CHAPTER 5
LIFE INSURANCE POLICY OPTIONS AND RIDERS

There are a number of policy options and riders that the purchasers of insurance need to understand. Obviously, life and disability agents need to have a good grasp of this information in order to explain it to clients.

NONFORFEITURE OPTIONS

All states have adopted laws modeled after the NAIC Standard Nonforfeiture Law. These rules have to do with permanent policies that have cash values. If a policyowner allows a policy to lapse or chooses to surrender the contract, he/she is entitled to the policy's cash values. The policyowner does not lose or forfeit these values. A surrender charge fee can be charged to a policyowner when a life insurance policy is surrendered for its cash value. This fee reflects insurance company expenses incurred by placing the policy on the books and subsequent administrative expenses.

Prior to the 1905 Armstrong Investigation, insurance companies were keeping the cash values of a contract when a policy lapsed. Now policyowners are entitled to choose nonforfeiture options. These are ways the cash values can be paid out or used by the policyowners. There are three nonforfeiture options: (1) cash surrender; (2) reduced paid-up insurance; and (3) extended term insurance.

CASH SURRENDER OPTION

If a policyowner chooses, he/she may request a cash payment of the cash values when the policy is surrendered. In a whole life policy, there will be a table of guaranteed values showing the cash values in the policy during at least the first 20 years. The cash surrender value will be reduced by the amount of any outstanding policy indebtedness.

Permanent policies should start generating cash values by the third year that they are in force. A part of each premium is allocated to the policy reserve. The remaining balance of the premium is used to cover acquisition costs, agents' commissions, administrative costs, etc. In the first couple of years the entire premium goes to cover reserve requirements and other company expenses. Due to the fact that the policy when first issued is heavily loaded with expenses, cash values do not start accumulating until the third year. Consequently, the longer a policy is in force, the greater the cash values, the greater the loan values, and the greater the nonforfeiture values.

REDUCED PAID-UP INSURANCE OPTION

If a policyowner elects the reduced paid-up nonforfeiture option, the cash values in the policy will be used as a single premium to purchase insurance of the same plan as the current policy. The amount of insurance that can be purchased is based on the insured's attained age (present age) and the amount of cash surrender. If a person originally had a whole life policy, his/her new policy would be a whole life policy that is fully paid up with the cash values from the original policy. The new reduced paid-up policy will also build cash values over the life of the contract.

EXTENDED TERM OPTION

The third nonforfeiture option is extended term insurance. The insurance company will use the cash values in the original policy to buy a term insurance contract for the same face amount as the original policy. This is a new contract and the length of time that this policy is in force will be determined by the insured's attained age and the amount of the cash values. If this is a participating policy, any accumulated dividends or cash value of paid-up additional insurance will be used as part of the cash value available to buy the extended term contract. If there is an outstanding loan against the policy when it lapses, the amount of the loan will be deducted from the amount of cash values with which to buy the extended term thus reducing the amount of time of the term contract. The amount of the loan also is deducted from the face amount of the new extended term. The reason for this is to protect the insurer. An insured might find that he/she is terminally ill and decide to borrow against the policy and ask the company to change the contract to an extended term. In this case the beneficiary would be receiving the same amount, but a lot of the cash value already had been removed by the insured. The insured will have "taken" the insurance company. Therefore, the loan amount is deducted from the face amount of the new term contract.

In California all permanent policies must include provisions for nonforfeiture options or benefits. The provisions must state that after a policy has been in force for one year, the insurer will grant a paid-up nonforfeiture benefit on a plan stated in the policy. The policyowner needs to make this request within 60 days after the premium due date. The provisions must state that after an ordinary policy has been in effect for three years or an industrial life policy has been in effect for five years that the insurer will pay a cash surrender amount in lieu of a paid-up non-forfeiture benefit. Policies that provide for unscheduled changes in benefits or premiums must contain an explanation of the mortality table, interest rate, and method of calculating the cash surrender values or paid-up nonforfeiture benefits.

