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Course

Life Insurance Principles

(203C)

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THE CONCEPT OF LIFE INSURANCE

The concept of life insurance is a means of spreading financial loss among many individuals so that the cost to anyone individual is small compared to the actual loss.

Younger individuals in the pool contribute more because normally they will live longer than older individuals in the pool.

The advantage of a younger person participating in the pool is that in the event he or she were to die before the anticipated age, that individual would be assured that the remaining family members would have the security of financial coverage as provided for in the insurance policy.

Thus life insurance is a way of spreading among many individuals financial loss resulting from an individual's death.

An insurance company is the entity that coordinates the administration and details of selling the life insurance program, collecting the money required to make the "pool" effective, and paying out the benefits to the designated individuals as desired by the insured.

Life insurance is a contract, and as in any other contract, is a promise between two or more parties promising a certain performance in exchange for some form of consideration.

In order for a contract to be legal certain requirements must be met under the law. All parties to the contract must be of sound mind and legal age. A contract can be either verbal or written. Most contracts, including insurance contracts, are written.

A life insurance policy is a unilateral contract wherein the insurance company promises to perform in accordance to the terms of the policy and it's riders in exchange for a premium.
As long as the owner of the policy continues to pay the premium the insurance company must perform on its' contractual obligation.

Besides competence of mind and legal age in order for a contract to be valid it must also have offer and acceptance and consideration.

Consideration occurs when the policy owner promises to pay the insurance company a premium in exchange for the insurance.

Offer occurs when the potential policyholder applies for insurance and proceeds to submit the first premium.

Acceptance occurs when the insurance company accepts the application, the first premium and issues the policy.

Insurance contracts have certain characteristics with which you should be familiar.

The term waiver is a voluntary relinquishing of a right or privilege, and the term estoppel is used to refer to that individual's inability to enforce a right that the individual has previously relinquished.

Insurance contracts are ALEATORY in nature. This means that the parties to the contract may not necessarily receive equal value. An example might be an individual dying very early in the stage of the contract thus having paid less premium than the benefit received by the beneficiary.

Insurance contracts are also contracts of ADHESION. This means that one party draws up the contract and the other party "adheres" to its terms. In the event of dispute over interpretation courts most normally rule on behalf of the policy owner or the beneficiary.

Because insurance contracts rely on "GOOD FAITH" performance, there is a duty by the parties to disclose all material facts. Failure to do this usually gives the other party grounds to void the contract

Insurance contracts are both EXECUTORY and CONDITIONAL. Conditional in the sense that the policy owner must perform certain acts such as provide proof of claim and pay the premiums. Executory in that something in the future must occur in order to complete the contract, such as the payment of a death benefit upon the demise of the insured.

Mortality Tables provide insurance companies the guide that helps to set insurance premiums. Together with the Mortality Rate insurance companies evaluate the risk involved in insuring life policies.

THE NEED FOR LIFE INSURANCE

The chief function of life insurance is to create a sum of money under the conditions outlined in the insurance policy. This is known as creating an estate.

The life insurance estate is created for many different reasons. The money is usually paid to a beneficiary to take care of the debt caused by the death of the insured such as funeral expenses; to take care of debt left by the deceased; or perhaps as a gift to the beneficiary; or maybe to take care of future needs of the beneficiaries.

Thus life insurance either becomes survivor protection need or a total needs protection.
Some of the considerations that an individual might take into account in planning for the estate might be:

- Medical bills left behind after death
- General bills left behind, such as, credit cards, mortgages owed
- Future education for children
- Estate taxes
- A revenue stream of future income for the survivors

A person who wants to make sure that all obligations of the family are well taken care of will plan an estate that is sufficient to cover all needs. An estate large enough to cancel all debt, provides the liquidity to pay taxes, and enough money to support the beneficiaries.

An individual can choose many options in creating an estate, but only life insurance creates an immediate estate.

A saving account requires years of deposits or a very large deposit earning interest immediately before it represents an "estate" for the survivors.

Investment in the stock market is no guarantee of an estate.

But, life insurance can create an estate of any value simply by paying a small premium. It takes only one premium payment to establish the security of a large or predefined amount granting the beneficiaries immediate security even if the insured were to die the next day.

LIFE INSURANCE BENEFITS FOR THE LIVING

In addition to death benefits, life insurance can also provide benefits during the life of the insured.

As premiums are paid into a life policy, they accumulate and the policy develops a "cash value" enabling the individual to take advantage of the available cash, use the value to establish collateral for a loan, or perhaps set up a scheduled pay out benefit.

In addition to financial security a properly planned life insurance program provides mental tranquility for the survivors who are able to carry on with every day life without having to deal with the financial stress that might have burdened them.

There are two methods used to calculate the required amount of insurance needed by a family should the wage earner die early in life.
Capital Retention or Capital Conservation is a method used that does not draw on the principal but simply uses the interest to generate income for the family. This method guarantees income forever and ever regardless of how long the beneficiary lives. The funds can also outlive the beneficiary and be given away to loved ones or charity.

The second method is the Capital Utilization or Capital liquidation method. This method draws on both the interest and principal. Thus at some point in time the fund will be depleted and the beneficiary may out live the benefit.

Wise planning should be used in deciding the goal of the policy and its benefit to the beneficiary.

FOCUS POINTS

1. Life insurance is a means of spreading financial loss amongst many individuals.
2. Younger individuals who live out their life expectancy contribute more to the financial pool than older individuals
3. The advantage of life insurance to a younger individual is the benefit acquired if the individual were to die early.
4. Life insurance is a way of spreading financial loss in the event of some ones death.
5. An insurance company is the entity that coordinates the balances required to make life insurance work as a business.
6. Life insurance is a contract
7. A contract is a promise by two individuals or entities to perform in a certain manner in exchange for consideration.
8. Parties to a contract must be of sound mind and legal age
9. A contract can be either verbal or oral
10. Insurance contracts are written agreements.
11. A life insurance contract is unilateral.

12. Unilateral means as long as the premium is paid the insurance company must perform.
13. A valid contract must have offer, acceptance and consideration.
14. Consideration occurs when the premium is paid in exchange for the insurance.
15. Offer occurs by application and payment of premium.
16. Acceptance occurs by acceptance of application, acceptance of premium and issuing of policy.
17. A waiver is the voluntary relinquishing of a right or privilege
18. Estoppel is the inability to enforce a right previously relinquished.
19. Insurance contracts are Aleatory.
20. Aleatory means both parties do not receive equal rights.
21. Insurance contracts are Adhesion contracts.
22. Adhesion is a contract drawn up by one party.
23. "Good Faith" performance requires both parties to disclose material facts.
24. Insurance contracts are both Executory and Conditional.
25. Executory means something in the future must occur in order to complete the contract.
26. Conditional means the policy owner must perform certain acts.
27. Mortality Tables and Mortality rates help insurance companies evaluate the risk involved insuring life policies.
28. The chief function of life insurance is to create an estate.
29. Estates are created to take care of the future needs of the beneficiaries.
30. Life insurance can provide benefits during the life of the insured.
31. Cash value establishes benefits during the life of the insured.
32. Cash value can be used as collateral.
33. Cash value can be borrowed against.
34. Capital Retention draws on the interest not the principal.
35. Capital Utilization can deplete an account prior to the death of a beneficiary.

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THE LIFE INSURANCE POLICY

Life insurance is a contract between an individual and an insurance company. In this contract, the insurance company agrees to pay a stated amount of money to a beneficiary, under certain conditions, in exchange for a sum of money called the premium. It is important to note that a life insurance policy is in fact a legal contract. It is an agreement between two parties to do something in exchange for the premium that is paid to the company.

THE USES OF LIFE INSURANCE

Life insurance is primarily used to function in personal and family situations. As a rule a person's death creates an immediate need for money. The following is a list of some of the needs that might be created from an individual's death.

- Expenses created by final illness.
- Burial and funeral expenses.
- Debts due at time of death.
- Costs to administer the estate.
- Federal and state death taxes.
- Inheritance taxes.

Money may also be needed to provide for the following:

- Payoff mortgage or purchase a new home.
- Provide an education for children.
- Meet unexpected financial needs.

Life insurance can also provide benefits for business situations. Here are a few examples:

- Loss caused by death of a key employee.
- Collateral for loans.
- A business insurance fund.
- Buy-out business interest of a deceased owner.
- Fringe benefits for employees.
- Fund qualified retirement plans.

LIFE INSURANCE AS A PROPERTY

Few people consider life insurance as property. Is it possible for a premium payment of $100.00 to create an immediate estate or property valued at $250,000.00? That is possible with life insurance. Here are some advantages of life insurance as property:

- As an asset it is very secure.
- There is no managerial care.
- It can be purchased in any desired amount.
- It provides a reasonable rate of return.
- Proceeds are payable immediately.
- Policy owner chooses the method of payment for premiums.

THE LIFE INSURANCE APPLICATION

THREE PARTIES TO AN APPLICATION

A life insurance application contains three parties:

- The proposed insured.
- The applicant.
- The policy owner.

THE PROPOSED INSURED

The person whose life is being insured by the life insurance policy.

THE APPLICANT

The person that is making application to the insurance company for the life insurance and may or may not be the proposed insured.

THE POLICY OWNER

The person that usually pays the premiums and the person who retains all rights to any values or options contained in the policy.

DEFINITION OF AN APPLICATION

In order for a person to purchase life insurance they must make a request to the insurance company of their choice. The form on which this request is made is known as an application.

Most companies now require that the proposed insured be physically present in front of the agent while the questions on the application are being filled out. The application is crucial in that it provides the data that the underwriters and insurance company will use to determine if a policy will be issued.

When the proposed insured signs the application he is making a formal request to the company that a policy be issued on his life. In addition, the signature on the application indicates that the information is true and correct to the best of his knowledge.

