance policy and purchase a new one with the proceeds.

State law determines the legal meaning of the word "replacement," and it varies substantially by state. It is a good idea to become familiar with your own state's definition of the term. To locate your state's insurance code and replacement regulations, a good place to start is with the National Association of Insurance Commissioners Web site (www.naic.org). Follow the link to your state's insurance department.

You will quickly find that your state has some fairly strict insurance regulations, but enforcement varies by state. Some state insurance departments are better funded and hence better staffed than others. In general, the larger state insurance departments are better equipped to enforce the replacement regulations, but this is not always the case.

Q95 What Issues Favor Replacement?

Has the insured's insurability and/or health improved since the existing policy was issued? If the existing policy was issued in a substandard rating class (i.e., with an extra premium charge), will the company replace/remove the rating? If the insured person was formerly a smoker but is now a non-smoker, will the current company change the premium to a non-smoker rate? If the current company will not assist the policy owner in these circumstances, replacement might well be justified.

What is the current company's financial condition compared to the proposed carrier? Has either company's financial condition significantly deteriorated? A justified replacement may be needed in order to rectify an unjustified replacement. Policy ownership problems may trigger replacement. For example, if an ex-spouse or business partner claims partial or full ownership, a replacement might be indicated. The current policy may no longer suit your current life insurance needs. The policy may be an old non-participating policy (i.e., it does not pay dividends) which has not been updated by the company to give you the benefit of potentially more favorable current interest and mortality experience.

When costs charged in an existing policy are greater than the costs that would be charged in a new policy (i.e., including consideration of new premium taxes, sales loads, and surrender charges), then a replacement could certainly be justified. Costs in an existing policy can be higher than costs charged in a new policy for a variety of reasons. In many cases, internal policy costs were never analyzed, and because insurers are permitted to "quote" low premiums and project high account growth while at the same time charging high costs without disclosing the higher risks of additional "premiums calls" to achieve expected/illustrated results, costs are often not understood or analyzed.

Q96 What Issues Favor Retention of an Old Policy?

- If you replace the existing policy, you will incur new first-year expense charges for agent compensation, issue, and underwriting.
- The suicide clause and contestable period (where the company can challenge the policy) start anew, unless the replacing insurer is willing to waive them (be sure to ask).

- If your health has deteriorated since the issue of the original policy, or if the original policy was issued with no premium difference between smokers and non-smokers and you are a smoker.
- If the existing policy has especially favorable policy provisions such as an attractive guaranteed interest rate on policy loans. Keep in mind that recent tax law changes may have diminished the benefits of a policy loan.
- If the existing policy does not qualify for an Internal Revenue Code Section 1035 tax-free exchange (there is more information on this in a separate section of this report). For example, if there is a policy loan outstanding, it may be difficult to affect a tax-free exchange. The taxable income generated by an exchange that does not qualify for tax-free treatment could be significant.

Different considerations apply to the decision-making process for term life insurance vs. permanent policies. You will find worksheets in Questions 98 and 99 that will help you do a replacement self-evaluation of both permanent and term life insurance.

Replacing an existing life insurance policy may not be in the policy owner's best interest. Buying a new policy most likely means a new sales load for commissions and other charges assessed by the company, along with a new suicide clause. The latter is the company's right to challenge a death claim during the first two years the policy is in-force, if suicide is the cause of death. Two years is typical, but some policies have a one-year suicide exclusion. Existence of the suicide and contestability periods, advancing age or health concerns, and the loss of important grandfathered rights are some of the obvious reasons that most replacements cannot be justified. Before replacing policies, discuss it with the carrier. As carriers continually enhance their policies, they recognize that their policies may become obsolete and will consider upgrade and exchange programs.

On the other hand, there may be circumstances where replacement is indicated by the facts and circumstances. The ethical agent will provide the client with the facts and objective information needed to make an informed decision. These should include the reasons why the current policy should not be replaced and—when appropriate—how the existing policy might be modified to accomplish the goals. The need for additional coverage is not, by itself, a justification for replacement. A better approach is purchasing a new policy to cover the additional amount needed.

Q97 What Are Some Questions to Consider Before Replacing?

- What do you wish a new policy to achieve that your existing policy does not?
- Have you contacted the current company to see if the policy can be modified to meet the desired objectives? Policy performance may actually be quite competitive, if the factors adversely affecting this performance have been experienced by all insurers. In particular, the dramatic fall in interest rates over the last 20 years has lowered the returns of all traditional whole life and universal life policies to one degree or another. Rather than replace the competitive policy of a well-rated insurer, whose returns have only gone down to some extent with the broad decline in interest rates, it may be more appropriate to make any necessary adjustments to ensure the continuation of the policy by raising the premium, paying it for a longer time, reducing the policy's death benefit, or seeking an adjustment with an updated policy from the same insurer.
- Compare the benefits of each policy. Differences in the underlying investments of the old and new policies may make rate-of-return comparisons difficult or misleading, especially if the proposed new policy is variable and equity investments are contemplated in place of the old insurer's fixed-income-oriented investment portfolio. Investment returns obviously need to be adjusted for risk for comparisons to be meaningful, and the other factors affecting product performance—mortality, expenses, and lapse rates—need to be considered as well.
- Compare internal policy costs and performance requirements for both policies.
- Be aware that a new policy will have new suicide and incontestable provisions, unless the company is willing to waive them.
- Will the replacement (if it is a permanent life insurance policy with a cash value) qualify as a tax-free exchange under Internal Revenue Code Section 1035? (See Question 101.)
- Will you be able to qualify both financially and health-wise for the new coverage?
- Have you been urged to borrow from a current policy or policies to finance the new coverage? This is not a good idea.

- Is this a replacement proposal that attempts to increase the death benefit for an existing premium or to lower the premium for an existing death benefit, by guaranteeing a death benefit—but only to a certain advanced age, such as age 95 or 100. Purchasers of "permanent" insurance want their policies to be "permanent" and not to expire before they do, if they happen to live an especially long time.

Term life insurance is less complicated than permanent, cash-value life insurance, so we will consider term life insurance first.

Q98 What Type of Worksheet Can I Use With a Proposed Term Life Insurance Replacement?

This worksheet summarizes some important factors to consider. Not all of these factors necessarily apply to your situation. This is not an exhaustive list, but it covers the most likely scenarios. The worksheet is a good base on which to build in deciding whether or not to replace an in-force term policy. If you are familiar with spreadsheet computer programs like Excel, Lotus 1-2-3, or Quattro Pro, you can build a spreadsheet that will give you a side-by-side comparison of your present term policy and the proposed policy.

Term insurance generally does not pay dividends and does not accumulate cash values. Term insurance runs for a specified period of time, and it expires without value at the end of that term. During the term it provides pure life insurance protection in the amount for which you contract with the life insurance company. A good example is a $1 million 10-year term policy. If the insured person dies during the 10-year term period, the policy pays $1 million to the designated beneficiary. If the insured person dies after the 10 years is up, the policy pays nothing. Many term policies are renewable at a higher premium rate, and many are convertible to permanent life insurance at any time during the policy term.

Term policies come in many forms. The most common are annual-renewable term, decreasing term (e.g., mortgage cancellation insurance) and level-premium term. Some policies offer guarantees and others do not. It pays to shop around. You may also want to record the comparison information you

are given, the source, and the date. Try to verify that the information is current, because you will be making a decision based on that information.

	Present Policy	Proposed Policy
Company Name		
AM Best Rating and Ranking (16 Ratings from A++ to S)		
Standard & Poor's Rating and Ranking (9 Ratings from AAA to R)		
Moody's Rating & Ranking (9 Ratings from AAA to C)		
Fitch Rating & Ranking (9 Ratings from AAA to C)		
Type of Coverage: Annual Renewable Term (ART), Level Premium, Decreasing Term, Mortgage Insurance, Etc.		
Date of Issue		
Face Amount (Death Benefit)		
Annualized Premium		
Premium Detail–Will the Premium Increase? • If yes, by how much? • If it is level, then how much longer will it remain at the current level? • What will happen to it at the end of the level premium period?		
What are the Premium Guarantees, if any?		
Is it Group or Individual Coverage? • If Group, do you plan to stay with the group, employers, association, union, etc.?		
Policy Expiration Date		
Conversion and/or Exchange Option? • If yes, until what date? • Is there a conversion premium credit?		
Is there a Re-Entry Provision, and if so what are the details?		
Are there any riders on the policy, such as Waiver of Premium, Accidental Death Benefit, Family Rider, Spouse Rider, Child Rider, Etc.?		
Cost of Rider(s)		

Q99 What Type of Worksheet Can I Use With a Proposed Permanent Life Insurance Replacement?

Because of the cash-value element and its complexities, it is much more difficult to analyze a permanent life insurance policy in a potential replacement situation. There are many types of different permanent life insurance policies. For the purpose of this worksheet, we will use the generic term "permanent life insurance" to mean any type of life insurance that builds up a cash value, including whole life, universal life, variable life, variable universal life, and all variations on each of these policy types.

Please note that the use of the word "illustrated" in this worksheet means that results are not guaranteed. An illustration is nothing more than a projection based on a bundle of assumptions that are almost certainly not going to occur in real life. That does not mean that life insurance companies are guilty of a sinister conspiracy against the consumer. Quite the contrary, the truth is that neither the insurance company nor any person knows the future, so we have to make intelligent guesses. The result is a so-called linear or deterministic projection.

Perhaps the key assumption in a linear projection is the future interest rate that will be credited by the company to the policy. This is usually expressed as a level interest rate. For example, an illustration might assume an interest credited rate of 6%. In the real world, interest rates fluctuate, so in practice, that 6% illustrated rate is not realistic, even if it is a perfectly reasonable assumption. A truly realistic illustration would have to assume a constantly variable interest rate, which is virtually impossible. Since we don't know the future, how does one come up with a variable interest rate?

Keep in mind that different companies use different assumptions in preparing illustrations. Illustrations alone should never be used to compare policies. State insurance regulations require—for your protection—that both the proposed replacing company and your existing company prepare current illustrations for your consideration in making an intelligent replacement decision.

These illustrations will show the effects of the surrender charge on the existing and proposed policies. In situations where the current policy will be modified, but not terminated, comparisons should include in-force ledgers of the policy before and after the change, if available. The terms "ledger" and "illustration" mean the same. Some companies use the term "ledger illustration" instead.

Reduced-scale illustrations—illustrations showing lower interest-rate-crediting assumptions—should be provided on both existing and proposed policies to demonstrate the effects of volatility on the performance of non-guaranteed policy elements under varying circumstances. This is a reasonable substitute for the stochastic modeling described above. In other words, if an illustration with a lower interest rate than is reasonably thought will be achieved shows that the plan will work, there is every indication that it will work in the real world, as long as things don't go completely awry.

The reduced-scale illustrations should be consistent with those required by NAIC model illustration regulations, when applicable in your state. This worksheet is intended for evaluation purposes only and is not a substitute for state replacement requirements. Also, for variable life insurance, you will need to look at the sub-accounts and most likely will need the use of an investment analyst.

The term "sub-account" means the funds within a variable life or variable universal life policy in which the money is invested. A sub-account is similar to a mutual fund, except that it comes under the umbrella of a life insurance policy. It is, however, highly misleading to think of a variable life or variable universal life policy as a mutual fund with a thin layer of life insurance on top. We mention this because that terminology is sometimes used by well meaning but misguided agents to describe a variable life policy. A better way to think of a variable life or variable universal life policy is as a permanent life policy which uses mutual funds (sub-accounts) to manage the cash value element within the policy.

Illustrations should never be the sole criteria for evaluating a replacement. Illustrated cash values and illustrated death benefits are never reliable predictions of future results. More information is needed. At a minimum, you should attempt to find out what the underlying assumptions are for the in-force illustration on the current policy, and for the sales illustration for the proposed policy. You should be aware that there might be differences in the assumptions used by each company, which may render a comparison based upon such illustrations invalid. Make sure you are comparing apples to apples. You can use the table on the following page. Also keep in mind that replacement of an existing policy generally results in the reduction of cash-surrender value as a result of new acquisition costs.

A valuable tool to assist you in replacement situations is a current "in-force illustration." In-force illustrations allow you to gauge past performance against anticipated future performance. These are for simple situations that do not include a policy loan and for some of the other more complex situations listed throughout this book.

Lastly, consider requesting a Veralytic report (see Question 92 for more information). A Veralytic report can help you understand whether internal policy costs are competitive and performance requirements are reasonable.

Q100 Are There Any Special Situations to Consider?

Is there a policy loan? If there is, then the situation has just become even more complicated. You should consult the section (Chapter 10, Questions 106-109) in this book on policy loans. For example, will the new company assume the loan from the old company? Most companies will not. The simplest solution is to repay the loan on the old policy before exchanging it. Otherwise you might wind up with taxable income as a result of the replacement.

Issues for policy loans for both the current policy and, if applicable, the proposed policy:

- Gross Interest Rate
- Fixed or Variable Rate
- Direct Recognition
- Universal Life: What is the current spread between the loan rate and interest credited on the borrowed amount? Is this spread guaranteed?

Does the policy qualify as life insurance under Internal Revenue Code Section 7702?

Section 7702 states that a life insurance policy issued after 1984 will be treated as life insurance for tax purposes only if it is:

1. Considered a life insurance contract under applicable (state) law; and
2. It meets either the cash value accumulation test or a combination guideline premium—cash corridor test.

Issue dates—depending on the issue date on which the current policy was issued, the following "grandfathered features" will be lost if the policy is replaced:

Company Name	Present Policy	Proposed Policy
AM Best Rating and Ranking (16 Ratings from A++ to S)		
Standard & Poor's Rating and Ranking (9 Ratings from AAA to R)		
Moody's Rating & Ranking (9 Ratings from AAA to C)		
Fitch Rating & Ranking (9 Ratings from AAA to R)		
Type of Coverage: Whole Life, Universal Life, Variable Life, Variable Universal Life, Joint/Survivor Life, Etc.		
Date of Issue		
Current Face Amount (Death Benefit)		
Is the death benefit • Level or increasing? • How many years is it guaranteed for? • How many years will it last for based on current/ illustrated assumptions?		
Annualized Premium—the mode by which the premium is paid will affect the performance of the policy.		
How will the premium payment mode affect the policy— • Premium necessary to guarantee coverage at initial/current levels for duration of policy? • If the premium is to be payable for a certain number of years? • Number of years based on current assumptions? • Number of years based on guaranteed assumptions?		
Cash/Surrender Value—current policy? Compare current policies projected values (based on current assumptions) with new policy's first-year value (note: surrender charges may significantly if not completely reduce early values in any new policy).		
Policy Maturity/Termination Date		
Term Rider (if applicable)— • If yes, what is the ratio the initial term amount to the total death benefit? • Does the term rider convert to permanent insurance? • If so, when does it do so and is it guaranteed? • Is the term rider guaranteed in any other fashion?		
Are there any riders on the policy? If so, which ones?		
Cost of Rider(s)		

- August 8, 1963—The current policy was purchased on or before 8/6/63, so IRC Section 264(a)(3), which limits deductions for interest indebtedness, does not apply. If the current policy has met the "four out of seven" test of IRC Section 264(c)(1), interest on indebtedness is deductible to the extent otherwise allowed by law. Personal interest deductions are generally denied for tax years beginning after 1990, regardless of when the policy was purchased. IRC Sec. 163(h)(1).
- June 20, 1986—The current policy was purchased on or before 6/20/86. Certain policies purchased for business purposes after this date have a $50,000 ceiling on the aggregate amount of indebtedness for which an interest deduction is allowed. IRC Sec. 264(a)(4).
- June 20, 1988—Policy was issued on or before 6/20/88 and is not subject to Modified Endowment Contract rules. IRC Sec. 7702A. Substantial increases in the death benefits of grandfathered contracts after 10/20/88 may cause the imposition of the MEC rules. H.R. Conference Report No. 1104, 100th Cong., 2d Sess. (TAMRA '88) reprinted in 1988-3 CB 595—596.
- October 21, 1979—Variable annuity contracts purchased before 10/21/79 are eligible for a step-up in basis, if the owner dies before the annuity starting date. IRC Sec. 72; Rev. Rul. 79-335, 1979-2 CB 292.
- August 14, 1982—An annuity issued prior to 8/14/82 is subject to more favorable (basis out first) cost recovery rules for withdrawals. IRC Sec. 72(e). Such policies are not subject to the 10% penalty on withdrawals made prior to age 59. IRC Sec. 72(q)(2).
- February 28, 1986—To the extent contributions are made after 2/28/86 to a deferred annuity held by a non-natural person (such as a business entity), the contract will not be entitled to tax treatment as an annuity. IRC Sec. 72(u).
- September 14, 1989—A survivorship life policy, issued prior to 9/14/89, is not subject to the 7-pay MEC test if there is a reduction in benefits. IRC Sec. 7702A(C)(6).

You should seek competent legal counsel before applying these factors to any specific situation.

Q101 Are There Any Tax Issues to Consider with a Replacement, and What Is Internal Revenue Code Section 1035?

Please note that this section is not intended as tax advice and should not be construed in such a manner. Please consult your tax advisor for advice in your specific situation.

Overview of Internal Revenue Code Section 1035

Typically, upon the surrender of a life insurance contract, gain is immediately recognized by the policy owner, to the extent the value of the policy received exceeds the policy owner's adjusted basis in the transferred policy.

Section 1035 allows certain exchanges of life insurance to be made without the immediate recognition of gain. Section 1035 allows the tax, that otherwise would be imposed on lump-sum disposition of certain life insurance policies (and annuities), to be postponed. The following are the types of exchanges allowed through Section 1035 that would result in no gain (or loss) to be recognized:

- An ordinary life insurance contract for another ordinary life insurance contract (one for which the face amount, i.e., the death benefit, is not ordinarily payable in full during the insured's life).
- An ordinary life insurance contract for an endowment contract (one that depends in part on the life expectancy of the insured but that may be payable in full in a single payment during the insured's lifetime).
- An ordinary life insurance contract for an annuity (one payable during the life of the annuitant only in installments).
- An endowment contract for another endowment contract that provides for regular payments beginning at a date not later than the date payments would have begun under the contract exchanged.
- An endowment contract for an annuity contract.
- An annuity contract for an annuity contract.

Section 1035 relates only to the exchange of non-qualified contracts; those that do not receive qualified retirement plan treatment.

Generally, a contract received in a 1035 exchange carries over elements of the original contract, in addition to basis. Please note that there are a number

of Internal Revenue Service Private Letter Rulings, Revenue Rulings, and modifications. These are the basic rules, however, as previously stated; they may not apply in your specific situation.

Q102 What Are Some Myths About Replacement?

Myth: Your policy is on the old mortality table and therefore your current insurance company is taking advantage of you by failing to recognize that people are living longer today than when the older mortality table was developed.

Fact: The non-forfeiture values and reserves are based on the older table, but that alone is not a problem. The real issue is whether current mortality experience is being reflected in the dividend, if the policy is participating, or in the mortality charge, if the policy is interest-sensitive.

Myth: Your policy is out of date. A claim like this implies that periodic policy recycling is "normal" and an accepted and desirable business practice.

Fact: If current mortality and interest experience is being credited, the age of the policy should not be of concern. If not, you may have a valid case for replacement. Another valid replacement indicator: the policy owner has an old policy in which the company made no distinction between smokers and non-smokers (some companies refer to this as a unismoker policy). If this is the case and the client is a non-smoker, replacement should be considered on the merits. Another situation is one in which the policy owner would like one or more features that are not available on the present policy.

Myth: The company that wrote your policy is out of business (or has been taken over). The real myth is that such a situation always has negative implications for the policy owners. It may be that the company has simply changed its name, which happens quite often in today's fast-paced business climate.

Fact: You need more information before reaching any conclusions. The company may have changed its name, been merged into another company, or been purchased by a stronger company—which could make retention of the existing policy that much more desirable.

Myth: You should buy cheap term life insurance and invest the difference in premium between term and permanent life insurance. The myth here is that there is never a need for permanent life insurance.

Fact: Sometimes there are permanent needs that require permanent life insurance, although in the majority of cases term life insurance will meet the need at a much more attractive cost. It depends on the situation and circumstances. When it comes to life insurance, one size definitely does not fit all.

Myth: The agent portrays state insurance-department-mandated replacement forms and procedures in a way that implies that the state endorses replacements. The agent might, for example, say that this is the state approved procedure for helping people in your situation.

Fact: The real intent of insurance-department replacement forms and procedures is to assist the consumer in making an intelligent decision about whether or not a replacement is desirable under the particular circumstances.

Q103 What Are Some Reasons for Replacing?

Survey Results: Showing Why Policy Owners Replaced Their Policies

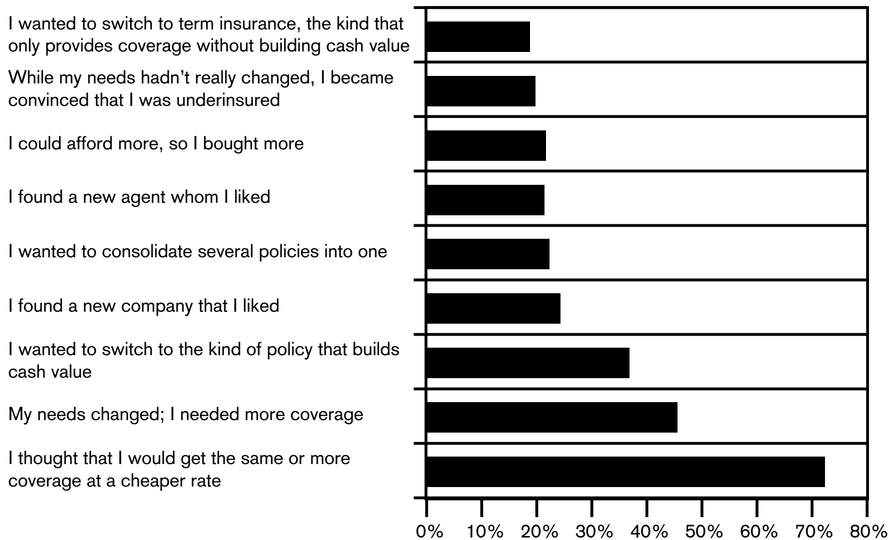


Chart Note: Multiple Responses were permitted.
(Source: Life Insurance Marketing and Research Association (LIMRA)— "Replacement Now," April 17, 1985, P.5)

Q104 What Are Some Areas to Use Caution in Making a Replacement?

Generally, the exchange or replacement of insurance or annuity contracts is a good idea, except for a very few reasons:

- The "bonus" credit can be offset by the insurance company's adding additional contract charges.
- Other contract provisions, like surrender charges, eventually expire with an existing contract. However, new charges may be imposed with a new contact or may increase the period of time for which the surrender charge applies.
- Higher charges, such as annual fees for the new contract, may apply.
- Costly new contract features may not be needed. Since the initial costs of a life insurance policy or annuity contract are charged against early cash value increases or may result in substantial surrender charges, the contract owner or policy owner that exchanges an existing policy or contract is undergoing this a second time.
- In a life insurance policy, incontestable and suicide clauses generally begin anew on the new contract.
- An existing life insurance policy or annuity contract may have more favorable provisions than a new life insurance policy or annuity contract, especially in areas such as loan interest rates, settlement options, disability benefits, and tax treatment, which may be lost.

No exchange or purchase of an annuity or life insurance policy should be made until all of the options have been carefully studied and any questions answered. The decision to exchange a policy or contract should be made only on the basis of the net improvement in the position of the client. It has been proven 1035 exchanges can accomplish that.

Q105 How Have the Replacement Regulations Evolved To Provide More Protections for Consumers?

Buying a life insurance policy—while usually a fairly simple transaction—can involve a complex array of financial data. An agent can easily mislead the purchaser, intentionally or unintentionally. Because replacement

is such a troublesome issue and a big problem, the National Association of Insurance Commissioners (NAIC) has formulated model replacement regulations, which require the disclosure of certain information considered pertinent to the proposed replacement decision. Here is a history of the replacement regulations:

- 1970—The NAIC adopted its first Model Replacement Regulation. This regulation requires an insurer (or agent) to provide the consumer contemplating a replacement with (1) a notice and (2) a Comparison Statement. The notice states that "as a general rule, it is not advantageous to drop or change existing life insurance in favor of a new policy." The Comparison Statement is to be completed by the replacing agent. It is to provide the consumer with comparative data on the existing and proposed policies, in order to assist the consumer in his or her replacement decision.
- 1978—The NAIC adopted a revised, strengthened replacement regulation at its December 1978 meeting. Several states still pattern their replacement regulations on this version. The agent who proposes a replacement must provide the insured with a Replacement Notice and a completed Comparative Information Form. The agent is required to leave with the applicant copies of all sales materials used, and to send the replacing insurer signed copies of the Notice and the Comparative Information Form, plus a copy of the sales proposal(s). An agent attempting to conserve the in-force policy (i.e., persuade the policy owner to change his or her mind about replacement) must leave with the consumer a copy of all materials used in connection with that effort, and must submit to his or her own company a copy of such materials.

  The replacing insurer must mail the existing insurer a verified copy of the Comparative Information Form within three days of receiving the insurance application. In turn, the replacing insurer must delay issuance of the new policy for twenty days or provide a 20-day unconditional refund offer with the replacing policy. If the existing insurer undertakes a conservation effort, it must either complete, correct, and send to the consumer the Comparative Information Form it received

from the replacing insurer or send the consumer a Policy Summary completed in compliance with the solicitation regulation (if the state has adopted one). Cost comparison information need not be included in the Policy Summary. The existing insurer is, in turn, to provide the replacing insurer with a copy of the materials it sent the consumer in its efforts to conserve the policy.

- 1984—The 1984 NAIC Model Replacement Regulation was adopted. This model is patterned in key parts, after the replacement regulation adopted by Virginia in 1982. Several states have regulations similar to this model. The new regulation retains much of the previous version, but it eliminates the requirement that a comparison form be used. The notice that must be given to the applicant is far simpler than earlier versions and it puts more of the burden on the consumer to protect his or her own interests. Other differences in procedure are mandated. Although the newer version is generally acknowledged to be an improvement over earlier model regulations, it still leaves much to be desired.

The NAIC continues to work on the replacement issue and further evolutionary changes can be expected in replacement regulations.

- 2000—The 2000 NAIC Life Insurance and Annuities Replacement Model Regulation is adopted.
- 2015—The 2015 Life Insurance and Annuities Replacement Model Regulation (Model #IV-613). This model regulation sets forth standards for the activities of insurers and producers with respect to the replacement of existing life insurance and annuities. It helps protect the interests of life insurance and annuity purchasers by establishing minimum standards of conduct to be observed in replacement or financed purchase transaction. It updates definitions to include newer products and duties of producers and insurers.

