CHAPTER 3
ECONOMIC BASIS OF LIFE INSURANCE

Essentially, the reason for purchasing life and health insurance is to protect one’s human life value. From an economic standpoint, this is the sum of an individual's net future earnings—the dollar value of an individual's future earning capacity. This value can be subject to loss due to death or disability. When the ability to produce income is lost, not only is the individual affected but all those who depend on this person may suffer as well. The family unit could be devastated. Without the wage earner, it may not be possible to pay the normal monthly bills or much less to meet the cost of education for the children. It is for the preservation of the life style and security of the family that life and health insurance exist.

It is said that life insurance creates an "immediate estate". When a person purchases life insurance, he/she has an estate immediately to leave to a beneficiary. The limit of liability of the insurance company is the amount stated in the insurance contract. No matter what plans a person makes to secure his/her financial future and that of his/her family, a life insurance policy should be a part of the entire financial plan.

Although it is hard to put a price on the value of a life, there are several ways to look at it. The human life value approach is the stream of income method. The items taken into consideration are the insured's annual salary, annual expenses, years remaining until retirement, and the future value of the current dollar. Thus the insured needs to purchase an amount of insurance which can replace his income should he/she die at an early age.

Another way to decide on the amount of insurance to buy is the needs approach. Using this method, it is the survivors' needs that we are considering. Among the items to be considered are last expenses of the deceased insured, continuing family income, money for the children's education, and paying off outstanding debt. An adequate amount of insurance will need to be purchased to pay for these expenses.

The estate planning method is another technique in which life insurance can be used. In this approach, the insured is trying to preserve assets rather than having them sold to pay estate taxes. People with significant assets will need the advice of a tax attorney and might employ this method.

Some reasons to purchase life insurance are:

- to keep families and businesses intact
- peace of mind; security
- an investment/savings vehicle
- to pay last expenses
to cover estate taxes and probate costs
- to provide investment capital—important to our economy
- to provide benefits at a minimal cost

A life insurer shall provide to all prospective insureds a buyer’s guide prior to accepting the applicant’s initial premium. However, if the policy applied for contains an unconditional free look of at least ten days, the buyer’s guide shall be delivered with the policy or prior to delivery of the policy. According to the NAIC, this guide will help an applicant by (1) pointing out things to consider before buying insurance, (2) deciding on the amount and type of insurance to buy, and (3) making an informed decision when purchasing a policy. Items for the applicant to consider:
- Review your needs and circumstances
- Be sure you can afford the premium payments
- Do not sign an application until you review it carefully
- Do not buy life insurance unless you intend to keep it
- Do not drop one policy and buy another one without thoroughly studying both policies
- Read your policy carefully
- Review your life insurance needs with your agent every few years to stay current with your income and needs

CATEGORIES OF LIFE INSURANCE

All life insurance can be broken down into three categories:

1. Ordinary insurance
2. Group insurance
3. Industrial insurance

Ordinary insurance is a policy written on an individual basis. More specifically it is considered to be permanent insurance. Ordinary insurance has the following characteristics: (1) It has a face amount of at least $1000 (many companies will not write a policy for such a small amount). (2) Premiums for the insurance coverage are paid directly to the insurer on an annual, semi-annual, quarterly, or monthly pre-authorized check basis. (3) Policies are underwritten on an individual basis, meaning that each applicant must meet the criteria of the company in order to be insured.

Group insurance provides coverage for a number of people under one contract. It is written for employer-employee groups, associations, unions, creditors, and other common interest groups such as professional associations, lodges, and civic groups. Group insurance underwriting is based on the group rather than the individuals composing the group. Normally, all or a portion of the premium is paid by the sponsoring organization (e.g. the employer).
Industrial life insurance policies are individual life policies sold in low face amounts, usually $1000 or less. These policies originated in the late 1800s and were sold to low income industrial workers who could not afford high premiums. Essentially these policies were to cover last expenses—medical bills and burial costs. These are permanent forms of insurance (whole life, limited pay life, and endowment); term insurance is not written. All family members are covered from birth to age 65 or 70. The agent is responsible for collecting the premium payments on either a weekly or monthly basis and must give the insured a written receipt. When the agent is collecting these premiums, it is said he/she is servicing his/her debit. The premiums, ranging from ten cents to a dollar or so, are level premiums and the cost to the insured is high in relation to the amount of coverage provided. This is due to the fact that the frequent premium payments make it a costly administrative matter for the insurer. Furthermore, there are usually less strict underwriting guidelines (no medical examination required) which result in a higher rate of mortality than is true in ordinary insurance.

The California Insurance Code defines industrial life insurance as life insurance with an aggregate face amount sold to any one person and in force at one time to be an amount not exceeding $10,000. Basic features of industrial life policies are similar to those of ordinary policies such as containing a grace period, incontestability, misstatement of age, non-forfeiture, reinstatement, free look, entire contract, and owner’s rights. However, industrial life insurance has some features that set it apart from other forms of life insurance. These include the following:

- **Facility of payment clause** states that if the named beneficiary does not submit a claim within 30 to 60 days after the insured’s death, or if the beneficiary predeceases the insured or is legally incompetent, the insurer has the right to make payment to the insured’s estate or to any relative who appears to be equitably entitled to the payment. This may include the person who has paid medical or burial expenses on behalf of the insured.
- **Assignment** of an industrial policy can be only to a bank as collateral for a loan.
- **Loans** are not allowed as cash values are very small.
- **Accidental death and dismemberment** which provides double indemnity and lump sum benefits to the insured for dismemberment and loss of sight normally are included in these contracts for no additional premium.
- **Lump sum payments** are the only manner in which payments will be made to the beneficiary. There are no provisions for settlement options because of the small face amounts of insurance.
- **Applications** are not made part of the policy as in ordinary insurance.
- **Suicide clause** generally is not contained in industrial life policies.
Today industrial life insurance represents approximately 1% of the life insurance in force. It has declined due to the increase in workers' wages, the growth of group life insurance and social security benefits.