MINOR APPLICATIONS

In most states a person is not considered an adult until 18 years of age. As a rule, minors are not permitted to enter into contracts. However life insurance is the exception in that a person is a minor only until age 15. In the event that the proposed insured is younger than age 15 one of the following persons must sign the application on behalf of that child:

- The mother or father of the minor child.
- A court appointed safeguard for the well being of the minor.
- The grandparents of the minor child.

CORRECTING APPLICATIONS

Should it be necessary to correct a mistake regarding information given on the application, the proposed insured must initial any and all changes on that application.

Mistakes on the application can be costly, especially when the company is paying an outside reporting service to conduct an inspection. Any changes that are made on a completed application must have the approval of the proposed insured. The normal procedure is to return the incorrect application to the agent who in turn will take it to the insured to have the errors initialed.

INCORRECT/INCOMPLETE APPLICATIONS

Should an application contain incorrect or incomplete information it should not be taken lightly. In the event that the company has already made a decision on a risk, based on these inaccuracies, it could result in a serious loss.

Should the error be discovered after the issuance of a policy the company can cancel or rescind the entire contract from the date of issue. Of course this must take place before the incontestability clause of the contract takes effect.

REPRESENTATIONS/WARRANTIES

All statements on applications are regarded as representations. When an individual makes a statement he believes to be true, he is making a representation of the truth. While it is possible that a representation may be found to be untrue, a person who makes a representation believes it to be true.

A warranty on the other hand is a statement made with such absolute certainty that it is guaranteed to be true. No statement on an application is considered a warranty.

Misrepresentation - A false representation can be defined as a misrepresentation.

FRAUD

There are three elements necessary to constitute fraud:

- A person makes an intentional misrepresentation of what is known to be a material fact.
- The person has intent to gain advantage.

- A person relies upon a second party that suffers a loss.

There can be no fraud unless there is intent.

CONCEALMENT

Concealment is close to misrepresentation when it comes to information included on a policy application.

While misrepresentation, as stated earlier, is something known to be untrue, concealment is withholding of facts that the applicant should have given to the insurance carrier at the time of application.

CONDITIONAL RECEIPT

Always collect the first full premium from the applicant at the time of application. The receipt that is located at the bottom of the application is called a conditional receipt. The word "conditional" is very important because the agent is not guaranteeing that the policy will be issued. Issuance of the policy is subject to the full approval of the insurance carrier.

The conditional receipt serves two functions:

- It acknowledges the first full premium.
- It states in very clear terms that the policy acceptance is subject to the approval of the carrier.

SHOULD THE INSURED DIE

In the event the proposed insured dies before the policy is issued, according to the conditional receipt, the following will take place:

- If the insurance carrier had issued the policy to the proposed insured, had they still been living, then the proceeds would be paid to the beneficiary.
- Should the above not be the case and the claim is denied the premium will be returned to the beneficiary.

POLICY EFFECTIVE DATE

Full protection takes effect as of the policy effective date. The policy effective date also begins the date on which the contestable period begins to run. The policy effective date also is the date on which the suicide clause begins to run.

There are three reasons why the policy effective date is important:

- Insurance begins on this date.
- The contestable period begins on this date.
- The suicide clause begins on this date.

BACKDATING POLICIES

Policies can be backdated, as a rule, a maximum of six months. Most companies allow backdating for several reasons:

- Ten-times backdating can save an age by one year of the proposed insured and this can result in a lower premium for the proposed insured.
- Backdating is useful to assist the policy-owner in coordinating dates to fit their income pattern. Perhaps the backdating may change the policy to closely match paydays.
- Occasionally some policy forms have minimum and maximum age limits and backdating may be able to put the applicant's age into the window of acceptable age limits.

HOW MUCH LIFE INSURANCE DO I NEED?

The majority of families in America are inadequately insured. As a rule individuals should carry life insurance equal to five or six times annual earnings.

USING THE NEEDS APPROACH TO LIFE INSURANCE

The following are a few of the more popular applications for life insurance to provide for a need that occurs as a result of a death.

ESTATE SETTLEMENT NEEDS

Cash is needed for burial expenses, installment debt, administration expense, estate tax and in some cases expense for the last illness.

READJUSTMENT PERIOD

Following the death of a head of family there is usually a one to two year period in which the family needs to continue to receive the same amount of income it would have received had the head of the family lived.

DEPENDENCY PERIOD

This period usually follows the readjustment period in that it lasts until the youngest child of the family reaches age 18.

BLACKOUT PERIOD

This is the period when social security benefits to a surviving spouse are temporarily terminated. This occurs when the youngest child reaches age 16 and will not resume until the surviving spouse reaches age 60.

SPECIAL NEEDS

Special needs may consist of a fund to pay off the mortgage, education fund for the children's education or an emergency fund for unexpected expenses.

RETIREMENT FUND

In this instance the head of a family may also wish to provide the surviving spouse with funds for retirement.

FOCUS POINTS

1. A life insurance policy is a legal contract.
2. Life insurance is primarily used to function in personal and family situations.
3. Needs that might be created from an individual's death include expenses from illness, burial, funeral, debts owed, taxes, and administration of the estate.
4. Other needs one might encounter include paying off a mortgage, childrens' education, unexpected expenses.
5. A life insurance application involves three parties the proposed insured, the applicant, and the policy owner.
6. The application provides crucial information to an underwriter.
7. The application is a formal request to be insured.
8. The signatures on an application certify the "good faith" performance of the applicant.
9. Any changes made on a completed application must be initialed and approved by the proposed insured.
10. Should an error be discovered in the application the insurance company can cancel the policy
11. All statements on the application are regarded as representations.
12. Fraud is created by intentional misrepresentation, intent to gain advantage, a second party suffers a loss.
13. Concealment is withholding of facts the applicant should have revealed.
14. The initial receipt for premiums is called a "conditional receipt".
15. A conditional receipt does not guarantee acceptability of the applicant.
16. Should a proposed insured die during the period of conditional receipt and policy issuance, the claim would be paid if there were no reason to have denied the application.
17. The policy effective date is important in determining the insurability date, the contestable period date, and suicide clause date.
18. Backdating of policies is permitted by most insurance companies.
19. Individuals should carry life insurance equal to five or six times their annual earnings.
20. Life insurance is valuable in settling estate needs.
21. Life insurance can assist a family during the "re-adjustment period " after a death.
22. Life insurance can be beneficial for a child during the dependency period.
23. Life insurance can fill the gap during a "black-out" of income period.
24. Life insurance can come in handy in resolving special needs.
25. Life insurance can provide retirement funds for the survivor.

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TYPES OF LIFE INSURANCE

TYPES OF LIFE INSURANCE AND WHAT IS AVAILABLE

- Term Insurance.
- Whole Life.
- Universal Life.
- Variable Life.
- Adjustable Life.
- Modified Life.
- Family Life.

TERM INSURANCE

Term Insurance is the most basic type of life insurance. Some of its characteristics:

- Term Insurance provides only temporary protection from one to 20 years or until the insured reaches a specified age. Should the insured be alive at the end of the term period the protection expires.
- Term Insurance has no cash value or savings element. It is strictly pure protection.
- Term Insurance can be renewable and convertible. Renewable means that you can continue the coverage for additional periods without proof of insurability. As a rule the premium increases each time the policy is renewed based on the age of the insured at the time of renewal. Convertible means that the term policy can be exchanged for some type of cash value insurance without proof of insurability.

Term Insurance comes in a variety of policies. They are:

A. YEARLY RENEWABLE TERM - This is issued for a one year period and the policy owner has the right to renew coverage for successive one-year periods.

B. **FIVE, TEN, FIFTEEN, OR TWENTY YEAR TERM** - Term insurance can be purchased for a specific period such as five, ten, fifteen or twenty years, and in some instances even longer periods. The premium remains level during the policy term and should the policy be renewed at the end of the term the premium will increase.
C. **TERM TO AGE SIXTY-FIVE OR SEVENTY** - In this instance the term insurance is provided to a stated age. The premium remains level during the policy term and the insurance expires when the stated age is attained. As a rule the insured has the right to convert this term insurance to a cash value policy; however the policy must be converted sometime prior to the expiration date.
D. **DECREASING TERM** - With a decreasing term policy although the premiums remain level during the policy term the face amount of insurance gradually decreases over time. For example a $100,000.00 policy issued for a decreasing term of 30 years could decline to $50,000.00 by the end of the twentieth year and zero by the end of the thirtieth year.
E. **REENTRY TERM** - This is a new type of term insurance that some companies make available. With this policy the premiums are based on a low-rate schedule. Under the terms of this policy the insured must demonstrate evidence of insurability, usually every one to five years.

WHOLE LIFE

Whole Life Insurance has level premiums and will provide protection until age 100.
Some examples of Whole Life Insurance are:

A. **ORDINARY LIFE INSURANCE** - Ordinary Life Insurance is a form of Whole Life. Lifetime protection is provided until age 100 and the premiums remain level. In the event the insured is still alive at age 100 the full-face amount will be paid without death having to occur.
B. **LIMITED-PAYMENT LIFE INSURANCE** - This is another form of Whole Life Insurance. Although the premiums are level they are only paid for a certain number of years. After this payment period, the policy becomes paid up. Limited-Payment policies can be issued for ten, twenty or thirty years. A policy that is paid up at age sixty-five or seventy is still available. The premiums for a Limited-Payment policy are higher than an ordinary life insurance policy but the cash value is also higher.
C. **ENDOWMENT INSURANCE** - This is the third basic type of Whole Life Insurance. An endowment pays policy proceeds to the named beneficiary if the insured dies within a certain period. Should the insured survive to the end of the stated period, the policy proceeds are paid to the policy owner.

UNIVERSAL LIFE

Universal policies are sold as investments that combine insurance protection with savings. Actually, a Universal Life Policy can be defined as a flexible premium deposit fund that is combined with monthly renewable term insurance.
Here's how it works:

- First, an initial specific premium is paid. Then expenses are deducted from the gross premium and the balance is credited to the policy's initial cash value.
- Second, a monthly mortality charge is conducted from the cash value to pay for the pure insurance protection.
- Finally, the remaining cash value is then credited with interest at a specified rate.