Q&A

CHAPTER 10

WHAT YOU NEED TO KNOW ABOUT POLICY LOANS

Q106 What Is a Policy Loan, and Why Might I Not Want One?

Life insurance policies have evolved from a simple method of sharing risk to complex financial instruments. Policy loans are one of the most complex, misunderstood, and misused components of a life insurance policy. They are like termites, and if left to their own devices, they eventually will cause an insurance policy to collapse on itself. This could result in the insured having no coverage and, possibly, a huge tax penalty.

The term "policy loan" is a misnomer, according to *Law and the Life Insurance Contract* by Muriel Crawford and William Beadles. A loan is defined as the transfer of money by one person—the creditor—to another person—the debtor—upon agreement that the debtor will return to the creditor an equivalent sum at a later date, usually plus interest. A policy loan is not truly a loan, because the policy owner does not agree to repay the money transferred to

him or her by the insurer, although interest is still charged. It is an advance of money that the insurer eventually must pay out under terms of the policy. Thus, a policy loan does not create a creditor-debtor relationship between the insurer and the policy owner.

U.S. Supreme Court Justice Oliver Wendell Holmes came to the same conclusion in Board of Assessors v. New York Life Insurance Company, one of the leading court decisions involving policy loans. "The so-called liability of the policyholder never exists as a personal liability, it is never a debt, but is merely a deduction in account from the sum the plaintiffs (the insurer) ultimately must pay," the justice wrote in 1910.

Policy loans are more complicated than agents sometimes purport them to be, with promises of premium-free life insurance. In reality, borrowing to pay premiums reduces the death benefit. Some companies today even suggest to clients with underperforming policies that a policy loan could support their faltering policy. But this robs Peter to pay Paul, and the policy owner eventually must make up the difference.

Out-of-control policy loans can erode a life insurance policy over time, eventually draining all the death benefits as well as saddling the policy owner with a substantial tax bill.

The basic calculation for the potential taxable income impact would be to add the net cash (surrender) value plus any dividends received (either prior or accumulated) and the loan balance at the time of surrender. From that sum, subtract the basis (sum of premiums) paid into the policy and that will be the gain in the policy that is subject to income tax. Please note that this is a rule of thumb and may not apply in all cases depending on ownership, transfers, if it is held inside a qualified plan, etc. However, this should give you a starting point. A carrier will usually be able to provide you with the basis and the other necessary figures as well as the potential gain typically reported to the Internal Revenue Service on a 1099. Please note that this is not tax advice; for tax advice, please consult your tax advisor.

On a whole life insurance policy, it's also important to understand whether your insurer uses direct recognition or indirect recognition on a policy loan. With direct recognition, the insurance company will determine your loan interest rate and your cash value dividends based on the amount of your

loan. With non-direct recognition your cash value will continue to increase as if you didn't take out a loan. While this may seem like non-direct recognition loans are more favorable, keep in mind that the insurance company will make adjustments to maintain profitability.

Q107 Are Policy Loans Tax-Free?

The Tax Reform Act of 1986 magnified the tax ramifications of policy loans and added new penalties, making this area even more complex. Consider the so-called minimum-deposit life insurance plans. Before the passage of TRA '86, interest due on loans to finance these types of life insurance policies, sold after March 1, 1954, was not tax deductible. This was further expanded under Internal Revenue Code Section 264(a)(3), which states, "a deduction is denied for interest paid on an indebtedness incurred or continued to purchase or carry a life insurance, endowment, or annuity contract . . . pursuant to a plan of purchase which contemplates the systematic direct or indirect borrowing of (sic) part of or all of the increases in the cash value of such contract either from the insurer or otherwise."

This rule (also referred to as the plan-of-purchase rule) applies only to contracts issued between August 6, 1963, and the implementation of TRA '86. It contains four exceptions. If a financed plan met at least one of these exceptions, interest was deductible. A simplified explanation of these exceptions follows. For more detailed information, check the full version of the Internal Revenue Code.

- **The four-out-of-seven rule**. This provides that interest on a financed plan is tax deductible if no part of (at least) four of the first seven annual premiums of a policy is paid through borrowing, either from the policy or elsewhere. A new seven-year period begins if a "substantial increase in borrowing occurs." If borrowing in any year exceeds the premium for that year, the excess is considered to be borrowings used to finance the previous year's premium. If the policy owner borrows an amount that exceeds the total of three years' premiums, then the four-out-of-seven rule has been violated, irrespective of when the borrowing occurred during the period. Once the seven years have passed, it

appears that borrowing beyond that period could be at any level. This was the most commonly used exception.

- **The $100 exception**. The interest deduction will be allowed for any taxable year in which the interest in connection with any systematic plan of borrowing does not exceed $100. Where such interest exceeds $100, the entire amount of interest (not just the amount in excess of $100) is nondeductible under Internal Revenue Code Section 264(a)(3).
- **The unforeseen-events exception**. If the indebtedness is incurred because of an unforeseen substantial loss of income or unforeseen substantial increase in the taxpayer's financial obligations, the deduction will be allowed under this rule, even though the loan is used to pay premiums on the contract. An event is not "unforeseen," however, if at the time the contract was purchased it could have been foreseen.
- **The trade-or-business exception**. If the indebtedness is incurred in connection with the taxpayer's trade or business, the interest deduction will not be denied. Thus, if an insurance policy is pledged as part of the collateral for a loan, the interest deductions will come within this exception if the taxpayer can show that the amounts borrowed were actually used to finance the expansion of inventory or other similar business needs.

Q108 How Does a Policy Loan Become Harmful?

Let's look at a case study. As part of a divorce settlement, a woman owned a life insurance policy that had been issued to her ex-husband. At the time of issue, the insured was 38. The policy was a whole life paid up at age 90 with a death benefit of $100,000. But, before the policy had been transferred to the woman, a policy loan had been taken out on the policy.

After 22 years, the policy had an outstanding loan of $62,098.42, with an interest rate of 5%. The policy's basis (the sum of premiums paid minus the sum of any dividends received in cash or credited against the premiums) at the time was $59,018, and the net surrender value was $947.43. The policy had reached a point at which it was "overloaned," which means the woman could no longer borrow against the policy to pay the premiums and loan interest. The policy owner had received a bill of $2,949.67 for loan interest due, and

the annual premium due was $2,152. This meant that there was an annual cost of $5,101.67 to carry a policy with a net death benefit of $37,901.58 (original death benefit of $100,000, less the outstanding loan balance of $62,098.42).

The policy owner had few options. She could pay the $5,101.67 to keep the policy in-force. Surrendering the policy and collecting the $947.43 would have resulted in a taxable gain of $4,027.85. This taxable gain is calculated by taking the gross proceeds (the net surrender value of $947.43, plus the outstanding loan of $62,098.47) and subtracting the basis of $59,018. In this scenario, the policy owner would have had to pay $1,611.14 in income taxes (in the 40% total tax bracket), and she no longer would have the benefit of the life insurance policy.

Another option was to take extended term life insurance in the amount of the original policy's current net benefit ($37,901.58) for about 12 months or to take a reduced paid-up policy with a death benefit of $3,399. She chose to take the reduced paid-up death benefit, which means there are no further premiums or interest due.

The situation above is quite common. The tax ramifications for this woman were minimal. Others do not fare as well.

Q109 How Can a Policy Loan Be a Pitfall?

Law and the Life Insurance Contract addresses the potential tax pitfalls for which life insurance policyholders must be on the lookout. The book specifically mentions minimum-deposit insurance plans, which are financed through payments—either out-of-pocket or with a policy loan. "Minimum deposit insurance plans can constitute an unexpected 'tax trap' for the ill-informed or just unlucky," the book states. "These potential pitfalls suggest that financing life insurance should be approached only with the greatest of care. Even then, it is risky and subject to factors beyond the insurer's and policy owner's control."(*Law and the Life Insurance Contract*; Muriel T. Crawford and William T. Beadles; Irwin, 1989, 6th Edition).

An example that illustrates this "tax pitfall" is that of a 31-year-old man whose father had bought him a financed (minimum-deposit) policy, with a death benefit of $150,000, when the insured was 4 years old. The man's father was the original owner, and ownership was transferred to the insured on his

21st birthday. The man's father remembered that the agent who sold the policy had told him that, after the initial payment, the policy could be put on automatic premium loan. There would be no further premiums or other costs to be paid, the agent had said, and there always would be a fully paid-up death benefit of $150,000. This was simply not true, even though the policy had been sold on the basis of its being a fully guaranteed policy.

The situation was dire. The policy loan was up to $70,327.83, and, with dividend additions, the gross death benefit had grown to $184,300.17. The problem was revealed when it was discovered that the net cash value was $74,600.61. This was the maximum allowable loan on the policy. But, at the next renewal, the loan would increase to $75,414.72, so no further loan value was available. The insured received a bill for loan interest of $3,348.94, and because the premium was $1,515, his total annual out-of-pocket cost would be $4,863.94 for $185,000 of coverage. This was not an affordable premium for this insured. If he let the policy lapse, he would have a taxable gain of $39,247.41. There would have been a net surrender value of $5,352.98. Assuming that the insured was in a combined 35% tax bracket, he would have had to pay $8,383.61 for a supposedly paid-up-for-life policy. The only way to have prevented the policy from exploding was to surrender paid-up additions, which the carrier said would not lower the basis. This was a short-term solution.

The carrier did not give the policyholder any indication that the policy was so far off the original marks. This is not unusual. Only a few carriers have added a line to their annual reports stating the client age at which policies will lapse, making it important for policyholders to monitor policy performance regularly. Often, the agent who sold the policy has no further contact with the insured after the original sale, so the policy is not reviewed. Policy loans present a similar issue. A policy with a large loan and loan interest can eventually crash, creating an issue of no coverage and a significant phantom income-tax gain. This is because the IRS considers any policy value over basis to be taxable income. For example, a 35-year-old man owned a policy that his father had purchased for him when he was 4 years old for a single premium of $10,000. The policy contract was designed to default to an automatic premium loan, which means the son was borrowing his annual premium payments against the value of the policy.

He, therefore, has never made a premium payment out of his own pocket. Recently, however, the automatic loan program reached its limit—that is, the total value of the policy had been borrowed against. As a result, the insurer notified the insured man that annual payments of $4,000 would be required to keep the policy in-force. If he let the policy lapse, he would have had a phantom taxable gain of more than $70,000—the value of the policy, less the $10,000 initial payment. This was a significant problem for the man, since his annual income was about $45,000. He decided to keep the policy in-force until a better solution could be found.

How long will companies continue to lure life policyholders with the promise of something for nothing? As these examples demonstrate, a policy loan can be a time bomb in a life insurance policy. And as with any type of bomb, if not defused correctly, it can be disastrous. That ticking sound you hear is all the policy loans out there just waiting to explode.

Q&A

CHAPTER 11

LIFE INSURANCE AND QUALIFIED RETIREMENT PLANS

Q110 Should I Have a Life Insurance Policy Inside of a Qualified Retirement Plan?

Qualified retirement plans are designed to encourage employees to save money now, so that they will have enough to sustain them when they are no longer working. Employer contributions are deductible for the employer and tax deferred for employees, within certain limits. The money that employees authorize their employers to divert into these savings plans—called elective deferral contributions—are tax deferred. Earnings on these monies are also tax deferred. Participants pay income tax when they receive distributions from their plans.

Simply stated, a qualified plan is a tax-favored accumulation vehicle. Permanent (cash value) life insurance can also be used as an accumulation vehicle. In these cases, premiums are paid with after-tax dollars, and the death benefit is income-tax free.

Paying life-insurance and annuity premiums with qualified-plan dollars is controversial. Why put an accumulation vehicle that enjoys tax-deferred treatment inside a plan that, by definition, is tax deferred? Life insurance and annuities are relatively expensive, in part because the vast majority of them are sold by agents on commission. This leaves producers open to allegations that their sales pitches may be aimed more at filling their own wallets, rather than helping customers choose their best investment tool.

When asked why he targeted banks, bank robber Willie Sutton, as the legend goes, replied, "Because that's where the money is." Miners headed to California in 1849 because they heard that gold was there. Some producers recommend paying life-insurance and annuity premiums with qualified-plan dollars, in part, because the plans are a ready source of otherwise scarce premium dollars.

Selling life insurance is a tough but financially rewarding job for the producers who master the art and climb to the top of their field. Selling annuities is easier, but the temptation is there to sell high-commission life policies. The truth is, commission payouts are life and annuity producers' bread and butter. The fact that this business is highly commission-driven draws the attention of regulators who are increasingly focused on market conduct.

The plaintiffs' bar (attorneys) has noticed that life insurance and annuities are being sold within qualified plans. Many cases have been filed and settled. There will probably be more.

Q111 Why Can It Be a Good Idea to Have Life Insurance Inside of a Qualified Retirement Program?

To understand why, a good starting place to look is at 403(b) plans, which are tax-deferred retirement plans for employees of schools and other nonprofit organizations. These plans are also known as tax-sheltered annuities, even though the term includes mutual funds and "incidental" life insurance. The rules for selling life insurance inside a 403(b) plan are fairly loose. A participant can use up to 50% of the aggregate contributions made to a 403(b) plan to purchase whole life insurance. In the case of universal life insurance, only 25% of the aggregate contributions can be used to purchase a policy.

Consider, for example, that a tax-sheltered annuity participant has accumulated $100,000. Now suppose a producer persuades the participant to use $49,000 to pay for a whole life insurance policy. The result: life insurance sales charges and other expenses eat up a lot of participant dollars, which otherwise could be growing toward a retirement nest egg. There is no question that this sale earned the producer a nice commission. But there are arguments in favor of such a purchase:

- The life insurance is purchased with pretax dollars.
- The life insurance provides a self-completing financial and/or estate plan.
- The participant may keep the policy after retirement (by paying income tax on the cash value).
- Premiums can be paid from previously accumulated contributions.
- If no longer needed, the life insurance cash value can be transferred to an annuity contract.
- The participant can borrow the cash value subject to Internal Revenue Service Code Sec. 72(p) rules.
- The life insurance company calculates the annual cost of insurance that must be included in the participant's taxable income. This amount is based on so-called "P.S. 58" one-year term rates described in Revenue Ruling 55-747, 1955-2 CB 228.

Q112 Why Is Having Life Insurance Inside a Qualified Retirement Program Not a Good Idea?

The arguments against buying life insurance with qualified-plan dollars are as follows:

- It is more of a commission-driven than a needs-oriented sale.
- The mortality charges introduce an additional cost element when compared with an annuity or mutual fund. (Annuities on which the surrender charge is waived upon death contain a mortality element, but it is small enough to ignore for our purposes.)
- It is an attempt to fill a permanent need with temporary coverage. The life insurance policy must be distributed by the plan at retirement and

income tax paid on it, or it must be converted to an annuity payout or surrendered.

- Income tax must be paid each year on the current cost of the "incidental" life insurance element.
- It uses up the participant's 403(b) contribution limit—called the exclusion allowance.
- All other things being equal, a lot less money will be accumulated when life insurance is used as the accumulation vehicle.

Q113 What Else Do I Need to Know About Life Insurance Inside a Qualified Plan?

Qualified plans, including employee stock-ownership plans, can offer life insurance to plan participants as long as the U.S. Treasury's "incidental benefit" rule is met. That is, the life insurance must be secondary to the plan's mission of providing retirement income. In general, the incidental rule is satisfied if the cost of the life insurance is less than 25% of the cost of benefits under the plan. In addition to the 25% rule, another test applies: The initial amount of life insurance protection cannot exceed 100 times the monthly annuity payable upon retirement. The so-called "100 to 1" test does not limit the death benefit, but instead it provides a safe harbor for plan trustees.

On or before retirement, the plan must surrender the life insurance and use the cash value to provide retirement benefits or distribute the policy to the participant. In general, the cash value of the life insurance policy must be included as taxable income in the year the distribution is made. A better measure of the value of the life insurance policy, however, may be the policy reserve maintained by the life insurance company.

Only recently have annuities inside qualified retirement plans become controversial. In some cases, annuities are the traditional funding vehicle. For example, two of the three permissible investment vehicles for most 403(b) participants are annuities-fixed annuities, variable annuities, and mutual funds. The controversy focuses on variable annuities, which typically have considerably higher expense charges than mutual funds.

Again, the argument centers on funding a tax-deferred plan with a high-expense investment vehicle—a variable annuity. This is a fair concern, since

there are several alternative investment vehicles that have lower expense charges than variable annuities.

Solving this problem is theoretically easy. If you must fund a qualified plan with variable annuities, make sure the cost is comparable to the mutual fund alternative. Several companies offer low-cost variable annuities, but they don't pay any agent commission. Therein lies the problem. We have come full circle back to the fact that this is a commission-driven business. Logically, variable-annuity sales should be a tiny fraction of what they are. A fee-only financial advisor usually will recommend a variable annuity, only when the client has a maximized qualified pension plan and individual retirement account contributions—and has cash left to invest. Quite simply, the public does not seek out variable annuities; agents sell them to the public. The same is true of life insurance.

Producers often urge affluent clients to allocate some of their qualified retirement funds to life insurance and annuity contracts. The sales pitch inevitably stresses the tax benefits of purchasing these products within a qualified plan. Keep in mind that most tax professionals will say that letting tax considerations drive the decision-making process is a bad idea. It always seems to come back to haunt you.

Including life insurance inside a qualified plan is fraught with complexity. Absent careful planning, the ability to avoid estate taxes and some income taxes on the death benefit will be lost. The combined effect could mean loss of 70% to 80% of the death benefit and/or the accumulated value.

Q114 Are There Any Government Regulation Issues and Concerns (Insurance Industry As Well) Regarding Life Insurance in a Qualified Plan?

We must also consider the Employee Retirement Income Security Act of 1974, when life insurance or annuities are included in a qualified plan. The U.S. Department of Labor oversees ERISA. The Department of Labor has contended that funding death benefits in qualified plans with permanent life insurance is a breach of fiduciary duty. To date, the majority of cases involving the Department of Labor have dealt with highly abusive practices in plans

covering large numbers of employees. Sooner or later, the department will focus its attention on smaller plans, too.

The life insurance industry has a big public-relations job ahead. It cannot fall back on the ancient standard of *caveat emptor*—let the buyer beware. The industry must proactively set market-conduct standards and enforce them rigorously.

The Insurance Marketplace Standards Association is an important step in the right direction. Mandatory commission disclosure at the point of sale would be helpful in exposing commission-driven products. As experience in the United Kingdom demonstrates, mandatory commission disclosure need not put agents out of business. In the mid-1990s, British financial-services regulators began requiring life companies to reveal expenses, commissions, lapse rates, and surrender values to consumers at the point of sale. This transparency led to a more professional sales force and improved persistency. It also demonstrated that consumers don't mind if agents receive commissions, but they will object to big commission numbers.

It is not always inappropriate to employ life insurance inside qualified plans, but many of these sales are inappropriate. In the right situation, with good legal and tax advice and a competent insurance advisor, it can all work out just fine.

That, unfortunately, describes a small percentage of such sales, but word is getting out. At the time of the writing of this book, two well-known life insurers recently acknowledged that they no longer allow the use of their life insurance products inside qualified plans. The wisdom of that decision will become apparent as yet another round of class-action litigation rocks the industry in the foreseeable future.

Despite all the issues discussed above, life insurance sales to pension plans were on the rise again in 2001. The justification is that the 2001 tax law increased the amount that individuals could contribute to their pension and profit-sharing plans. Before the tax changes, high net worth individuals were limited in their contribution level and there was not enough capacity to commit premium dollars to a retirement plan.

In 2002, the defined benefit commenced to increase and, combined with the elimination of the actuarial reductions in benefits at age 62, meant a further increase for many. This increase allows for potentially increased life insurance inside the plan.

The issues discussed above still apply. And thus, the use of life insurance inside a qualified plan usually will lead to more problems than benefits.

CHAPTER 12

TAXES AND LIFE INSURANCE

Note: The information discussed in the following questions (115–121) is based on certain life insurance policy, tax, and legal assumptions, but is not meant as legal or tax advice and is, also, subject to change. Only your own attorney, accountant, or other tax professional can give you such advice.

Q115 Does the Cash Value of My Permanent Life Insurance Policy Grow on a Tax-Deferred Basis?

The Tax Court has held, in a case involving a cash-basis taxpayer, that the cash values were not constructively received by the taxpayer where he could not reach them without surrendering the life insurance policy. The necessity of surrendering the life insurance policy constituted a substantial "limitation or restriction" on their receipt. (Theodore Cohen, 39 TC 1055 (1963), 1964-1 CB 4.)

Q116 How Are Withdrawals from a Permanent Life Insurance Policy Typically Taxed?

Living proceeds received under life insurance contracts that satisfy the conditions of the "seven pay test" of IRC Sec. 7702A (b) (i.e., not modified endowment contracts) are taxed according to the FIFO method of accounting. They are taxed under the "cost recovery rule" no matter when the contract was entered into or when premiums were paid. In other words, such amounts are included in gross income only to the extent they exceed the investment in the contract. However, distributions taken in the first fifteen policy years that reduce the benefits of the contract may be, to a limited extent, taxable. (IRC Sec. 7702)

Q117 Are Policy Loans Income-Tax Free?

Policy loans under life insurance policies are not treated as distributions, assuming the policy qualifies as life insurance under IRC Sec. 7702 and is not considered a modified endowment contract. Upon lapse or surrender, the outstanding loan balance is automatically repaid from policy values held as collateral (death benefit is reduced by the amount of the policy loan). However, this use of collateralized policy values to repay a loan during a lapse or surrender may cause the recognition of taxable income. (IRC Sec. 7702)

Q118 What Are the Income-Tax Consequences of the Inside Interest During the Policy's Lifetime and at Surrender/Termination?

The value of a life insurance policy can impact a number of situations. Often omitted in sales presentations is the possibility of a taxable gain if the policy is surrendered. The inside interest is typically income-tax deferred. The inside interest is either income-tax exempt or partially income-tax exempt, depending upon how the policy terminates and the circumstances surrounding termination. There are four possibilities:

1. The policy terminates upon the insured's death. The death benefit is generally received income-tax free by the beneficiary, so the inside interest is income-tax exempt.

2. The policy is surrendered and the sum of the cash value and the total dividends is smaller than the total premiums; that is, there is a "loss" on surrender. The cash value is generally received income-tax free by the policyholder so the inside interest is income-tax exempt. The "loss" is not deductible, because the price of the protection exceeds the inside interest, and the price of the protection is not deductible, except to the extent it offsets what otherwise would be taxable as inside interest.
3. The policy is surrendered and the sum of the cash value and the total dividends is equal to the total premiums; that is, there is no "gain" or "loss" on surrender. The cash value is generally received income-tax free by the policyholder, so the inside interest is income-tax exempt. In this instance, the price of the protection and the inside interest are equal, so that the otherwise nondeductible price of the protection offsets the otherwise taxable inside interest.
4. The policy is surrendered and the sum of the cash value and the total dividends is larger than the total premiums; that is, there is a "gain" on surrender. The "gain" generally is ordinary income to the policyholder in the year the policy is surrendered, so that the inside interest is partially income-tax exempt and partially taxable. The inside interest, which in this instance exceeds the price of the protection, is income-tax exempt to the extent of the price of the protection and taxable to the extent the inside interest exceeds the price of the protection.

   (*Source: The Insurance Forum; November 2001 issue; article excerpt; Dr. Joseph Belth.*)

Q119 Are There Any Taxes on a Life Insurance Death Benefit?

The common conception is that life insurance is not subject to taxation. This is half-true and half-false. Life insurance is almost always not subject to income taxation, however, under current tax law, it is still subject to estate taxation.

As a general rule, life insurance death proceeds are excludable from the beneficiary's gross income (IRC Sec. 101(a)(1)). Death proceeds from single-premium, term life insurance, periodic-premium, or flexible-premium life insurance policies are received income-tax free by the beneficiary regardless

of whether the beneficiary is an individual, a corporation, a partnership, a trustee, or the insured's estate (Treasury Regulation 1.101-1). However, the death benefits may be subject to estate taxes, gift taxes, and any other inheritance tax. This is a good reason to visit with an estate planning professional; somebody who is appropriately licensed and qualified.

How to roughly calculate your potential estate tax:

Step 1: Total your gross estate. Include anything of value in which you have an ownership interest: Home and other real estate, retirement plan balances, stocks, mutual funds, other investments, businesses, life insurance proceeds (not held outside your estate), etc.

Step 2: Subtract all allowable deductions, such as funeral and administrative expenses, mortgages, loans, credit card debt, qualified charities, Adjustable Taxable gifts (post-1976 lifetime taxable transfers not included in gross estate), gift taxes paid on post-1976 taxable gifts, and applicable tax credits (e.g., unified tax credit, state death tax credit, foreign tax credit, tax on prior transfers credit, marital deduction, other applicable expenses).

Step 3: Add the value of lifetime taxable gifts.

Step 4: Deduct the exemption amount.
Year 2022: $12.06 million (single person) and $24.12 million for a married couple
Years 2023-2025: Indexed for inflation*
Year 2026: Exemption reverts to $5 million indexed for inflation ($5.49 million)

Step 5: Multiply the balance by the applicable estate tax rate. For the first $1 million over the exemption, there's a sliding tax rate of 18% to 39%, which results in a total tax of $345,800 on the first $1 million. For any amount over $1 million, the tax rate is 40%.*

*Visit the IRS Web site for the exemption amount for years 2023–2025 and the tax rate for the first $1 million over the exemption (here: https://www.irs.gov/businesses/small-businesses-self-employed/estate-tax).

Notes:
Your estate may be valued at death or six months later, whichever is more beneficial. If you own a farm or closely held business, your method of paying tax will be different.

Use this information to generate a rough idea of your potential estate tax. Be sure to check that this is the current tax table by visiting the IRS Web site at www.irs.gov or consult with a properly certified estate planning advisor.

Estate tax table:
The Tax Cuts and Jobs Act of 2017 increased the estate, gift, and generation skipping tax exemption from $5M indexed for inflation to $10M indexed for inflation. Starting in 2018, this exemption is $11,180,000. In 2026, this exemption is set to expire and revert to $5M indexed for inflation. With such high estate tax exemptions, most Americans fall within the exemption amounts and will not have taxable estates at their death.

State Estate Taxes:
Prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) in 2001, most states relied on the federal estate tax credit as a mechanism to generate additional revenue without increasing the tax burden on its residents' estates. To take full advantage of the federal credit, most states imposed an estate tax equal to the federal credit for state estate taxes paid. This method of generating estate tax revenue, commonly referred to as the "sponge" tax, worked for states until EGTRRA repealed the estate tax credit, replacing it with a federal deduction.