**Home service life insurance** is a variation of industrial life insurance. The major difference is that the face amount is larger. It normally is written for amounts of $10,000 or $15,000 and the premiums are either debited from a bank account or mailed.

**Temporary insurance** is written for a specific amount of time and only pays if the insured person dies during the term. At the end of the term, the policy expires with no value.

**Permanent insurance** provides protection for the insured's entire life span. It builds cash values and the policyowner has the right to surrender the policy for the cash values, exercise other non-forfeiture options, or borrow against the cash values.

**TERM INSURANCE**

As mentioned earlier, term insurance provides life insurance protection for a designated number of years—anywhere from one year to thirty years. It is pure insurance protection only as it accumulates no cash values and expires with no value at the end of the term. It is less costly than permanent forms of insurance as the premiums are calculated to cover the costs of mortality (death benefit of policy) and expenses of the company only without a reserve for cash values. It should be noted that the shorter the initial term coverage, the lower the premium. A five-year term would be less costly than a ten-year term. If someone is in need of a large amount of insurance and does not have a lot of money for premium payment, term insurance would be an appropriate selection.

There are three types of term insurance. They are level term, decreasing term, and increasing term. Level term and decreasing term are the two most common forms of term insurance.

**Level term** insurance provides for a level death benefit and a level premium. If a person purchased a $50,000 ten-year level term, the policy would pay $50,000 any time the insured person died during the ten-year period. The premium payment also would remain the same during the ten-year period. At the end of ten years, the policy would end without value.

**Decreasing term** insurance has a death benefit that decreases, but the premiums remain constant or level. If someone purchased a $50,000 ten-year decreasing term policy, the face amount of the policy would be zero at the end of ten years although the premium would stay the same during the whole period. This becomes a costly form of insurance toward the end of the term.
Decreasing term insurance is used frequently to cover decreasing financial obligations. To be assured the home mortgage is paid off in the event of the untimely death of a borrower, a person may wish to purchase insurance to pay off the debt. As the financial obligation on a home loan decreases through time, the necessary amount of insurance coverage to pay off the loan also decreases. This is **mortgage redemption insurance**.

**Credit life insurance** usually is written as decreasing term. When someone is financing a purchase (e.g. car, furniture) and wants the loan retired in the event of death, credit life insurance may be included in the transaction. The premium for the insurance is added to the finance contract and financed along with the item being purchased. The death benefit is paid to the lender (creditor) to satisfy the debt. The insurance company issuing the insurance receives the full premium when the contract is written. Credit life insurance may be issued to an individual as a single policy. However, it most often is sold to a bank or lending institution as group insurance that covers all the lender's borrowers.

As of January 1, 1985 the California state legislature reserved for itself the adoption of rules and regulations governing rates charged or compensation derived from the sale of credit life and credit disability insurance. The legislature also creates the rules and regulations governing retention and reserve levels.

**Increasing term insurance** is not as common as level or decreasing term. This type of term insurance has a death benefit that increases at periodic intervals. The amount of increase can be either a specific amount or a percentage of the original amount. Although this could be a separate policy, it is normally written as a rider to a permanent policy, such as the cost of living rider or the return of premium rider.
Term insurance can be written as renewable, convertible, or nonrenewable. Nonrenewable term is for a certain amount of time at the end of which the policy simply terminates. If the policy is issued as renewable term, the policy may be renewed for another term without proof of insurability. A five-year renewable term policy may be renewed for another five-year period with no proof of insurability needed. An annual renewable term (ART) may be renewed each year without proof of insurability. It should be noted that although proof of insurability is not required that the insured person is older at each renewal and thus the premium will increase as mortality increases with age.

Convertible term insurance allows the policyowner to convert the term coverage to permanent insurance without proof of insurability. A person wanting permanent insurance protection might feel the premiums are presently too high. This person then decides to purchase convertible term insurance. He/she now has insurance protection and the right to change to a permanent policy during the term without proof of insurability. Normally when this right is exercised, a new permanent policy will be issued based on the attained age (present age) of the insured. Some companies may allow this conversion to be based on original age when the term contract first was issued. From that point forward, the premiums would be based on the younger age. Due to this, the policyowner would need to make up the difference in cost between term and permanent coverage and interest on this amount. By converting at original age and paying the additional necessary sum, the new policy builds cash values more quickly than if converted at attained age.

Not all companies allow the conversion for the entire length of the convertible term contract. In other words, a ten-year convertible term policy may be convertible to permanent insurance only during the first seven years. Agents should know their company's requirements for conversion and make sure their clients understand these rules.

For term policies to be either renewable or convertible, these features must be included in the contract when it is issued. The insurance company is assuming an additional risk when offering these features to an insured and must charge a higher premium for including these features in the policy. Normally these features of renewability and convertibility are only added to level term policies.

There are advantages and disadvantages to all forms of insurance. Consequently, when selecting a form of insurance, the needs of the client must be ascertained before making the selection.