Universal Life has the following basic characteristics:

- There are two forms available.
- Protection, savings, and expense components are separated.
- There is a stated investment return.
- Considerable flexibility.
- Cash withdrawals are permitted.

VARIABLE LIFE

With a Variable Life Insurance policy, the face amount of insurance varies according to the investment experience of a separate account that is maintained by the insurer. This is the perfect solution to the fact that inflation can quickly erode the real purchasing power of life insurance. Under the Variable Life Insurance policy the premiums are invested in equities or other investments. Should the investment experience be favorable the face amount of insurance is increased.

However, should the experience be unfavorable the amount of insurance is reduced. In no event can the amount of insurance be reduced below the original face amount. The Variable Life Insurance policy was designed to maintain the real purchasing power of the death benefit.

ADJUSTABLE LIFE

This type of Whole Life policy permits changes to be made in the following areas:

- Amount of life insurance.
- Period of protection.
- Amount of premium.
- Duration of premium-paying period.

This type of insurance is frequently called "Life Cycle" insurance because policy changes may be made to conform to different periods in the insured's life. Within certain limits, the policy owner can make the following adjustments as the situations warrants:

- Reduce or increase the amount of insurance.

- Shorten or lengthen the period of protection.
- Increase or decrease the premiums paid.
- Lengthen or shorten the period for paying of premiums.

A cost of living provision can also be attached to the Adjustable Life Policy and this will in fact maintain the real purchasing power of the insurance.

MODIFIED LIFE

This is a type of Whole Life Policy in which the premiums are reduced for an initial period of three to five years and then the premiums increase thereafter. The initial or reduced premium as paid in the beginning is slightly higher than Term Insurance rates but substantially lower than the premium paid for an ordinary Life Policy issued at the same age.

There are different types of Modified Life Insurance:

- One version of Term Insurance is used for the first three to five years and then automatically converts into an ordinary life policy at a premium that will be higher than what would have been paid for a regular ordinary Life Policy issued at the same age.
- In another version of Term Insurance, the approach is to redistribute the premiums by charging lower premiums during the early years of the policy but higher premiums thereafter.

Modified Life Insurance can be attractive to individuals expecting increases in income.

FAMILY LIFE

Family Life is a Whole Life Policy designed to insure all family members in one policy. This policy is sold in units that state the amount and types of life insurance on the family members. One unit for example may consist of the following:

- $5,000.00 of Ordinary Life on the head of the family.
- $2,000.00 of Term to sixty-five on the spouse.
- $1,000.00 of Term Insurance on each child up to stated age.

As a rule, Term Insurance under the Family Life Policy can be converted to some form of permanent insurance, typically the children's protection can be converted up to five times the face amount without proof of insurability.

Finally, there is no additional premium if another child is born and newborn children are usually automatically covered after a fifteen-day waiting period.

FOCUS POINTS

1. Term insurance is the most basic type of life insurance.
2. Term insurance provides only temporary protection until the insured reaches a specified age.
3. Term insurance has no cash value or savings element.
4. Term insurance can be renewable and convertible.
5. Term insurance comes in the formats of yearly renewable; five, ten fifteen, or twenty year term, term to age sixty five or seventy, decreasing term, and reentry term.
6. Whole life insurance has level premiums and will provide protection until age 100.
7. Ordinary life insurance has death benefits or full face pay out at age 100.
8. Limited payment life insurance features level payments for a specified number of years and then it becomes fully paid up.
9. Endowment policy pays policy proceeds to the named beneficiary if the insured dies within a certain period of time. Should the insured outlive the period the proceeds are paid to the policy owner.
10. Universal Life policies are sold as investments that combine insurance protection with savings.
11. In a Universal Life policy protection, savings, and expense components are separated.
12. A Universal Life policy has a stated investment return.
13. A Universal Life policy has considerable flexibility and cash withdrawal privilege.
14. In a Variable Life policy the face amount of insurance varies depending on investment performance of the policy.
15. Adjustable Life policies permit changes to be made in the areas face amount, period of protection, amount of premium, and duration of premium.
16. Adjustable Life is often called “Life Cycle” insurance because policy changes may be made to conform to different periods in the insured’s life.
17. A cost of living provision can be attached to an Adjustaable Life Policy.
18. Modified Life offers reduced premiums in the first three to five years and then premiums increase thereafter.
19. There are several formats of Modified Life Insurance.
20. Family Life is a Whole Life Policy designed to insure all family members in one policy.

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CHARACTERISTICS OF DIFFERENT POLICIES

WHOLE LIFE INSURANCE

This type of insurance most characteristically has a cash value accumulation.

It is a simple process wherein an individual pays a premium for their entire life in exchange for coverage in the event they die early. As the premiums build up the risk by the insurance company decreases.

If one were a gambling person, one might say that the insurance company is betting that the individual will live out their life; whereas, the insured is betting that they may die early.

In a Whole Life policy when the insured dies the beneficiary receives the face amount of the policy.

Because many individuals enjoy the protection offered by a Whole Life policy but do not want to pay a premium for their entire life, a policy called a Limited Life policy is made available. In this policy an individual pays for a specified number of years and then stops, but the insurance protection continues for life.

One of the most common type of Limited Life policy is the paid up at age 65 policy.

A variety of blended policies are offered that incorporate whole life features and term insurance to create a choice to meet every consumer's need.

Single Premium Whole Life insurance is a format wherein the policy owner pays one lump sum premium up front for the face amount of protection.

The advantages that one might have with this form of payment is that it is less costly and allows the purchaser to begin accumulating tax free rewards that are not payable until the money is withdrawn.

INTEREST SENSITIVE WHOLE LIFE POLICIES

Interest sensitive whole life provides a level death benefit, requires a fixed schedule of premium payments and uses current interest and mortality assumptions to determine policy cash values.

Interest sensitive whole life combines features of whole life and universal life.

The main attractions of this product are a fixed premium payment, guaranteed death benefits, and a minimum guarantee of cash value.

One approach to an interest sensitive policy is the Low Premium approach. This approach normally offers premiums lower than a whole life policy but guaranteed cash values are generally lower.

This policy has a recalculation feature after an established period of time. The recalculated premium, depending on the policy's interest and mortality experience, can be higher or lower than the initial premium.

If the recalculated premium is lower than the initial premium the policy owner can pay the new lower premium or can continue to pay the higher premium with the difference being credited to the accumulated value.

For both options the death benefit remains the same.

If the recalculated premium is higher than the original premium, the policy owner may pay the new higher premium and maintain the original death benefit or continue to pay the lower premium and reduce the death benefit amount.

Another format of interest sensitive whole life is the higher initial premium method.
It usually has more substantial guaranteed cash values, a premium guaranteed not to increase, and an option to pay the premium from the accumulated value of the policy.

These types of policy usually are scheduled to terminate premium payments within a span of 5 to 12 years while at the same time continuing the death benefit beyond this point.
An individual can chose to continue paying premiums after the so-called "vanishing" period and ad to the cash value of the policy.
Some policies have riders providing for lump sum premiums to be deposited within the first year of the policy.
The death benefit in interest sensitive whole life policies is a level benefit equivalent to the face amount of the policy.

Like other life products the interest sensitive whole life policy must meet the definition of life insurance as contained in the Tax Equity and Fiscal responsibility Act of 1982 (TEFRA).
The policy cash surrender value may at no time exceed the net single premium, which would be required to fund future benefits.

In addition under the "corridor" provision, the cash value of a life policy must not account for more than a certain percentage of the total death benefit.

If the policy fails to meet one of these two tests it is disqualified to be a life product fot tax purposes.

Provisions are made part of interest sensitive whole life policies to automatically raise the death benefits to maintain the policy's life insurance qualification.

Interest sensitive whole life policies come with a guaranteed minimum cash value.

Some companies determine the cash values monthly and others yearly. The process for determining valuation of interest sensitive whole life policies is:

- Accumulated value determined as of the previous valuation date
- Plus interest for the period since the last valuation date
- Plus any net premium credited to the policy since the last valuation date
- Minus the cost of providing insurance protection until the next valuation date

The interest rate used in crediting the interest credit is determined differently by different companies.

The most common methods are the Declared Rate and the Indexed Rate.

The Declared Rate is a method wherein an insurance company declares a current interest rate and this becomes the established rate for the policy.

In the Indexed Rate method the rate is determined by an outside index, such as the yield on Treasury notes.
How money is credited also differs and some companies use the Portfolio Rate and others use the New Money/Old Money Rate.

The Portfolio Rate credits one rate to the entire policy value regardless of when the premium was paid.

On the other hand the New Money/ Old Money method applies different interest rates to different premium payments depending on when the premium was paid into the policy. As declared rates change so will the computation on additional paid in premiums change.

In many cases there is no guarantee on how long a given rate will be guaranteed. The rate and the frequency of change are left entirely to the determination of the insurance company. In interest sensitive whole life policies there is a Guaranteed Minimum usually based on an outside index.

Computed charges for mortality rates may go up or down, but may not rise above the guaranteed maximum. These rates vary from company to company.

Surrender charges are another factor in interest sensitive whole life policies.

Surrender charges vary from company to company and are usually deducted from the accumulated value of the policy to arrive at the actual cash value on surrender.

Most commonly surrender charges are based on a percentage of the annual premium, a fee per $1000 of coverage, a percentage of the cash value or perhaps a combination of all these factors.

Surrender charges are usually imposed within the first 20 years of a policy and in some cases no longer than the first five years. The surrender charges usually decline as the policy gains maturity.

Front-End Loads and Policy fees are another element of interest sensitive whole life policies.

Front-end loads refers to a percentage that is deducted out front from every premium before the balance is credited to the accumulation amount. This fee usually is in the 2% to 7.5% range.
A few interest sensitive whole life policies offer partial surrender features. In the case of partial surrenders the cash surrender and the death benefit are reduced by the amount of the surrender.