In conclusion, the policyowner needs to pick the nonforfeiture option that suits his/her circumstances.

Cash surrender—If he/she does not need insurance and simply wants the money.

Reduced paid-up insurance—If he/she wants lifetime paid-up protection at a lesser face amount. This option lasts the longest period of time.

Extended term insurance—If he/she needs the same amount of insurance for a lesser amount of time. This option provides the most face amount of coverage but only for a limited amount of time.

DIVIDEND OPTIONS

Life insurance contracts can be issued on either a participating (par) or non-participating (non-par) basis. When a person buys a policy from a mutual insurer that person is becoming a part owner in the company. As an owner, the policyowner has voting rights and also is able to share or participate in the company's surplus. At any given age the owner of the par policy may pay premiums that are a little higher than on a non-par policy. This is due to the fact that an extra charge to cover unexpected contingencies is structured into the premium payment of the par policy.

A mutual company will analyze its operations at the end of the year and determine its surplus. The surplus a company has may come from several different areas. These are:

Savings in mortality costs. Fewer people have died during the year which

translates to fewer claims having to be paid.
More interest earned on investments. If a company experiences a greater investment return than projected, it will create surplus.
Operating expenses or loading decreases. If a company can decrease the cost of its overhead, it will increase the surplus.

Based on these factors, the company will determine its surplus. The surplus will be returned to the policyowners in the form of a dividend. Dividends are regarded by the government as a **return of excess premium** charged the policyowner. As it is a return of excess premium, dividends paid on participating policies are **not taxable**. However, since the surplus can vary from year to year, dividends **cannot be guaranteed**. Any illustration used by an agent that includes dividends should state clearly that future dividends cannot be guaranteed. Dividends normally become payable by the end of the first or second year. A provision in each par policy will state when a policyowner can expect to start receiving dividends.

The agent should understand the dividend options in order to help the client select an appropriate option. When the policyowner selects a dividend option, it will stay in effect until the policyowner notifies the company that he/she wishes to make a change. The policyowner may change the choice of dividend option during the duration of the policy. However, if one-year term or paid-up additional insurance is not an original dividend option, it is possible that the insurer might ask the insured to prove insurability when picked at a later date. The five most common dividend options are:

1. cash
2. reduce premium
3. accumulate at interest
4. paid-up additional insurance
5. one-year term

CASH DIVIDEND OPTION

Dividends are usually paid annually after a policy has been in force a year or two. If the policyowner picks the cash dividend option, the company will issue a check for the dividend amount. This option is picked frequently when a policy is paid up.

REDUCE PREMIUM DIVIDEND OPTION

This option allows the policyowner to use the dividend to pay part of the premium. The premium notice sent to the policyowner will show the gross premium minus the dividend. The policyowner simply pays the net amount. If the dividend ever equals or exceeds the premium, no premium payment will be due and any excess amount can be used for another option such as accumulate at interest.

ACCUMULATE AT INTEREST DIVIDEND OPTION

The insurer retains the dividend with this option and interest will be paid at a rate specified in the policy and compounded annually. The interest rate is usually a guaranteed minimum and, if the insurer experiences a good investment return, excess interest may be paid on the accumulations. It should be noted that with this option, although the dividend is not taxable, any interest earned is taxable in the year earned.

The amount of money accumulating at interest is completely separate from the insurance contract. Therefore, the policyowner can remove this money at any time and it has no bearing on the cash values in the insurance policy.

If an insured dies, any amount left accumulating at interest will be paid to the beneficiary along with the death benefit of the policy.

PAID-UP ADDITIONAL INSURANCE DIVIDEND OPTION

Dividends may be used to purchase more insurance of the same kind as the original or base policy. The insurer uses the dividend as a single premium to buy more paid-up insurance. The amount of paid-up insurance that is purchased is based on the amount of the dividend and the insured's attained age.