Advantages of term insurance are that it is less costly than permanent insurance, that it is excellent for covering decreasing financial obligations, and that it can be used in conjunction which other forms of insurance to give
additional protection for a specific period or can be added as a rider to a permanent policy to provide the additional protection.

Disadvantages of term insurance are that it can become expensive through time as one ages and that a person might find himself/herself unable to obtain insurance due to cost or becoming uninsurable. Another disadvantage of term insurance is that it builds no cash values and, therefore, has no living benefits. Even term policies that are renewable are not renewable beyond a certain age—perhaps 65 or 70.

PERMANENT INSURANCE

Whole life insurance (straight whole life) was the most popular form of permanent life insurance in the 1900s. It is designed to last for the entire span of life of the insured individual. This is considered to be age 100. Mortality tables currently end at age 100. Therefore, there is no life insurance after that age.

Whole life insurance is a product that provides for a level death benefit and level premiums. The face amount of insurance stays the same for the length of the policy (until death or age 100) and the premiums never fluctuate and are payable to age 100. In order to allow an individual to have level premiums, in the early years it is necessary for the insured to pay more premium than is needed to provide the current year’s insurance protection. However, in the later years of the policy, the insured is paying less than is needed to cover the cost of insurance protection.

Another characteristic of whole life insurance is that it builds cash values. Part of the premium payment goes into the cash value account of the policy and earns a guaranteed interest rate as stated in the contract. These cash values grow on a tax-deferred basis. A whole life contract normally will not have any cash value until the third year. This is due to the fact that in the first several years the insurance company is recapturing the cost of issuing the contract. It is required that these policies have a table of guaranteed values to allow a policyowner to know the amount of cash value accumulation at various years. The cash values in a whole life contract will equal the face amount of the policy at age 100. When this occurs, it is said that the policy has endowed or matured. The insured at age 100 may receive this amount.

An insured with a whole life contract may borrow against the cash values in the policy. If he/she does take a loan against the cash values, interest will be charged. A policyowner is not required to repay a policy loan. If the loan is not repaid, it is simply deducted from the face amount of the insurance policy along with any outstanding interest before the beneficiary receives the death proceeds.
A policyowner also may surrender a policy and receive the accumulated cash values. As permanent insurance allows for policy loans and cash surrender, it is said these policies have **living benefits**. The owner of the policy has use of the cash values while alive.

**Limited payment whole life** policies differ from straight whole life policies in that they allow for the premium to be paid over a shorter period of time. Common forms of limited payment life policies are 20-payment, 30-payment, and life paid-up at 65. A 20-payment policy allows for the payments to be paid in 20 years; a 30-payment life policy spreads the payments over a 30-year period. A life paid up at 65 means that premiums are paid until 65 years of age. In all of these cases, the policies do not endow until age 100. Since the premiums are being condensed into a shorter time frame, the premiums must be higher than on a continuous premium whole life policy. As the premiums are higher, the cash values grow more quickly in a limited payment whole life policy during the premium paying years. In the later years of the policy, the cash values of the limited payment policy will be equal to the cash values of the continuous premium whole life policy.

**Single premium whole life policies** are paid for with one premium payment. The entire cost of the contract is paid at the time of purchase. If a person had such a contract and died shortly afterward, it would be a costly way to have purchased insurance. If the insured lives to age 100, it would cost him/her less than if he/she made annual payments until age 100.

A major drawback to single premium whole life policies is that they are classified as modified endowment contracts which have some negative features. This will be discussed shortly.

**Indexed whole life policies** have a face amount that increases automatically as the Consumer Price Index increases. Such policies keep the face amount of the policy from being eroded by inflation. The policyholder might assume the risk of future increases and have to pay an additional premium with each increase in face amount of insurance. Another way this might be handled is...
the insurer assumes the risk and, therefore, the policyholder would not have to pay a higher premium.

**Indeterminate premium whole life policies** have premiums that can be adjusted based on the insurer’s anticipated future experience. The maximum premium that may be charged is stated in the policy although the premium at issue is lower for a specified period (normally 2 to 3 years). After this period the premium may be raised, lowered, or stay the same based on the company’s expected mortality, expense, and investment projections.

**Current assumption whole life policies** provide flexible premium payments that are tied into current interest rate fluctuations. Insurers may increase or decrease the premium within a certain range depending on interest rate fluctuations. During a period of high interest rates, premiums could be reduced. Conversely, premiums could be increased within certain limits during periods of low interest rates. Adjustments in premiums normally are made on an annual basis.

**Graded premium whole life policies** have premiums that are lower than the typical whole life contract for an initial period—usually five to ten years. After that time the premium increases each year until leveling off. As these premiums go up annually for a period of time, they are sometimes referred to as **step-rated premiums**. The premium rates are actuarially equivalent to the standard whole life contract.

**Modified whole life policies** have lower premiums in the first years—usually three to five years—followed by a higher premium for the life of the contract. With some companies the policy may be a combination of term during the lower premium payment period which automatically converts to whole life with a higher premium. The purpose of such a policy is to allow an individual with limited financial resources who has prospects of greater earnings to purchase permanent insurance.
The advantages of whole life insurance are that the insured has permanent protection, has level premiums that allow him/her to know the cost of protection, and has guaranteed cash values that provide living benefits.