In addition to the standard policy some additional riders are available. These riders include a Term rider for a spouse and or children; Disability waiver of premium; accidental death benefit; cost of living adjustment, guaranteed insurability; and a death benefit advance pay for a terminally individual.

At the end of each policy year, the owner of the policy receives a report detailing the activity of the policy.

UNIVERSAL LIFE INSURANCE

In a Universal life policy the policyholder can adjust the premium payments and death benefit without having to obtain a new policy. In addition to the death benefit a universal policy also accumulates cash value.

A universal life policy offers both a level and an increasing death benefit option.

When an individual chooses a level benefit option this pretty much functions as any traditional life policy might function.

The cash value of a universal life is tax deferred until the individual surrenders the policy and never subject to income tax if the policy is held until the death of the insured.

Depending on the policy, universal life policies can have front end and back end sales loads, or a combination of the two.

VARIABLE UNIVERSAL LIFE

Variable life insurance provides equity-based cash values and life insurance protection. In this type of policy the consumer takes the investment risk not the insurer. Because the policy owner takes the investment risk, variable life is regulated as a security. This means that besides meeting state insurance requirements, variable life must also meet state and federal security requirements.

Universal life provides the consumer the ability to change the death benefit and the premium contribution.
Variable universal life incorporates the flexibility of universal life, the investment features of variable life and the tax advantages of all life insurance products.

The variable universal life is policy is not dependent on the payment of a specific premium by a given date. The policy owner can add money to the cash value account on whatever basis is convenient within the top limit set by legislation and within the low limit set by the insurance company.

Variable universal life can have front-end loads, back-end loads or a combination of the two. A flat fee may also be deducted.

Once the fees are deducted policy owners can allocate premium payments amongst the available investment options.

Every business day, the market value of the securities held in the investment is determined, thus creating the cash value of a variable universal life policy. The cash value of a variable universal life can change on a daily basis.

The grace period involved in a universal life is not determined by when a premium is not made, but is based on maintaining a cash value in the account. Because this is an investment product, a bad decision could cause the cash value to be depleted thus creating the need for an influx of premiums to maintain the policy. Should this occur the policy owner is notified and has 61 days grace in which to replenish the cash value to maintain the policy.

The cash value of a variable universal life policy is maintained in a separate account, apart from the general assets of the company. From this account two types of deductions are made: monthly deductions for the cost of insurance, riders and policy expenses, and a daily mortality expense risk charge.
The monthly deductions may also consist of certain administrative charges.

When a policy owner takes out a loan against a variable universal life policy, the interest charged is part of the cost of the loan. The amount of the cash value for the loan is credited with a rate of interest that is generally lower than the investment return earned on the rest of the cash value in the account.

Policy owners may withdraw money from their policies; the death benefit of the policy is usually reduced by the amount of the withdrawal.

A Level Death Benefit Option permits the policy owner to specify the total death benefit they want in the policy. This amount stays the same until the policy owner decides to change it. The ratio of cash value to death benefit must stay within the specified limits to meet the definition of life insurance for tax purposes.

The sum of cash value and insurance protection must always equal the total death benefit specified in the policy.

A Variable Death Benefit Option permits the policy owner to specify the amount of pure insurance coverage, and this remains constant. While the death benefit varies.

A policy owner has the option of switching back and forth between the level death benefit option and the Variable death benefit option.

Additionally, as a policy owners needs change, coverage can be either increased or decreased as the need arises.

Because the investment side of the policy can suffer negative effects, insurance companies offer either as part of the policy or as an optional rider, a guaranteed death benefit provision.

The Settlement options offered under a variable universal life policy include:

- Joint and Survivor option-payments are made on the lives of two beneficiaries with payments continuing to the second beneficiary after the death of the first.
- Fixed period option-equal payments are made to the beneficiary over a specified period of years.
- Fixed amount option-fixed payments are made to the beneficiary until all policy proceeds are exhausted.
- Life income option-equal payments are made for the life of the beneficiary.
- Interest option-the insurer retains the policy proceeds and pays the beneficiary the interest earned.

Variable Universal Life Policies offer the policy owner a variety of investment options. Policy owners are permitted to make transfers or exchanges amongst these options. Rules regulating these transfers vary from company to company.

Some general guidelines include the following:

- Limits on the timing and amount of transfers from fixed accounts
- Limits on the number of transfers that can be made within a one year period
- Fees for transfers made in excess of a certain limit
- A limit on the minimum dollar amount or percentage of account value being transferred
- A limit on a minimum dollar amount or percentage of value that remains in the account
- A limit on the frequency of transfers
- A limit on the interval period between transfers.

Asset allocation is part of the formula used in managing a variable universal life policy.

To meet a policy owner's end goal, different investment options must be exercised and re-arranged on a continues basis. Adjusting the percentage of assets devoted to each investment option increases the chances that the policy owner's goals will be met.

Some variable universal life policies offer asset allocation services that automatically move the policy owner's money according to a professional asset manager's assessment of the outlook of the markets. With this type of policy, this is accomplished by allowing the asset manager to make the appropriate transfers between accounts.

Some policies offer asset allocations that change the mix of investments on an on going basis to maximize the return for the policy owner.

Some variable UNIVERSAL LIFE POLICIES OFFER A PORTFOLIO REBALANCING FEATURE.
This allows the policy owner to establish target percentages for various investment options and usually quarterly, transfers are automatically made among the options to bring the mix in line with the policy owner's objectives.

Dollar cost averaging is another method of managing a variable universal life account.
This method permits an individual to invest the same dollar amount in the same securities at regular intervals, over a period of time, regardless of whether the price of the security is going up or down.
Dollar cost averaging allows an individual to automatically buy more shares when the market is down and fewer shares when the market is up. Thus the average cost per share will always be less than the average market price.

Transfers from one account to another in a variable universal life policy are not taxed at the time of transfer. Annually, policy owners receive detailed reports that summarize policy activity and values on a month-to-month basis. Semiannually they receive reports that list the securities held by the separate investment accounts.

Certain considerations should be taken into account if one is to use the single premium method in purchasing a variable universal life policy.
As the name implies a single premium policy is purchased with a single premium and no additional premium need ever be paid to keep the policy in force.

The single premium is based on the policy's death benefit amount, the insurer's expected rate of return and the life expectancy of the insured. With a variable universal life the policy's cash value must always be sufficient to pay the cost of maintaining the insurance protection and the policy's death benefit. Since the policy's cash value can rise or fall based on investment experience, it then becomes possible that a variable universal life policy with a bad investment experience could lapse, unless additional premiums are paid into the policy. Because of this, a variable life policy requires an initial premium that is of a substantial nature.

In some cases, a single premium variable universal life policy may have a schedule of additional premium payments. The policy owner is not obligated to adhere to these payments unless the cash value is not sufficient to meet the requirements.

Since a variable universal life is considered both a life product and a security, it is subject to regulation by the state insurance department and by state and federal securities commissions.

- Who are these regulators and what roles do they play?
- The Securities and Exchange Commission or the SEC is the agency of the federal government, which regulates the offering of securities to the public. It enforces the securities laws enacted by congress. The SEC also issues its own regulations.
- The National Association of Securities Dealers or NASD is a self-regulatory organization whose members are from the securities industry. NASD keeps a watchful eye on its' members activities, to make sure that they are in compliance with federal laws and regulations. NASD also issues its own rules, which are binding upon its members.
- A broker/dealer is an individual or a firm registered with the SEC to buy and sell securities either for its own account or for the account of others. Most variable universal life companies establish a broker/dealership to distribute their product.
- A registered representative is an agent for a broker/dealer. This individual represents the broker/dealer in a transaction with the public.

PRE-REQUISITES OF SELLING VARIABLE UNIVERSAL LIFE

In addition to having a life license, one must have become a registered representative of one's company broker/dealer. In order to become a registered representative, you must pass either the Series 6 or Series 7 examination covering the Uniform Securities Act. Some states also require an additional examination to sell registered contracts.

Sales activities in this area must be strictly supervised by the broker/dealer, and strict compliance to NASD rules and regulations are mandatory.

The necessity of these rules is for the purpose of providing prospects with accurate information before making a buying decision that involves risk.

Some of the most important rules to remember follow.

A **prospectus** must be provided to each prospective consumer prior to the time of decision-making. A prospectus summarizes the detailed statement previously filed with the Securities Exchange Commission.

Any and all solicitations must be either preceded or accompanied by a prospectus.

The prospect should be encouraged to read the prospectus and formulate his or her own decision.

Because of the strict sales rules, companies often times prepare brochures, pamphlets, and sales presentation folders that are provided to the sales agent as an assurance that all NASD rules have been followed.

An agent must use the highest ethics in presenting this type of product. It is important that no statements are made in regard to predicting losses or gain.

It is critical that a prospect not be made to believe that the product is sanctioned or approved by the Securities Exchange Commission. Your statement to the client must not go any further than to acknowledge that both the statement and the prospectus has been filed with the Securities Exchange Commission.

NASD places strict rules on the rate of return that may be illustrated to a prospect.
Hypothetical illustrations cannot show a rate of return exceeding 12% and must also show examples of 0% return illustrations.

Illustrations must show maximum guaranteed mortality and expense charges at each rate of return. Preceding any illustrations a statement must prominently be made that the underlying investment accounts may affect the policy's cash value and death benefit. It must also be stated the illustration is hypothetical and is not meant to project or predict investment results.

NAIC (National Association of Insurance Commissioners) also has issued guidelines that must be used in illustrations dealing with variable universal life products.

The NAIC guidelines states that all illustrations should provide accurate representations of what a policy owner might expect from an actual variable life policy.
Statements made to prospects must not be misleading, must not exaggerate or make unreasonable claims. No assurances should be made of either potential losses or gains.
The recommendation of a va*riable universal life must be suitable for the prospects needs.*

- ❑ Does it meet client's tolerance for risk?
- ❑ Does the prospect already own any equity-based product?
- ❑ What is the client's expectation of return on the investment?
- ❑ Can the prospect afford additional premiums if the cash value were to drop?
- ❑ Is the prospect been made aware of the potential of additional premiums should the cash value drop?