The base policy is amended to show the additional amount of paid-up insurance. These "paid-up adds" will develop cash values. Upon the death of the insured, the death benefit is the face amount of the policy plus the paid-up additional insurance. If the policyowner surrenders the policy for the cash values, he/she will receive the cash value from the policy and the paid-up additional insurance.

ONE-YEAR TERM DIVIDEND OPTION

This fifth dividend option uses the dividend to purchase a term contract of one-year duration. The amount of insurance purchased will be whatever the dividend can purchase at the insured's attained age or to purchase one-year term insurance equal to the base policy's cash value. If there is excess dividend after purchasing an amount of insurance equal to the cash values, the remainder may be applied to any other dividend option.

The usual reason to use one-year term is to keep the total amount of insurance equal to the face amount when there is a loan against the policy. Outstanding loans plus interest due are deducted before a death benefit is paid to the beneficiary. This option attempts to preserve the face amount for the beneficiary.

There are other dividend options besides these five. These are the most common and the ones all agents selling participating policies need to understand. If a policyowner does not state a dividend option in writing, the policy must state which dividend option automatically will apply.

SETTLEMENT OPTIONS

The policyowner chooses a beneficiary and he/she also may decide on how the beneficiary will receive the proceeds from the policy. The policyowner has the right to make changes to the settlement option during the lifetime of the insured. If the policyowner has not stated a settlement option, the beneficiary then would have the right to select a settlement option if he/she so desires. Remember that any outstanding indebtedness will be deducted from the policy before payment is made to the beneficiary. The death benefit will include any dividends accumulated at interest, paid-up insurance additions, or one-year term insurance additions.

A settlement option really is a mode of distributing the proceeds from the policy in other than a lump sum. Most policy proceeds are distributed in a lump sum. However, it is important that policyowners and beneficiaries realize that there are settlement options.

There are good reasons to elect a settlement option. It could be that the beneficiary cannot manage money and would spend it recklessly or perhaps an individual does not know how to handle investments and it is preferable for the insurer to oversee the investments and pay interest to the beneficiary on the policy proceeds. Settlement options include:

- Interest only option
- Fixed period option
- Fixed amount option
- Life income option

INTEREST ONLY SETTLEMENT OPTION

With this option, the proceeds of the policy are held by the insurance company and interest is paid to the beneficiary at regular intervals which can be monthly, quarterly, semi-annually, or annually. As interest is the only thing being paid, the principal amount stays intact. A minimum interest rate to be paid is guaranteed in the policy. If the insurer has high earnings, it might pay a higher amount than the guaranteed rate.

The insurer will not hold the principal amount indefinitely. The policyowner needs to state how he/she wants the principal sum to be paid. One choice would be the interest only would be paid to a stated date or for a stated amount of time and then paid to the beneficiary in cash or another settlement option. The policyowner also may state that the beneficiary may withdraw the principal in whole or in part. Perhaps the policyowner wants the primary beneficiary to receive interest only and upon the beneficiary's death have the principal sum be paid to a contingent beneficiary or to the estate of the policyowner.

FIXED PERIOD SETTLEMENT OPTION

Under the fixed period settlement option the insurer pays the beneficiary equal amounts of money consisting of principal plus interest at regular intervals over a specified period of years. The amount of the payment is determined by the number of years over which the proceeds are being distributed—the longer the period, the smaller the payments; the shorter the period, the higher the payments.

There is a guaranteed interest rate but, if the company pays an excess interest rate, the payments will be increased. The length of time is not extended. If the primary beneficiary dies, payments will be continued to a contingent beneficiary. If there is no contingent beneficiary, an amount reflecting the current value of the number of payments remaining will be paid to the estate of the last beneficiary.

FIXED AMOUNT SETTLEMENT OPTION

With the fixed amount settlement option the death benefit is paid to the beneficiary in a series of fixed amount installments until the proceeds plus interest are exhausted. The size of the payment will dictate how long payments will be made. Excess interest will prolong the payment period. The size of the installment payment will not change. Any fractional amounts are paid in full with the last full installment.