The disadvantages of whole life insurance are that it provides less protection per dollar than does term insurance and that the premium-paying period may be for a longer time than the insured is working. Also, as the face amount of insurance stays the same through the years, the protection offered can be eroded by inflation.

ENDOWMENT POLICIES

The Tax Reform Act of 1984 changed the tax law definition of life insurance. Due to the accelerated growth of cash values in endowment contracts, this act stated that any policy issued after January 1, 1985 could not endow prior to age 95 in order to qualify as life insurance. This means the policy’s cash value accumulation and its death benefits would be taxed. Consequently, it is unlikely that anyone will see an endowment policy issued after 1984. The law did not affect policies issued prior to this date.

Endowment policies are a form of permanent insurance. They are like whole life contracts except they endow prior to age 100. For instance, if a 30-year-old man purchased a 20-year endowment policy, he would have insurance coverage for 20 years and if he died during the 20-year period his beneficiary would receive the face amount of the insurance contract. This policy would also endow in 20 years meaning the cash values in the policy would equal the face amount of the contract at that time—at age 50 in this example. The insured could receive the face amount of the policy at this time.

Since these types of policies are designed to build cash values rapidly, the premiums are comparatively high. These policies are used to provide a living benefit at a specified future date. Retirement endowments are sold to provide a retirement income and normally endow at 65 or at another age when the insured plans to retire. Juvenile endowments are sold on the lives of children and usually endow at age 18 or 19 to provide funds for college education.

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20-yr. Endowment Policy

- **Pure Insurance**
- **Cash Value**

age 30 | age 50

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Chapter 3  
Economic Basis of Life Insurance
A pure endowment is a policy that provides no life insurance protection and provides for the payment of the face amount only if the insured lives to the end of the endowment period. If the insured dies prior to the maturity of the policy, all benefits are forfeited. This is a high-risk form of savings.

MODIFIED ENDOWMENT CONTRACTS

In 1988 Congress passed the Technical and Miscellaneous Revenue Act (TAMRA). This law was passed primarily to discourage the sale and purchase of life insurance for investment purposes or as a tax shelter. Effectively this created a new class of insurance called a modified endowment contract (MEC). This law did not affect policies sold prior to June 20, 1988; such policies were grandfathered.

Life insurance has enjoyed very favorable tax treatment through the years. Cash value accumulations grow tax deferred; policy loans are not taxed; and policy withdrawals are not taxed unless the amount withdrawn exceeds the total amount paid into the contract by the policyowner.

Essentially a MEC is any policy funded more rapidly than 7-pay life. This seven-pay rule states that if a policyowner places more money into a life contract than exceeds the sum of the net level premiums that would have provided paid-up benefits in seven years, the policy automatically would become a modified endowment contract. Once classified as a MEC, the policy will remain a MEC for its duration. For example, a policyowner purchased a 7-year limited payment life policy of $75,000 that called for premium payments of $5,000 a year. In year one and two the policyowner paid $5,000 annually. In the third year he/she paid $6,000. This is more than allowed by the seven-pay test and this policy has now become a MEC.

Money withdrawn from a MEC is subject to unfavorable tax rules. Any money distributed from the policy is considered to come first from earnings and is taxed as ordinary income. After the earnings are withdrawn, the policyowner’s cost basis may be recovered tax free. There also is a 10% tax penalty on these amounts received by the policyowner before age 59 ½.

Agents must be alert to the implications of this law and provide a full explanation to clients of the ramifications of this law. Insurers are responsible for notifying policyowners when a policy exceeds the seven-pay test and becomes a MEC. An insurer could refund the excess premium to the policyholder to avoid the policy from becoming a MEC.

SPECIAL USE POLICIES

There are a number of policies that have been developed to fit special situations. Many of these are a combination of permanent and term insurance.
Various insurance companies may call these policies by different names and the policies themselves may be slightly different in their structure.

FAMILY INCOME POLICIES

A family income policy is a combination of whole life insurance with a decreasing term rider. The whole life portion gives the insured permanent lifetime protection. The decreasing term rider provides monthly income benefits to the family. The length of time the family will receive monthly income benefits corresponds to the number of years of the decreasing term rider. If it is a 15-year decreasing term rider, the family income period is 15 years. This 15-year period begins with the effective date of the policy. In other words, if the insured dies five years after inception of the policy, there would be 10 years left on the decreasing term rider and the family would receive monthly income benefits for 10 years. If the insured lives more than 15 years, the term portion would have ceased, but the insured would still have the permanent policy. These term riders are normally for 10, 15, or 20 years.

If the insured dies while the term coverage is in force, some companies may pay one half of the policy’s face amount to the beneficiary at that time and the other one half at the end of the monthly income period. Other companies may pay the whole face amount of the permanent policy when the family income period has ended.

FAMILY MAINTENANCE

Family maintenance policies are a combination of whole life insurance with a level term rider. The difference between this contract and a family income policy is the length of time the family will receive monthly benefits. With family maintenance policies, the income period begins on the date of the insured’s death as long as the rider is in force and will continue for the number of years of the level term rider. Thus if a man had a 15 year level term rider and dies anytime during the 15 year period, his family would receive 15 years of monthly income.

The amount of monthly benefits is usually based on multiples of $10 or $20 per $1000 of whole life coverage. A $10 family maintenance policy with a $100,000 base of whole life insurance would pay the family $1000 per month. A $20 family maintenance policy with a $100,000 base would pay the family $2000 per month.