Some variable universal life policies offer a refund privilege or "free look" period. This period will vary from 10 days after receipt of policy to 45 days from the signing of the application.

Some policies also permit the exchange of the policy for a different life product within the first 24 months of the policy.

Regardless of the living benefits of life insurance, life products are mainly sold as protection against early or unexpected death.

Replacement of life insurance policies must address the need for replacement. Ethical issues are a constant consideration in making these decisions with the client.
Life insurance policies are considered to be property; therefore, gain or loss on an exchange of such policies would be subject to federal income tax. Under section 1035 of the IRS, no gain or loss is recognized when one life insurance policy is exchanged for another.

VARIABLE UNIVERSAL LIFE AND THE MARKET PLACE

Variable universal life can serve as a hedge on inflation because it can be adjusted to keep pace with erosion in purchasing power.
If investment experience is favorable funds will be available in the cash value to pay for increases in coverage.

For those who do not want to leave their future welfare in the hands of Social Security, variable universal life provides a vehicle to maintain control of their future. Through variable universal life they manage the death benefit, the premium, flow, and the investments made with the cash value.

Variable universal life deals effectively with a policy owner's personal needs and changes in market conditions and the economy.

Variable universal life can effectively meet the need of the young single consumer because it never becomes obsolete. It serves to provide insurance protection and at the same time permits the building of cash values at a very low cost due to age and health positioning. As a young consumer's needs change a variable universal life policy will never get out of step with his or her needs.

As a consumer gets married and has children variable universal life can serve the needs of the growing family. The cash values offer both a potential for growth and a choice of options depending on how much risk they want to assume. Accumulated funds can be withdrawn through partial surrender, or borrow against cash values.

Other advantages include:

- Putting in more money as their income increases
- Reduce the amount paid in should their expenses increase
- Put in an scheduled amounts should additional monies become available
- Skip payments without losing the insurance coverage
- Increase coverage without increasing the premium

As one gets older and reaches retirement the variable universal life once again is flexible enough to meet the consumers new needs.

With proper management the variable universal life can:

- Offer tax advantages to the policy owner and beneficiary
- Offer a form of estate planning
- Set up a distribution which receives favorable annuity tax treatment
- Provide access to cash values through partial surrender.
- Create borrowing power against cash values, if more advantages
- Be purchased with pre tax dollars
- Provide income protection as an income stream
- Provide income protection in a lump sum
- Provide income in a second to die situation

FOCUS POINTS

1. Whole life insurance most characteristically has a cash value accumulation.
2. In whole life insurance the insured is buying protection in the event he or she dies early.

3. As a premiums build up the risk by the insurance company decreases.
4. In a Whole Life policy when the insured dies the beneficiary receives the face amount of the policy.
5. The premium in a Whole Life policy is paid for life.
6. In a Limited Life policy an individual pays for a limited amount of years but the insurance protection continues for life.
7. One of the most common Life Policy is the paid up at age 65 policy.
8. In a single premium Whole life policy the owner pays one lump sum premium up front for the face amount of protection.
9. A single premium policy is less costly and allows the purchaser to accumulate tax free rewards that are not payable until the money is withdrawn.
10. Interest Sensitive Whole Life provides a level death benefit.
11. Interest Sensitive Whole Life requires a fixed schedule of premium payments.
12. Interest Sensitive Whole Life uses current interest and mortality assumptions to determine policy cash values.
13. Interest Sensitive Whole Life combines features of whole life and universal life.
14. A fixed premium payment, guaranteed death benefit and minimum guarantee of cash values are all attractive features of Interest Sensitive Whole Life.
15. An interest sensitive policy offers a Low Premium approach which offers premiums lower than a whole life policy, but guaranteed cash values are generally lower.
16. Interest Sensitive Whole Life policies have a recalculation feature.
17. A recalculated premium can be higher or lower than the initial premium.
18. An Interest Sensitive Whole Life policy using a higher initial premium method has a substantial cash value, a premium guaranteed not to increase, and an option to pay the premium from the accumulated value.
19. Policies using a higher initial premium method usually terminate the premium payments within a 5 to 12 year span.
20. The death benefit in Interest Sensitive Whole life policies is a level benefit equivalent to the face amount of the policy.
21. In an Interest Sensitive Whole Life policy the cash surrender value can at no time exceed the net single premium, which would be required to fund future benefits.
22. Under the "corridor" provision, the cash value of a life policy must not account for more than a certain percentage of the total death benefit.
23. Interest Sensitive Whole Life policies come with a guaranteed minimum cash value.
24. Some companies determine cash values monthly and others yearly.
25. The interest rate used in crediting the interest credit is determined differently by different companies.
26. The most common methods of crediting interest rates are the Declared Rate and the Indexed Rate.
27. In the Declared Rate the insurance company "declares " a rate.
28. The Indexed Rate is determined by an outside index, such as the yield on Treasury notes.
29. Money is credited in two fashions, the Portfolio Rate and the Old Money/New Money Rate.
30. Portfolio Rate credits one rate to the entire policy value.
31. The New/Money Old Money method applies different interest rates to different premium payments depending on when the premium was paid.
32. In interest rate sensitive whole life policies there is a Guaranteed minimum rate based on an outside index.
33. Surrender charges vary from company to company.
34. Surrender charges are usually imposed within the first 20 years of a policy.
35. In some cases surrender charges are only applied for the first five years.
36. Front-End Loads and Policy fees are another element of interest sensitive whole life policies.
37. In addition to the death benefit a Universal policy also accumulates cash value.
38. A Universal policy offers both a level and increasing benefit option.
39. The cash value of a Universal Life is tax deferred.
40. Depending on the policy, Universal Life policies can have front and back end sales loads.
41. Variable life insurance provides equity-based cash values and life insurance protection.
42. In A variable Life insurance the consumer takes the investment risk not the insurer.
43. Because the policy owner takes the risk Variable Life is regulated as a security.
44. Variable Universal Life incorporates the flexibility of Universal Life, the investment features of Variable Life and the tax advantages of all life products.
45. The cash value of a Variable Universal Life can change on a daily basis.
46. The grace period in a Universal Life is based on maintaining a cash value in the account.
47. A policy owner has sixty-one days grace in which replenish the cash value of a Variable Universal Life.
48. The cash value of a Variable Universal Life policy is maintained in a separate account, apart from the general assets of the company.
49. When a policy owner withdraws money from their Variable Universal policy, the death benefit is reduced by the amount of the withdrawal.
50. A level death benefit option permits the policy owner to specify the total death benefit they want in the policy.
51. The sum of cash value and insurance protection must always equal the total death benefit specified in the policy.
52. A policy owner has the option of switching back and forth between the level death benefit option and the variable death benefit option.
53. Settlement options include joint and survivor, fixed period, life income, interest option.
54. Variable Universal policies offer the policy owner a variety of investment options.

55. Rules that vary from company to company regulate the transfers and exchanges.
56. Asset allocation is part of the formula used in managing a Variable Universal Life.
57. Some Variable Universal Life Policies offer a portfolio-rebalancing feature.
58. Dollar cost averaging is a method of managing a Variable Life account.
59. When selling a Variable Universal Life account a prospectus must be provided to each prospective consumer.
60. NASD places strict rules on the rate of return that may be illustrated to a prospect.
61. Hypothetical illustrations cannot show a rate of return exceeding 12% and must show examples of 0% return illustrations.

5

LIFE INSURANCE COMPANIES

Life insurance companies can be organized in several ways; however, most are organized either as stock companies or as mutual companies.

A **STOCK LIFE INSURANCE COMPANY** gets its name from its basic ownership characteristic. Its stockholders - people, who have bought stock in the company, own a stock company. The stockholders may or may not also be policy owners. The sole function of the stockholders is to elect a board of directors who in turn will guide the operation of the company. If the company is successful financially, the stockholders will receive dividends that are paid for each share of stock owned. A stock life insurance company, like all other corporations, is in business to make a profit for the stockholders.

A **MUTUAL INSURANCE COMPANY** is also a corporation, and it also derives its name from its basic ownership characteristic. Unlike a stock company that is owned by its stockholders, a mutual company has no stockholders. Control in a mutual company rests with the policy owners who "mutually" own the company. The policy owners elect a board of directors, and any "profits" are returned as dividends to the policy owners in the form of reduced costs for insurance. It should be mentioned here that dividends from a mutual company are not profits in the mercantile or commercial sense but rather the return of an "overcharge" of premium.

For example, a mutual life insurance company might sell life insurance at one specific age for $20 per $1,000 of face amount. Once a dividend has been declared, each policy owner might then receive credit on the premium statement in the amount of $2 per $1,000. Thus, the resultant cost for the insurance is $18 per $1,000 of face amount.

While not true in every case, mutual insurance companies usually issue "participating" life insurance policies. The term participating means that if the company realizes a savings in death claims due to a lower mortality rate, or an increase in the interest earned, or if it realizes some efficiency in its operation, which reduces expenses, these savings or "profits", is passed along to the policy owner in the form of policy dividends. Thus, the policy owner in a mutual life insurance participates in any savings or "profits" enjoyed by the company.
Never imply to a client that a stock company is better from an organizational standpoint than a mutual company, or vice versa, or that participating policies are better than non-participating ones. Both types of companies and both policies have merit.

Before any life insurance company can sell insurance in any state, it must be licensed to sell insurance or, as it is called, *admitted* to that state. An insurer that is admitted to a state is authorized to do business in that state. If an insurer is not admitted to a state, it is unauthorized to do business in that state.

Another type of insurer with which you should be familiar is the fraternal benefit society, also known as a "fraternal". A fraternal insurer is a social and benevolent organization that provides, among other services, life insurance benefits for members. Membership in such an organization is often based on factors such as a person's nationality, religion, or occupation, but whatever the criterion for membership, keep in mind that fraternal have functions other than providing insurance.