The 50 states responded to the repeal of the state estate tax credit in various ways. Many states took action to prevent future estate tax revenue losses by "decoupling" their estate tax laws from the federal estate tax credit. Seventeen states and the District of Columbia may tax your estate, an inheritance, or both, according to the Tax Foundation (www.taxfoundation.org).

Eleven states have only an estate tax: Connecticut, Hawaii, Illinois, Maine, Massachusetts, Minnesota, New York, Oregon, Rhode Island, Vermont, and Washington. Washington, DC, does as well. Estate taxes are levied on the value of a decedent's assets after debts have been paid. Maine, for example, levies no

tax on the first $5.8 million of an estate and taxes amounts above that at a rate of 8 percent to a maximum 12 percent.

Iowa, Kentucky, Nebraska, New Jersey, and Pennsylvania have only an inheritance tax—that is, a tax on what you receive as the beneficiary of an estate. Kentucky, for example, taxes inheritances at up to 16 percent. Spouses and certain other heirs are typically excluded by states from paying inheritance taxes. Maryland is the lone state that levies both an inheritance tax and an estate tax.

Please note that I am not an attorney and this is not legal advice. You should consider consulting an attorney or at the minimum purchasing an appropriate book from Nolo Press. This applies for any tax related question.

Q120 How Could the Estate Tax Affect My Estate?

The table on the following page shows that the estate tax (as long as it is around) affects everyone including the most rich and famous. The table is an overview of the gross estates, settlement costs, and percent their estate shrunk due to settlement costs. Please note this table is based upon publicly available information and may not be accurate in all cases. Please also note that this is based upon the estate tax rates at the time of each person's death. The bottom line is that proper planning is an important part of life for everyone.

Q121 How Is a Monetary Settlement Received f rom an Insurance Company Class Action Settlement Taxed?

Policyholders eligible for compensation are usually given several options, depending on the life insurance company. The tax ramifications will depend on the method you choose. You will need to discuss this with your tax advisor. On most life insurance policies (except for Modified Endowment Contracts (MECs), discussed in Question 12), any amount taken from a policy, up to the amount of premiums paid in (your basis), is received income-tax free; any amount received after that is subject to income tax (treated as gain).

Name:	Gross Estate:	Settlement Costs:	Percent Shrinkage:
Marilyn Monroe	$818,176	$450,327	55%
Henry J. Kaiser, Sr.	5,597,772	2,488,364	44%
Elvis Presley	10,165,434	7,374,635	73%
Alwin C. Ernst, CPA	12,642,431	7,124,112	56%
William Boeing	22,386,158	10,589,748	47%
Walt Disney	23,004,851	6,811,943	30%
John D. Rockefeller	26,905,182	17,125,988	64%
Bill Graham	30,000,000+ (Estimated)	16,000,000+ (Estimated)	53% (Estimated)
Malcolm Forbes	1,000,000,000 (Estimated)	550,000,000 (Estimated)	55% (Estimated)

Policyholders eligible for compensation in a class action lawsuit may be offered several options. Most of the carriers involved have offered two to three "relief choices" to policyholders eligible for class action settlements. The choices included a refund of premiums (with interest) and two types of "basic claim relief." There could be taxable money involved in each choice.

If you opt for a return of premium with interest, the premium is not subject to taxes, but the interest would be. For other settlement options, distributions from a life insurance policy are not taxable until you've received more money than you paid in premiums. Any amount above that is taxed at the ordinary income rate.

If you take a settlement from a life insurance company due to a lawsuit, the company will send you an Internal Revenue Service (IRS) Form 1099. This form shows whom you received income from and how much. Therefore, the IRS will know that you received this money, and will match it up with your tax return. This form shows gross earned income, which is fully taxable. The insurance company should also provide you with a document showing how the amount of the settlement breaks down. This allows you to pay taxes only on the amount above the sums of your premium paid if applicable. These forms are required to be sent by the insurance company by January 31st of the year your tax is due.

You will receive either a Form 1099MISC, which applies to miscellaneous income and shows the toal amount you received, or a Form 1099INT, which lists the interest payment of your premium that you received.

This can be confusing, so you should seek a qualified tax advisor.

CHAPTER 13

LIFE INSURANCE TRUSTS

Q122 What Is an Irrevocable Life Insurance Trust, and Why Should I Consider It?

One of the main reasons to have set up these trusts historically has been to avoid or minimize any potential estate tax. Currently, there are other planning purposes for these trusts. An advantage of the life insurance trust is that it removes the life insurance from the estate of the insured. *Please note that I am not an attorney, and this is not to be used as legal advice.*

Despite the advantages of an irrevocable life insurance trust (ILIT), it is important for anyone thinking about setting one up to keep these points in mind:

- If you transfer an existing life insurance policy into the ILIT and die within three years of the transfer, then the policy will revert back to your estate and will be subject to estate taxes.
- The trust is irrevocable. If it is your trust and you are funding it with a life insurance policy, you are considered the grantor. You must give up

complete control over the trust and will not have any rights including: changing the beneficiary, making policy loans, withdrawing funds, and terminating the policy.

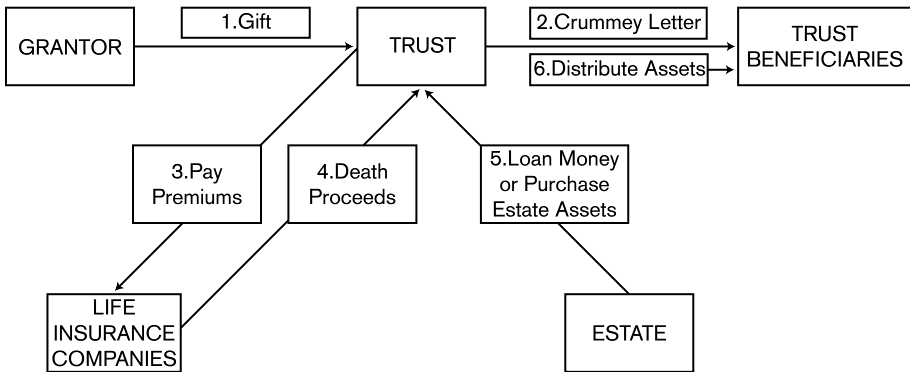
- Once a payment is made to the trust, the trustee will send out a letter under the gift-tax exclusion rules, under what's known as the Crummey provision (named after a legal case regarding this issue). This letter allows beneficiaries a 30-day period (typically) wherein they have the opportunity to withdraw their share.
- Enables the grantor to leverage the annual gift-tax exclusion to a much larger sum of money, through the purchase of life insurance.
- Provides the insured's heirs estate liquidity on a transfer tax-free basis.
- Replaces estate assets used to pay estate taxes or to provide a charitable bequest.
- Gives the grantor the opportunity to control the distribution of the death proceeds through the trust provisions in a manner consistent with overall estate objectives.
- Protects the trust assets from the trust beneficiaries' creditors.
- The heirs are not obligated to use the proceeds to pay the estate taxes.
- Trusts can cost approximately $1,000 to $3,000 and should be drawn up by an attorney. The more complex the situation, the higher the fee can be.

You should carefully consider who the trustee is and discuss the ramifications with your attorney.

Special Considerations of Life Insurance

An example: If the owner resides in a community-property state and the policy is purchased with community-property funds, one-half the proceeds are owned by the surviving spouse, no matter who the policy names as the beneficiary. This result can be varied by a written agreement between the spouses in which one spouse transfers all interest in a particular insurance policy to the other spouse. Insurance companies should supply this form upon request. (*Plan Your Estate*, NOLO Press.)

Q123 How Does an Irrevocable Life Insurance Trust Work?



1. Grantor/insured annually makes a gift to the irrevocable trust in an amount sufficient to pay the premiums on a life insurance policy.
2. The trustee of the trust annually makes the gifts available to the trust beneficiaries for a limited number of days pursuant to the Crummey withdrawal provisions in the trust document. This qualifies the gift for the gift tax annual-exclusion treatment.
3. If the trust beneficiaries fail to exercise the withdrawal right over the cash gift, the trustee may use the gift to pay premiums for the life insurance policy. The trustee is the owner and beneficiary of the policy.
4. At the death of the grantor/insured, the life insurance death proceeds pass transfer tax-free to the trust.
5. The trustee may loan money to purchase assets from the estate, thus providing liquidity to the estate to help pay estate taxes.
6. The trust assets are distributed to the beneficiaries of the trust as directed by the terms of the trust document

Q124 What Is My Basic Role If I'm Named Trustee?

The first thing to realize is the importance of fully understanding your role and responsibility as a trustee. As a trustee, you also become a fiduciary. Both are defined here:

- Fiduciary: A fiduciary is defined as a person who occupies a position of special trust and confidence in handling the affairs or funds of another person (*Law and the Life Insurance Contract*).
- Trustee: A person to whom property is legally committed in trust, to be applied either for the benefit of specified individuals, or for public uses; one who is entrusted with property for the benefit of another; also, a person in whose hands the effects of another are attached in a trustee process. (Source: *Webster's Revised Unabridged Dictionary.*)

Fiduciaries of an irrevocable life insurance trust have a duty to act in the best interest of beneficiaries. Most fiduciary breaches are the result of a lack of prudence. Basically, the fiduciaries do not understand their responsibilities.

Q125 What Are Some Tools to Assist Me as a Trustee and Fiduciary?

This book provides some tools in performing your duties. If you wish an external resource, find a knowledgeable advisor to assist you or seek out a professional trustee or learn more about life insurance policies and trusts. Be advised that a significant percentage of advisors and professional trustees do not possess sufficient knowledge to be of significant assistance.

Issues to keep in mind are:

- Are the policy type, face amount, planned premium, riders, underwriting class, insured, ownership, and beneficiary designations correct?
- Is the policy performing according to the original illustrations, sales letters, and materials?
- Are there are any surprises—such as unexpected loans, required premiums, or change in modified endowment contract status?
- Do you have a current in-force illustration? This is the only way to evaluate the policy, so it is important to examine the carrier's illustration questionnaire. My recommendation is to do this every 2-3 years.
- Review the rate of return as discussed in Question 19.
- Do you get an analysis of internal policy costs? ILIT Trustees are governed by the Uniform Prudent Investor Act (UPIA) as adopted by

each state. UPIA Section 7 requires that trustees may only incur costs that are appropriate and reasonable.

- Is the policy providing good value?
- Should it be replaced? (See Chapter 9, Questions 93–105.)
- Avoid using illustration comparisons for decision-support. Fiduciaries/Trustees have a duty to exercise reasonable care, skill, caution, prudence, and diligence. Use of illustration comparisons as decision-support would therefore be difficult to defend given such comparisons are now considered "misleading," "fundamentally inappropriate," and unreliable by financial, insurance, and banking industry authorities (see Question 21).

CHAPTER 14

MISCELLANEOUS ISSUES

Q126 What Happens When It Is Time for a Claim to Be Paid?

It is a good idea for a policy to be in an easily accessible place for the beneficiary. A safe deposit box may not be advisable as some states will seal the safe deposit box upon the death of the owner. The next step is to either call your life insurance agent or call the life insurance company to request the form. The life insurance company will require a certified copy of the death certificate. It is advisable for the person handling the affairs of the deceased to obtain several death certificates.

If your policy is part of a group employee benefits program (as an insured), you should make sure that it is noted somewhere for your beneficiary. You may be able to call the insurance company, or your employer's human resources department may need to be contacted.

Other types of life insurance are with credit card companies or other financial institutions, travel life insurance, mortgage life insurance, accidental death insurance, credit life insurance, and with the Social Security

Administration. Finding these policies may require research and phone calls to lenders, etc., regarding any life insurance benefits.

When submitting a claim, the insured may have chosen a payment plan. If you are not aware of the option, the insurance company will inform you about the option and how it works. If the policy owner has not chosen the settlement option, it will need to be chosen at the time the claim is filed. There is no income tax on the death benefit, however, interest that you receive from the death benefit may be subject to income tax. However, if the beneficiary, for any reason, cannot manage money, then the other settlements should be considered, unless there is someone who can manage the money for them.

The more commonly found settlement options are:

- **Lump sum**—The life insurance company pays the entire death benefit in one lump sum, which allows you to do what you wish with it.
- **Retained Asset Account**—The company typically will open a money-market account and issue a check book. That way, you do not need to make any decisions until you are ready. There are no restrictions on this account of any type. You can always write a check for the remaining balance.
- **Specific income provision**—You receive from the company both principal and interest on a predetermined schedule.
- **Life income option**—You receive a guaranteed income for life. The amount of income depends on the death benefit, your gender, and your age at the time of the insured's death.
- **Interest income option**—The company holds the proceeds and pays you interest on them. The death benefit remains intact and goes to a secondary beneficiary upon your death.

This is an area where life insurance companies do act quickly. If all the paperwork is in order and a death certificate is received, a beneficiary usually receives the death benefit within a week when the life insurance carrier does act quickly.

If an insured passes away within two years of the life insurance policy's issue date, the incontestability and suicide clauses can come into play. The suicide clause is self-explanatory. The incontestability clause allows the insurer

to challenge a policy for suspected mistruths, such as concealing a condition such as heart trouble and/or passing away from something heart related. This would be grounds for denying a claim. A common occurrence is when someone is a smoker and claims not to be. In this event, the insurer will either completely deny the claim or pay the death benefit, based on the amount of coverage that the premiums paid would have purchased on a smoker basis. If an insurer does decide to investigate, it can take between a month to a month and a half in most cases. Therefore, be truthful and honest; otherwise, you can negate the whole reason for getting life insurance in the first place.

Q127 What Happens When You Need to Track down a Missing and/or Unknown Life Insurance Policy?

Depending on the life insurance company, they may require the life insurance policy at the death of the insured. Alternatively, you may know that the insured had a life insurance policy(ies), but you do not know who the carrier was.

Even if you find the life insurance policy(ies), there may be a question as to whether or not you will actually receive the death benefit due. You will need to find out if the policy is still in-force. This will depend on the type of policy, and sometimes, on the carrier:

- Term life insurance is very simple. If the insured passes away at or after the policy has passed the grace period, the premium has not been paid, and the carrier will not accept payment, then there is no death benefit. If the insured passes away before this point, then the death benefit will be paid.
- Whole life should continue if there is an automatic premium loan provision that will borrow money from the policy's cash value to pay premiums. Once the cash value is exhausted, the policy will lapse.
- Universal life—each month the company will deduct from the cash value the cost of insurance (mortality cost), expense charges, and any other costs. Once the cash value is exhausted, the policy will lapse.
- Other policies such as variable life, variable universal life, and survivorship life policies of each type of will stay in-force, depending on whether they are a type whole life or universal life.

- Typically, with a permanent life policy, you will receive the money, if the death occurred while the policy was in-force, meaning all premium payments were made up until the time of death. If a certain amount of time since the death occurs, the carrier will pay the benefit with interest from the date of death; the amount of time varies by carrier.

Please note that there may exist certain modifications on each type of policy; so it is always a good idea to check with the insurance company. Older policies can have different methods than those discussed above.

If the policy lapsed—meaning the insured stopped making premium payments before he died—there is a chance that you might get nothing. When a permanent life insurance policy lapses, most insurance companies switch its status from permanent insurance to one of two options:

- "**Extended term**"—The insurance company uses the cash value of the policy to buy a short-term life insurance policy.
- "**Reduced paid up**"—The insurance company will keep the policy in-force, but reduces the death benefit.

If the policy lapses, and the extended-term period expires before the insured dies, the policy is worthless and the beneficiary will get nothing. If the insured dies before the extended-term period is up, the beneficiary will receive the death benefit. If the policy lapsed because the insured died (thus ending premium payments), the beneficiary will still collect the full death benefit, regardless of when the extended term was up. In any case as before, a death certificate is still required.

The following is a checklist of tips for keeping life insurance policies where beneficiaries may find them as well as for other places where beneficiaries can look:

- **Keep all your financial records (especially your life insurance policy) in one place**—Don't force your beneficiaries to search your house from top to bottom when you're gone.
- **Your safety deposit box**
- **Your file cabinets, address books, etc.**
- **Your computer**

- **Your beneficiary should go through canceled checks and contact your bank for copies of old checks**—Look for checks made out to insurance companies.
- **Check credit card statements**—Credit card companies also issue life insurance.
- **If you are a beneficiary, ask those who may have known about your relative's finances**—Contact the deceased's family, friends, and advisors, i.e., lawyer, accountant, banker, financial advisor, insurance agent(s), and trustee. The insurance agent(s) would be the most likely to know about life insurance policies.
- **The beneficiary should check probate court records**—for details of your relative's estate. If the estate has gone through or is in probate court, a life insurance policy could show up as an asset.
- **The beneficiary should contact the deceased's current and prior employers**—The Human Resources person should know of any group insurance as well as any supplement life insurance; or, if applicable, check with the Union Welfare office.
- **Contact the Medical Information Bureau**—They offer a "policy locator service." The service offers a way to help locate lost life insurance policies by submitting a decedent's name for a search against their policy locator database. This database contains information processed over the last eleven years (as of 2006), consisting of over 140 million records representing inquiries submitted on individually underwritten life insurance applications. Application activity often leads to policies, and matches against this database are identified. As of January 2022, the cost for this service is $75 U.S. The Web site address is https://www.mib.com/pls.html.
- **Contact every insurance company with which you had a policy**—even if you're not sure it is still in-force. There are over 750 life insurance companies in the United States.

- **Check email and the mail for a year after death for premium notices**—If a policy has been paid up, there will not be any notice of premium payments due. Typically the company may still send an annual notice regarding the status of the policy, or it may pay or send notice of a dividend.
- **Review your loved one's income tax returns for the past two years**—Look for interest income from and interest expenses paid to life insurance companies. Life insurance companies pay interest on accumulations on permanent policies and charge interest on policy loans.
- **Check to see if the insurance company has changed names**—This can be done through your state's insurance department (see listing in Appendix A). Another resource is online at AM Best's Web site—www.ambest.com.
- **Check with the state's unclaimed property office**—After a number of years (typically 3 years and can be dictated by the state), if an insurance company holding the unclaimed money cannot find the rightful owner, it must turn over either the full death benefit or the cash value to the state's comptroller's department (only if the insurance company knows that the insured has passed away). The state where the insured last lived is usually the state where the funds are turned over to. The department maintains a database that lists the names and addresses of lost beneficiaries. There are millions of insurance policies that are "lost," and you are not alone in trying to track down a "lost" policy. Many states will try to contact beneficiaries. See Appendix C for a listing of each state's unclaimed property office's contact information.

Q128 What If a Life Insurance Company Goes Bankrupt?

In the early 1980s, the issue of a life insurance company becoming bankrupt or insolvent was a relative rarity. By the early 1990s, however, there were some well-known insurance companies that were placed into receivership.

Because insurance companies are regulated by the states, federal bankruptcy law is not applicable to insurance receivership proceedings. In fact, insurance companies cannot declare bankruptcy; instead, they are placed into insolvency receivership or liquidation by the state's insurance department.

State liquidation courts then rule on the many complex issues involved in an insurance company insolvency, including what becomes of the insurance policies and cash values.

Oftentimes, the policies can be bought by other insurers with the death benefits remaining the same, but this may involve a lowering of cash values and/or an increase in premiums.

Insurance companies are regulated by individual states, and it is ultimately the responsibility of the states to safeguard the solvency of insurers licensed to do business in their state. When states determine that an insurer is insolvent, the mechanism used to protect policyholders is the guaranty association system. All 50 states, the District of Columbia, and Puerto Rico have guaranty associations to which licensed life and health insurers must belong.

The best resource for information on this issue is the National Organization of Life and Health Insurance Guaranty Associations (www.nolhga.com). The following information is from their Web site.[4]

> The National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) is a voluntary association composed of the life and health insurance guaranty associations of all 50 states, the District of Columbia, and Puerto Rico. When an insolvency involves multiple states, NOLHGA assists its state guaranty association members in quickly and cost-effectively fulfilling their statutory obligations to policyholders.
>
> NOLHGA was founded in 1983 after the state guaranty associations determined that there was a need for a coordinating mechanism to assist affected guaranty associations in efficiently meeting their statutory obligations in the face of the often-complex issues resulting from the insolvency of an insurer licensed to do business in multiple states.
>
> State guaranty associations provide coverage, up to certain statutory limits, for resident policyholders of insolvent member insurers.

4. The language from NOLHGA's Web site is reprinted with the permission of NOLHGA, all rights reserved. Information on NOLHGA's Web site is not intended as legal advice; no liability is assumed in connection with its use. Consumers should seek advice from a qualified attorney when considering any questions relating to guaranty association coverage.

NOLHGA provides its member state guaranty associations with a method for quickly and cost-effectively fulfilling their statutory obligations to policyholders in the event of a multi-state life and health insurer insolvency.

When an insurer licensed in multiple states is declared insolvent, NOLHGA, on behalf of affected member state guaranty associations, assembles a task force of guaranty association officials. This task force—with the support of NOLHGA staff, legal experts, actuaries, and financial experts—develops a plan for meeting member association obligations. Typically, the task force analyzes the company's commitments; ensures that covered claims are paid; and, where appropriate, arranges for covered policies to be transferred to a healthy insurer. The task force may also support the efforts of the receiver to dispose of the company's assets in a way that maximizes their value. When there is a shortfall of estate assets needed to fulfill all of the covered policyholder obligations of the insolvent insurer, guaranty associations assess the licensed insurers in their states a proportional share of the funds needed.

At all steps in the process, the affected state guaranty associations, working together through NOLHGA, cooperate with the receiver and other interested parties to build consensus on the steps needed to resolve an insolvency equitably and efficiently.

There are several key benefits that the state guaranty associations seek to achieve by working together through NOLHGA. The first is to decrease costs to the member insurers that fund state guaranty associations. Rather than each state association hiring its own legal and financial experts, the associations work together through NOLHGA and use one team of experts, significantly reducing costs to guaranty associations. This coordination of effort also helps reduce the length of time a receiver may require to develop a plan of rehabilitation or otherwise resolve a multi-state insolvency.

Since its creation in 1983, NOLHGA has assisted its member guaranty associations in guaranteeing more than $22 billion in coverage benefits for policyholders and annuitants of insolvent companies.

In that time, the associations have provided protection for more than 2.5 million policyholders and worked on more than 100 multi-state insolvencies.

NOLHGA Coverage Amount:

While laws governing maximum limits and types of policies covered vary from state to state, most states are consistent with the NAIC Model Act and provide coverage at least in the amounts specified below. Check your state association's website to confirm the applicable benefit levels in your state.

- $300,000 in life insurance death benefits
- $100,000 in cash surrender or withdrawal values for life insurance
- $250,000 in present value of annuity benefits, including net cash surrender/withdrawal values
- $500,000 in major medical or basic hospital, medical, and surgical insurance policy benefits
- $300,000 in long-term care insurance policy benefits
- $300,000 in disability insurance policy benefits
- $100,000 in other health insurance benefits

In most states, the aggregate benefit level for an individual life in any one insolvency is $300,000 (except if there is covered major medical insurance or covered basic hospital, medical, and surgical insurance, in which case the aggregate benefit is $500,000). The above coverage levels apply separately for each insolvent insurer.

Q129 As a Business Owner, Are There Any Special Planning Concepts?

This question is designed to serve as an overview of some of the most commonly used business planning concepts funded with life insurance. For each of these concepts listed, where applicable, description, plan objective, advantages, disadvantages, income tax position, gift tax position, estate tax position, ownership, premium payor, beneficiary, disability benefit, control of policy values, loss of use of money, cost recovery, deductible contribution of

premium, corporate resolution, plan document or agreement, and discrimination available.

Please note that there are other concepts that are not included, including Corporate Owned Life Insurance (COLI) and Bank Owned Life Insurance (BOLI), among others. These are important concepts, however, they are complex and are subject to changing regulations at this time.

CAVEAT: The information contained herein is to serve as an overview only. Consideration of the usage of any concepts requires an analysis of all the facts surrounding the case. Further amplification of concept features would have resulted in a voluminous and cumbersome amount of material. Feature descriptions are based on interpretations of existing tax laws at the time this book was written, which are subject to change and may not be current. Legal opinions are to be secured from the client's attorney/tax advisors as the concepts are applied.

BUY-SELL CROSS-PURCHASE

DESCRIPTION:	Exchange stock or business interest for cash and/or notes among business owners or third-party buyers.
PLAN OBJECTIVE:	Convert non-liquid business interest to cash.
ADVANTAGES:	Fair market value guaranteed and immediate; keep heirs out of business. Allows owners to achieve the ownership percentages desired. Number of policies grows quickly when more than 2 owners (each partner owns a policy on every other partner).
DISADVANTAGES:	Ties up personal discretionary income. Number of policies grows quickly when more than 2 owners (each partner owns a policy on every other partner).
INCOME TAX POSITION:	Gain, if any, upon sale of appreciated stock subject to income tax. Surviving

	owners receive an increased tax basis in their ownership interest.
GIFT TAX POSITION:	None.
ESTATE POSITION:	Value of business interest, as established in buy-out agreement, includable in owner's estate.
OWNER OF POLICY:	Business purchasers, if not trusted.
PREMIUM PAYOR:	Business purchasers or trustee.
BENEFICIARY:	Business purchasers, if not trusted.
DISABILITY BENEFIT:	Yes, if waiver of premium is included.
CONTROL OF POLICY VALUES:	Business purchasers or trustee.
LOSS OF USE OF MONEY:	Yes.
COST RECOVERY:	No.
DEDUCTIBLE CONTRIBUTION OF PREMIUM:	No.
CORPORATE RESOLUTION, PLAN DOCUMENT, OR AGREEMENT:	Agreement only.
DISCRIMINATION AVAILABLE:	Not applicable.

BUY-SELL ENTITY STOCK REDEMPTION

DESCRIPTION:	Corporation redeems deceased's stock for cash and/or notes.
PLAN OBJECTIVE:	Creates market for stock at a fair value and liquidity for stockholders.
ADVANTAGES:	Fair market value guaranteed and immediate; keep heirs out of business.
DISADVANTAGES:	No improved cost basis for surviving stockholder; life insurance cash value or proceeds may be subject to alternate minimum tax.

INCOME TAX POSITION:	Gain, if any, upon sale of appreciated stock subject to income tax. Surviving owner's basis is not changed. Death Benefit may be subject to Federal Alternative Minimum Tax (AMT).
GIFT TAX POSITION:	None.
ESTATE POSITION:	Value of business interest, as established in buy-out agreement, includible in owner's estate.
OWNER OF POLICY:	Corporation, if not trusted.
PREMIUM PAYOR:	Corporation.
BENEFICIARY:	Corporation, if not trusted.
DISABILITY BENEFIT:	Yes, if waiver of premium is included.
CONTROL OF POLICY VALUES:	Corporation.
LOSS OF USE OF MONEY:	Yes.
COST RECOVERY:	No.
DEDUCTIBLE CONTRIBUTION OF PREMIUM:	No.
CORPORATE RESOLUTION, PLAN DOCUMENT, OR AGREEMENT:	Yes.
DISCRIMINATION AVAILABLE:	Not applicable.