The family income and family maintenance policies are to provide additional coverage during the child rearing years. The monthly payment schedule is to help the young family with budgeting.
FAMILY PROTECTION POLICY

The family protection policy is a policy that provides protection for all family members. It is normally written as whole life on the head of household and level term on the spouse and children although it occasionally is written as decreasing term insurance. This policy provides minimal life insurance protection and the coverage is sold in units. For instance, a unit might be $2,500. If the father has four units, he would have $10,000 worth of insurance; the spouse might have 2 units or $5,000 worth of life insurance; and each child might have 1 unit or $2,500 worth of life insurance.

Any child born or adopted after a family policy is issued is automatically covered under the policy with no additional premium due. This coverage for the child normally starts when the child is a few days old and continues to a stated age, frequently 18. The spouse’s coverage usually lasts until age 65. If the coverage is written as level term, it usually is written as convertible term. Convertible term means the individual has the right to convert the term coverage to an equal amount of permanent insurance with no proof of insurability.

RETIREMENT INCOME

The retirement income policy provides a death benefit during a period of time while the insured is building cash value in the policy. These policies are costly as the cash value accumulation is high in order to pay a monthly income benefit. These policies pay a retirement benefit based on the amount of insurance coverage written—perhaps $10 per $1,000 of life insurance coverage for a specified period or the insured’s lifetime.

MULTIPLE PROTECTION POLICIES

A multiple protection policy pays twice or three times the face amount of the policy if death occurs during a specified period. If the insured dies after the specified period, only the face amount of the policy will be paid. The specified
period may be for a certain number of years (e.g. 10, 15, or 20 years) or to a specified age (e.g. 65 years old). This form of insurance is a combination of permanent insurance with level term for the multiple protection period.

JUVENILE INSURANCE

Juvenile insurance is written on children from one day old to 15 or 16 years of age. The applicant and owner of such a policy are normally the parent or the guardian. A rider that can be attached to a juvenile policy is the **payor benefit rider**. This is a waiver of premium on the juvenile policy. If the premium payor dies or becomes totally disabled, the premium on the policy is waived until the insured child reaches a given age—usually between ages 21 and 25 at which time he/she can take over the premium payments.

There is another type of juvenile insurance that is referred to as the jumping juvenile or junior estate builder policy. This policy will have a face amount that jumps five times at a given age—frequently 21 years old—without any additional premium due or proof of insurability required. A $1,000 jumping juvenile will jump to $5,000. A $5,000 jumping juvenile will jump to $25,000.

Juvenile insurance policies protect the insurability of the child and premiums are reasonable.

JOINT LIFE POLICIES

A joint life policy may cover two or more lives on one policy. These policies may be written as a first to die or a second to die (last survivor) policy or it may pay double death benefits if both insureds die.

These policies are usually written as whole life insurance and the premiums are based on the average age of the insureds. By purchasing one policy, the dollar outlay for premiums would be less than if purchasing separate policies.

A **first-to-die policy** pays the death benefit upon the death of whichever insured person dies first with the death benefit normally being paid to the surviving insured. The policy then is terminated, but normally the surviving insured has the option to purchase an individual policy without having to prove insurability. This policy is frequently used by husband and wife and also by business partners to fund a buy-sell agreement.

A **second-to-die policy** or **last survivor policy** pays nothing on the death of the first party. It only pays when the last insured individual dies. These policies are used mostly by husband and wife for estate planning purposes and the face amounts are usually more than one million dollars. The proceeds from
the policy provide the money to pay estate taxes so that other assets do not have to be liquidated.

**FLEXIBLE POLICIES**

In the 1970s insurance companies introduced a number of new policy forms. These contracts—notably adjustable life, universal life, variable life, and variable universal life—are more flexible in design and provisions than the more traditional forms of insurance (whole life and term life). The intense competition for investment dollars and fluctuations in inflation and interest rates caused the insurance industry to develop these new forms of insurance.

**ADJUSTABLE LIFE**

Adjustable life insurance allows for changes to be made to the face value, premiums, and plan of insurance at the discretion of the policyowner. The policyowner decides on how much insurance protection he/she needs and how much premium he/she wishes to pay. Then the appropriate plan of insurance is selected to meet the criteria. As financial needs and objectives change, changes in the policy can be made. Changes may be made to any or all of these provisions:

- Face amount of the policy
- Amount and/or frequency of premium payments
- Period of insurance protection

The policy may be converted from term insurance to whole life or limited-payment life or the reverse. Most of these contracts place limits on the changes in face amounts or premium payments to specified minimums and maximums. Normally, if the policyowner wishes to increase the face amount of the policy, evidence of insurability is required.

A young man with a family and house payment with an adjustable life policy who can afford $600/year premium will most likely want to use these dollars to buy as much face amount of protection as possible. He could select term life insurance at that time. Later in his life when his financial obligations have decreased, he may want to change his term policy to a permanent policy with a lower face amount. With an adjustable life policy he may make these changes without having to have another policy issued.

**UNIVERSAL LIFE**

Universal life is a policy characterized by its flexibility. A definition of universal life is that it is an adjustable benefit life insurance contract that accumulates cash value and has flexible premiums. The policy is referred to as an “unbundled” policy as its three basic elements—investment earnings, pure
cost of life insurance protection, and the company expenses—are separately identified in the policy and in the policyholder’s annual report. Things to know about universal life are:

- Premiums are flexible; not fixed.
- Protection is adjustable; not fixed.
- Cash values earn a current rate of interest; not fixed.