LIFE INCOME SETTLEMENT OPTION

Under this settlement option, the beneficiary receives a guaranteed income for life.

The insurer uses the amount of the death benefit to purchase a single premium immediate annuity for the beneficiary. Annuities were developed to provide a stream of income for the recipient's lifetime. The payment is actuarially calculated to last the lifetime of the beneficiary. Income payments will continue as long as the beneficiary is alive even if the principal is depleted. There are a number of distinct methods in which the installments can be paid. The four most common will be mentioned here.

Straight life income (life income) pays the payee a specified income for his/her lifetime. Upon the payee's death, nothing further is paid to anyone.

Refund annuity pays a lifetime income to the payee and to a second payee if the full amount of proceeds have not been paid out to the original payee.

Life income certain pays the payee for life and pays a second payee if the first payee dies prior to the number of years specified in the certain period, i.e. 5, 10, 15, or 20 years.
Joint and survivor life income provides for two beneficiaries upon the death of the insured. Two beneficiaries receive the proceeds of the life policy. Upon the death of the first beneficiary, the second beneficiary continues to receive proceeds for life. The income received by the second beneficiary frequently is a lesser amount.

Sometimes a policyowner may no longer want to pay for a permanent policy. The policyowner can surrender the policy and request the insurer to use the cash value to pay an income. If the policyowner wants a lifetime income, the cash value of the policy is used to purchase an annuity under one of the above settlement options.

Insurance companies will handle settlement options, but they will have rules to avoid arrangements that are uneconomical to administer. Insurers will provide administrative services; they will not provide judgment services. In other words, insurers will not provide trustee services. A policyowner could not request that an insurer pay proceeds to a beneficiary according to his/her needs.

LIFE INSURANCE POLICY RIDERS

A rider can be defined as an endorsement to an insurance contract that modifies clauses and provisions of the policy. A rider can add benefits to a policy—usually for an additional premium. A rider also can take benefits away. A waiver is a form of rider that excludes benefits and for which there is no additional premium. For instance, a waiver on a life policy may exclude death due to certain hazardous hobbies.
ACCIDENTAL DEATH RIDER

For an additional premium the accidental death rider may be added to a policy. This frequently is called double indemnity as most accidental death riders pay twice the face amount of the policy if death is due to an accident. However, some accidental death riders pay three or more times the face amount. The amount paid is referred to as the **principal sum**. It should be noted that the extra premium for the rider has no effect on the cash values of the contract. The additional premium simply covers the extra risk the company is incurring.

The insurance company may have a liberal definition of accidental death or a strict, limited definition of accidental death. For this benefit to be paid, the accident must conform to the policy's definition. Deaths due to self-inflicted injury, war, or private aviation activities will be excluded. An insured sometimes may not die immediately after suffering an accident. Because of this, the policy will state within how many days of the accident that the insured must die in order for accidental death benefits to be paid. This time period usually is 90 days.

If there is an outstanding policy loan at the time of death, the loan amount and any interest will be deducted from the face amount of the policy but not from the accidental death rider.

This rider normally expires when the insured reaches a given age—somewhere between 60 to 70. When the rider terminates, the additional premium charged for the rider will be dropped. If a policy lapses due to non-payment, a company may agree to reinstate the policy but it can refuse to reinstate the accidental death rider. If the extended term or reduced paid-up nonforfeiture options are selected, none of the riders for additional benefits will be included in the new policy.

ACCIDENTAL DEATH AND DISMEMBERMENT RIDER

An accidental death rider also may include another benefit if the insured is dismembered due to an accident or if this loss occurs within 90 days of the accident. This is referred to as accidental death and dismemberment (AD&D). The dismemberment portion will pay the **capital sum** (face amount of policy) if the insured loses two limbs or the sight in both eyes. Some policies may pay a lesser sum if the insured loses one limb or one eye. Dismemberment means the actual severance or removal of the limb.