SECTION 303—PARTIAL REDEMPTION

DESCRIPTION:	Partial redemption of stock without being treated as a dividend.
PLAN OBJECTIVE:	Provide liquidity for estate settlement costs and business continuation for surviving family members.
ADVANTAGES:	Conversion of non-marketable stock to cash for liquidity.

DISADVANTAGES:	No improved cost basis for surviving stockholder; life insurance cash value or proceeds may be subject to alternate minimum tax.
INCOME TAX POSITION:	Gain, if any, upon sale of appreciated stock subject to income tax.
GIFT TAX POSITION:	None.
ESTATE POSITION:	Fair market value of stock includible in shareholder's estate.
OWNER OF POLICY:	Corporation.
PREMIUM PAYOR:	Corporation.
BENEFICIARY:	Corporation.
DISABILITY BENEFIT:	Yes, if waiver of premium is included.
CONTROL OF POLICY VALUES:	Corporation.
LOSS OF USE OF MONEY:	Yes.
COST RECOVERY:	No.
DEDUCTIBLE CONTRIBUTION OF PREMIUM:	No.
CORPORATE RESOLUTION, PLAN DOCUMENT, OR AGREEMENT:	Yes.
DISCRIMINATION AVAILABLE:	Not applicable.

EXECUTIVE BONUS (SECTION 162) ARRANGEMENT

DESCRIPTION:	Employer payment of premiums to provide additional personal life insurance coverage to key employees and owners.
PLAN OBJECTIVE:	Help owner and key employee buy additional life insurance protection.
ADVANTAGES:	Flexible. Easy to design. Discriminatory.

DISADVANTAGES:	Can place employee in a higher income tax bracket.
INCOME TAX POSITION:	Bonus considered income to employee.
GIFT TAX POSITION:	Upon assignment, three-year time limit must be met to remove from employee's estate.
ESTATE POSITION:	Includable if incidence of ownership by insured is involved.
OWNER OF POLICY:	Insured or third party.
PREMIUM PAYOR:	Employee using premium bonus.
BENEFICIARY:	Named by owner.
DISABILITY BENEFIT:	Yes, if waiver of premium is included.
CONTROL OF POLICY VALUES:	Insured or third-party owner.
LOSS OF USE OF MONEY:	Yes, on after-tax cost of bonus.
COST RECOVERY:	No.
DEDUCTIBLE CONTRIBUTION OF PREMIUM:	Bonus deductible to corporation when paid to employee (if not considered unreasonable compensation).
CORPORATE RESOLUTION, PLAN DOCUMENT, OR AGREEMENT:	No.
DISCRIMINATION AVAILABLE:	Yes.

GROUP CARVE OUT

DESCRIPTION:	Replace excess group term life insurance (over $50,000) with individual life insurance contracts for employees.
PLAN OBJECTIVE:	Provide permanent insurance protection for employees on a more attrac-

tive basis than group term. (May also reduce employer cost.)

ADVANTAGES: Life insurance protection for employees on a more attractive economic basis than excess group term.

DISADVANTAGES: Can place dollars received in higher individual income tax bracket (assuming corporation has taxable income less than $75,000); guaranteed issue may be unavailable.

INCOME TAX POSITION: Income tax free to beneficiary, but premium or P.S. 58 economic benefit currently taxable to employee if bonus plan or split dollar is used.

GIFT TAX POSITION: Upon assignment, three-year time limit must be met to remove from employee's estate.

ESTATE POSITION: Included if not assigned to a third party; three-year rule applies.

OWNER OF POLICY: Insured or third party.

PREMIUM PAYOR: Employer (employee may contribute to some plans).

BENEFICIARY: Named by insured employee or third party owner.

DISABILITY BENEFIT: Yes, if waiver of premium is included.

CONTROL OF POLICY VALUES: Insured or third party owner.

LOSS OF USE OF MONEY: Yes.

COST RECOVERY: No.

DEDUCTIBLE CONTRIBUTION OF PREMIUM: Yes, to employer if Section 162 Bonus Plan is used.

CORPORATE RESOLUTION, PLAN DOCUMENT, OR AGREEMENT:	No.
DISCRIMINATION AVAILABLE:	Yes.

GROUP TERM LIFE

DESCRIPTION:	Provides insurance coverage at reasonable rates to employee and/or dependant.
PLAN OBJECTIVE:	Provide personal insurance for employees and/or dependents.
ADVANTAGES:	Life insurance protection for employees at reasonable rates.
DISADVANTAGES:	The irretrievable cost of the program; non-discriminatory.
INCOME TAX POSITION:	First $50,000 of coverage tax free; excess taxed at Table 1 rates (unless plan is discriminatory). Premiums deductible by employer on all employees except partners and sole proprietors.
GIFT TAX POSITION:	Upon assignment, three-year time limit must be met to remove from employee's estate.
ESTATE POSITION:	Included if not assigned to a third party; three-year rule applies.
OWNER OF POLICY:	Employer owns master policy with employee receiving certificate.
PREMIUM PAYOR:	Employer (employee may contribute to some plans).
BENEFICIARY:	Named by insured employee or third party owner.
DISABILITY BENEFIT:	Yes, if waiver of premium is included.

CONTROL OF POLICY VALUES:	Generally, no policy values, as term is used.
LOSS OF USE OF MONEY:	Yes.
COST RECOVERY:	No.
DEDUCTIBLE CONTRIBUTION OF PREMIUM:	Yes, to employer for employees.
CORPORATE RESOLUTION, PLAN DOCUMENT, OR AGREEMENT:	Yes.
DISCRIMINATION AVAILABLE:	No, see Internal Revenue Code Section 79.

PAYROLL DEDUCTION LIFE

DESCRIPTION:	Mass marketed individual life insurance paid by salary deductions.
PLAN OBJECTIVE:	Help wage earners pay for personal life insurance coverage conveniently.
ADVANTAGES:	Guaranteed issue available; convenient, portable coverage.
DISADVANTAGES:	Benefits provided by after-tax employee dollars.
INCOME TAX POSITION:	Premium payments using after-tax dollars.
GIFT TAX POSITION:	Upon assignment, three-year time limit must be met to remove from employee's estate.
ESTATE POSITION:	Included if not assigned to a third party; three-year rule applies.
OWNER OF POLICY:	Insured or third party.
PREMIUM PAYOR:	Employee.
BENEFICIARY:	Named by insured employee or third party owner.

DISABILITY BENEFIT:	Yes, if waiver of premium is included.
CONTROL OF POLICY VALUES:	Insured or third party owner.
LOSS OF USE OF MONEY:	Yes.
COST RECOVERY:	No.
DEDUCTIBLE CONTRIBUTION OF PREMIUM:	No.
CORPORATE RESOLUTION, PLAN DOCUMENT, OR AGREEMENT:	Yes (salary deduction authorization forms).
DISCRIMINATION AVAILABLE:	Yes.

SALARY CONTINUATION—DEATH BENEFIT ONLY

DESCRIPTION:	Provides death benefits only to employee's beneficiaries.
PLAN OBJECTIVE:	Lock in key personnel and provide additional benefits for owners.
ADVANTAGES:	Discriminatory; locks in key employees; legal way to use corporate dollars for personal benefits.
DISADVANTAGES:	Benefits provided by agreement subject to continuation of business; employer deduction delayed until benefits paid.
INCOME TAX POSITION:	Annual death benefit fully deductible by corporation, taxable as ordinary income to beneficiary in excess of first $5,000 (assuming death benefit was forfeitable before employee's death).

GIFT TAX POSITION:	May be completed gift at employee's death.
ESTATE POSITION:	No, unless employee retains any right in the plan.
OWNER OF POLICY:	Employer (corporation).
PREMIUM PAYOR:	Employer (corporation).
BENEFICIARY:	Employer (corporation).
DISABILITY BENEFIT:	Yes, if waiver of premium is included.
CONTROL OF POLICY VALUES:	Employer (corporation).
LOSS OF USE OF MONEY:	Use of money may be recoverable when plan is funded by life insurance.
COST RECOVERY:	Possible when plan is funded by life insurance.
DEDUCTIBLE CONTRIBUTION OF PREMIUM:	No.
CORPORATE RESOLUTION, PLAN DOCUMENT, OR AGREEMENT:	Yes.
DISCRIMINATION AVAILABLE:	Yes.

KEY PERSON

DESCRIPTION:	Plan to indemnify business for death of a key person and loss of his/her skill and experience.
PLAN OBJECTIVE:	Provide tax-free dollars to recruit, hire, train, or replace skills and profits of deceased key personnel.
ADVANTAGES:	Guarantee flow of tax-free dollars to replace lost profits; recruit, hire, and train replacement; ensure business continuity.

DISADVANTAGES:	Premiums paid with after-tax employer dollars; life insurance cash value or proceeds may be subject to alternate minimum tax.
INCOME TAX POSITION:	Premium payments nondeductible by employer; insurance proceeds received tax-free by employer.
GIFT TAX POSITION:	None.
ESTATE POSITION:	May increase value of business interest includible in deceased key employee/owner's estate.
OWNER OF POLICY:	Employer (corporation).
PREMIUM PAYOR:	Employer (corporation).
BENEFICIARY:	Employer (corporation).
DISABILITY BENEFIT:	Yes, if waiver of premium is included.
CONTROL OF POLICY VALUES:	Employer (corporation).
LOSS OF USE OF MONEY:	Use of money may be recovered when plan is funded by life insurance.
COST RECOVERY:	Premiums recovered through tax-free life insurance proceeds.
DEDUCTIBLE CONTRIBUTION OF PREMIUM:	No.
CORPORATE RESOLUTION, PLAN DOCUMENT, OR AGREEMENT:	Yes.
DISCRIMINATION AVAILABLE:	Yes.

KEY EMPLOYEE COVERAGE WORKSHEET

Key Employee—is an important coverage as are all the others. To give you an idea of the value of these concepts, here is a sample worksheet for Key Person coverage:

	EXAMPLE	YOUR COMPANY
Key Executive's Salary	$ 100,000	$ ___________
Total Salary Compensation for Management Group	$ 500,000	$ ___________
Executive's Salary as % of Total Management Compensation	20%	___________ %
Transition Period (Years)	2	___________
REPLACEMENT COST (TRANSITION AND TRAINING)—(A)*		
Replacement Executive's Salary **	$ 150,000	$ ___________
Current Executive's Salary	-$100,000	-$ ___________
Additional Salary	$50,000	$ ___________
Transition Period (Years)	x 2	x ___________
Total Additional Salary	$100,000	$ ___________
Fee to Executive Recruiter (20% of Salary)	$30,000	$ ___________
Replacement Cost (Additional Salary Plus Recruiter's Fee)	$ 130,000	$ ___________
POTENTIAL IMPACT ON SALES—(B)		
Anticipated Sales for ______2 Years	$ 5,000,000	$ ___________
% Attributed to Current Executive	20%	___________%
Sales Attributed to Current Executive	$1,000,000	$ ___________
Sales Potentially Lost	$ 500,000	$ ___________
POTENTIAL IMPACT ON CREDIT LINES—(C)		
Anticipated Line of Credit	$1,000,000	$ ___________
% Attributed to Current Executive	20%	___________%
Credit Line Potentially Lost	$200,000	$ ___________
OTHER POTENTIAL IMPACT—(D)	___________	___________
TOTAL KEY EXECUTIVE VALUATION (A)+(B)+(C)+(D)	$ 830,000	$ ___________

* This may indicate the executive's relative importance and may be useful in determining the impact on sales and credit lines. ** Replacement executive's compensation may have to be substantially higher if he does not have an equity ownership position.

Appropriate worksheets are available for some of the other methods either through the Internet, books, etc. However, for buy-sell planning and most of the others, it is important to meet with your advisors (especially your attorney; tax attorney preferable for planning and agreements).

Q130 Can I Donate My Life Insurance Policy to a Non-Profit/ Charitable Organization?

Donating life insurance policies to a non-profit/charitable organization is a fairly common event. A main reason is that it amplifies the gift. If a gift of premiums, of let's say $1,000 a year, were given to the organization for 20 years, that would be substantially less than a death benefit of $100,000 at that time.

However, some development professionals are not familiar with the concept or do not wish to accept life insurance as a gift. Be advised that the policies can present potential hazards for the organizations. The other issue is that life insurance is not often understood and as such is refused as a gift.

This does not mean that a life insurance policy will not be accepted. It simply means that the planned-giving officer at the organization will need to be educated by either a life insurance agent or other advisor who can assist them in feeling comfortable. If the planned-giving officer is knowledgeable about life insurance or has an advisor whom to call, then the policy can typically then be gifted.

The issues that will typically be addressed by a non-profit/charity in accepting a policy would be:

- An appraisal of a life insurance policy and a determination of its fair market value
- Valuations in special circumstances
- An assessment of the danger of accepting an encumbered policy (with a policy loan outstanding)
- Completion of Internal Revenue Service Form 8283
- A review of any other risks in accepting a life insurance policy

The value of the gift can depend on a number of variables and, for this you would need to consult a properly qualified appraiser for life insurance policies.

As mentioned, using life insurance in conjunction with charitable gift planning has also been around for quite some time and for the most part is

generally accepted. An outright gift of a life insurance policy to charity works out well for both the donor and for the recipient charity. Typically, such a gift will result in an income tax deduction for the donor to the extent of his or her basis in the policy (or the policy value if less). No income tax deduction is available if the donor merely designates the charity as policy beneficiary, whether revocable or irrevocable, for failure to satisfy the partial interest rule.

There is generally no insurable interest on the donor's life on the part of the charity. Thus, the gift could be made but is potentially voidable under a traditional concept of insurable interest. The unwelcome tax consequence is that because the charity's interest is voidable under the state's insurable-interest law, and a challenge to such interest would likely cause ownership of the policy to revert to the donor or his heirs, the gift is only a partial interest, which does not qualify for the income tax or gift tax charitable contribution deductions.

Virtually every state has enacted provisions allowing charities to own life insurance policies where the insured is a donor in whose life the charity does not otherwise have an insurable interest. They typically require the consent of the insured. Some define "charitable organization" with reference to IRC Sec. 501(c)(3) (e.g. Fla. Stat. Ch. 27.404); others refer to their own law (e.g. N.Y. Ins. Law §3205(b)(3)). These variations mean that although insurable interest should not present a real problem to charitable giving of life insurance policies, the planner should (as always) be sure to consult applicable state law.

There are some uncommon additional tax risks due to Investor Initiated Life Insurance (see Question 132: What is Stranger-Owned Life Insurance (STOLI))? Investors are involving charities in their efforts to acquire life insurance policies that would not otherwise be available because the investors lack an insurable interest in the insureds. One variation of non-recourse premium financing transactions involves promising modest benefits to a charity or university in order to market to its list of wealthy older donors and alumni. (In North Carolina and Texas, for example, legislators changed the definition of "insurable interest" to allow charities and other tax-exempt entities to participate in STOLI transactions. In other states, lobbying continues with key legislators to change the insurable interest law and allow STOLI transactions for their favorite charity or university.)

This allows the promoters to identify clusters of potential insureds through a single source. The promoters typically convince the donors to allow

the investors to use their "excess insurability" by promising the charity an expected payment estimated at 2% to 5% of the eventual death benefit after payment of all expenses and a guaranteed profit to the investors. In essence, the charity is paid a modest finder's fee. Meanwhile, the charity may not be aware of its potential exposure under the securities laws, the potential 100% excise tax on money going into one of these schemes, the potential harm to its reputation, or the risk to its tax-exempt status.

The two preceding paragraphs are from: "Free Life Insurance: Risks and Costs of Non-Recourse Premium Financing" by R. Marshall Jones, Stephan R. Leimberg, and Lawrence J. Rybka, attorneys.

Q131 What Are Some Tips on Understanding Viatical and Life Settlements to Sell a Life Insurance Policy?

People living with a terminal illness often face very tough financial choices. A life settlement or viatical settlement is one option that can give you cash to help with expenses. A life or viatical settlement is the sale of a life insurance policy to a third party. The owner of the policy sells it for a percent of the death benefit. The buyer becomes the new owner and/or beneficiary of the life insurance policy, pays all future premiums and collects the entire death benefit when the insured dies.

Initially, back in 1989, the viatical business began with good intentions, as a method to allow terminally ill AIDS patients early access to a portion (or all) of their life insurance policy's death benefits. Viaticals eventually expanded to include other conditions such as cancer, heart disease, and any other life-threatening illness.

The industry has been troubled by a high number of unethical, illegitimate operations. These operations have gone after potentials viators in an aggressive manner. These companies have given the industry a bad name and led to more regulation and scrutiny.

The main difference between life settlements and viatical settlements is that with a viatical settlement the insured must be terminally ill. Life settlements do not require the insured to be terminally ill, but they must be a maximum age, and the amount of settlement will depend on their age and health.

Defining common terms:

- The person selling the life insurance policy is the viator. He or she will get money from the settlement. This person gives up ownership of the policy in return for cash now. The viator generally has a terminal illness.
- A life or viatical settlement provider is the person or company that buys the life insurance policy. The buyer becomes the policy owner, and must pay any premiums that are due, and eventually collects the entire death benefit from the insurance company.
- The person or company who represents the seller and can "shop" for offers is a settlement broker. The buyer pays the broker a commission if the sale is completed.
- An accelerated death benefit (ADB) is a feature of a life insurance policy that typically pays some or all of the policy's death benefit before the insured dies. It may be another way to get cash from a policy without selling it to a third party.

Issues to consider with viatical settlements:

- To sell your life insurance policy, you must have a terminal disease and an estimated life expectancy of 36 months in most cases, or less, although there are companies that will buy policies from people with greater life expectancies, such as 60 months.
- There is no requirement that you have to be an AIDS patient. More and more companies are expanding to terminally ill cancer and heart patients or to those suffering from other fatal diseases. Up until recently, AIDS patients have been the main source because the disease's course is fairly predictable, but that could change as new treatments and drugs that prolong life are used by more AIDS patients.
- Many different types of policies can be sold, including whole life, term, and universal. In many cases, group policies also can be sold—for instance, if a disability waiver locks in coverage, and the policy is assignable or convertible. You will need to check specifics with the company. In addition, policies need to have been in-force beyond any contestability period, usually two years. Group policies that are converted must not require a new contestability period.
- To sell the policy, your financial advisor may be able to assist you; keep in mind that he or she will receive a fee (commission) on the sale of a

percentage (5% to 7%) of either the cash value or death benefit. You may also choose to approach viatical funding companies directly. Make sure you get offers from more than one, and do not be afraid to negotiate. If you do not have any advisors, there usually are brokers and providers who advertise in magazines and newspapers for the gay community. Community organizations and health, financial, or legal professionals may provide a referral. In some states, it is not legal for doctors or lawyers to collect a fee from a company for steering clients their way.

- Check whether or not your state insurance department has licensing and other requirements for funding or brokerage companies to conduct business in that state; currently only a few states do. The number of states that do, however, is growing quickly. It's important to check to see whether your company is properly licensed. Otherwise, you might get hit with unnecessary taxes. Recent changes in federal tax laws allow an exemption from federal taxes on proceeds from viatical settlements only when you do business with a company that is properly licensed. If your state doesn't have licensing requirements, then the company must comply with the National Association of Insurance Commissioner's Model Act and Regulations on viatical settlements (see above).
- The company must be licensed in the state where it is making the transaction, not where it is located. For example, if a company is based in California but doing business in New York, it must be licensed in New York. If the company is doing business in Nevada, there is no law there. That means you should do business only with companies that comply with the National Association of Insurance Commissioner's Model Act and Regulations on viatical settlements. Ask any broker or funding company with which you deal whether they are licensed and, if so, in which states. Call those state's insurance divisions to verify and see if there are any complaints. See Appendix A for contact information on the various state insurance departments. You should also check with your own state insurance regulators to see if new regulations are imminent.
- Keep in mind that you do not need to sell the entire policy. You can sell whatever percentage you would like (the company may have a minimum as a purchase requirement).

- The amount you receive will depend on a variety of factors, such as anticipated life expectancy (unfortunately the shorter it is, the higher the pay out), the anticipated premiums the company will have to pay, if there are any loans outstanding against the policy, whether there is a premium waiver in case of disability, the insurance company's ratings, prevailing interest rates, and the company's targeted rate of return. A life expectancy of 6 months or less typically brings about 80 percent of the policy's death benefit, although sometimes it can be as high as 85 percent. Conversely, a life expectancy of 60 months would bring 25 to 30 percent.
- If you have cash value in the policy, you can usually withdraw it.
- The process typically takes four to eight weeks to viaticate a policy, although it can take longer, especially with some group policies. You can help speed things up by notifying your physician and insurance company to expect the inquiries from the viatical company.
- After Dec. 31, 1996, the proceeds from a viatical settlement will no longer be subject to federal tax under some circumstances. The person selling the policy must have a life expectancy of two years or less. Also, the company buying the policy must be properly licensed in states that require that and/or the company has to comply with the National Association of Insurance Commissioner's Model Act and Regulations on viatical settlements.
- The lump sum payout could result in the loss of state and federal need-based aid such as Medicaid, food stamps, or SSI.
- Depending on your financial situation, specifically, if you owe a lot of money to hospitals, doctors, or other creditors, they may seek payment from the proceeds you receive. Also, if you have filed bankruptcy, the creditors lay claim.
- The viatical company normally will not contact you after settlement, but it will track your status so it knows when the policy "matures"—that is, when the viator dies and the policy becomes payable. It can do this in a number of ways, for example by keeping in touch with your primary physician. You should check how a company you are considering handles this sensitive issue.

- Viatical contracts are required by some states to have a period when the contract can be canceled for a period of 30 days from the time it is signed, and 15 days after the viator receives the proceeds. Companies in states where there is no such regulation almost always offer a similar clause.
- If you live past your anticipated life expectancy, there are no repercussions for you. That is part of the risk for the company.
- As with anything and as the song goes "You Better Shop Around" to make sure that you are getting a fair price. This is a type of transaction that you can negotiate with the companies. There is usually no set price.

Life Settlements

A life settlement allows a person to sell a life insurance policy and receive a cash amount higher than the cash surrender value. The policy ownership is transferred to an unrelated investor in exchange for a cash payment in excess of the policy's cash surrender value. The investor makes required premium payments and collects the death benefit when the insured person dies. Life settlements are identical in form to viatical settlements, except for the expected remaining lifetime of the insured, which is less than two years for viaticals.

The following are some facts about life settlements to keep in mind:

- Most companies require that the insured be a minimum age of at least 65 or older.
- The policy usually has to have a minimum death benefit of $250,000.
- May be useful where a policy is not performing up to expectations.
- The life insurance is not needed
  - in a business insurance situation such as a "key person" or a "buy-sell" agreement where an insured leaves and the policy is no longer necessary; or
  - When a loan secured by life insurance has been paid in full.
- The proceeds from the life settlement can be used to
  - provide cash gifts to family members; or
  - provide funds for charitable giving or to establish a charitable remainder trust.

- The policy is beyond the two-year contestable period.
- Useful when an insured person's health has substantially worsened since policy's issue date and/or when current life expectancy is between 2 and 12 years.
- Returns to investors are above average, sometimes reaching 12% or more; the shorter the life span, the greater the return.
- The investor incurs significant transaction expenses, including underwriting, commissions, reinsurance, administration, and taxes on the gain at death.
- Commissions to financial advisors, brokers, and independent agents with a life insurance license generally range from 4% to 6% of the amount paid for the settlement.
- The policy may be resold multiple times.
- Lack of privacy—ongoing tracking of the insured person's health and medical records until death.

What are the current tax considerations for life settlements?

- On the sale of a life policy, the tax treatment of life settlements generally leads to a three-tier taxation of the proceeds paid to the policy owner, where a portion may be taxed as ordinary income, a portion as long-term capital gains, and a portion as income tax free.

  The Tax Cuts and Jobs Act (2017) includes the following guidance on the taxation of a life insurance policy sale to the seller. Here are the three steps:

  1. Determine total gain by subtracting the cost basis of the policy, typically the total premium paid, from the amount received from the sale by the policy owner.
  2. Determine the amount that will be taxed as ordinary income, which is the difference between the cash value in the policy and the cost basis. This is the same process used to calculate the taxable amount of a policy surrender. The cost basis in both transactions is received free of income tax—it is the return of premium paid. Before the new tax law, a policy seller would have to reduce the cost basis by the mortality charges paid in the policy, which was a complex process.

3. Calculate that portion of the sale that will be taxed at capital gains rates by subtracting the amount taxed as ordinary income (step two) from the total gain (step one). The amount above the cash value is taxed as capital gains.

Here's an example:

1. Amount received ($1,000,000) less cost basis ($250,000) equals total gain ($750,000).
2. Cash value ($350,000) less cost basis ($250,000) equals amount to be taxed as ordinary income ($100,000).
3. Total gain (from step 1—$750,000) less amount taxed as ordinary income (from step 2—$100,000) equals amount to be taxed as capital gains ($650,000).

Note that if there is no cash value in the policy, the total amount received above cost basis is taxed at capital gains rates.

- At the insured's death, the life settlement investor normally owes income tax on the excess of the death benefit over the investor's investment in the contract.
- If the life policy were retained rather than sold, the entire death benefit would pass income tax free to the insured's estate or named beneficiary.

Recent statistics on life settlements

- Approximately $848 million of life insurance coverage was settled in 2020. The Life Settlements Report by The Deal 2021.
- Policies resulting in settlements represent less than 1% of all policies issued by carriers (Life Settlements, Secondary Annuities, and Structured Settlements—Conning, Inc. publication, 2016).

Life settlements are generally accepted as legal. Forty-three states in the U.S. have created laws around the practice of life settlements, as of December 2021. You can find a Life Settlement Regulation—Map of Regulatory Law here: https://www.lisa.org/regulations-overview/.

What are some tips to consider prior to selling a life insurance policy through a viatical settlement or a life settlement? (Non-Investor Initiated

Life Insurance—See Question 132: What Is Stranger-Owned Life Insurance?) (STOLI):

- Is there still a need for life insurance?
- If you're interested in selling your policy, you should visit your State Insurance Department for more information and to review the appropriate state insurance department laws. Contact information for each State Insurance Department can be found in Appendix A.
- Consider all your options.
- Find out if the policy has any cash value. This cash value may be used to meet immediate needs and keep the policy in-force for beneficiaries. The cash value may also be able to be used as security for a loan from a financial institution.
- Find out if the life insurance policy has an accelerated death benefits provision. It could pay a substantial portion of the policy's death benefit and then the policy would not need to be sold to a third party. A greater number of companies and policies are including this type of provision than in the past.
- If I sell my policy, how do they decide how much cash I get?
- Is this an employer or other group policy? If so, do I need their permission to sell it?
- If I sell my policy, who will be the legal owner?
- Do I need the advice of a tax or estate-planning advisor before I decide to sell my policy?
- Find out the tax implications. Not all proceeds are tax-free.
- Know that the proceeds are subject to the claims of any creditors.
- Understand what information a buyer must know about you to buy your policy, and who else might get that information. Know that you must provide certain medical and personal information and that this may be disclosed to investors.
- Understand how the process works and when the phases will happen.
- Decide whether to sell the policy directly to a life or viatical settlement provider or to go through a settlement broker who will do the comparison shopping.