Each state defines and provides for the regulation of fraternal benefit societies in its insurance laws. But, although the exact definition of a fraternal may differ from state to state, an organization usually must have certain characteristics to qualify as a fraternal benefit society. First, the organization generally must exist only for the benefit of its members and of their beneficiaries and be non-profit. Second, it must be organized without capital stock.

A third characteristic is that the society usually is organized on a lodge system. This means that the organization must have local lodges or chapters that hold regular meetings to carry on the activities of the society. Ritualistic ceremonies are often a part of those activities.

Finally, the organization must have a representative form of government. There must be a governing body chosen by the members directly or by delegates, in accordance with the organization's bylaws or constitution.
GOVERNMENT INSURANCE PROGRAMS have been established for a variety of reasons throughout history. Social insurance programs have been created to allow the government to make compulsory a program lacking equity in order to cover

fundamental risks and to redistribute income. Government insurance programs have been created when private insurers would have been subjected to adverse selection or were incapable of meeting society's needs.
By its administration of various Federal insurance programs, the U.S. government has become the largest insurer in the world. These various programs include Social Security, Medicare, and the Railroad Retirement, Disability, and Unemployment Programs.
RECIPROCALS are groups of individuals (called "subscribers") who are insured under an arrangement where each subscriber is both an insured and an insurer. In other words, the other members of the group insure each subscriber. However, the liability of each subscriber is limited.

The administrator of the reciprocal is the "attorney-in-fact". He or she is granted this power by the subscribers through a broad power of attorney, and receives a percentage of the gross premiums paid by the subscribers. Other than this payment to the attorney-in-fact and administrative expenses, the cost to the reciprocal is limited to the amount of the losses that occur. Any unused premiums are returned to the subscribers.

LLOYD'S OF LONDON is a name familiar to many in the insurance industry. However, perhaps the most interesting fact about Lloyd's of London is that it is not an insurer nor does it issue policies. Rather, Lloyd's of London is an association of members who write insurance for their own accounts. The New York Stock Exchange bears the same relationship to stock purchases as Lloyd's bears to the purchase of insurance.

Like the Stock Exchange, Lloyd's provides quarters for its members as well as procedures for business transactions. Though neither organization engages in trade, both provide facilities and rules that govern how its members will pursue trade. In addition, Lloyd's maintains worldwide underwriting information and a complete record of losses. It also aids in loss settlements and supervises salvage and repairs throughout the world.

At Lloyd's, an insurance transaction begins when a proposal is placed before the underwriting members, or their agents, by a licensed broker. The broker prepares the policy and submits it to the Policy Signing Office where the policy is examined. If the policy conforms to agreed-upon rules, it is submitted to the underwriters. Those underwriters who wish to participate in the policy affix their signatures or "underwrite" the risk. American Lloyd's associations operate under the same principles and methods as Lloyd's of London.

FINANCIAL STATUS OF INSURERS

Changing economic conditions and highly publicized failures of financial institutions (from savings and loan companies to insurance companies) have focused much attention on the financial status of private insurers. Independent rating services provide ratings consumers can use to measure the status of a company and compare it to others.

The two most popular rating services are *A.M. Best Company* and *Standard and Poors*. *A.M. Best Company* looks at profitability, leverage, and liquidity and assigns ratings from A++ (Superior) to C and C- (Fair) and below. *Standard and Poor's* focuses on the claims paying ability of an insurer and offers ratings from AAA (Superior) to D (Insurers placed under an order of liquidation).

In most cases, insurance companies pay a fee to be rated by a rating service. Other rating services include *Moody's Investors Service* (measuring financial strength), and *Duff and Phelps* (measuring claims paying ability and managerial soundness). In addition to private rating services the National Association of Insurance Commissioners measures company performance and prepares analytical reports as part of the Insurance Regulatory Information System (IRIS). Agents have access to IRIS ratios that serve as indicators of a company's financial condition in various areas.

FOCUS POINTS

1. Most life insurance companies are organized as either stock or mutual company
2. The sole function of stockholders is to elect a board of directors who will guide the operation of the company.
3. Stockholders may or may not also be policy holders
4. A stock life company is in business to make a profit for the stockholders.
5. A mutual company is controlled by the policy owners who “mutually” own the company.
6. Profits in a mutual company are returned as dividends to policy owners
7. Dividends or Profit in a mutual company are returned as an “overage” of premiums.
8. Before any life insurance company can sell insurance in a state it must be “admitted” or licensed by the state.
9. A fraternal insurer is a social and benevolent organization that provides life insurance benefits to its members.
10. Fraternal insurers have functions other than providing insurance.
11. Each state defines and provides for the regulation of fraternal benefit societies in its insurance laws.
12. Although the definition of fraternal differs from state to state, a fraternal must exist only for the benefit of its members and their beneficiaries.
13. A fraternal must be non-profit and be organized without capital stock.
14. Fraternals must be organized under a lodge or chapter system and hold regular meetings of the society.
15. Fraternals must have a representative form of government in accordance with the organization bylaws and constitution.

16. Government insurance programs have been created to allow the government to make compulsory a program lacking equity in order to cover the fundamental risks and redistribute income.
17. The federal government is the largest insurer in the world.
18. Reciprocals are groups of individuals (called "subscribers") who are insured under an arrangement where each subscriber is both an insured and an insurer.
19. In reciprocals the liability of each subscriber is limited.
20. The administrator of a reciprocal is the "attorney-in-fact".
21. Other than a percentage of the gross premium fee paid the "attorney in fact" and administrative expenses, any unused premiums are returned to the subscribers.
22. Lloyd's of London is not an insurer nor does it issue policies.
23. Lloyd's of London is an association of members who write insurance for their own accounts
24. Lloyds of London provides facilities and rules that govern how its members will pursue trade.
25. Lloyd's maintains worldwide underwriting information and a complete record of losses.
26. Lloyd's aids in loss settlements and supervises salvage and repairs throughout the world.
27. Independent rating services provide ratings consumers can use to measure the status of a company and compare it to others.
28. The two most popular rating services are A.M. Best Company and Standard and Poors.

6

POLICY PROVISIONS OF LIFE INSURANCE POLICIES

Most agents have never read the required policy provisions that are contained in every policy sold. It is important to note that policy provisions are in fact contractual provisions and govern what the policy owner can and cannot do with the policy.
Here is an overview of some of the policy provisions:

- Ownership Clause.
- Entire Contract Clause.
- Incontestable Clause.
- Suicide Clause.
- Grace Period.
- Reinstatement Clause.
- Misstatement of Age.
- Beneficiary Designation.
- Change of Plan Provision.

OWNERSHIP CLAUSE

The owner of a Life Insurance Policy can be the applicant, the insured, or the beneficiary. In most cases, the applicant and insured are the same person. Under the Ownership Clause, the policy owner possesses all contractual rights in the policy while the insured is still alive. These rights include the selection of a settlement option, naming and changing the beneficiary designation, election of dividend options, and other rights. These contractual rights typically can be exercised without the beneficiary's consent.

In addition, the Ownership Clause provides for a change in ownership. The policy owner can designate a new owner by filling out an appropriate form with the company. The insurer may require that the Life Insurance Policy be endorsed to show the name of the new owner.

ENTIRE CONTRACT CLAUSE

The Entire Contract Clause states that the Life Insurance Policy and attached application constitute the complete contract between the insurer and policy owner. No statement can be used by the insurer to void the policy unless the statement is a material misrepresentation and is part of the application. In addition, any officer of the company cannot change the terms of the policy unless the policy owner agrees to the change.

INCONTESTABLE CLAUSE

Under the Incontestable Clause, the company cannot contest the policy after the policy has been in force two years during the insured's lifetime. The insurance company has two years to discover any irregularities in the contract, such as a material misrepresentation or concealment. If the insured dies after that time, the death claim must be paid.

For example, if John conceals a cancer operation when the application is filled out and dies after expiration of the incontestable period, the death claim WILL be paid.

The purpose of the incontestable clause is to protect the beneficiary if the insurance company tries to deny payment of the death claim years after the policy is issued. Since the insured is dead, allegations by the insurer concerning statements made in connection with the application cannot be easily refuted. After the incontestable period has expired, with few exceptions, the company must pay the death claim.

SUICIDE CLAUSE
A typical Suicide Clause states that the face amount of the policy will not be paid if the insured commits suicide within two years after the policy is issued. The only payment is a refund of the premiums. The purpose of the Suicide Clause is to reduce adverse selection against the insurer by providing the insurer some protection against an individual who purchases a Life Insurance Policy with the intention of committing suicide.

GRACE PERIOD
A Grace Period is another important contractual provision. A typical Grace Period gives the policy owner thirty-one days to pay an overdue premium. The life insurance remains in force during the Grace Period. If death occurs during the Grace Period, the overdue premium usually is deducted from the policy proceeds.

REINSTATEMENT CLAUSE
If the premium is not paid during the grace period, a life insurance policy may lapse for nonpayment of premiums.

The Reinstatement Clause allows the policy owner the right to reinstatement of a lapsed policy under certain conditions:

- The insured must provide evidence of insurability, a condition that insurers often waive for lapses of less than two months.
- All overdue premiums plus interest must be paid.
- A policy loan must be repaid or reinstated.
- The policy has not been surrendered for its cash value.
- The lapsed policy must be reinstated within five years.

If the policy owner wishes to continue the same type of life insurance coverage, it usually is more economical to reinstate a policy than to buy a new one. This is because a new policy is likely to have a higher premium, since it will be issued when the insured is older.

MISSTATEMENT OF AGE
The insured's age may be misstated in the application. Under the Misstatement Clause, the amount paid is the amount of life insurance that the premium would have purchased at the insured's correct age.

Example: Assume that Mary's correct age is thirty but is incorrectly recorded in the application as age twenty-nine and the premium for an ordinary life application at age twenty-nine is $20.00 per $1,000.00 and $21.00 per $1,000.00 at age thirty. If Jane has $15,000.00 of Ordinary Life Insurance and dies, only 14/15ths of the proceeds will be paid, or $14,000.00.