Premiums plus interest payments accumulate in the cash value account. When sufficient cash values accumulate, the policyowner has the flexibility to determine the amount and frequency of premium payments. The cost of insurance is taken directly from the cash value account, usually on a monthly basis, and resembles one-year renewable term. The universal life mortality charge steadily increases as the insured ages. Therefore, more of the premium paid is used to cover mortality costs as the years progress. As long as there is enough money in the cash value account to cover the cost of insurance protection, the policy will stay in force. If the cash values are depleted, the policy will terminate.

Universal life earns a current rate of interest. Current rate consists of (1) guaranteed interest and (2) excess interest. The guaranteed rate is stated in the contract and is usually about 4%. The excess rate will vary with the current level of interest rates. Current rate is then the sum of the guaranteed interest and the excess interest. The current rate of interest is usually set once a year (although some companies may adjust it more frequently). An illustration on a universal life policy should show the growth of cash values based on the present current rate of interest and also on the guaranteed rate of interest which, of course, would be the worst case scenario.

The company’s expenses—sales and administrative costs—also must be considered. This charge also is referred to as a “load”. Universal life policies may have a front-end load or a back-end load. In a front-end load, a specified percentage expense charge (e.g. 7½%) is deducted from each premium payment before the balance is credited to the cash value account. In a back-end load, there are service charges for such things as withdrawals from the policy, policy surrender, and for coverage changes. In the back-end load, the entire premium goes into the cash value account and, accordingly, such contracts can be illustrated showing a more favorable return.

Universal life policies also allow the policyowner to increase or decrease the face amount of coverage. An increase in coverage will require proof of insurability. Another distinguishing feature of universal life policies is the fact that partial withdrawals can be made from the cash value account. The policyowner may withdraw the desired amount directly from the cash value account and pay a service charge. No interest is credited by the insurer or paid by the policyowner on the amount withdrawn. This is not treated as a loan; it reduces the amount of the cash value account. If the partial withdrawal is repaid, it will be treated as a
premium payment and be subject to any sales load the policy may contain. Of course, the policyowner may surrender the policy at any time and receive the cash values. Normally a surrender charge will be levied unless the policy has been in force for a number of years. Another way of receiving money from the policy is to take out a loan. A loan will be charged interest. If not repaid, the loan and interest will be deducted from the face amount of the policy.

Universal life insurance offers two death benefit options: Option 1 is the level death benefit option and Option 2 is the increasing death benefit option.

Under Option 1 or the **level death benefit option**, the death benefit is the policy’s face amount which is composed of the sum of the cash value account plus the amount at risk (pure insurance protection). As the cash values grow, the amount at risk correspondingly decreases. To meet the tax law definition of insurance, policies cannot endow prior to age 95. There must always be an amount at risk. This minimum of separation between the cash values and the face amount of the policy is called the **risk corridor**. If the cash values near the face amount of the policy, the face amount must be raised.

Under Option 2 or the **increasing death benefit option**, the death benefit of the policy is the face amount of the policy plus the cash value account. The amount at risk is a level amount—the face amount of the contract. The increasing death benefit option is more costly than the level death benefit option as the policyowner is purchasing more pure insurance protection.
VARIABLE LIFE

Variable life insurance is a securities-based permanent life insurance policy. The main difference between variable life and traditional whole life is in the reserves. In traditional products, the reserves are invested by the insurance company and placed in conservative investments such as bonds, mortgage loans, etc. These reserves are held in the company's general account. With variable life insurance the reserves are in the separate accounts of the insurance company. These reserves are invested in higher risk investments such as stocks and other equity-type securities. The policyowner gets to choose how the cash values are invested in a variable life policy---stocks, bonds, money market accounts, or other equity investments. Typically, most products offer around twelve funds which is a family of funds approach. A family of funds is a group of funds under the management of the same company although the funds usually have different advisors.

The cash values of a variable life policy are not guaranteed. They are determined by the investment performance of the separate account. The death benefit of the variable life policy also changes to reflect these changes in value. As this product is not fully guaranteed, the agent selling this type of life insurance must hold a life license and a securities license (normally the Series 6 or Series 7). The Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority (FINRA) regulate variable life insurance. The Securities Act of 1933 requires a prospectus be delivered to the client at or before the point of sale. The Securities Act of 1934 requires the company and its sales representatives to be registered with the federal authorities. The Investment Company Act of 1940 requires the registration of separate accounts as an investment company. Another federal regulation is a mandatory 45 day free-look provision from the date of policy application. The policyowner, if dissatisfied, must be allowed to convert the policy to traditional whole life within 24 months of issuance. Besides federal rules, the State Department of Insurance (DOI) also regulates these contracts. All variable contracts must be filed with and approved by the state DOI.

There is a minimum death benefit (face amount of policy) that will be paid to the beneficiary upon death of the insured and the policyowner will be required to make scheduled premium payments. However, there are no guaranteed cash values. The cash values will fluctuate through time depending on the investments in the separate account. Depending on the investment return, the variable life policy's death benefit will increase or decrease. One of the major benefits of this product is protection from erosion of life insurance dollars by inflation. Through history the stock market has kept pace with inflation. Variable life contracts should not have illustrations showing returns of greater than 12% in order to prevent agents from making unrealistic promises as to the performance of the variable life contract.
VARIABLE UNIVERSAL LIFE

A variable universal life policy combines the features of the variable policy and the universal life policy. The policy is variable in its investment aspect. The policyowner can make his/her own decisions as to the investments.