- If you don't use a settlement broker, comparison shop on your own.
- Any life or viatical settlement offer is just that, an offer that does not need to be accepted.
- Check all application forms for accuracy, especially information about medical history.
- You must be truthful in your answers to application questions.
- Make sure the settlement provider agrees to put your settlement proceeds in escrow with an independent party or financial institution to make sure your funds are safe during the transfer.
- Find out if you have the right to change your mind about the settlement after you get the proceeds. If you have that right, you'll have to return the money you were paid and the premiums the buyer paid. In many states you have a certain period of time to change your mind.
- Can the policy be resold?

The transaction process for a life settlement

1. Application: After choosing proper representation to settle a policy, the policy owner must fill out an application and provide proper documentation, such as policy copies and medical records.
2. Information gathering: No medical exam is required, but policy information and medical records are necessary for evaluating each case.
3. Appraisal: The process of assessing the insured's current health and their policy enables buyers to develop an offer based on the unique characteristics of each case.
4. Offers: Offers consist of both the amount of money the buyer is willing to pay and any terms they may propose to complete the transaction. Terms include timing and other information that may need to be confirmed before the sale is completed.
5. Finalize the sale: Once an offer has been accepted, a set of documents, including a contract and other disclosure forms, is prepared and sent to the policy owner or their representative. Most states have regulations that allow a policy owner (seller) to change their mind up to 15 days after all the forms are signed and due diligence is completed.

The above transaction process is from the Life Insurance Settlement Association, which is the trade association for the life settlement industry and associated businesses.

Q132 What is Stranger-Owned Life Insurance (STOLI)?

Please note that the practice of STOLI has been banned in at least 29 states (as of 2019), and the majority of remaining states are considering banning it. Visit this website to check the current state laws: https://blog.lisa.org/member/life-settlement-regulation-by-state-map. Both the National Association of Insurance Commissioners (NAIC) and National Conference of Insurance Legislators (NCOIL) have adopted model acts for doing so. However, since STOLI is still allowed in some states (or recently was), this question should still be helpful in understanding the issues.

Stranger-owned life insurance (STOLI) is an attempt to twist life insurance into a speculative financial instrument to take advantage of the unique tax features of life insurance (i.e., income tax-free death benefit and cash value accumulation). Using life insurance as a commodity to speculate in human lives threatens the survival of life insurance companies. The difference between STOLI and life settlements is that life settlements are supposedly for purchasing in-force policies that were purchased when there was a "real" insurable need and which no longer exists, rather than STOLI, which involves no "real" insurable need. STOLI goes by other names, including Investor Initiated Life Insurance (IILI), SOLI, and SPINLIFE. STOLI also combines premium financing (see Question 133: What Is Premium Financing?) into the mix.

The concept includes the bribing of wealthy, elderly individuals to apply for large policies destined for purchase by investors. Basically, the insured is provided with life insurance for two years with no out-of-pocket cost—"free insurance." These prospective insureds, generally between age 72 and 85 with a net worth of at least $5 million, are approached with the concept that they "own" an asset in the form of their insurability and that they can monetize this wasting asset by consenting to be insured under a STOLI policy.

This concept of selling an individual's unused insurance capacity through a structured life settlement may appear advantageous to all parties involved.

However, combining the use of premium financing with the future planned life settlement may be contrary to one of the basic principles upon which the insurance industry is founded, which is the insurable-interest doctrine.

STOLI is not a type of life insurance product; it is a particular use of a life insurance policy, such as key person, buy-sell, etc. However, it is a potentially "malignant" concept and is un-established in many areas, as we will look at. The concept combines the premium-financed purchase of a life insurance contract with the future sale of that contract in a life settlement.

The parties to a STOLI transaction:

- Insured—person whose life the insurance is on
- Life insurance agent/broker—person who "sells" the life insurance
- Life insurance company
- Investor group—the viator or life settlement market maker
- Special purpose lender—see premium-financing section
- Internal Revenue Service—possibly depending on how the policies are set up and the future interpretation of these types of policies.

How it works (an example of a basic STOLI arrangement; please note there are many types):

1. An agent/broker proposes to a prospective insured that they own a "wasting asset" in the form of their insurability and that this can be monetized by consenting to be insured under a STOLI policy. There is no traditional life insurance need and they are acquiring the life insurance strictly for monetary purposes. They are generally offered one (or a combination) of the following if they qualify for the program: two years of free life insurance; an up-front cash distribution of 1.5% to 3% of the death benefit (or a free luxury car); a portion of the net profits from the expected sale of the policy to a life settlement company after two years; or, in some instances, another 1.5% to 3% of the insurance benefit when the insured dies. The insured will generally not put up any money themselves.
2. The client secures a non-recourse premium-financing loan from the lender to finance a life insurance policy.
3. The proposed insured qualifies for the issuance of a $2 million or larger permanent life insurance policy.

4. The third-party investor group makes or guarantees a non-recourse loan to the non-grantor irrevocable trust created to purchase the policy.
5. As part of the policy purchase, the trust collaterally assigns the policy to the lender.
6. After 24 months or longer, in order to satisfy both the policy's incontestability provision and state insurance laws regulating the sale of newly issued policies, the insured's trustee chooses from the following options, if available:
   - repay the loaned premiums with interest along with any cash advances, origination fees, termination fees, or other charges; pay all future premiums and keep the policy; or
   - sell the policy to a life settlement company; or
   - transfer ownership of the policy to the lenders in full satisfaction of the loan.

There are many issues to be concerned about when reviewing/considering a STOLI transaction and the discussion of which for the most part, are beyond scope of this book.

The following is a partial list of potential issues that appeared in articled titled "Free Life Insurance: Risks and Costs of Non-Recourse Premium Financing," by R. Marshall Jones, Stephan R. Leimberg, and Lawrence J. Rybka, attorneys.

- Future insurability—if the maximum amount of life insurance (capacity) is purchased on a single life, then that insured would probably not be able to ever purchase life insurance again in the future. This would be of concern if a true need were to surface. This is an especially important factor—as the capacity for life insurance is shrinking both in the U.S. and around the world, it is becoming difficult if not impossible to write large amounts of life insurance (partially due to STOLI).
- Ethical/moral issues—As mentioned in the introduction, there are some ethical and moral concerns with selling your life insurance and/or insurability (unused life insurance capacity) to an investor group or stranger. A review of these issues is beyond the scope of this book.
- Appropriate disclosures—there are no standard disclosures at this time.

- Policy resale—the original purchaser is not obligated to keep the policy; they can resell it.
- Privacy—life settlement contracts have little protection for personal and health information.
- Violations of state "insurable interest" insurance laws and regulations—third-party investors offer the insureds two years of "free" insurance, because it is illegal for them to purchase insurance on the life of an individual unless the original applicant-owner has an insurable interest at the time the policy is purchased. Without an insurable interest, the policy would be void from inception and the death benefit will not be paid to the investors. To protect the public, all states have insurable interest statutes designed to discourage speculation on an insured's life. Generally, the initial owner and beneficiary must have a strong economic interest in, and benefit from, the continued life of the insured. For example, family members are generally presumed to have an insurable interest in their spouses and parents. These laws vary from state to state.
- Litigation risk—if a state insurance department rules that an insurance interest law is violated, the insured's trust and estate, and their agents and advisors, may become embroiled in unexpected litigation. This could occur either during the insured's lifetime or after death.
- Premium financing issues—(see Question 133: What Is Premium Financing and How Does It Work?) There are special issues to STOLI regarding the cost of repaying the loan and keeping the policy: It is very unusual for an insured to participate in a "free insurance" premium financing program with the primary intent of repaying the loan after two years and keeping the insurance for the originally stated "insurable interest" purpose. In general, the purpose of the repayment option is to give apparent legitimacy to the insurance transaction and not to encourage repayment. In fact, the insured usually has lower-cost private or commercial recourse financing available as an alternative. The decision to use higher-cost non-recourse financing is yet another indication that the insured never intended to pay premiums after the second policy year. Even the most compliant

and professional non-recourse premium financing programs generally expect to earn at least a compounded 15% return on equity for the investors. Many programs impose a much higher actual cost of repayment through a combination of exit fees and other charges to dramatically discourage repayment.

- Fraud and misrepresentation by the insured—the standard life insurance application requires insureds to sign written statements regarding their health, financial circumstances, policy ownership, and the purpose of the insurance. Companies rely on this information as part of their consideration for issuing coverage. The answers to most of these questions become part of the contract. Most life insurance contracts provide that the policy may not be contested by the insurance company after two policy years. A standard part of "free insurance" premium-financing transactions is an indemnification provision whereby the insured agrees to indemnify the lenders and investors for any loss resulting from a material misrepresentation or omission. The insured, or the insured's family, may be liable for the investors' loss—potentially the multi-million-dollar death benefit that was not paid to the investors—if any misrepresentation of these items is discovered during the contestable period. If the misrepresentation is intentional and material, it may give rise to fraud that extends beyond the contestable period.
- Rebating—another area of risk to insureds is the use of cash incentives to purchase the policy. The New York State Insurance Department General Counsel Opinion, citing lack of insurable interest for one of these transactions, also made the point that free insurance might constitute an illegal rebate. Most state insurance regulations either prohibit or severely restrict the offer of rebates to clients who buy insurance. The few states that allow this practice require that any rebates fit within specific parameters established by the state. (California does allow rebates under certain specific conditions.)
- Violations of state insurance statutes on "wet ink" viaticals—many states have enacted model statutes prohibiting the sale of life insurance as an investment for the benefit of a disinterested third party. Furthermore, to guard against so-called wet ink viatical transactions (i.e.,

the sale of a newly issued policy to a life settlement company "almost before the ink is dry"), the National Association of Insurance Commissioners' (NAIC) Viatical Settlements Model Regulation has been adopted by a number of states to prohibit the sale of insurance policies within 24 months of the policy issue date. This restriction applies to both policy owners and licensed life insurance agents and brokers.

- Potential violations of federal or state securities law—in addition to insurance law issues, advisors must consider these programs as possible securities transactions. Insureds, their advisors, and insurance agents/brokers may face significant, long-term financial exposure if the non-recourse premium-financing transaction is a security but not structured to be fully compliant with federal and state securities laws. One of the more serious and often overlooked transaction risks is the possibility that the insured, the trustee, and the advisors are participating in the issuance, sale, or solicitation of unregistered securities in violation of sections 5(a) and 5(c) of the Securities Act of 1933. This risk should cause great pause, because transactions falling under securities law may require very specific disclosure in the transaction and many additional statutory remedies.
- The risk of failure to comply with the Patriot Act—some countries have more favorable tax laws regarding investor-owned life insurance that make U.S.-issued life insurance policies particularly attractive. Consequently, foreign investors have entered both the non-recourse premium-financing market and the life settlement arena.
- The unknown tax cost of the unpaid loan—there does not appear to be any clear or certain guidance regarding the tax consequences related to non-payment of the loan. An argument can be made that any "free" insurance benefit should be taxed as ordinary income and that income tax may be due on 100% of any forgiven loan balance, including all accrued interest and any waived fees or charges. The tax opinions will vary from advisor to advisor and from transaction to transaction.
- The risk of estate tax on the death benefit—because the investors are looking for insureds with a projected life expectancy of 120 months (ten years) or less, advisors must evaluate the risk that the death ben-

efit will be included in the insured's taxable estate if he or she dies during this period.

What is the impact on life insurance carriers of stranger-owned life insurance?

There is some debate as to what the bottom-line impact will be to life insurance companies. There will be some impact due to the way that life insurance companies price their policies. The pricing of a life insurance policy is dependent upon a number of actuarial-based assumptions, one of which is expected lapse rates.

The majority of life insurance policies in force today were sold, and priced, prior to the secondary life insurance marketplace. Therefore, when the products were designed, companies took into historical lapse rates (this includes surrenders). Lapse rates impact the premiums since insurance companies assume that a certain number of policyholders will lapse (discontinue paying premiums) rather than retaining the policy until death.

Life insurance product pricing is a function of three pricing factors: cost of insurance charges (COIs), policy expenses, and policy interest earnings.

This is a delicate balance for companies to be both competitive and profitable. Well, some companies try harder to be profitable than others, but that's another story.

Life settlements make estimating lapse assumptions more difficult because policyholders are opting to sell their policies rather than allowing them to lapse. If insurers price policies based on significantly lower lapse assumptions than are realized, insurers lose. Furthermore, the insurer cannot raise rates on guaranteed premium policies to make up the shortfall. Consequently, they could be compelled to hoard more reserves to pay claims. This will impact profitability and could upset the delicate balance.

Q133 What Is Premium Financing and How Does It Work?

Premium financing has been around for years in the life insurance industry and has been heavily promoted, especially among wealthier clients. It occurs when an outside (third party) lending source like a bank or hedge fund pays premiums on a life insurance contract.

The unique characteristics in these premium-financing arrangements are that the loan is assumed to be renewed until death and the insurance proceeds are relied upon to be sufficient to repay the loan at death and to provide your client's family with the insurance coverage they need. Conceptually, this is a great idea: you use borrowed funds to pay for the insurance program, which will ultimately pay off the loan and provide the family with the needed funds at their death.

Premium financing is especially attractive in low-interest-rate environments when it is likely that the death benefit will exceed the loan and accrued interest. This can also be an attractive method of buying more life insurance if a trust is unable to purchase additional insurance due to taxable gift limitations.

Interest is generally compounded in a premium-finance arrangement with an optimal loan period of less than 10 years. Therefore, the best prospects for premium financing are insureds who are age 70 or older, with a life expectancy of from 10 to 15 years.

Unfortunately, there are significant risks that you assume that could derail the entire program. In addition to determining product suitability, purchasers should be wary of loan terms and implied interest rate assumptions when considering premium financing. Purchasers need to understand the life insurance contract, including the future yield assumptions, death benefit structure, cost assumptions, and, of course, the appropriate amount of the death benefit. The individual should have a net worth of at least $5 million and have a significant life insurance need with an annual premium of usually $100,000 plus.

Most loans for premium are variable; the interest rate depends on the type of contract and the personal guarantee of either the insured or the purchaser. Financing for premiums is generally based on LIBOR (the London interbank offered rate) plus an additional percentage cost, assuming sufficient collateral. Banks will usually lend up to 70% of the cash value of a universal life contract or below 50% when lending against the cash value of a variable universal life contract.

How does premium financing work?

The premium-financing loan works similarly to other loans and has these three components:

1. Interest rate is usually a variable one-year rate but can sometimes be fixed up to 10 years.
2. Loan term is usually for one year, but can sometimes be as high as 10 years. Each year during the loan term, the lender will review the loan to make sure everything is in order. If the numbers don't match up, adjustments will have to be made to bring everything in line. At the end of the loan, term, you must either repay the loan or reapply for a new loan, which will be subject to new financial underwriting. There is no guarantee the lender will renew the loan either due to a change in financial situation or a change in the lender's willingness to offer this type of loan.
3. Collateral has to be posted for the loan. The policy's cash surrender value is usually acceptable as collateral and, to the extent it is not sufficient to cover the loan, additional collateral will have to be posted—usually in the form of marketable securities. There may be an indefinite number of collateral calls should the value of the collateral fall at any time.

How does a premium financing loan tie in with a life insurance policy? Some carriers have recently developed death benefit riders, which are intended to grow the death benefit by the amount of the loan and, in some cases, also the interest. Today's riders fall into one of three categories:

1. Return-of-Premium Rider—increases the death benefit each year by the premiums paid in that year. The death benefit is intended to keep pace with the loan's principal so the loan principal can be repaid at death while still providing the insurance coverage needed. This rider is used when the goal is to pay the loan interest each year.
2. Return-of-Premium with Interest Rider—increases the death benefit each year by that year's premiums and interest. This death benefit is intended to keep pace with the loan's principal plus accrued interest so the entire loan can be repaid at death while providing the needed insurance coverage. This rider would be used to accrue loan interest.
3. No Rider—leaving the only option as the choice of type of death benefit—either the Level Death Benefit Option or the Increasing Death Benefit Option—neither of which are designed to work in

the premium financing sale. The best option would most likely be the Increasing Death Benefit option to have some death benefit growth to at least keep pace with part of the growing loan balance.

While the life insurance purchase and the loan are two separate transactions, attempts have been made to combine them. In recent years, lenders have become more willing to provide the necessary capital for clients to fund their insurance programs, and carriers have become more receptive to designing their products to work in the premium-financing markets. Since the insurance policy and the loan operate independently of each other, there are no built-in mechanisms or guarantees that they will work in sync. In other words, should changes to one occur without a corresponding change in the other, the entire premium-financing arrangement could fail to perform as projected, resulting in a precarious situation.

What are the risk factors affiliated with using premium financing?

The following risk factors, both alone or in combination, would result in a significant burden and could cause the entire program to fail:

- Interest Rate Risk—If the loan interest rates increase more than projected, more money may need to be paid into the program, and/or more collateral may need to be provided than originally anticipated. If there is not sufficient funds and/or collateral to make up this shortfall, the entire loan could be called—forcing the loan be repaid prior to the original planned-on date, which could be an inopportune time.
- Collateral Risk—If the value of collateral falls below the level required by the lender to satisfy the loan, additional collateral could be required. If there is not sufficient collateral to make up this shortfall, the entire loan could be called—forcing the repayment before originally planned. This also could occur at an inopportune time and put collateral at risk.
- Asset Risk:
    - While Alive—Should the loan be called and the collateral posted not be sufficient to repay the loan, other assets, whether cash or otherwise, may be at risk of being forfeited to satisfy the outstanding loan balance.

- At Death—Should the total death benefit be less than expected:
  - The net death benefit available after repaying the loan could be less than needed to satisfy estate liquidity needs, thus, putting other assets at risk of having to be sold to satisfy this need.
  - If the total death benefit is less than the outstanding loan balance, not only would there not be any death benefit available for the family, but the family would owe the remaining loan balance—without neither the funds to satisfy this loan obligation nor those to satisfy the estate liquidity need.

- Earnings Risk:
  - If the policy's cash surrender value does not perform as projected, there may be a requirement of more collateral than originally anticipated. If the policy's death benefit does not, or can not, grow sufficiently to keep pace with the outstanding loan, then there is risk of either not getting as much coverage as expected, after the loan is paid off, or, worse yet, getting no insurance coverage at all and having to come up with additional funds to repay the balance of the loan. There is no guarantee that the insurance policy will be able to repay the entire loan and provide the needed insurance protection.

  If a Side Fund is used to accumulate assets to later offset the loan, the growth of this side fund could be lower than projected. This could require that additional funds be paid off the loan as scheduled and/or require a longer time than expected to repay the loan from the Side Fund.
- Policy Design Risk:
  - Policy Pricing—The cost of an increasing death benefit, especially in the later years, can have an enormous effect on the policy's premium requirements. With premium-financing programs, higher premiums means larger loans since a larger loan is needed to pay the policy's higher premium. However, a larger loan means even higher death benefits are needed, which in turn mean higher premiums. This circular dependency can require significantly more insurance just to satisfy the ultimate loan. While this may be nice

for commission purposes, it poses a particular problem if the cost to maintain the entire program becomes either more expensive than just purchasing the insurance outright or becomes cost prohibitive.

- o Lack of Guarantees—There is no guarantee the policy will keep pace with the outstanding loan balance. Since the loan is repaid from the insurance proceeds first, if the loan is larger than projected, the additional amount would be paid from the death benefit originally intended to be available for the beneficiary. Therefore, there would be insufficient coverage, or possibly no coverage.

- Loan Underwriting Risk—Loans can be made for a fixed term of years, but can not be made in perpetuity. Premium-financing programs assume the loan continuously gets renewed at the end of each term until the insured's death when the insurance proceeds are intended to repay the loan. Since each loan renewal is subject to the lender's underwriting guidelines, the lender's desire to continue to fund insurance premiums and the individual's financial situation, there is no guarantee the lender will renew the loan nor that any lender will offer a new loan to continue the program. In this event, the loan could be required to be repaid at a time other than death and from funds other than the insurance policy.
- Reinsurance Risk—Depending on the design of the insurer's policy, if an increasing death benefit is used to keep pace with the outstanding loan balance, the ultimate death benefit may have to be underwritten up-front. The following could be issues in these situations:
  - o The insured doesn't qualify, due to medical or other reasons, for the required amount of reinsurance, thereby limiting the amount of coverage available to repay the loan.
  - o Even if the insured can qualify, there may not be sufficient reinsurance available in the marketplace to satisfy the ultimate need—thereby limiting the amount of insurance that can be purchased up-front.

Since worldwide reinsurance capacity is limited, if the insured is able to secure all the reinsurance they need, these committed amounts would not

be available to satisfy any of their other insurance needs, such as key person, increased estate liquidity needs, etc.

Q134 What Is Private Placement Life Insurance?

Private Placement Life Insurance Products (PPIP) are non-registered Variable Universal (VUL) policies and Variable Annuity (VA) contracts that are offered exclusively to high net worth individuals. These products are filed with and approved by state insurance departments and are designed to comply with the current Internal Revenue Service (IRS) tax code. They have been referred to as a "hedge fund in a life insurance wrapper."

A Private Placement Variable Universal Life (PPVUL) Policy is a non-registered-tax U.S.-tax-compliant (Internal Revenue Code (IRC) Section 7702), flexible premium life insurance policy that provides the same income-tax exempt death benefits as other variable life policies. Premiums less charges and fees are invested into the various investment options inside the insurer's separate account. PPVUL provides flexible investment options (with some non-registered investments within asset classes that are not available in other life insurance policies), flexible premium payments, and flexible compensation to brokers. PPVUL purportedly provides transparency to the buyer and seller.

What are the similarities between PPVUL and VUL?

- Under current U.S. Tax Law, the tax benefits include:
  - tax deferral of any current policy investment earnings and gains;
  - tax-free exchanges between the underlying investment options;
  - tax-free withdrawals (up to basis) and loans from the policy cash value free of income tax (provided the policy is a non-MEC (modified endowment contract) under IRC Section 7702A);
  - income tax-free death benefit to the policy's beneficiaries.

How does a PPVUL differ from Variable Universal Life insurance (VUL)?

- Higher face amounts are required to maintain IRC Section 7702 compliance. Financial underwriting can be stringent and the reinsurance marketplace can be restrictive. Underwriting requirements are the same.

- Investment flexibility:
  - o access to alternative investment styles and managers;
  - o ability to use hedge fund strategies aimed at reducing volatility;
  - o can add/customize options without a lengthy filing and SEC registration subject to minimum deposit requirements of $5 million within total life of the policy.
- Load and charge structure:
  - o State regulators mostly allow charges to be negotiated, including insurance product charges, distribution expenses, and front-end loads, which are all generally more competitive than retail products.
  - o No surrender charges—retail life insurance policies generally have significant back-end surrender charges (on a decreasing scale lasting through fifteen and up to twenty years).
  - o Compensation is usually asset based and is relatively low as a percentage of premiums.
- The funds can have liquidity issues, for example, where the money is "locked up" for five years.
- Can only be purchased by an "Accredited Investor" who is a "Qualified Purchaser," as defined by Regulation D of the Securities Act of 1933.

Insurance companies requires the investment manager to comply with IRC Section 817 and related rules with respect to "diversification requirements and investor control." A prospective policy owner must relinquish control and ownership with respect to the investment options available within a policy.

Q&A

CONCLUSION

WHAT SHOULD I MAKE OF ALL OF THIS?

Life insurance is a very valuable component of financial planning. Life insurance is also a very complex financial instrument and needs to be treated as such. Every day life insurance companies introduce new products and marketing concepts. As you've seen in this book, selecting and maintaining the "right" life insurance policy is a challenge.

The human mind seeks simple answers, but very often the simple answer is not the right answer. Proper selection of a life insurance product requires more than simply choosing the lowest priced policy. Many other factors must be considered in making an intelligent choice. For most people, consulting a qualified and objective life insurance specialist is the best way to ensure that an appropriate recommendation is made in the circumstances.

The problem, from a consumer perspective, is making sure that the advice given is professionally objective. There are many fine people who make their living selling life insurance, but they depend for a living on making sales. This tends to affect their recommendations. For example, very often inexpensive term life insurance will do the job effectively for the least cost.

Yet even when term insurance will suffice, a great deal of permanent coverage is aggressively sold in these circumstances. The fact is that commissions on term insurance are much lower than on permanent coverage. Therefore, the incentive is there to sell permanent over term.

This is the reality and that is one reason why I decided to seek a life insurance analyst's license as well as to write this book.

The other purpose of this book is that oftentimes the life insurance salesperson does not service/review the life insurance coverage. As we've seen with the permanent (cash value) life insurance policies, this can lead to some bad situations.

The tools in this book are designed to assist you in understanding life insurance and monitoring your portfolio easier.

Please keep in mind there is no substitute for the value that life insurance can bring into play for providing discounted dollars and protection that you need.

The more informed you are, the better choices you can make.

"The man who questions opinion is wise; the man who quarrels with facts is a fool."