WAIVER OF PREMIUM RIDER

This rider allows for the waiver of premium payments in the event of the total disability of the insured. The insurance company determines if the insured is totally disabled. If the insured is determined to be disabled, the policyowner does not have to make any premium payments for as long as the disability lasts.
There is an amount of time that the insured must be totally disabled called the waiting period. The waiting period typically is six months (three months with some companies). If a scheduled premium payment is due during the waiting period, the policyowner must make the payment. If the disability does last longer than the waiting period, any premiums paid during the waiting period will be refunded by the company.

Total disability can be interpreted differently by insurers. It can be defined as the insured's inability to engage in his/her own occupation or the insured's inability to engage in any occupation for which he/she is suited by education, training, or experience. Some policies might define it as the inability to do his/her own occupation for a specified period (e.g. 1 or 2 years) and after that period apply the broader definition of any occupation.
.
The waiver of premium rider normally stays in effect until the insured reaches a specified age, commonly 60 or 65. If there was an additional charge for this rider, the premium payment will decrease when the waiver of premium rider expires. If the insured becomes totally disabled before the specified age, premiums are waived for the duration of the disability which could be the insured's lifetime. Disability caused by war, during the commission of a crime, or self-inflicted injury are typical exclusions in the waiver of premium rider.

While premiums are being waived during disability, the policy remains in full force. It is just as if the policyowner were making the payments. Cash values continue to increase, dividends are paid on participating policies, and the policyowner may take out a policy loan. Should the insured recover, the policyowner will start making premium payments again. None of the premium payments paid by the company need to be repaid by the policyowner.

If an insured has waiver of premium on a universal life policy, only the portion of the premium that pays the expenses of the policy will be waived. The portion contributed to the accumulation fund is not paid.

A version of this rider is the **waiver of premium with disability income**. This rider allows for the waiver of premium during total disability and it pays a weekly or monthly benefit to the insured during the disability. The amount of income is usually a dollar amount per $1000 of the face amount of the life policy to which the rider is attached.

PAYOR BENEFIT RIDER

This rider may be added to juvenile policies for an extra charge. It allows for the waiver of premiums if the payor (usually a parent or guardian) dies or becomes permanently disabled. The payor usually must show evidence of insurability. Premiums are waived until the child reaches a given age (21 to25) at which time he/she can take over the premium payments.

GUARANTEED INSURABILITY RIDER (OPTION TO PURCHASE OTHER INSURANCE)

This rider guarantees the insured that he/she may purchase more insurance at future dates without proof of insurability. The option dates normally are the policy anniversary nearest the insured's birthdays at ages 25, 28, 31, 34, 37, and 40. Age 40 typically is the last age when more insurance may be purchased under the guaranteed insurability rider. The insured usually has 90 days in which to exercise the option. If he/she does not exercise the option, it will not effect future option dates. A marriage and stork provision can be added to the guaranteed insurability rider to trigger additional dates when more insurance may be purchased upon marriage of the insured or birth of a child.

The amount of insurance that may be purchased at each interval typically is limited to the type and face amount of the original policy. If the insured had a $20,000 whole life contract, he/she could purchase up to $20,000 at each interval. When more insurance is purchased, the additional coverage is based on the attained (present) age of the insured.

If either the waiver of premium rider or accidental death benefit rider is included in the original policy, many companies will allow these riders to apply to the additional amounts of insurance purchased under the guaranteed insurability rider. Of course, an additional amount of premium will be charged.

The major benefit of this rider is not having to prove insurability. If an insured has this rider and he/she becomes uninsurable, the insured can continue to buy more insurance coverage at each interval at standard rates.

RETURN OF PREMIUM/RETURN OF CASH VALUE RIDERS

Both of these riders are increasing term insurance added to an underlying policy. With the return of premium rider, there is an increasing amount of term insurance that equals the amount of premiums paid. With the return of cash value rider, an additional amount of increasing term insurance equaling the cash value is provided. Actually these riders do not return the premiums or cash values. The policyowner really is buying term insurance that pays an additional amount equal to premiums paid or the amount of cash value.