This contract is universal in its flexible premium and adjustable benefit. Premiums are flexible and can vary as to amount and frequency. The policyowner can increase or decrease the death benefit according to the policy guidelines. Cash values may be accessed through partial withdrawals and policy loans.

The variable life policy and variable universal life policy should be regarded as permanent insurance with long-term investments features. Benefits of these contracts are:

- Control over cash values.
- Free switching between funds without incurring a charge.
- Cash values are accessible through partial withdrawals and loans.
- Increasing death benefits if the investments perform well.
- Tax advantages as these are life insurance products and grow tax deferred.

The biggest drawback of the variable policies is the possibility for poor performance of the investments. This would result in lower death benefits, less cash values, and poorer future income prospects than anticipated.

Life Insurance Policy Illustrations: (CIC 10509.950-10509.965) The insurance code imposes rules to ensure that illustrations do not mislead purchasers of life insurance and to make illustrations more understandable by providing illustration formats, prescribing standards to be followed when illustrations are used, and specifying the disclosures that are required in connection with illustrations. Illustrations should use language that is understandable by the typical purchaser of insurance. The following applies to all group and individual life insurance policies and certificates except variable life insurance, individual and group annuity contracts, and life insurance policies with death benefits less than $10,000.

An illustration used in the sale of a life insurance policy shall be clearly labeled “life insurance illustration” and include, but not limited to, the following information:

1. Name of insurer.
2. Name and business address of producer or insurer’s authorized representative, if any.
3. Name, age and sex of proposed insured, except where a composite illustration is permitted.
4. Underwriting or rating classification upon which the illustration is based.
5. Generic name of the policy, the company product name, if different, and form number.
6. Initial death benefit
7. Dividend option election or application of non-guaranteed elements, if applicable.

When using an illustration in the sale of a life insurance policy, an insurer or its producer shall not do any of the following:

1. Represent the policy as anything other than a life insurance policy.
2. Use or describe non-guaranteed elements in a manner that is misleading or has the capacity or tendency to mislead.
3. State or imply that the payment or amount of non-guaranteed elements is guaranteed.
4. Use an illustration that does not comply with the insurance code.
5. Use an illustration that at any policy duration depicts policy performance more favorable to the policy owner than the currently payable scale or a scale based on actual recent historical experience of the insurer.
6. Provide an applicant with an incomplete illustration.
7. 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.
8. Use the term “vanishing” 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.
9. Except for policies that can never develop non-forfeiture values, use an illustration that is not self-supporting (the accumulated value of all policy cash flows equals or exceeds the cash surrender values).
10. Use an illustration that is not “self-supporting.”
11. If an interest rate used to determine the illustrated non-guaranteed elements is shown, it shall not be greater than the earned interest rate based on insurer’s actual recent historical experience.

A basic illustration shall conform with the following requirements:
1. Contain the date on which it was prepared.
2. Each page shall be numbered.
3. The assumed dates of payment receipt and benefit payout within a policy year shall be clearly identified.
4. If the age of the proposed insured is a component of the tabular detail, it shall be issue age plus the number of years the policy is assumed to have been in force.
5. The assumed payments on which the illustrated benefits and values are based shall be identified as premium outlay or contract premium.
For policies that do not require a specific contract premium, the illustrated payments shall be identified as premium outlay.

6. Guaranteed death benefits and values available upon surrender, if any, for the illustrated premium shall be shown and clearly labeled guaranteed.

7. If the illustration shows any non-guaranteed elements, they cannot be based on a scale more favorable to the policy owner than the insurer’s actual recent historical performance. These elements must be clearly labeled non-guaranteed.

8. The guaranteed elements, if any, shall be shown before corresponding non-guaranteed elements and shall be specifically referred to on any page of an illustration that show only the non-guaranteed elements.

9. The account value of a policy, if shown, shall be identified by the name this value is given in the policy being illustrated and shown in close proximity to the corresponding value available upon surrender.

10. The value available upon surrender shall be the amount available to the policy owner in a lump sum after deduction of surrender charges, policy loans, and policy loan interest, as applicable.

11. Illustrations may show policy benefits and values in graphic or chart form in addition to the tabular form.

12. Any illustration of non-guaranteed elements shall be accompanied by a statement indicating that:
   A. The benefits and values are not guaranteed.
   B. The assumptions on which they are based are subject to change by the insurer.
   C. Actual results may be more or less favorable.

13. If the illustration shows that the premium payer may have the option to allow policy charges to be paid using non-guaranteed values, the illustration shall clearly disclose that a charge continues to be required and that, depending on actual results, the premium payer may need to continue or resume premium outlays. If a contract premium is due, the premium outlay display shall not be left blank or show zero unless accompanied by an asterisk or similar mark to draw attention to the fact that the policy is not paid up.

14. If the applicant plans to use dividends or policy values, guaranteed or non-guaranteed, to pay all or a portion of the contract premium or policy charges, the illustration may reflect those plans and the impact on future policy benefits and values.

A basic illustration shall include a numeric summary of the death benefits and values and the premium outlay or contract premium. For a policy with guaranteed death benefits, it shall be shown for at least policy years 5, 10, and 20 and at age 70, if applicable. For multiple life polices the summary shall show policy years 5, 10, 20, and 30.
A statement substantially similar to the following shall be signed by the applicant or policy owner:

“I have received a copy of this illustration and understand that any non-guaranteed elements illustrated are subject to change and could be either higher or lower. The agent has told me they are not guaranteed.”