BENEFICIARY DESIGNATION
The beneficiary is the person or party named in the policy to receive the policy proceeds. There are numerous Beneficiary Designations in life insurance such as:

- The Primary Beneficiary is the first party who is entitled to receive the proceeds at the insured's death.
- The Contingent Beneficiary is the beneficiary entitled to proceeds if the primary beneficiary is not alive.
- A Revocable Beneficiary designation means that the policy owner has the right to change the Beneficiary Designation without the beneficiary's consent.
- An Irrevocable Beneficiary designation means that the policy owner cannot change the beneficiary without the irrevocable beneficiary's consent.
- A Specific Beneficiary designation means that the beneficiary is named and can be identified. For example, Martha Smith may be specifically named to receive the policy proceeds if her husband should die.
- A Class Beneficiary designation means that a specific individual is not named but is a member of a group to whom the proceeds are paid. One example of a class Beneficiary Designation would be "children of the insured."

CHANGE OF PLAN PROVISION
The Change of Plan Provision allows the policy owner to exchange the present policy for a different one. If the change is to a higher premium plan, such as exchanging an ordinary life policy for an endowment at age sixty-five, the policy owner must pay the difference in cash values between the two contracts plus interest at a stipulated rate. Since the net amount at risk is reduced, evidence of insurability is not required. Some insurers also allow the policy owner to change to a lower premium policy, such as exchanging an endowment contract for an ordinary life contract. The insurer refunds the difference in cash values to the policy owner. However, evidence of insurability is required since the net amount at risk is increased.

FOCUS POINTS

1. Policy provisions are contractual provisions that govern what a policy owner can and cannot do with the policy.
2. The owner of a life insurance policy can be the applicant, the insured, or the beneficiary.
3. In most cases the applicant and the insured are the same person.
4. Under an OWNERSHIP CLAUSE the policy owner possesses all contractual rights in the policy while the insured is still alive.
5. Contractual rights typically can be exercised without the beneficiary's consent.
6. A policy owner designating a new owner and filing out the appropriate forms can implement changes in ownership.
7. The ENTIRE CONTRACT CLAUSE states that the life policy and the attached application constitute the complete contract between the insurer and the policy owner.

8. Any officer of the company cannot change the terms of a life policy unless the policy owner agrees.
9. The INCONTESTABLE CLAUSE prevents the company from contesting the policy after it has been in force for two years.
10. An insurance company has two years to discover any irregularities in the contract such as a material misrepresentation or concealment.
11. A typical SUICIDE CLAUSE states that the face amount of the policy will not be paid if the insured commits suicide within two years after the policy is issued.
12. The GRACE PERIOD of a policy gives the policy owner thirty-one days to pay an overdue premium.
13. If death occurs during the grace period the overdue premium is usually deducted from the policy proceeds.
14. The REINSTATEMENT CLAUSE allows the policy owner the right to reinstate the policy under certain conditions.
15. A lapsed policy must be reinstated within five years.
16. It is usually more economical to re-instate a policy than to buy a new one.
17. The MISSTATEMENT OF AGE Clause specifies that the amount of death benefit paid is the amount that the premium would have purchased at the insured's correct age.
18. The Beneficiary is the person or party named in the policy to receive the policy proceeds.
19. A CONTINGENT beneficiary will only receive benefits if the Primary beneficiary is not alive.
20. A revocable beneficiary can be changed without the permission of the beneficiary.
21. A CLASE beneficiary means that a specific individual is not named but is a member of a group to whom proceeds are paid.
22. A CHANGE OF PLAN PROVISION allows the policy owner to exchange the present policy for a different one.

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PREMIUMS

SINGLE AND PERIOD PREMIUMS

There are two basic ways to purchase a life insurance policy. The first is by paying the entire cost in one lump-sum payment. This is the "single premium" method. The second method of purchasing a policy is by the payment of periodic premiums. Rather than making a single payment for the insurance, the policyholder makes annual, semi-annual, or more frequent payments.

A single premium policy is seldom purchased because of the large lump-sum payment that is generally required. The typical policyholder finds the periodic payments much easier to make.
A second reason why single premium policies are seldom purchased concerns the cost of the policy if the insured dies in the early years of the contract. In this situation, the amount paid for the insurance under the periodic method will be less than the single premium amount.

PARTS OF THE PREMIUM

There are three basic factors that affect the premium charged for a life insurance policy. The first is "mortality". Mortality refers to how many people within a given age group will die each year. The second factor is interest. Interest refers to the earnings the company receives on the premiums dollars it invests. The third factor is expenses. Expenses are, of course, all of the costs the company incurs in selling, issuing, and servicing its policies.
As an individual grows older, the cost of insurance increases, since growing older increases the chance of death. Insurance companies use mortality tables and other statistics to determine the number of insured's, within each age group, who will die each year. What happens if more people died in a year than the company predicted? The company will pay out more for death claims than was anticipated.

Another factor that influences the cost of insurance is the interest income that the company earns from its investments. Insurance companies receive millions of dollars each month in premium dollars. And, while each company has death claims and other expenses, the costs for these claims and expenses should be less than the total premiums received.

By law, a life insurance company is permitted to invest this extra money to obtain additional revenue in the form of interest. Most life insurance companies invest in stocks, bonds, construction projects, and in a variety of other ventures designed to provide a return on their investment. The principal, as well as the interest earned, on these investments establishes a fund to pay all death claims as they occur and also helps to offset the cost of insurance.

In addition to savings which may result from lower than anticipated mortality, an insurance company may also realize income from investments. Naturally, the insurance company is not permitted to keep all the money it receives. Expenses, of course, have to be paid. And, in addition to death claims, expenses include such items as:

- Agent's commissions.
- Salaries.
- Advertising.
- Physical examinations.
- Legal costs.
- Policy issue costs.

Here is a very simple formula that indicates how these factors affect premium costs:

Death claims + other expenses - interest earned = premium to be charged.

Keep in mind that no company determines the premium to be charged by the simple method we have described above. This simplified approach merely describes the important relationship between these factors.

NET AND GROSS PREMIUM

The premium that a company charges for a life insurance policy is called the "gross" premium. When a company is calculating the premium for a policy, it begins by determining the "net" premium. Once the net premium has been computed, the company then adds the expense factor, or "loading", to this net premium to arrive at the gross premium.

MORTALITY AND INTEREST FACTORS

Two basic factors go into the calculation of the net premium—the mortality and interest factors.

An insurance company cannot predict when a particular insured will die. However, by using the mathematical concept of probability, the company can predict, with a great deal of accuracy, the number of insured's that will die each year. This prediction of future mortality is made on the basis of past mortality experience and assumes that future experience will parallel past experience. But, if past mortality is to be a reliable basis for prediction, accurate data must be kept on a large group of representative individuals for a sufficiently long period of time.

Information on past mortality is analyzed and arranged in a table, called the "mortality table" which shows probable death or mortality rate at a specific age. Beginning with a given number of individuals at a given age, the mortality table shows the number of people out of the group who probably will die at each age and the number who will survive.

Even if the mortality rates and the mortality table are accurate, a company that wants a reliable estimate of future mortality must apply the rates to a large enough group of individuals for the "law of averages" to operate.

LEVEL PREMIUM CONCEPT RESERVES

Once the net single premiums are computed, the company then converts that premium into a "net level premium"; since few policies are purchased by the single premium method.

The early renewable term premium, also called a "natural or step-rate" premium, increases each year as the insured ages and the risks of mortality increases. The premium rises rather gradually during the younger ages, but increases sharply for the older ages. As a result, the premiums can become prohibitively expensive for most insured's at the older ages.

To overcome the problem of annually increasing premiums, companies develop the level premium plan. With this plan, the premium remains the same during the premium payment period rather than increasing as the probability of death increases. This level premium is higher than the natural, or yearly renewable term; premium in the early years of the policy but is lower than the natural premium in the later years.

Under the natural premium plan, the net premium charged policy owners each year is just sufficient to pay the expected claims for the year. This is not true for the level premium plan. The net level premium payments made in the early years of the contract are greater than the amount needed to pay the policy claims during those years.

By investing the excess part of the premium in the early years, the company accumulates funds to cover the deficiency that occurs in the latter years. These funds, which the company holds to meet future policy obligations, constitute the policy reserve or simply the "reserve". The reserve is the amount that, together with future premiums and interest earnings, will be sufficient for the company to pay all future policy claims, based on the company's mortality and interest assumptions. Thus, the reserve is a liability - future obligation to the company. Because a company's ability to fulfill its contract obligations depends upon sufficient policy reserves, the state requires a company to maintain certain minimum reserves. Most states now require that the insurance company become part of the legal reserve pool.

State laws specify the mortality table and the assumed rate of interest to be used in calculation of the legal minimum reserves. Because of these state regulations, reserves are often called "legal reserves".

INSURANCE AGE

Premiums charged for life insurance depend upon the insured's age. The mortality factor is one of the three basic elements of the premium and the mortality factor varies with an insured's age.

However, the age used to determine the premium is the insured's insurance age. The insured's insurance age may, or may not, be the same as his actual or chronological age.

A company may use one of two methods of determining an insurance age.

In the first method, an insured's insurance age is his age at the insured's nearest birthday. If the insured turned age 30 less than 6 months ago, the insured's age would be 30. However, if the insured's 30th birthday was more than 6 months ago, the insurance age would be 31 since the next birthday would be nearer than the last.

Although the nearest birthday is the more commonly used method, some companies may use the insured's last birthday to determine the insurance age. The insurance age under this method is the same as the insured's actual age, regardless of the number of months since his or her last birthday.