—Frank A. Garbutt

APPENDIX A

CONTACT INFORMATION FOR ALL STATE INSURANCE DEPARTMENTS

Alabama
Department of Insurance
201 Monroe Street, Suite 502
Montgomery, AL 336104
334-241-4141 (Consumer Services)
334-269-3550
www.aldoi.gov

Alaska
Department of Insurance
Robert B. Atwood Building
550 W. 7th Avenue, Suite 1560
Anchorage, AK 99501-3567
907-269-7900
https://www.commerce.alaska.gov/web/ins/

Arizona
Department of Insurance
Consumer Affairs Division
100 N. 15th Avenue, Suite 261
Phoenix, AZ 85007-2630
602-364-3100
https://insurance.az.gov/

Arkansas
Insurance Department
1 Commerce Way
Little Rock, AR 72202
501-371-2600
www.insurance.arkansas.gov

California
California Department of Insurance
Consumer Services Division
300 S. Spring St., South Tower
Los Angeles, CA 90013
800-927-4357
www.insurance.ca.gov

Colorado
Department of Insurance
1560 Broadway, Suite 850
Denver, CO 80202
303-894-7499 (Consumer Information)
303-894-7490
https://doi.colorado.gov/

Connecticut
Insurance Department
153 Market Street, 7th Floor
Hartford, CT 06103
860-297-3800
https://portal.ct.gov/cid

Delaware
Delaware Insurance Department
1351 West North Street, Suite 101
Dover, DE 19904
302-674-7300
https://insurance.delaware.gov/

District of Columbia
Department of Insurance
1050 First Street, NE, Suite 801
Washington, DC 20002
202-727-8000
www.disb.dc.gov

Florida
Department of Insurance
The Larsen Building
200 East Gaines Street, Room 101A
Tallahassee, FL 32399-0301
850-413-3140
www.floir.com

Georgia
Department of Insurance
Two Martin Luther King, Jr. Dr.
West Tower, Suite 716
Atlanta, GA 30334
404-656-2070
https://oci.georgia.gov/

Guam
Department of Insurance
1240 Army Drive
Barrigada, Guam 96913
United States
671-635-1817
https://www.guamtax.com/

Hawaii
Department of Insurance
PO Box 3614
Honolulu, HI 98611-3614
808-586-2790
http://cca.hawaii.gov/ins/

Idaho
Department of Insurance
700 W. State St., 3rd Floor
Boise, ID 83720-0043
208-334-4250
www.doi.idaho.gov

Illinois
Department of Insurance
302 West Washington Street
Springfield, IL 62767-0001
217-782-4515
www.insurance.illinois.gov

Indiana
Department of Insurance
311 W. Washington St., Suite 300
Indianapolis, IN 46204
317-232-2395
www.in.gov/idoi

Iowa
Insurance Division
1963 Bell Avenue, Suite 100
Des Moines, IA 50315
515-281-5705
https://iid.iowa.gov/

Kansas
Kansas Insurance Department
1300 SW Arrowhead Road
Topeka, KS 66604-4073
785-296-3071
https://insurance.kansas.gov/

Kentucky
Department of Insurance
500 Mero Street 2 SE 11
Frankfort, KY 40601
502-564-6034
https://insurance.ky.gov

Louisiana
Department of Insurance
1702 N. Third St.
Baton Rouge, LA 70802
225-342-5423
ttp://www.ldi.la.gov

Maine
Department of Insurance
34 State House Station
Augusta, ME 04333-0034
207-624-8475
https://www.maine.gov/pfr/insurance/

Maryland
Department of Insurance
200 St. Paul Place
Baltimore, MD 21202
410-468-2000
www.mdinsurance.state.md.us

Massachusetts
Department of Insurance
1000 Washington Street, Suite 810
Boston, MA 02118
617-521-7794
https://www.mass.gov/orgs/division-of-insurance

Michigan
Department of Insurance
530 West Allegan Street
Lansing, MI 48933
517-284-8800
https://www.michigan.gov/difs/

Minnesota
Department of Insurance
85 7th Place East
Suite 500
St. Paul, MN 55101
651-296-2488
https://mn.gov/commerce/industries/insurance/

Mississippi
Department of Insurance
1001 Woolfolk State Office Building,
501 North West Street
Jackson, MS 39201
601-359-3569
www.mid.state.ms.us

Missouri
Department of Insurance
301 West High Street
PO Box 690
Jefferson City, MO 65102-0690
573-751-2640
573-751-4126
www.insurance.mo.gov

Montana
Department of Insurance
840 Helena Ave., Suite 270
Helena, MT 59601
406-444-2040
https://csimt.gov/

Nebraska
Department of Insurance
Terminal Building
941 O St., Suite 400
Lincoln, NE 68508-3690
402-471-2201
https://doi.nebraska.gov/

Nevada
Department of Insurance
1818 East College Parkway, Suite 103
Carson City, NV 89706
775-687-0700
https://doi.nv.gov/

New Hampshire
Department of Insurance
21 South Fruit St., Suite 14
Concord, NH 03301
603-271-2261
Toll free: 1-800-852-3416 (NH)
TTY: 1-800-735-2964 (NH)
Fax: 603-271-1406
E-mail: consumerservices@ins.nh.gov
www.nh.gov/insurance

New Jersey
Department of Insurance
PO Box 325
Trenton, NJ 08625
609-292-5360
https://www.state.nj.us/dobi/index.html

New Mexico
Department of Insurance
1120 Paseo de Peralta, Suite 428
Santa Fe, NM 87501
855-427-5674
https://www.osi.state.nm.us/

New York
Department of Insurance
25 Beaver St.,
New York, NY 10004
212-480-6400
https://www.dfs.ny.gov/

North Carolina
Department of Insurance
1201 Mail Service Center
Raleigh, NC 27699-1201
855-408-1212
www.ncdoi.com

North Dakota
Department of Insurance
State Capitol
600 East Boulevard
Dept. 401, 5th Floor
Bismarck, ND 58505-0320
701-328-2440
https://www.insurance.nd.gov/

Ohio
Department of Insurance
50 West Town Street, 3rd floor, Suite 300
Columbus, OH 43215
614-644-2673
https://insurance.ohio.gov/wps/portal/gov/odi

Oklahoma
Department of Insurance
400 NE 50th Street
Oklahoma City, OK 73105

405-521-2828
https://www.oid.ok.gov/

Oregon
Department of Insurance
PO Box 14480
Salem, OR 97309-0405
503-947-7980
https://dfr.oregon.gov/Pages/index.aspx

Pennsylvania
Department of Insurance
1326 Strawberry Square
Harrisburg, PA 17120
717-787-2317
www.insurance.pa.gov

Puerto Rico
Department of Insurance
World Plaza Building
268 Munoz Rivera Avenue
San Juan, Puerto Rico 00918
787-722-8686
www.ocs.pr.gov

Rhode Island
Department of Insurance
1511 Pontiac Avenue
Cranston, RI 02920
401-462-9520
https://dbr.ri.gov/divisions/insurance/

South Carolina
Department of Insurance
1201 Main Street, Suite 1000
Columbia, SC 29201
803-737-6160
www.doi.sc.gov

South Dakota
Department of Insurance
445 East Capital Avenue
Pierre, SD 57501
605-773-4104
https://dor.sd.gov/

Tennessee
Department of Insurance
500 James Robertson Pkwy
Suite 660
Nashville, TN 37243-0565
615-741-2241
https://www.tn.gov/commerce/insurance-division.html

Texas
Department of Insurance
333 Guadalupe Street
Austin, TX 78701
512-676-6000
https://www.tdi.texas.gov

Utah
Department of Insurance
4315 S. 2700 W.
Suite 2300
Taylorsville, UT 84114-6901
801-957-9200
www.insurance.utah.gov

Vermont
Department of Insurance
89 Main Street
Montpelier, VT 05620-3101
802-828-3301
https://dfr.vermont.gov/industry/insurance

Virgin Islands
Department of Insurance
1131 King Street, Suite 101
Christiansted, St. Croix, Virgin Islands 00820
340-773-6449
https://ltg.gov.vi/departments/banking-insurance-and-financial-regulation/

Virginia
Department of Insurance
1300 E. Main Street
Tyler Building
Richmond, VA 23219
804-371-9741
www.scc.virginia.gov

Washington
Department of Insurance
Insurance Building
PO Box 40255
Olympia, WA 98504-0255
360-725-7100
www.insurance.wa.gov

West Virginia
Department of Insurance
West Virginia Lottery Building
900 Pennsylvania Avenue
Charleston, WV 25302
304-558-3386
www.wvinsurance.gov

Wisconsin
Department of Insurance
125 S Webster St.
Madison, WI 53703-3474
608-266-3585
www.oci.wi.gov

Wyoming
Department of Insurance
Herschler Building
106 E. Sixth Avenue
Cheyenne, WY 82002
307-777-7401
https://www. insurance.state.wy.us

APPENDIX B

ADDITIONAL FACTORS THAT MAY IMPACT UNDERWRITING AND WHAT YOU NEED TO KNOW

Any underwriting will include exam requirements, which will depend on the company, your age, the amount applied for, and specific medical conditions. Both medical and non-medical factors can affect an underwriter's decision. The following is a list of the most common medical and non-medical factors and information that the underwriter will usually be looking at, and a general idea of what decision to expect. Please keep in mind that this is to give you a sense of what to expect and is not a guarantee of a specific outcome. You will find that the decisions can vary from company to company.

As a reminder, and as we discussed in Question 76, a substandard table rating/flat extra is an extra premium imposed by a life insurance company based on certain health conditions and other areas such as avocation, travel, etc. These are applied against a company's standard rates rather than the preferred rates. A flat extra is a flat dollar amount of premium in addition to the initial premium amount. A table rating is an additional percentile of premium multiplied by the cost per $1,000 of coverage; each table is an additional 25% of premium. These may drop off or reduce automatically after a certain number of years. If you feel that the reason for this extra premium no longer exists, you can petition the company to have it removed (at no cost to you).

PLEASE NOTE THAT THE FOLLOWING INFORMATION IS NOT MEDICAL ADVICE NOR IS ANY OF IT GUARANTEED. IT IS SUBJECT TO CHANGE AND IS PRESENTED HERE TO GIVE YOU A GENERAL IDEA.

Avocation or Hobbies and Aviation Risk Factors—Non-medical factors, such as avocations or hobbies, can frequently affect the underwriter's decision.

The rate class will depend on a number of issues and can range from preferred to highly rated.

Alcohol—If use is socially, then it should not be a problem. If recovering, then the premium will be rated for the first few years and will be more favorable the longer the time period eventually to a possible preferred.

Aortic Valve Disorder—Very mild cases of aortic valve regurgitation are usually approved at Standard, sometimes better. More severe cases where fatigue, chest pain, atrial fibrillation, edema, enlarged heart (cardiomegaly), or heart failure is present will be rated to a decline. Case will also be table rated to a decline depending on how many valves have had to be replaced.

Asthma—Bronchial asthma: mild, lungs clear = standard with possibility of preferred; moderate, chronic with acute episodes, treated by injection or spray, slight wheezing = Standard to Table 2 range; severe episodes treated by hospitalization, chronic steroid use = Table 2 to Table 6 range.

Atrial Fibrillation—Approval depends on the severity of the arrhythmia, what treatment has been utilized, if another cardiac condition is present, and how many episodes client has had. Many underwriters will issue credits for a recent, well done stress and/or echo or a cardiac catheterization, which is normal. A history of heart attack, angioplasty, or bypass surgery combined with an arrhythmia usually results in a decline from the carrier. Simple arrhythmias can be Standard. Others are usually Table 2 and up depending on the findings of the cardiac work-up and period of stability.

Bladder Cancer—The underwriting offer will depend on the grade and invasiveness of the tumor. Low grade tumors that did not invade beyond the mucosa can usually be approved at Standard. More invasive, severe tumors may have a postponement period of 1–5 years with a flat extra then added on.

Breast Cancer—The offer depends on tumor size, invasiveness, and stage. Most breast cancers carry a 1–5 year postponement depending on the factors listed above. Afterward a flat extra is added along with a possible table rating for more severe cancers. Depending on the type and severity of the cancer, the flat extra/rating can be lifted after 5–10 disease-free years.

Bundle Branch Block (BBB)—A left BBB is a medium rating at minimum. Right BBB without any complications is usually Standard. Approval will

depend on the severity of the BBB, age at diagnosis, and any related complications or diseases.

Cancer—Many cancers can be Standard after a 5 to 7 year period from the date of the last treatment. Prior to that, expect flat extra ratings of anywhere from $5.00 to $15.00 per thousand.

Cardiac Catheterization—Underwriting offer depends on the severity of the disease in conjunction with family history and/or any contributing factors (hypertension, diabetes, obesity, etc). Mild disease under good control can be Standard. Moderate to severe disease can be anywhere from a low rating to decline depending on control, compliance, and contributing factors.

Cholesterol Levels—Carriers usually put the most emphasis on HDL ratio, but they also factor in total cholesterol. If both of these are within normal limits (ratio of 5.0–5.5 or below and total of 200–220 or below for most companies), carrier will offer their best rates if all other criteria are met. As both of these numbers increase, the offer will be closer to Standard. Most carriers will apply table ratings to total cholesterol that exceeds 300 and a ratio that exceeds 10.0.

Chronic Bronchitis—Mild disease with minimal reduction in lung function can be Standard. Others will be moderate substandard rating up to decline for severe diseases.

Chronic Lymphocytic Leukemia—The offer will depend on the age of onset and the number of symptoms you experience. If leukemia was acquired before the age of 50, white blood count is under relative control, and no anemia or enlargement of the organs is present, the best offer will be a mid-range rating. Persons diagnosed at an earlier age or with a more progressive form of the disease can expect a very high rating to decline.

Colorectal Cancer—The offer will depend on how invasive the tumor is and the Duke's score. Depending on these two factors, there will be a postponement period of 1–5 years depending on severity, then a flat extra. Standard is available after a certain period (anywhere from 3–10 years) again, depending on severity of tumor.

Coronary Artery Bypass Graft (CABG)—Applicants are typically insurable 6 months after a bypass. May be insurable after 3 months with negative stress

test performed after the bypass. Most often will receive a mid to low table rating 3–6 months after the procedure.

Coronary Artery Disease—There are many factors to consider when underwriting CAD, including age, smoking status, cholesterol, LV function and ejection fraction (both of which can be found on the stress test), whether or not you had a heart attack, if an angioplasty or bypass graft(s) was done, and any information from your physician(s) regarding current cardiac condition. Because so many factors are involved, it is probably best to consult with a life insurance advisor so they can contact an underwriter with case specifics in order to obtain a tentative quote. However, good cases are generally in the table 2–4 range. Best cases can be Standard after 10 years.

Crohn's Disease—Crohn's Disease in the most mildest of cases, last attack over 5 years ago, duration less than 2 weeks, and no maintenance medications could possibly be Standard. Most common underwriting for Crohn's Disease is a low table rating. Very severe Crohn's Disease, frequent attacks, need corticosteroids for maintenance and will most probably be a decline.

Depression—Some situational depression = Preferred. Mild and controlled with medications = Standard to low table rating. Manic depression and/or bipolar = mid-table rating and up, and suicidal thoughts and attempts = postpone for 2 years.

Diabetes—The rating for DM depends upon the age at onset and the duration of the disease. Good control and not requiring insulin will reduce the rating. Sometimes an offer to Standard can be obtained if the DM is well controlled for at least 1 year and current blood sugar is within normal limits. Will not do better than Standard. Insulin using diabetics are usually a low table rating at the very best. Evidence of neurological, kidney, or vision problems will add greatly to any rating. Coronary artery disease with diabetics is a very poor risk.

Driving Under the Influence—DUI may be standard after 3 years. Sometimes a single episode violation can be Standard sooner. This will require adequate explanation. Multiple DUIs are usually a decline.

Drugs—Marijuana use is a possible smoker. Drug abuse: postpone for 2 years; 2–4 years = high table rating; 4–6 years = low to mid table rating; 6+

years = Standard; and some carriers will go preferred with 10+ years out of rehabilitation.

Emphysema—If still smoking, high substandard to a decline. Mild emphysema may be standard if diagnosed early and lung function is close to normal. Others will be moderate to high table rating.

Hepatitis A, B, C—Approval depends on type of hepatitis (A, B, C, alcoholic, etc.), if it is chronic or acute, the cause of the hepatitis (virus, parasite, etc.), the results of current tests and labs, age and treatment. If the case is mild, in remission and all lab results are normal, Standard is usually available. More severe cases that are chronic with elevated labs and current flare up are table rated. If you are currently drinking alcohol, the case is usually a decline.

Hypertension (High Blood Pressure)—Well-controlled hypertension can expect a possible preferred rating with some of the carriers. Uncontrolled hypertension will require several table ratings added to a standard rate, depending on the blood pressure readings.

Irregular Heart Beat—Approval depends on the severity of the arrhythmia, what treatment has been utilized, if another cardiac condition is present, and how many episodes client has had. Many underwriters will issue credits for a recent, well done stress and/or echo or a cardiac catheterization, which is normal. A history of heart attack, angioplasty, or bypass surgery combined with an arrhythmia usually results in a decline from the carrier. Simple arrhythmias can be Standard. Others are usually a low table rating and up depending on the findings of the cardiac work-up and period of stability.

Mitral Valve Prolapse—MVP is probably the most common of the heart valve lesions. Many individuals with MVP are asymptomatic. Usually an individual with a negative echo and no complications or family history of heart disease can get Standard. Some carriers will even go Preferred with an especially good history.

Multiple Sclerosis—Assuming diagnosis has been made—typically postponed within 1st year of diagnosis. Age 35 and over at onset—slowly progressive with infrequent episodes = mid-table rating. More progressive disease with frequent episodes (more than 2 per year) = high table rating. Rapidly progressive disease = decline.

Myocardial Infarction (Heart Attack)—Most carriers will wait 3-6 months after the incident before making an offer. The extent of table ratings and/or flat extras depends on the severity of the MI, your age at the time of underwriting, your current smoking status, and the results of recent cardiac tests. The best way to gauge how you will be underwritten is to consult your life insurance advisor with the specific details so that they can discuss it with an underwriter.

Ovarian Cancer—The offer will depend on the stage of the tumor and how far the cancer spread. Most ovarian cancers will have a 1–5 year postponement period followed by a flat extra of anywhere from $7 to $15 per thousand for 5 or more years.

Pacemaker—Approval is dependent primarily on the underlying impairment that precipitated the pacemaker installation. In other words, you are usually not rated solely on the fact that the pacemaker was installed, but rather based on the disease or event that caused the pacemaker to be needed. Most pacemaker cases will be rated following a rather lengthy postponement period to determine stability. It is probably best to discuss the specific details of the case with your life insurance advisor so they can discuss it with an underwriter.

Parkinson's Disease—Those Parkinson's disease individuals who have later onset disease without the problems of depression or dementia can usually be offered policies at very mild ratings, such as low table ratings. Disease more severe than mild will be in the mid-table ratings.

Percutaneous Translumitnal Angioplasty (PTCA)—The best-case scenario is a low table rating with select cases becoming standard after 10 years.

Pneumonia—Preferred is possible with a single episode completely healed. Multiple episodes usually indicate an underlying disorder and the rating will be for the underlying disease.

Prostate Cancer—Offer depends on the age at diagnosis, Gleason score, method of treatment, and pre-operative PSA level. If client had a radical prostatectomy or radiation treatment, case will be postponed for 3-6 months. If you are younger than age 50, your case will be postponed at least 5 years. After the postponement period, the case will be approved with a table rating that usually remains for the life of the policy.

Prostate Specific Antigen (PSA)—A PSA of approximately 0-4 is normal for males to age 60. After age 60 the normal PSA may increase to 4.5-6.5. "Free PSA" should be above 20%. If the elevated PSA is a new finding on the carrier's lab tests, carrier will usually postpone the case until you have gone to your doctor for a work up. Some carriers may offer a table rating depending on the degree of elevation. If you have a history of elevated PSA due to enlarged prostate or infection, the carrier will usually not rate the file (can get Standard or Preferred) as long as you have recently had follow up with your doctor and cancer has been ruled out.

Proteinuria—The offer will depend on the type of proteinuria. Transient and orthostatic proteinuria is of no medical concern and carries no extra rating. You can usually be approved at what he otherwise qualifies for medically. Proteinuria related to diabetes, hypertension, or other known kidney disorders can be Standard to table rated depending on your age (older people—above 50—normally have a larger amount of protein in their urine) and the amount of protein found in the specimen. However, even a small amount of protein with diabetes is not a good sign and can cause a case to be highly rated or even declined.

Pulmonary Disease (COPD)—COPD is usually underwritten based on several factors, including the results of pulmonary function tests, frequency of attacks, frequency of hospitalization, and current smoking history. A mild case of COPD with little obstruction and few attacks may be Standard to a low table rating depending on whether or not you are a smoker. Moderate to severe cases of COPD are usually in the middle table rating to decline range, again depending on whether or not you currently smoke.

Pulmonary Function Testing (PFT)—Entirely dependent on the results of the test. When there is a history of pulmonary disease, normal PFTs can result in a standard rating.

Renal (Kidney) Disease—Anywhere from standard on up to decline. Much will depend on the kidney's ability to act as a filter and this will be assessed by the BUN and creatinine levels. If these are normal and stable then standard is possible.

Rheumatoid Arthritis—If uncomplicated, most of these cases will be Standard and mild cases even Preferred. If any of the stronger medicines are

required for control, i.e. gold salts, prednisone, or methotrexate, then the case may be rated slightly.

Sarcoidosis—After complete recovery, Standard is not usual. Prior to that, table ratings or flat extra ratings may be applied. A low to midrange table rating may be appropriate for disease that is stable but not yet resolved.

Skin Cancer—The offer depends on the type of skin cancer, invasiveness, tumor size and stage. Basal cell carcinoma is the least serious type of skin cancer and many carriers will offer Preferred if you are medically healthy otherwise. Skin cancers confined to the dermis or outer layers of skin and removed completely can usually be approved at Standard. Persons with the most severe forms of skin cancer will be postponed from 1-5 years, and then a flat extra will be added.

Sleep Apnea—If the apnea is mild, it can usually be treated with lifestyle change and may resolve itself. Most carriers will offer Standard in these cases. More serious apneas may require a CPAP (Continuous Positive Airway Pressure) machine or even surgery. More severe cases will be table rated and non compliance with treatment will usually result in a declination.

Systemic Lupus Erthematosas (SLE)—If Lupus involves the skin only then standard may be expected. Lupus that involves the kidneys, heart, or lungs is often highly rated to decline.

Testicular Cancer—The offer will depend on how invasive the tumor is as well as the stage and type. A non-invasive tumor (Stage 0), can often be considered at Standard. For more severe tumors, there could be a postponement period of 1-5 years followed by a flat extra. However, testicular cancer responds very well to current treatment and many testicular cancers, even those that are metastic, can be approved Standard in a relatively short period of time.

Tobacco Usage—Underwriting approvals vary widely from carrier to carrier. Some carriers will accept occasional cigar smokers (usually < or = 12/year) as a nonsmoker. Others consider any tobacco use as "smoker" class. Some have separate classifications for "smoker" and "tobacco." However, most carriers will consider an applicant with greater than .5 nicotine in the urine as a smoker. A value of .5 or less nicotine in the urine is usually considered as "second-hand smoke," and many applicants, if they do not admit to any tobacco use on the application, will be considered nonsmokers with this

value (please see Question 79 for information on how this can void a life insurance policy). The best way to gauge how you will be underwritten is to consult your advisor with the specific smoking details. The rates for smokers are significantly higher than those for non-smokers.

Transient Ischemic Attack (TIA)—Underwriting offer will depend on age at time of attack and number of attacks. Over age 40, will be a postpone until 3 months after last attack. After the postponement, file will be approved with a low table rating. Possible Standard after 5 or more years without any further episodes. Some TIA cases will fit into a special table low-middle table range to Standard underwriting programs. Please check with your advisor for details.

Ulcerative Colitis—Mild Ulcerative Colitis—less than 1 attack per year, no maintenance medications, or have been surgically corrected can possibly be Standard. Generally, ulcerative colitis is underwritten with low to mid-range tables added to a Standard rate. Severe ulcerative colitis will be declined until surgically corrected.

Valvular Heart Surgery—Most cases will be postponed for 6 months after valve surgery. After this time the approval usually depends on how many valves have been replaced and the current assessment of the valve disorder. Mild cases with one valve replaced are about a low to middle table rating. More severe cases with up to three valves replaced are very highly rated to a decline.

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GLOSSARY

KEY LIFE INSURANCE TERMS

Absolute Assignment: The irrevocable transfer of all the policy owner's rights in a life insurance policy.

Accelerated Death Benefit Rider: Rider that allows payment of a portion of the face amount prior to the death of the insured, if the insured is diagnosed with a terminal illness or injury.

Acceptance: Assent by an offeree to the terms of an offer.

Accident: An event or occurrence that is unforeseen and unintended.

Accident and Health Insurance: A type of coverage that pays benefits, sometimes including reimbursement for loss of income, in case of sickness, accidental injury, or accidental death.

Accidental Death Benefit: A feature of a life insurance policy providing an additional benefit if the insured dies in an accident. Because the face amount of the policy is often doubled under this provision, it is also called a double indemnity.

Acquisition Costs: The insurer's cost of putting new business in-force, including the agent's commission, the cost of clerical work, fees for medical examinations and inspection reports, sales promotion expense, etc.

Actual Authority: The authority to act on the principal's behalf that an agent reasonably believes he or she has been given by the principal. Actual authority can be express or implied.

Actuarially Fair: The price for insurance that exactly represents the expected losses.

Actuary: Mathematician employed by an insurance company to calculate premiums, reserves, dividends, and insurance, pension, and annuity rates, using risk factors obtained from experience tables. These tables are based on both the company's history of insurance claims and other industry and general statistical data.

Additional Insured: An assured party specifically named under an insurance policy

Adhesion, Contract of: A contract that is drafted by one party and accepted or rejected by the other, with no opportunity to bargain with respect to its terms.

Adjustable Life Insurance: A type of insurance that allows the policyholder to change the plan of insurance, raise or lower the face amount of the policy, increase or decrease the premium, and lengthen or shorten the protection period.

Adjusted Gross Estate: Approximately the net worth of the deceased—the beginning point for the computation of estate taxes.

Adjuster: A person who investigates and settles losses for an insurance carrier.

Adjusting: The process of investigating and settling losses with or by an insurance carrier.

Adjustment Bureau: Organization for adjusting insurance claims that is supported by insurers using the bureau's services.

Adverse Selection: The tendency of persons who present a poorer-than-average risk to apply for, or continue, insurance to a greater extent than do persons with average or better-than-average expectations of loss.

Admitted Assets: Assets allowed by state regulatory authorities and by the National Association of Insurance Commissioner for statutory accounting statements. Only the value of the admitted assets may be shown on the statutory balance sheet. (See also Non-admitted Assets).

Age Last: Age based on the individual's current age or their age on their last birthday.

Age Limits: Stipulated minimum and maximum ages below and above which the company will not accept applications or may not renew policies.

Age Nearest: Age based on the individuals nearest birthday. If the individual is more than 6 months or 182 days into their birthday year, the birthday would be treated as if it had already occurred that year (also referred to as Insurance Age).

Agent: An insurance company representative licensed by the state, who solicits, negotiates, or effects contracts of insurance, and provides service to the policyholder for the insurer.

Alien Insurer: An insurance company domiciled in another country.

Amendment: A formal document changing the provisions of an insurance policy signed jointly by the insurance company officer and the policyholder or his authorized representative.

Annual Statement: The annual report, as of December 31, of an insurer to a state insurance department, showing assets and liabilities, receipts and disbursements, and other financial data.

Anti-selection: The tendency of persons who present a poorer-than average risk to apply for, or continue, insurance to a greater extent than do persons with average or better-than-average expectations of loss.

Apparent Authority: Agency authority a person has because a principal has created the appearance of authority to a third person.