A statement to be signed and dated by the insurance producer should state:

“I certify that this illustration has been presented to the applicant and that I have explained that any non-guaranteed elements illustrated are subject to change. I have made no statements that are inconsistent with the illustration.

If a basic illustration is used by an insurance producer in the sale of life insurance, a copy of that illustration signed by the applicant or policy owner and producer shall be submitted to the insurer at the time of application. If no illustration is used, the producer shall certify to that effect in writing on a form provided by the insurer. On this same form the applicant shall acknowledge that no illustration was provided and shall further acknowledge that an illustration conforming to the policy as issued will be provided no later than at the time of policy delivery. A copy signed by the applicant shall be provided to the insurer and the policy owner. If the illustration is sent by mail, a duplicate copy of the illustration shall be included for the policy owner to sign and return in an envelope provided by the insurer that is self-addressed and has postage prepaid. Such signed illustrations shall be retained by the insurer until three years after the policy is no longer in force.

A supplemental illustration may be provided to the applicant if it meets these requirements:
- It is attached to or accompanied by a basic illustration
- The non-guaranteed elements shown are not more favorable than the corresponding elements in the basic illustration
- It contains the same required statement as the basic illustration that non-guaranteed elements are not guaranteed
- For a policy that has a contract premium, the contract premium underlying the supplemental illustration is equal to the contract premium shown in the basic illustration

REVIEW QUESTIONS

1. What type of policy contains living benefits?
   A. Term insurance
   B. Permanent insurance
   C. All life insurance contracts
   D. None of the above.
2. It is common practice for policy loans to be made on which of these?

1. Industrial life policies
2. Credit life policies
3. Ordinary life policies
4. Term insurance

A. 1 & 3
B. 2 & 4
C. 3 only
D. 3 & 4

3. A single premium whole life policy endows prior to age 100 due to the sizable premium that is paid at the time of purchase.

A. True
B. False

4. A life insurance policy that continues to provide protection after the premium period has ended is called a:

A. Whole life policy
B. Limited payment life policy
C. Level term policy
D. Decreasing term policy

5. A level term policy is one on which:

A. The premium remains the same as the protection is reduced.
B. The premium and the protection remain the same for the term of the policy.
C. Protection remains level while the premium is decreased.
D. Protection remains constant for the term of the policy while the premium increases.

6. Term insurance is designed to meet which of these needs at the lowest cost?

A. Retirement income.
B. To accumulate savings for a child’s college fund.
C. A temporary protection to cover financial obligations that will be repaid in a defined time span.
D. All of the above.
7. Term insurance differs from permanent insurance in that term:
   A. Builds cash value but pays no death benefit.
   B. Pays money to a living insured.
   C. Builds no cash values but does pay a death benefit.
   D. Has a higher premium per $1,000 of insurance.

8. Which of these will a convertible term life insurance policy allow the insured to do?
   A. Change to a permanent plan of insurance without evidence of insurability at standard rates.
   B. Renew the policy at the end of the policy term without evidence of insurability.
   C. Change to a permanent plan of insurance after proving insurability.
   D. Change to a renewable term contract without evidence of insurability.

9. Which form of insurance would be best suited to make sure a mortgage is paid off if the borrower dies?
   A. Endowment policy
   B. Whole life policy
   C. Credit life policy
   D. Credit disability policy

10. What type of policy provides a death benefit for all family members?
    A. Endowment contract
    B. Variable universal life
    C. Family protection policy
    D. Family maintenance policy

11. What is a major difference between a family income policy and a family maintenance policy?
    A. Family income pays a monthly benefit to the family and family maintenance pays a lump sum only to the family.
    B. Family income pays a monthly income to the family for a stated number of years while family maintenance pays the family a monthly income for the number of years remaining on the term rider.
    C. Family income policies have a level term rider to provide the monthly benefit and family maintenance polices have a decreasing term rider to provide the monthly benefit.
    D. The major difference is the length of time the monthly benefit will be paid.
12. What type of policy might contain a payor benefit rider?

   A. Family income policy  
   B. Juvenile policy  
   C. Industrial life policy  
   D. Credit life

13. A joint life policy written as a first to die might be used for which of these situations?

   A. Business partners who wish to be able to buy out a deceased partner.  
   B. An employer wanting to insure a key employee.  
   C. A creditor wanting to recover the loan of a deceased debtor.  
   D. A parent wishing to insure a child’s policy will stay in force if the parent dies.

14. A flexible benefit cash value policy which earns a current rate of interest with flexible premiums is:

   A. Modified endowment contract  
   B. Variable life  
   C. Adjustable life  
   D. Universal life

15. Which of the following is true?

   A. Variable life insurance does not have a guaranteed death benefit but it does have guaranteed cash values.  
   B. Variable life insurance cash values are placed in the general account of the insurance company.  
   C. Variable life insurance has no guaranteed cash values or death benefit.  
   D. Variable life insurance has a guaranteed minimum death benefit but no guaranteed cash values.

16. Which of the following will require an agent to hold a securities license in order to sell?

   A. Universal life insurance  
   B. Adjustable life insurance  
   C. Variable life insurance  
   D. All annuity contracts
17. Which of the following life insurance policies would provide a 25 year old woman with the most rapid growth of cash value?

A. Straight whole life  
B. 20-pay life  
C. Life paid-up at age 65  
D. Convertible term