COST OF LIVING RIDER

Life insurance policies such as whole life have a level face amount of insurance. Through time the amount of insurance can be eroded by inflation. A cost of living (COL) or cost of living adjustment (COLA) rider may be added to a policy in order to provide an increase in the amount of insurance coverage without the insured having to prove insurability. The amount of increase is tied to an inflation index—usually the Consumer Price Index (CPI) with a maximum annual percentage increase, i.e. 5%. Any increase in death benefit will result in a higher premium. A decline in the CPI will not result in a decline of insurance coverage. There will be no future increases until the CPI again exceeds its prior high point.

ADDITIONAL INSUREDS

Riders can be used to provide insurance for more than one family member. Typically it is a term rider covering a family member other than the insured and it is attached to the base policy covering the insured. A children's rider will cover only the children. A family rider covers all family members.

SUBSTITUTE INSURED RIDER

This really is a business use of life insurance. Normally an insured under a life insurance policy cannot be changed or substituted. However, a company may have a policy on a key employee. If this key employee leaves or retires, the insurance can be changed to cover the life of the employee's replacement subject to the new key employee proving insurability. The policy stays in effect with the same amount of coverage. The premiums will be adjusted based on the new key employee's age and sex.

DISABILITY INCOME RIDER

Disability income insurance provides for loss of income when the insured is disabled due to sickness or accident. It pays the insured periodic payments while he/she is disabled. Disability income benefits can be provided by a separate disability income policy or by adding a disability income rider to a life policy. This rider really is a form of health insurance, but it can be added to a life contract. Disability income insurance does not cover medical bills resulting from the disability.

Disability income riders normally only pay an income benefit if the insured is totally disabled and there is usually a six-month waiting period before benefits are paid. Most such riders will not cover a disability that commences after age 60.

ACCELERATED BENEFITS RIDER

Until recent years the only methods of using cash values in a life policy while the insured was living were by borrowing against the cash values or surrendering the policy for the cash surrender value. Now with the accelerated benefits rider, a terminally ill person can access part of the policy proceeds prior to death. Medical proof of terminal illness must be provided. This is an advance against the death benefit. Since the insurance company is aware that death of the insured is imminent, the insurer is allowing the insured to use proceeds from the policy to pay for medical care. Most companies do not charge for this rider and many companies are simply incorporating this as a provision in their life policies.

The negative to the accelerated benefits is to the beneficiary. Any money advanced against the face amount will be deducted before paying the beneficiary the remainder.

Another choice for an insured who is ill would be to sell his/her life insurance policy to a viatical settlement company for a discounted face amount (e.g. 50% to 80%). This transfer is brought about by the use of an absolute assignment that gives all incidents of ownership to the viatical settlement company. Viatical settlement companies will purchase policies from insureds who are not necessarily terminally ill but whose prognosis is not good. Perhaps the insured's doctor feels this person may live several years. The viatical settlement company becomes the owner of the life policy, will pay the premiums, and will receive the death proceeds upon the death of the insured. As this is a business transaction, the viatical settlement company will have to pay taxes on its profit. The profit would be the difference between the face amount of the policy and the costs to the viatical settlement company (original purchase price of contract and premium payments).

Yet another development is the STOLI (stranger-originated life insurance). In STOLI arrangements, speculators who have no relationship to insured persons initiate coverage on older people—typically between the ages of 65 and 85 years old. These arrangements could involve the speculators offering the older person a lump sum for purchasing the policy, paying for the purchase of the policy at no cost to the individual in exchange for a partial payment of the policy's face value to the insured's beneficiaries upon the insured's death, or having an insured who is purchasing a life policy in his/her own name to sign an agreement where investors get beneficial ownership of the policy (usually after a two-year contestability period has expired) in exchange for the investors paying the premium.