Application: A signed statement of facts made by a person applying for life insurance and then used by the insurance company to decide whether or not to issue a policy. The application becomes part of the insurance contract when the policy is issued.

Assets: All funds, property, goods, securities, rights of action, or resources of any kind owned by an insurance company. Statutory accounting, however, excludes non-admitted assets, such as deferred or overdue premiums, that would be considered assets under generally accepted accounting principles (GAAP).

Assignment: The passing of beneficial rights from one party to another. A policy or certificate of insurance cannot be assigned after interest has passed unless an agreement to assign was made or implied prior to the passing of interest. An assignee acquires no greater rights than were held by the assignor, and a breach of good faith by the assignor is deemed to be breach on the part of the assignee.

Assumption Certificate: An endorsement to an insurance contract stating that reinsurance proceeds will be paid directly to the named payee in the event of an insurer's insolvency.

Assumption of Risk Doctrine: Defense against a negligence claim that bars recovery for damages if a person understands and recognizes the danger inherent in a particular activity or occupation.

Attained Age: The age of the insured at the time of renewal (current age).

Automatic Premium Loan: Cash borrowed from a life insurance policy's cash value to pay an overdue premium after the grace period for paying the premium has expired.

Automatic Reinsurance: An agreement that the insurer must cede and the reinsurer must accept all risks within certain explicitly defined limits. The reinsurer undertakes in advance to grant reinsurance to the extent specified in the agreement in every case where the ceding company accepts the application and retains its own limit.

Bad Faith: The allegation that insurers have failed to act in good faith, i.e., that they have acted in a manner inconsistent with what a reasonable policyholder would have expected.

Basis: An amount attributed to an asset for income tax purposes; used to determine gain or loss on sale or transfer; used to determine the value of a gift.

Beneficiary: The person named in the policy to receive the insurance proceeds at the death of the insured. A secondary or contingent beneficiary will receive the proceeds if the primary beneficiary cannot collect.

Benefits: The amount payable by the insurance company to a claimant, assignee, or beneficiary under each coverage.

Binder: A written or oral contract issued temporarily to place insurance in-force when it is not possible to issue a new policy or endorse the existing policy immediately. A binder is subject to the premium and all the terms of the policy to be issued.

Binding Receipt: A receipt given for a premium payment accompanying the application for insurance. If the policy is approved, this binds the company to make the policy effective from the date of the receipt.

Branch Office System: Type of life insurance marketing system under which branch offices are established in various areas. Salaried branch managers, who are employees of the company, are responsible for hiring and training new agents.

Breach of Contract: The failure of a party to perform a promise according to its terms, without a legal excuse.

Business Insurance: A policy that primarily provides coverage of benefits to a business as contrasted to an individual. It is issued to indemnify a business for the loss of services of a key employee or a partner who becomes disabled.

Business Life Insurance: Life insurance purchased by a business enterprise on the life of a member of the firm. It is often bought by partnerships to protect the surviving partners against loss caused by the death of a partner, or by a corporation to reimburse it for loss caused by the death of a key employee.

Buy-Sell Agreement: An agreement made by the owners of a business to purchase the share of a disabled or deceased owner. The value of each owner's share of the business and the exact terms of the buying-and-selling process are established before death or the beginning of disability.

Cancellation: The discontinuance of an insurance policy before its normal expiration date, either by the insured or the company.

Capacity: The amount of capital available to an insurance company or to the industry as a whole for underwriting general insurance coverage or coverage for specific perils.

Capital Retention Approach: A method used to estimate the amount of life insurance to own. Under this method, the insurance proceeds are retained and are not liquidated.

Capital Stock and Surplus: Represents the excess of a company's assets over its liabilities as reported in its financial statements. Stock companies have capital stock and surplus. Capital stock represents funds paid into the company by stockholders. Surplus represents the remaining excess of assets over liabilities. Mutual companies only have surplus since there are no stockholders in a mutual company.

Captive Agent: Representative of a single insurer or fleet of insurers who is obliged to submit business only to that company, or at the very minimum, give that company first refusal rights on a sale. In exchange, that insurer usually provides its captive agents with an allowance for office expenses as well as an extensive range of employee benefits, such as pensions, life insurance, health insurance, and credit unions.

Cash Surrender Value: The amount payable if a life insurance policy is canceled by the insured before it either matures or is payable on death.

Cede: To transfer risk from a direct insurer to his reinsurer.

Ceding Insurer: One who cedes a risk to his reinsurers or retrocessionaires.

Cession: Amount of the insurance ceded to a reinsurer by the original insuring company in a reinsurance operation.

Chartered Life Underwriter (CLU): An individual who has attained a high degree of technical competency in the fields of life and health insurance and who is expected to abide by a code of ethics. Must have minimum of three years of experience in life or health insurance sales and have passed ten professional examinations administered by The American College.

Child Rider: Rider that provides insurance to the insured's child(ren).

Claim: A request for payment of a loss, which may come under the terms of an insurance contract.

Claimant: The first or third party. That is any person who asserts right of recovery.

CLU: See Chartered Life Underwriter.

Collateral Assignment: A temporary transfer of some, but not all, policy rights to a lender to provide security for a loan.

Combined Ratio: Basically, a measure of the relationship between dollars spent for claims and expenses and premium dollars taken in; more specifically, the sum of the ratio of losses incurred to premiums earned and the ratio of commissions and expenses incurred to premiums written. A ratio above 100 means that for every premium dollar taken in, more than a dollar went for losses, expenses, and commissions.

Commission: The part of an insurance premium paid by the insurer to an agent or broker for his services in procuring and servicing the insurance.

Commissioner: A state officer who administers the state's insurance laws and regulations. In some states, this regulator is called the director or superintendent of insurance.

Concealment: Deliberate failure of an applicant for insurance to reveal a material fact to the insurer.

Conditional Receipt: A receipt given for premium payments accompanying an application for insurance. If the application is approved as applied for, the coverage is effective as of the date of the prepayment or the date on which the last of the underwriting requirements, such as a medical examination, has been fulfilled.

Conservation: The attempt by the insurer to prevent the lapse of a policy.

Consideration: One of the elements for a binding contract. Consideration is acceptance by the insurance company of the payment of the premium and the statement made by the prospective policyholder in the application.

Contest, Policy: A court action challenging the validity of a policy.

Contingent Owner: The person to succeed as owner of a life insurance policy if the original owner dies.

Contract: A binding agreement between two or more parties for the doing or not doing of certain things. A contract of insurance is embodied in a written document called the policy.

Contract Law: The portion of civil law that interprets written agreements between parties and resolves disputes between them.

Contribution Principle: The principle under which divisible surplus is distributed among policies in the same proportion as the policies are considered to have contributed to that surplus.

Conversion Privilege: A privilege granted in an insurance policy to convert to a different plan of insurance without providing evidence of insurability.

Convertible Term Insurance: Term insurance that can be exchanged, at the option of the policyholder and without evidence of insurability, for another plan of insurance. Credit life insurance is term life insurance issued through a lender or lending agency to cover payment of a loan, installment purchase, or other obligation, in case of death.

Cost Basis: An amount attributed to an asset for income tax purposes; used to determine gain or loss on a life insurance contract to determine the value of a gift.

Cost-of-Living Rider: Benefit that can be added to a life insurance policy under which the policy owner can purchase one-year term insurance equal to the percentage change in the consumer price index with no evidence of insurability.

Cost of Pure Risk: All costs related to pure risk, which includes, from the perspective of shareholders, retained risk, loss prevention costs, insurance costs, and more.

Coverage: The scope of protection provided under a contract of insurance; any of several risks covered by a policy.

Cross Liability Clause: Obligates an insurer to protect each insured separately.

Cross Purchase Agreement: Specifies the terms for the surviving partners or shareholders to buy a deceased's share of the business's ownership.

CSR: Customer service representatives support the work of insurance agents with a variety of tasks that must be done within a company or agency to deliver services to and handle requests from clients.

Cumulative Premium: The total amount paid over the course of a specified amount of years.

Current Assumption Whole Life Insurance: Nonparticipating whole life policy in which the cash values are based on the insurer's current mortality, investment, and expense experience. An accumulation account is credited with a current interest rate that changes over time. Also called interest-sensitive whole life insurance.

Current with Re-entry Premiums: Applicable to certain term life insurance policies; non-guaranteed premiums at the time of re-entry.

Death Benefit: A payment made to a designated beneficiary upon the death of the employee annuitant.

Declarations: Statements in an insurance contract that provide information about the property or life to be insured and used for underwriting and rating purposes and identification of the property or life to be insured.

Declination: The insurer's refusal to insure an individual after careful evaluation of the application for insurance and any other pertinent factors.

Deferred Compensation: Arrangements by which compensation to employees for past or current services is postponed until some future date.

Demutualization: The process of changing the legal structure of an insurance company from a mutual form of ownership to a stock form of ownership.

Deposit Premium: The premium deposit paid by a prospective policy holder when an application is made for an insurance policy. It is usually equal, at least, to the first month's estimate premium and is applied toward the actual premium when billed.

Deposit Term Insurance: A form of term insurance, not really involving a "deposit," in which the first-year premium is larger than subsequent premiums. Typically, a partial endowment is paid at the end of the term period. In many cases the partial endowment can be applied toward the purchase of a new term policy, or, perhaps, a whole life policy.

Direct Recognition: A procedure under a policy's dividends that directly reflects earnings on borrowed and non-borrowed values of that policy.

Direct Response System: A marketing method where insurance is sold without the services of an agent. Potential customers are solicited by advertising in the mail, newspapers, magazines, television, radio, and other media.

Direct Writer: Method of selling insurance directly to insureds through a company's own employees, through the mail, the Internet, or at airport booths.

Disability: A physical or a mental impairment that substantially limits one or more major life activities of an individual. It may be partial or total. (See Partial Disability; Total Disability.)

Disability Benefit: A feature added to some life insurance policies providing for waiver of premium, and sometimes payment of monthly income, if the policy holder becomes totally and permanently disabled.

Disclosure: The duty of the insured and his broker to tell the underwriter every material fact before acceptance of the risk.

Dismemberment: Loss of body members (limbs), or use thereof, or loss of sight due to injury.

Dividend: A policyholder's share in the insurer's divisible surplus fund apportioned for distribution, which may take the form of a refund of part of the premium on a participating policy.

Dividend Addition: An amount of paid-up insurance purchased with a policy dividend and added to the face amount of the policy.

Divisible Surplus: Represents that portion of a company's earnings for the year that have been designated for distribution as dividends to policy owners.

Doctrine of Reasonable Expectations: A legal doctrine that holds policies will be interpreted according to how a reasonable person who is not trained in the law would expect.

Domestic Insurer: An insurance company is a domestic company in the state in which it is incorporated.

Donor: The person making a gift.

Double Indemnity: A policy provision usually associated with death, which doubles payment of a designated benefit when certain kinds of accidents occur.

Earned Premium: That portion of a policy's premium payment for which the protection of the policy has already been given. For example, an insurance company is considered to have earned 75% of an annual premium after a period of nine months of an annual term has elapsed.

Economic Policy: Special type of participating whole life insurance in which the dividends are used to buy term insurance or paid-up additions equal to the difference between the face amount of the policy and some guaranteed amount.

Effective Date: The date on which the insurance under a policy begins.

Embedded Value: the sum of these two elements: (1) shareholders' equity considering the assets at market value and (2) in-force life insurance business valued at the present value of future after-tax statutory profits.

Endorsement: An additional piece of paper, not a part of the original contract, which cites certain terms and which, when attached to the original contract, becomes a legal part of that contract.

Endowment: Life insurance payable to the policyholder if living, on the maturity date stated in the policy, or to a beneficiary if the insured dies prior to that date.

Entire Contract Clause: Provision in life insurance policies stating that the life insurance policy and attached application constitute the entire contract between the parties.

Entity Purchase Agreement: Specifies the terms for the business to buy back a deceased's share of the business's ownership.

Equity in the Unearned Premium Reserve: Amount by which an unearned premium reserve is overstated because it is established on the basis of gross premium rather than net premium.

Estate: The assets and liabilities of a person left at death.

Estate Planning: Developing a plan to transfer all of your property from one generation to the next or within a generation.

Evidence of Insurability: Any statement of proof of a person's physical condition and/or other factual information affecting his/her acceptance for insurance.

Exclusive Agent: An agent who is employed by one and only one insurance company and who solicits business exclusively for that company.

Expense Loading: See Loading.

Expense Ratio: The ratio of a company's operating expenses to premiums.

Exposure Unit: Unit of measurement used in insurance pricing.

Extended Term Insurance: A form of insurance available as a non-forfeiture option. It provides the original amount of insurance for a limited period of time.

Face Amount: The amount stated on the policy that will be paid at death or maturity. It does not include additional amounts payable under accidental death or other special provisions, or acquired through the use of policy dividends.

Fair Premium: The premium level that is just sufficient to fund an insurer's expected costs and provide insurance company owners with a fair return on their invested capital.

Family Income Policy: Special life insurance policy combining decreasing term and whole life insurance that pays a monthly income of $10 for each $1000 of life insurance if the insured dies within the specified period. The monthly income is paid to the end of the period, at which time the face amount of insurance is paid.

Family Policy: A life insurance policy providing insurance on all or several family members in one contract, generally whole life insurance on the principal breadwinner and small amounts of term insurance on the other spouse and children, including those born after the policy is issued.

Fiduciary: A person who holds something in trust for another.

Fixed Amount Option: Life insurance settlement option in which the policy proceeds are paid out in fixed amounts.

Fixed Expenses: Fixed expenses are those not directly related to a policy (a premium tax, for example is a direct expense, as is the payment of a commission associated with the sale of a policy). Includes: advertising, accounting, planning, rent, computer facilities, etc. These expenses must be allocated to each "block" of policies sold and the distribution is discretionary and can be critical. Some insurers assume too many (or too few) policies will be sold, thereby reducing (or increasing) the fixed expense factor assumed in the pricing of the policy. This may lead to lower credits or increased policy charges.

Fixed Period Option: Life insurance settlement option in which the policy proceeds are paid out in fixed amounts.

Flexible Premium Policy or Annuity: A life accident policy or annuity under which the policyholder or contract holder may vary the amounts or timing of premium payments.

Flexible Premium Variable Life Insurance: A life insurance policy that combines the premium flexibility feature of universal life insurance with the equity-based benefit feature of variable life insurance.

Foreign Insurer: An insurer is a foreign company in any state other than the one in which it is incorporated.

Fortuitous Loss: Unforeseen and unexpected loss that occurs as a result of chance.

Franchise Insurance: Insurance under individual contracts issued to the employees of a common employer or the members of an association under an arrangement by which the employer or association agrees to collect the premiums and remit them to the insurer. The insurer usually agrees to waive its right to discontinue or modify any individual policy, unless it simultaneously discontinues or modifies all other policies in the same group.

Fraternal Life Insurance: Life insurance provided by fraternal orders or societies to their members.

Fraternal Society: A social organization that provides insurance for its members.

Free-Look Period: Time during which the policyholder may return the policy if he/she is not completely satisfied and receive a complete refund. The customary length of time for a "free look" is 30 days.

Fronting Company: A domestic insurance company that provides claims or administrative services to a captive.

Future Increase Option: A provision found in some policies that allows the insured to purchase additional disability income insurance at specified future dates regardless of the insured's physical condition.

General Agency System: Type of life insurance marketing system in which the general agent is an independent businessperson who represents only one insurer, is in charge of a territory, and is responsible for hiring, training, and motivating new agents.

Generation Skipping Tax: A transfer tax imposed on gift or inheritance to those at least two generations younger than the person making the transfer.

Gift: A voluntary transfer of property to another person, made without receiving consideration in return.

Grace Period: A period of time after a premium due date, usually 30 or 31 days, during which an insurance policy remains in-force and the overdue premium may be paid without penalty.

Gross Premium: The full amount of premium, ignoring taxes or deductions.

Graded Commission Scale: A commission scale providing for payment of a high first-year commission and lower renewal commissions.

Gross Estate: All of the assets and liabilities owned at death.

Guaranteed Insurability: An option that permits the policyholder to buy additional stated amounts of life insurance at stated times in the future without evidence of insurability.

Gross Rate: The sum of the pure premium and a loading element.

Group Contract: A contract of insurance made with an employer or other entity that covers a group of persons identified as individuals by reference to their relationship to the entity.

Group Creditor Life Insurance: Life insurance provided to debtors by a lending institution to provide for the cancellation of any outstanding debt should the borrower die. Normally term insurance limited to the amount of the loan.

Group Life Insurance: Life insurance usually without medical examination, on a group of people under a master policy. It is typically issued to an employer for the benefit of employees or to members of an association, for example a professional membership group. The individual members of the group hold certificates as evidence of their insurance.

Group Ordinary Life Insurance: Group insurance plan providing life insurance for employees. Traditional whole life policy is split into decreasing insurance protection and increasing cash values.

Group Paid-Up Life Insurance: Accumulating units of single premium whole life insurance and decreasing term insurance, which together equal the face amount of the policy. Provided through a group life insurance plan.

Group Permanent Plan: Type of pension plan in which cash value life insurance is issued on a group basis and cash values in each policy are used to pay retirement benefits when a worker retires.

Group Term Life Insurance: Most common form of group life insurance. Yearly renewable term insurance on employees during their working careers.

Group Universal Life Products (GULP): Universal life insurance plans sold to members of a group, such as individual employees of an employer. There are some differences between GULP plans and individual universal life plans; for instance, GULP expense charges generally are lower than those assessed against individual policies.

Guaranteed Insurability Option: See Future Increase Option.

Guaranteed Investment Contract (GIC): An investment contract with an insurer in which the insurer guarantees both principal and interest on a pension contribution.

Guaranteed Premiums: The guaranteed maximum payment for the purchased policy.

Guaranteed Purchase Option: Benefit that can be added to a life insurance policy permitting the insured to purchase additional amounts of life insurance at specified times in the future without requiring evidence of insurability.

Guaranteed Renewable Contract: A contract that the insured person or entity has the right to continue in-force by the timely payment of premiums for a substantial period of time, during which period the insurer has no right to make unilaterally any change in any provision of the contract, while the contract is in-force, other than a change in the premium rate for classes of policyholders.

Guaranty Fund: A fund, derived from assessments against solvent insurance companies, to absorb losses of claimants against insolvent insurance companies.

Home Service Life Insurance: Industrial life insurance and monthly debit ordinary life insurance contracts that are serviced by agents who call on the policy owners at their homes to collect the premiums. The amount of life insurance per policy generally is larger than $1000.

Human Life Value: For purposes of life insurance, the present value of the family's share of the deceased breadwinner's future earnings.

Incontestability: Life policies provide that, except for non-payment of premiums and certain other circumstances, the policy shall be incontestable after the policy has been in-force for two years during the lifetime of the insured.

Incontestable Clause: A policy provision in which the company agrees not to contest the validity of the contract after it has been in-force for a certain period of time, usually two years.

Incurred Claims: Incurred claims equal the claims paid during the policy year plus the claim reserves as of the end of the policy year, minus the corresponding reserves as of the beginning of the policy year. The difference between the year end and beginning of the year claim reserves is called the increase in reserves and may be added directly to the paid claims to produce the incurred claims.

Incurred-but-not-reported (IBNR) Reserves: Liability account on an insurer's balance sheet reflecting claims that are expected based upon statistical projections but which have not yet been reported to the insurer.

Indemnification: Compensation to the victim of a loss, in whole or in part, by payment, repair, or replacement.

Indemnity: Indemnity is the legal principle that ensures that a policyholder is restored to the same financial position after the loss as he was in immediately prior to the loss.

Independent Agent: An independent businessperson who usually represents two or more insurance companies in a sales and service capacity and who is paid on a commission basis.

Independent Agency System: Type of property and liability insurance marketing system, sometimes called the American agency system, in which the agent is an independent businessperson representing several companies. The agency owns the expirations or renewal rights to the business, and the agent is compensated by commissions that vary by line of insurance.

Indeterminate Premium Whole Life Insurance: Nonparticipating whole life policy that permits the insurer to adjust premiums based on anticipated future experience. Initial premiums are guaranteed for a certain period. After the initial guaranteed period expires, the insurer can increase premiums up to some maximum limit.

Indexing: Adjusting of values over time to reflect the impact of inflation.

Individual Contract: A contract of health insurance made with an individual called the policyholder or the insured, which normally covers such individual and, in certain instances, members of his family.

Individual Insurance: Policies that provide protection to the policyholder and/or his/her family. Sometimes called Personal Insurance as distinct from group and blanket insurance.

Industrial Life Insurance: Life insurance issued in small amounts, usually less than $1,000, with premiums payable on a weekly or monthly basis. The

premiums are generally collected at the home by an agent of the company. Sometimes referred to as debit insurance.

Inheritance Tax: A tax on the right of an heir to receive property at the death of another.

Initial Reserve: In life insurance, the reserve at the beginning of any policy year.

Insolvent: Having insufficient financial resources (assets) to meet financial obligations (liabilities).

Inspection Report: A report (usually written) of an investigation of an applicant, conducted by an independent agency that specializes in insurance investigations. The report covers such matters as occupation, financial status, health history, and moral problems.

Insurability: Acceptability to the company of an applicant for insurance.

Insurable Interest: The insured's financial interest in the subject matter of the insurance. A policy where the insured is without such interest is unenforceable.

Insurable Risk: The conditions that make a risk insurable are (a) the peril insured against must produce a definite loss not under the control of the insured, (b) there must be a large number of homogeneous exposures subject to the same perils, (c) the loss must be calculable and the cost of insuring it must be economically feasible, (d) the peril must be unlikely to affect all insureds simultaneously, and (e) the loss produced by a risk must be definite and have a potential to be financially serious.

Insurance: (1) A means whereby the losses of the few are distributed over the many. (2) A system under which individuals, businesses, and other organizations or entities, in exchange for payment of a sum of money (a premium), are guaranteed compensation for losses resulting from certain perils under specified conditions.

Insurance Age: Age based on the individual's nearest birthday. If the individual is more than 6 months or 182 days into their birthday year, the birthday would be treated as if it had already occurred that year (also referred to as Age Nearest).

Insurance Company: Any corporation primarily engaged in the business of furnishing insurance protection to the public.

Insurance Commissioner: The top insurance regulatory official in a state.

Insurance Examiner: The representative of a state insurance department assigned to participate in the official audit and examination of the affairs of an insurance company.

Insurance Guaranty Funds: State funds that provide for the payment of unpaid claims of insolvent insurers.

Insured: A person or organization covered by an insurance policy, including the "named insured" and any other parties for whom protection is provided under the policy terms.

Insurer: The party to the insurance contract who promises to pay losses or benefits. Also, any corporation engaged primarily in the business of furnishing insurance to the public.

Insuring Agreement: That part of an insurance contract that states the promises of the insurer.

Insuring Clause: The clause that sets forth the type of loss being covered by the policy and the parties to the insurance contract.

Inter Vivos Trust: A trust created while the creator of the trust is living. Also known as a living trust.

Interest: Money paid for the use of money.

Interest-Adjusted Method: Method of determining cost to an insured of a life insurance policy that considers the time cost of money by applying an interest factor to each element of cost. See also net payment cost index; surrender cost index.

Interest Crediting—New Money Method: A method under which for purposes of crediting interest under the company's dividend scale or other non-guaranteed pricing structure, the company's policies are subdivided into generations based on year(s) of issue. The crediting rate is determined sepa-

rately for each generation. Each crediting rate is based on the investment earnings of the funds underlying the particular group of policies and the reinvestment frequency.

Interest Crediting—Portfolio Method: The method under which, for purposes of crediting interest under the company's dividend scale or other nonguaranteed pricing structure, the same rate applies to all policies. The crediting rate is based on the investment earnings of all of the investments underlying the entire block of policies. The portfolio method may apply to all policy types issued by a company, or there may be separate portfolios for different policy types or years of issue.

Interest Maintenance Reserve (IMR): A statutory accounting method adopted by the National Association of Insurance Commissioners that is designed to capture all realized fixed income investment capital gains and losses resulting from the changes in the overall level of interest rates and amortize them over the remaining original investment period.

Interest Option: Life insurance settlement option in which the principal is retained by the insurer and interest is paid periodically.

Intestate: Without a will.

Investment Income: The income generated by a company's portfolio of investments (such as in bonds, stocks, or other financial ventures).

Irrevocable Beneficiary: Beneficiary designation allowing no change to be made in the beneficiary of an insurance policy without the beneficiary's consent.

Irrevocable Trust: A trust in which the creator does not reserve the right to reacquire the trust property.

Issue Age: The age of the insured at the time the policy is being issued.

Joint Tenants: A form of joint property ownership with right of survivorship, i.e., in which the survivors automatically own the share of a deceased co-owner.

Jumbo Risk: A risk involving exceptionally high benefits.

Jumping Juvenile Insurance Policy: Life insurance purchased by parents for children under a specified age. Provides permanent life insurance that increases in face value five times at age twenty-one with no increase in premium.

Key-Person Insurance: Insurance designed to protect a business firm against the loss of income resulting from the death or disability of a key employee.

Lapse: The termination or discontinuance of an insurance policy due to non-payment of a premium.

Lapsed Policy: A policy terminated for non-payment of premiums. The term is sometimes limited to a termination occurring before the policy has a cash or other surrender value.

Lapse Supported Pricing: A pricing structure that uses gains from terminated policies to support subsequent values of policies remaining in-force. If policy lapses are lower than assumed, the pricing will prove to be inadequate for the persisting policies in that block.

Law of Large Numbers: Concept that the greater the number of exposures, the more closely will actual results approach the probable results expected from an infinite number of exposures.

Legal Reserve: The minimum reserve that a company must keep to meet future claims and obligations as they are calculated under the state insurance code.

Legal Reserve Life Insurance Company: A life insurance company operating under state insurance laws specifying the minimum basis for the reserves the company must maintain on its policies.

Level Commission Scale: A commission scale providing for payment of commissions at the same rate every year the policy is in-force.

Level Premium: A premium that remains unchanged throughout the life of a policy.

Level Premium Life Insurance: Life insurance for which the premium remains the same from year to year. The premium is more than the actual cost of protection during the earlier years of the policy and less than the actual cost in the later years. The building of a reserve is a natural result of level premiums.

The overpayments in the early years, together with the interest that is earned, serve to balance out the underpayments of the later years.

Liability: Any legally enforceable obligation. Also, funds required for payment of future claims and expenses, including Asset Valuation Reserve.

Life Expectancy: The average number of years of life remaining for a group of persons of a given age according to a particular mortality table.

Life Income Option: Life insurance settlement option in which the policy proceeds are paid during the lifetime of the beneficiary. A certain number of guaranteed payments may also be payable.

Life Insurance: Insurance providing for payment of a specified amount on the insured's death, either to his or her estate or to a designated beneficiary; or in the case of an endowment policy, to the policyholder at a specified date.

Life Insurance In-force: The sum of the face amounts, plus dividend additions, of life insurance polices outstanding at a given time. Additional amounts payable under accidental death or other special provisions are not included.

Life Insurance Programming: Systematic method of determining the insured's financial goals, which are translated into specific amounts of life insurance, then periodically reviewed for possible changes.

Limited Payment Life Insurance: Whole life insurance on which premiums are payable for a specified number of years or until death if death occurs before the end of the specified period.

Liquidation: Dissolving a company by selling its assets for cash.

Living Benefits Rider: A rider that allows insureds who are terminally ill or who suffer from certain catastrophic diseases to collect part of their life insurance benefits before they die, primarily to pay for the care they require.

Living Trust: A trust created while the creator of the trust is living. Also known as an inter vivos trust.

Lloyd's of London: Insurance marketplace where brokers, representing clients with insurable risks, deal with Lloyd's underwriters, who in turn represent investors. The investors are grouped together into syndicates that provide capital to insure the risks.

Loading: The amount that must be added to the pure premium for expenses, profit, and a margin for contingencies. See Expense Loading.

Loan Value—The amount that can be borrowed at a specified rate of interest from the issuing company by the policyholder, using the value of the policy as collateral. In the event the policyholder dies with the debt partially or fully unpaid, then the amount borrowed plus any interest is deducted from the amount payable.

Loss—A claim under a policy. The financial loss caused to the insured by the happening of the event insured against.

Loss Prevention: Any measure that reduces the probability or frequency of a particular loss but does not eliminate completely all possibility of that loss.

Loss Ratio: A ratio calculated by dividing claims into premiums. It may be calculated in several different ways, using paid premiums or earned premiums, and using paid claims with or without changes in claim reserves and with or without changes in active reserves.

Loss Reserve: The amount set up as the estimated cost of a claim. See IBNR Reserve.

Loss Reserve Development: How the latest estimate of an insurance company's claim obligations compares to an earlier projection.

Lump-Sum Distribution: Payment within one taxable year of the entire balance payable to an employee from a trust, which forms part of a qualified pension or employee annuity plan on account of that person's death, separation from service or attainment of age 59.

Mail Order Insurer: Type of insurance company that sells policies through the mail or other mass media, eliminating need for agents.

Master Policy (or Master Contract): The policy issued to a group policyholder setting forth the provisions of the group insurance plan. The individuals insured under the policy are then issued certificates of insurance.

Material Facts: Any fact or circumstance that would affect the judgment of a prudent underwriter in considering whether he would accept the risk or not, and at which rate of premium.

Material Representation: A statement made to the underwriter before acceptance of risk, which is material to his decision in accepting and rating the risk.

Maximum Premium: The maximum periodic payment a company will require regardless of age and face amount to keep a policy in-force.

McCarran-Ferguson Act: Federal law passed in 1945 stating that continued regulation of the insurance industry by the states is in the public interest and that federal antitrust laws apply to insurance only to the extent that the industry is not regulated by state law.

Medical Examination: The examination given by a qualified physician to determine to the insurability of an applicant. A medical examination may also be used to determine whether an insured claiming disability is actually disabled.

Minimum Group: The least number of employees permitted under a state law to affect a group for insurance purposes; the purpose is to maintain some sort of proper division between individual policy insurance and the group forms.

Minimum Premium: The minimum periodic payment a company will allow regardless of face amount to keep a policy in-force.

Misquote: An incorrect estimate of the insurance premium.

Misrepresentation: A misstatement of fact made by the insured or his broker to the underwriter before acceptance of the risk that misleads the underwriter in assessing the risk and induces the contract. If the representation is material and amounts to misrepresentation, it is a breach of utmost good faith.

Mode of Premium Payment: The frequency with which premiums are paid—monthly, quarterly, semiannually, or annually.

Moral Hazard: Hazard arising from any nonphysical, personal characteristic of a risk that increases the possibility of loss or may intensify the severity of loss—for instance, bad habits, low integrity, poor financial standing.

Mortality Table: A statistical table showing the death rate at each age usually expressed as so many per thousand.

Mutual Life Insurance Company: Is organized and incorporated under a state's laws and has no stockholders. The policy owner is the customer and, in effect, an owner. A portion of surplus earnings may return to policyholders in the form of dividends. This is in contrast to a stock company, where the policy owner is a customer only.

MVR: Motor vehicle report.

National Association of Insurance Commissioners (NAIC): The association of insurance commissioners of various states formed to promote national uniformity in the regulation of insurance.

NAIC Certified: Products that have been certified by the NAIC.

NAIC Compliant State: A state that has passed the NAIC model illustration regulations.

Negligence: Failure to use the care that a reasonable and prudent person would have used under the same or similar circumstances.

Net Premium: The portion of the premium rate that is designed to cover benefits of the policy, but not expenses, contingencies, or profit. The term is also used to describe the portion of the premium remitted to the home office by an agent after deduction of the agent's commission.

Net Present Value (NPV): Means of evaluating which products offer the lowest cost, taking into account the time value of money for the life of the policy.

Net Written Premiums: Premium income retained by insurance companies, directly or through reinsurance, after payments made for reinsurance.

Non-admitted Assets: Assets that are not recognized by regulatory authorities in assessing solvency and include items such as furniture, certain equipment, and agent's balances. These assets are listed in exhibit 13 of the annual statement that insurers provide to insurance regulators.

Non-admitted Insurance Company: An insurance company not licensed to do business in a particular state; such a company, however, may sell excess and surplus insurance in that state if admitted insurers lack the capacity or expertise.

Non-cancelable Guaranteed Renewable Policy: An individual policy that the insured person has the right to continue to force until a specified age, such as to age 65, by the timely payment of premiums. During this period, the insurer has no right to unilaterally make any changes in any provision of the policy while it is in-force.

Non-disclosure: Failure by the insured or his broker to disclose a material fact or circumstance to the underwriter before acceptance of the risk.

Non-forfeiture Option: One of the choices available if the policyholder discontinues premium payments on a policy with a cash value. This, if any, may be taken in cash, as extended term insurance, or as reduced paid-up insurance.

Non-medical Limit: The maximum face value of a policy that a given company will issue without the applicant taking a medical examination.

Non-occupational Policy: Contract that insures a person against off-the-job accident or sickness. It does not cover disability resulting from injury or sickness covered by workers' compensation. Group accident and sickness policies are frequently non-occupational.

Non-participating Policy: A life insurance policy in which the company does not distribute to policyholders any part of its surplus. Note should be taken that premiums for nonparticipating polices are usually lower than for comparable participating polices. Note should also be taken that some nonparticipating polices have both a maximum premium and a current lower premium. The current premium reflects anticipated experience that is more favorable than the company is willing to guarantee, and it may be changed from time to time for the entire block of business to which the policy belongs. See also Participating Policy.

Non-Tobacco Status: No cigarette or tobacco usage based upon company guidelines.

Occupational Hazards: Occupations that expose the insured to greater than normal physical danger by the very nature of the work in which the insured is engaged, and the varying periods of absence from the occupation, due to the disability, that can be expected.

Operating Ratio: The sum of expenses and losses expressed as a percent of earned premium.

Ordinary Life: Synonymous with whole life and straight life. The three terms are applied to the type of policy, which continues during the whole of the insured's life and provides for the payment of amount insured at this death.

Other Insured Rider: Rider which provides coverage to an eligible business or family member other than the insured.

Override Commission: Commission payable in addition to the original commission.

Paid-up Insurance: Insurance on which all required premiums have been paid. The term is frequently used to mean the reduced paid-up insurance available as a nonforfeiture option.

Paramedical Examination: Physical examination of an applicant by a trained person other than a physician.

Participating Policy: A life insurance policy under which the company agrees to distribute to policyholders the part of its surplus that its board of directors determines is not needed at the end of the business year. Such a distribution serves to reduce the premium the policyholder had paid. See also Policy Dividend; Nonparticipating Policy.

Pegging: Pegging is a practical smoothing device used to arbitrarily increase the actual dividend(s) paid on a new lower dividend scale to eliminate a temporary reduction in the actual dividends paid from year to year on a policy. Usually only base policy dividends are pegged; dividends on riders and paid up additions (PUA) are not. (See Substitution). Pegging compares (normally before any adjustments for loans) the following: (a) the smaller of the dividend amount actually paid in the prior policy year and the prior year's dividend schedule payable in the current policy year, and (b) the current policy year's formula payment under the current year's schedule. This distribution does not follow the contribution method. It's done infrequently to enhance persistency.

Per Capita: This means that if a beneficiary dies before the insured, the remaining beneficiaries will equally divide that share of the proceeds in addition to receiving their own shares when the insured dies. (1) By head or by individual; (2) to share equally.

Peril: The cause of a loss insured against in a policy.

Permanent Life Insurance: Type of life insurance (other than term insurance) that accrues cash value and is designed for long-term, or permanent, needs of a policyholder. Includes universal and variable life, among others.

Persistency: The degree to which policies stay in-force through the continued payment of renewal premiums.

Persistency Bonus (Policy owner's): An enhancement to the policy's benefits, usually in the form of additional interest credits and/or reduced charges, for policies that remain in-force for a certain period. The bonus may or may not be guaranteed in the contract.

Personal Representative: A person appointed through the will of a deceased or by a court to settle the estate of one who dies.

Per Stirpes: This means that if a beneficiary dies before the insured, that beneficiary's share of the proceed will pass upon that beneficiary's heirs rather than going to the remaining beneficiaries when the insured dies. It means "by family branches." It's a method of dividing benefits among living members of a class of beneficiaries and the descendants of deceased members.

Physical Hazard: The risk associated with the subject matter of insurance.

Policy: The legal document issued by the company to the policyholder, which outlines the conditions and terms of the insurance; also called the policy contract or the contract.

Policy Dividend: A refund of part of the premium on a participating life insurance policy reflecting the difference between the premium charged and actual experience.

Policy Fee: Fee added to the periodic premium payments to cover undefined policy costs.

Policy Loan: A loan made by a life insurance company from its general funds to a policyholder on the security of the cash value of a policy.

Policy Owner: The person or business that owns the policy and is responsible for premium payments.

Policy Reserves: The measure of the funds that a life insurance company holds specifically for fulfillment of its policy obligations. Reserves are required by law to be so calculated that, together with future premium payments and anticipated interest earnings, they will enable the company to pay all future claims.

Policy Term: That period for which an insurance policy provides coverage.

Policyholder: The person who owns a life insurance policy. This is usually the insured person, but it may also be a relative of the insured, a partnership, or a corporation.

Policyholders' Surplus: Sum left after liabilities are deducted from assets. Sums such as paid-in capital and special voluntary reserves are also included in this term. This surplus is an additional financial protection to policyholders in the event a company suffers unexpected or catastrophic losses. In effect, it is the financial base that permits a company to sell insurance.

Pool: An organization of insurers or reinsurers through which particular types of risk are underwritten and premiums, losses, and expenses are shared in agreed-upon amounts.

Pooling Arrangement: An agreement to divide any losses that might occur equally among two or more people, typically with each paying the average loss.

Premium: The amount paid to an insurer or reinsurer in consideration of his acceptance of a risk.

Premium Discount: Periodic payment discount given by a company.

Premium Financing: A policyholder contracts with a lender to pay the insurance premium on his/her behalf. The policyholder agrees to repay the lender for the cost of the premium, plus interest and fees.

Premium Loan: A policy loan made for the purpose of paying premiums.

Premium Tax: A tax, imposed by each state, on the premium income of insurers doing business in the state.

Pricing Elements: The elements used in pricing a policy, principally investment earnings, mortality, and expenses. If actual experience is better than the assumptions made in determining the policy guarantees, the difference after reflecting surplus needs is available for distribution to policyholders through the company's dividend scale or other non-guaranteed pricing structure.

Primary Beneficiary: See Beneficiary.

Principal: One for whom an agent acts, especially as to contractual dealings with third persons.

Principal Sum: The amount payable in one sum in the event of accidental death and, in some cases, accidental dismemberment. When a contract provides benefits for both accidental death and accidental dismemberment, each dismemberment benefit is an amount equal to the principal sum or some fraction thereof.

Privacy: (1) The right to be let alone; (2) in insurance contexts, the right to fair personal information practices.

Probate: The court-supervised process of validating or establishing a distribution for assets of a deceased, including the payment of outstanding obligations.

Probate Estate: That portion of the assets and liabilities whose distribution is supervised by the courts in the probate process.

Projected Rates: Policy payment that is currently being charged by the company after the guarantee period.

Proof of Loss: Documentation presented to the insurance company by the insured in support of a claim so that the insurer can determine its liability under the policy.

Pro Rata Cancellation: When the policy is terminated midterm by the insurance company, the earned premium is calculated only for the period coverage was provided. For example: an annual policy with premium of $1,000 is cancelled after 40 days of coverage at the company's election. The earned

premium would be calculated as follows: 40/365 days X $1,000=$110 X $1,000=$110.

Profit Commission: A commission payable on the profit generated under an insurance or reinsurance contract as an encouragement to maintain the flow of profitable business.

Proportional Reinsurance: A type of reinsurance where the ceding insurer cedes to its reinsurer a predetermined proportion of the liability and premium of those policies subject to the reinsurance agreement.

Prospectus: A guide to the various sub-accounts and other required information by the National Association of Security Dealers (FINRA) and Securities and Exchange Commission (SEC). This is required with any variable insurance product.

Prototype Plan: A standardized plan, approved and qualified as to its concept by the Internal Revenue Service, which is made available by life insurance companies, banks, and mutual funds for employers' use.

Risk Classification: The process by which a company decides how its premium rates for life insurance should differ according to the risk characteristics of individuals insured (e.g., age, occupation, sex, state of health) and then applies the resulting rules to individual applications. See Underwriting.

Risk Control: Any conscious action (or decision not to act) intended to reduce the frequency, severity, or unpredictability of accidental losses.

Risk Pooling Arrangement: See Pooling Arrangement.

Risk Retention Group: An alternative form of insurance in which members of a similar profession or business band together to self insure their risks.

Select Mortality: Descriptive of the mortality experience of newly underwritten insureds. This period of discernibly different (favorable) mortality usually lasts 5 to 15 years.

Separate Account: An asset account established by a life insurance company separate from other funds, used primarily for pension plans and variable life

products. This arrangement permits wider latitude in the choice of investments, particularly in equities.

Settlement Options: The ways in which policyholders or beneficiaries may choose to have benefits paid other than a lump sum.

Skip Person: A beneficiary who is at least two generations younger than the person making the transfer.

Smoker Status: Cigarette or tobacco use based upon company guidelines.

Special Risk Insurance: Coverage for risks or hazards of a special or unusual nature.

Spousal Rider: Rider that provides coverage to the insured's spouse.

Standard Insurance: Insurance written on the basis of regular morbidity underwriting assumption used by an insurance company and issued at normal rates.

Standard Markets: Insurance companies for which the vast majority of people qualify.

Standard Provision: Those contract provisions generally required by state statutes until superseded by the uniform policy provision.

Standard Risk: A person who, according to a company's underwriting standards, is entitled to purchase insurance protection without extra rating or special restrictions.

State Insurance Department: A department of a state government whose duty is to regulate the business of insurance and give the public information on insurance.

Statutory Accounting Principles (SAP): Principles required by statute, which must be followed by an insurance company when submitting its financial statements to the various state insurance departments. They are designed to provide greater protection for the public against potential insolvency of these essential institutions. Such principles differ from the Generally Accepted Accounting Principles (GAAP).

Statutory Reserve: Reserves calculated on the basis of state requirements.

Statutory Surplus: The amount left after a company's liabilities are subtracted from assets when both those values are computed using Statutory Accounting Principles (SAP).

Statutory Underwriting Profit or Loss: Premiums earned less losses and expenses.

Step-Rate Premium: A rating structure in which the premiums increase periodically at predetermined times, such as policy years or attained ages.

Stock Life Insurance Company: A life insurance company owned by stockholders who elect a board to direct the company's management. Stock companies, in general, issue nonparticipating insurance, but may also issue participating insurance.

Stock Redemption Plan: An entity purchase form of buy-sell agreement within a corporation that involves the corporation buying back shares from a departing owner.

Straight Life Insurance: Whole life insurance on which premiums are payable for life.

Subagent: The agent of an agent.

Substandard Risk: An individual, who, because of health history or physical limitations, does not measure up to the qualification of a standard risk.

Substantial Compliance Rule: The rule that, where a policyholder has done everything possible to comply with the beneficiary change procedure set forth in the policy, but has failed because of circumstances beyond his or her control, the change will be effective.

Substitution: Substitution replaces the dividend formula that would have been used in the current policy year (normally before any adjustments for loans) with a prior formula if greater. Usually substitution is only used for very small base policy dividends in the first few years of a policy. See Pegging.

Supplementary Contract: An agreement between a life insurance company and a policyholder or beneficiary by which the company retains the cash sum

payable under an insurance policy and makes payments in accordance with the settlement option chosen.

Surplus: The amount by which the value of an insurer's assets exceeds its liabilities, i.e., the net worth of an insurance company.

Surrender: To terminate or cancel a life insurance policy before the maturity date. In the case of a cash value policy, the policyholder may exercise one of the non-forfeiture options at the time of surrender.

Surrender Charge: An amount retained by the issuer of a life insurance policy when a policy is canceled, typically assessed only during the first five to ten years of a policy.

Tax Basis: The cost from which your profits or losses are calculated for income tax purposes.

Taxable Estate: The value upon which estate taxes are calculated by the federal government.

Tenants in Common: A form of joint property ownership in which the owners may have unequal shares and that does not involve a right of survivorship.

Term Insurance: Life insurance protection during a limited number of years but expiring without value if the insured survives the stated period.

Termination Dividend: An additional dividend payable when a policy terminates (either by maturity, death, or surrender), reflecting a return to terminating policyholders of part of the company surplus held for this policy.

Tobacco Status: Status given to an individual who, in the past or present, has used any type of tobacco or nicotine product other than cigarettes.

Tort: A civil wrong, other than a breach of contract, for which a court of law will afford legal relief.

Treaty: An agreement between a reinsurer and a ceding insurer setting forth details of the reinsurance arrangement.

Trust: A legal instrument allowing one party to control property for the benefit of another.

Twisting: The practice of inducing by misrepresentation, or inaccurate or incomplete comparison, a policyholder in one company to lapse, forfeit, or surrender his insurance for the purpose of taking out a policy in another company.

Ultimate Mortality: Descriptive of the insured's mortality experience after the select period (5-15 years from issue), when mortality increases due to health deterioration.

Underwriter: Underwriters are the professionals upon whose experience and judgment the market depends for its expertise and reputation. It is the underwriter's responsibility to assess the merits of each risk and decide a suitable price, or premium, for accepting all or part of the risk.

Underwriting: The process of selecting applicants for insurance and classifying them according to their degrees of insurability so that the appropriate premium rates may be charged. The process includes rejection of unacceptable risks.

Underwriting Classes: Classification given to an individual based on personal and family health history.

Underwriting Profit or Loss: The amount of money that an insurance company gains or loses as a result of its insurance operations. It excludes investment transactions and federal income taxes.

Unearned Premium: The portion of a premium that a company has collected but has yet to earn because the policy still has unexpired time to run.

Unified Credit: A one-time credit of $192,800, usually applied against federal estate taxes that is available to every individual's estate. The credit also can be used for payment of federal gift taxes during that individual's lifetime.

Uniform Premium: A rating structure in which one premium applies to all insureds, regardless of age, sex, or occupation.

Unilateral Contract: A contract having promises by one party only.

Uninsurable Risk: One not acceptable for insurance due to excessive risk.

Unisex Rates: Rates that are used for both males and females.

Universal Life Insurance: A flexible premium life insurance policy under which the policyholder may change the death benefit from time to time (with satisfactory evidence of insurability for increases) and vary the amount or timing of premium payments. Premiums (less expense charges) are credited to a policy account from which mortality charges are deducted and to which interest is credited at a rate that may change from time to time.

Variable Life Insurance: A permanent whole life insurance policy under which the death benefits and/or cash values vary (the death benefit is guaranteed to be at least as large as the initial face amount) reflecting the investment experience of a separate pool(s) of assets supporting the reserves for such policies.

Variable Universal Life Insurance: Similar to universal life in that the policy owner chooses the premium to be paid each period, and has the option to increase or decrease the policy death benefit. However, the assets supporting the policy are maintained in one or more separate accounts, and the policy owner's values fluctuate (no guarantees).

Vested Commissions: Renewal commissions payable to the writing agent or his estate, whether or not he remains with the company.

Viatical Settlement: Payment of a portion of the proceeds from life insurance to an insured who is terminally ill.

Void Policy: One that legally does not exist.

Voidable Policy: Where the underwriter or insured has the right to avoid a policy (for example in the event of a breach of utmost good faith) the policy is termed "voidable."

Voluntary Market: The market where one seeking insurance obtains insurance in the open market with no help from the state, through an insurer of his or her own selection.

Waiting period: A period of time set forth in a policy that must pass before some or all coverages begin. See also Elimination Period.

Waiver of Premium: A provision in some policies to relieve the insured of premium payments falling due during a period of continuous total disability that has lasted for a specified length of time, such as three or six months.

Warranty: A statement guaranteed to be true in all respects. If the statement is untrue in any respect, even if it is not material, the contract of which it is a part can be rescinded.

Whole Life Insurance: Life insurance payable to a beneficiary at the death of the insured whenever that occurs. Premiums may be payable for a specified number of years (limited payment life) or for life (straight life).

Will: The legal statement of a person's wishes concerning the disposal of his or her property after death.

Written Premiums: The entire amount of premiums due in a year for all polices issued by an insurance company.

Tony Steuer—Bookshelf Special Offer

As a thank-you to my readers, you can receive 20 percent off digital versions of all my books when purchased from my website (www.tonysteuer.com) with coupon code GETREADYBLUEPRINT20.

The Get Ready! Blueprint is a 52-week guide to changing the way you think about money—an innovative/interactive workbook with an easy-to-use, step-by-step system to help you get useful tips on all areas of your financial life.

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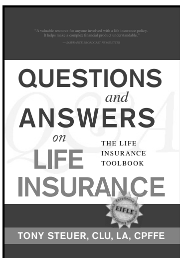

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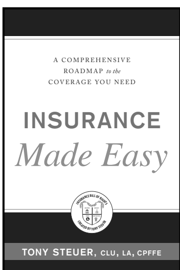

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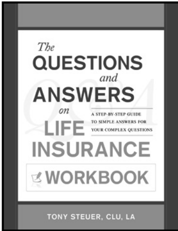

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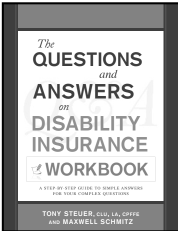

The Questions and Answers on Disability Insurance Workbook is a step-by-step workbook that leads you through the process of purchasing a disability insurance policy and monitoring an existing policy.

Veralytic Special Offer:

As a thank you for being a *Questions and Answers on Life Insurance* reader, Veralytic has provided the following special offer:

Consumers who purchased *Q&A on Life Insurance* are eligible for a 50% discount off the regular per-report fee (a $250 value). Advisors who purchased *Q&A on Life Insurance* are eligible for a 25% discount off the single-user subscription fee (a $600 value). Simply go to www.Veralytic.com to register. Either way, remember to use the discount code: SteuerQ&A2022. E-mail info@Veralytic.com for more information or go to www.Veralytic.com.

The Veralytic System measures internal policy costs and actual historical performance of life insurance. The Veralytic System evaluates any in-force policy or proposed permanent life insurance product on the following five considerations:

- Insurer financial strength
- Competitiveness of internal policy costs
- Illustration reliability
- Access to/restrictions on policy account values
- Actual historical performance of invested assets underlying policy account values

The Veralytic System rates each consideration against benchmarks for the universe of peer-group alternatives and assigns a star rating to the policy under evaluation. Each consideration is measured independently, given equal weight, and totaled for an overall Star Rating.

Thank you to Barry Flagg, founder of Veralytic, for this special offer and for his help in reviewing the sections on permanent life insurance components and illustrations.

A Note from the Author

Dear Reader,

Thank you for taking the time to learn all about life insurance from the basic essentials to the finer points of life insurance and how it fits into your financial life. I hope you are feeling more in control of your life insurance and ready to implement and monitor your optimal life insurance portfolio with *Questions and Answers on Life Insurance*.

If you loved the book and have a minute to spare, I would really appreciate a short review on your favorite book site. You're the reason why I continue to write about financial wellness and advocate for integrity in financial services.

If you think this book might help others to better understand life insurance, please share with them. Life insurance is a complex topic and this book will help you whether you are reviewing your own life insurance portfolio, or whether you're an insurance agent or financial advisor guiding clients with their life insurance portfolio. For members of the media and educators, this book is a great resource.

So, what's next? Join the Get Ready Movement and stay up to date on the latest in changing the way we think about money by subscribing to the Get Ready! Newsletter and joining our community.

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Thank you!

Tony

P.S. Listen to *The Get Ready Money Podcast*: Change the way you think about money. It includes insightful conversations with thought leaders that will provide you with practical advice that demystifies the complexities of finance and builds healthy habits that actually work.

P.S.S. If you are passionate about helping people feel empowered with their money, then please join the Get Ready! Expert Money Guides: Dedicated to Helping People Change the Way They Think about Money group on LinkedIn.

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Tony is the creator of the Get Ready Method, which is an easy-to-use roadmap to help you understand how everything fits together. It's based on eight habits that will empower you with money and transform your life. It includes an innovative and unique financial calendar system that provides a weekly action item to help you stay on track and keep all areas of your financial life up to date.

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Tony regularly consults with fintechs, financial planners, insurance agencies, attorneys, insurance companies, and other financial service companies on financial preparedness, insurance marketing, product best practices, and best practices. Tony is a past member of the National Financial Educator's Council (NFEC) Curriculum Advisory Board.

Tony is regularly featured in the media as an expert source, including ABC's *Seven on Your Side*, *Forbes*, NerdWallet, Cheddar TV, the *New York Times*, the *Washington Post*, *Fast Company*, the *Chicago Tribune*, CNBC, and Fox Business News. Tony is also a frequent guest on podcasts. Tony also served as a technical editor for The Retirement Bible and The Investing Bible.

He is passionate about giving back. Tony is involved with many worthwhile causes, including CLCS (Community Learning Center Schools—vice president) and JDRF (Juvenile Diabetes Research Foundation—volunteer),

and has served on multiple boards and advisory committees. Tony has also been a coach for his son's basketball team and baseball teams, taught wilderness first aid and white-water rescue, volunteered as a white-water raft guide, and performed improvisational comedy.

Tony Steuer lives in Alameda, California.

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