FOCUS POINTS

1. The two basic methods of purchasing life insurance is the "single premium" or periodic premium" method.
2. A lump sum or single premium policy creates a higher cost to the policy owner in the event of an early death.
3. The three basic factors that affect the premiums charged are "mortality", Interest earnings on investments and expenses of company.
4. Mortality tables and other statistics are used by insurance companies to determine the number of insured, within each age group, that will die each year.
5. Most insurance companies create interest revenue by investing in stocks, bonds and construction projects.
6. Death claims plus other expenses minus interest earned equals premiums charged.
7. The premium that an insurance company charges for a life insurance policy is called a gross premium.
8. A gross premium is determined by adding the net premium plus "loading charges" (expenses) to arrive at the gross premium.
9. The mortality and the interest factor are the two basic elements that go into the calculation of the net premium.
10. Once the net single premiums are computed, the company converts that premium into a " net level premium".
11. A " natural or step rate premium" increases each year as the insured ages and the risks of mortality increases.
12. To overcome the problem of annually increasing premiums, companies offer a "level premium" plan.
13. The 'reserve" is the amount that, together with future premiums and interest earnings, will be sufficient for the company to pay all future policy claims.
14. States require that a company maintain certain minimum reserves or be part of the legal reserve pool.

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EXCLUSIONS AND RESTRICTIONS ON LIFE POLICIES

Although few exclusions or restrictions are placed on Life insurance policies the more common ones are:

- Certain activities that are considered dangerous such as flying, hang-gliding, auto racing or skydiving may either be excluded or covered if an additional premium has been paid.
- A Suicide Clause excludes payment of the face amount in the event of suicide within two years of the issue date.
- An Aviation Exclusion may be present in the policy and would exclude death coverage from an aviation accident other than as a passenger on a regularly scheduled airline.
- The War Exclusion is designed to control adverse selection during times of war and may be inserted to exclude payment if death occurs as a result of war.

PAYMENT OF PREMIUMS

The policyholder of a life insurance contract has a choice as to how they may pay premiums. Premiums can be paid annually, semiannually, quarterly, monthly direct or monthly bank draft.
The company usually offers a discount for paying the premiums annually. The most popular method of payment is monthly bank draft.

- The method that causes the most lapses is quarterly followed by monthly direct billing.
- The method that best suits persistency is monthly bank draft followed by annually.

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SETTLEMENT OPTIONS

When benefits are paid following the death of the insured the payments of benefits is referred to as Settlement of the Policy. The following is an overview of the settlement options and then we will review them one at a time. They are:

- Lump sum settlement.
- Proceeds and interest.
- Fixed years installments.
- Life income.
- Joint life income.
- Fixed amount installments.
- Other mutually agreed methods.

LUMP SUM SETTLEMENT

This is when the beneficiary receives the policy proceeds in a single payment following the death of the insured.

PROCEEDS AND INTEREST

Under this option, the insurance company will hold the policy proceeds and make interest payments to the beneficiary. The minimum interest rate is spelled out in the policy and the company may at its discretion to pay a higher rate. The beneficiary still has the right to withdraw all or part of the proceeds of the policy at any time.

FIXED YEARS INSTALLMENTS

With this option, the insurance company pays the proceeds in equal monthly payments. The recipient of the proceeds chooses the number of years for which payments will be made.
The amount received monthly depends on three factors:

- Policy proceeds.
- Number of years payments are to be made.
- Interest rate paid by the insurance company.

Again, under this settlement option, the beneficiary still has the right to withdraw all or part of the proceeds at any time.

LIFE INCOME

Under this settlement option, the beneficiary will receive equal monthly payments for the life of the beneficiary. The amount of monthly payments depends on four factors:

- ❑ Policy proceeds.
- ❑ Beneficiary's sex.
- ❑ Beneficiary's age at time payments begin.
- ❑ Period certain for which payments are guaranteed.

Should payments be guaranteed for a period certain, such as ten years, payments will be made for the specified number of years regardless or whether the beneficiary lives to the end of that period. Should the beneficiary die during the period certain payments will continue to the beneficiary's designated successor.

Example: A beneficiary is going to receive $500.00 a month for 10 years certain. This means that should the beneficiary live the entire ten years he will receive $500.00 a month. After ten years there are no more benefits paid. However; if the beneficiary die in the sixth year, the remaining four years of $500.00 per month will go to his designated successor.

JOINT LIFE INCOME

When this option is chosen equal monthly payments will be made so long as either one or two payees is alive. This option may be used when a policy owner/insured contributes to the support of his or her parents. In the event of the insured's death, the parents, as beneficiaries, would receive monthly income for the rest of their lives.
The amount of the monthly benefits would depend on two factors that are:

- The policy proceeds.
- Parents' ages at the time they begin to receive benefits. However; under this option, the beneficiaries typically do not have the right to discontinue the monthly payments and receive the balance in a one-sum settlement.

FIXED AMOUNT INSTALLMENTS

Using this settlement option, the insurance company makes equal payments per month, or at longer intervals, in an amount chosen by the policy owner or beneficiary.

All proceeds held by the insurance company will earn interest. If the monthly payment is greater than the monthly interest earned, the balance of the proceeds held by the insurance company decreases each month until the total proceeds and interest due are paid out.

Under this option, the beneficiary may withdraw the unpaid balance at any time. If the beneficiary dies before the installment payments are completed, the unpaid balance is paid to the beneficiary's estate.

OTHER MUTUALLY AGREED METHOD

On occasion, a life insurance company may allow the policy owner to designate other payments methods if the insurance company agrees to them.

An example of this may be that the proceeds at interest are to be paid to the insured's spouse for the spouse's lifetime and, upon the spouse's death, a one-sum settlement is to be made to the insured's children.

FOCUS POINTS

1. Lump sum settlement is when the beneficiary receives the policy proceeds in a single payment following the death of the insured.
2. Under the proceeds and Interest option, the insurance company holds the policy proceeds and makes interest payments to the beneficiary.
3. Under proceeds and interest a minimum interest rate is spelled out in the policy.
4. Under proceeds and interest the beneficiary still has the right to withdraw all or part of the proceeds at any time.
5. Fixed years installment pays proceeds in equal monthly payments over a period of time as outlined by the recipient.
6. Under fixed year installments the beneficiary has the right to withdraw all or part of the proceeds at any time.
7. Life income provides the beneficiary equal monthly payments for the life of the beneficiary.

8. Under period certain guarantee, should the beneficiary die, the proceeds would be paid to the beneficiary's designated successor for the remaining period.
9. Under joint life income equal monthly payments will be made so long as either one or two payees is alive.
10. Under fixed amount installments, the insurance company makes equal payments per month, or at longer intervals, in amount chosen by the policy owner or beneficiary.
11. Under fixed amount installments, the beneficiary may withdraw the unpaid balance at any time.

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NON-FORFEITURE OPTIONS

Life insurance policies contain non-forfeiture options.

They are designed to give the insured ways in which he or she may gain continued value from a policy in the event the insured is unable to continue premium payments.
The five non-forfeiture options are as follows:

1. Cash Surrender Value
2. Reduced Paid-Up Insurance.
3. Extended Term Insurance.
4. Automatic Loan Provision.
5. Dividend Accumulations to Avoid Lapse.

CASH SURRENDER VALUE

A policy owner may surrender the policy and request that the company pays the cash surrender value of the policy, if any.

As a rule most policies have no cash value whatsoever for the first two to three years.

The Cash Surrender Value usually consists of the following:

- The policy cash value.
- Cash value of paid up additions.
- Dividends.

The Cash Surrender Value can be reduced by any outstanding policy loans and accrued loan interest on outstanding policy loans.

It is important to know that all coverage ceases when the policy is cash surrendered. Payment is usually made in one lump sum and in some cases in accordance with one of the other policy settlement options already discussed.

REDUCED PAID-UP INSURANCE

Under this option the policy owner may request that the cash value of the policy be used to keep a reduced amount of paid-up insurance in force under the same policy.
Usually the policy has a table contained in it that shows the amount of reduced insurance in any given year that the cash value that same year would purchase.

Although the policy has had its face reduced the policy will continue to earn cash value and pay dividends if applicable.

EXTENDED TERM INSURANCE

This option allows the same face amount of the policy to remain in effect for a specified number of years and days.

As with reduced paid-up insurance, the policy will contain a table showing how long in years and days the original face amount will remain in force during any given surrender year.

The length of time in years and days is calculated by taking the policy's cash surrender value, the insured's age and sex at the time premiums were discontinued and using that cash surrender value to purchase term insurance for a specified amount of years and days.

Under this option the policy does not continue to earn cash value or pay dividends if applicable.

AUTOMATIC PREMIUM PROVISION

It is possible for the insured to authorize the insurance company to make an automatic loan from the policy's cash value to pay any premium not paid by the grace period.

DIVIDEND ACCUMULATIONS TO AVOID LAPSE

Should the policy pay a dividend, then the dividend accumulations may be applied to any premium not paid by the end of the grace period. In the event the amount of accumulated dividends is not enough to pay the entire premium, coverage will then be extended in proportion with the amount of premium paid by the accumulated dividends. As a result of this a new grace period will start at the end of extension coverage.

FOCUS POINTS

1. Life insurance non-forfeiture options give the insured ways in which he or she may gain continued value from a policy in the event the insured is unable to continue premium payments.
2. There are 5 non-forfeiture options.
3. Cash Surrender Value permits the policy owner to surrender the policy in exchange for its cash surrender value.
4. Cash Surrender Value is made up of policy cash value, cash value of paid up additions, and dividends.
5. Cash Surrender value is reduced by any outstanding loans.
6. Reduced Paid up Option permits the policy owner to use the cash value to keep a reduced amount of paid-up insurance in force under the same policy.
7. A reduced policy will continue to earn cash value and pay dividends.
8. Extended Term Option allows the same face amount of the policy to remain in effect for a specified number of years and days.
9. Under Extended Term Option the policy does not continue to earn cash value or pay dividends.
10. Automatic Premium Provision permits the insurance company to make an automatic loan from the policy's cash value to pay any premium not paid by the grace period.
11. Should a policy pay a dividend, the dividend accumulation may be applied to any premium not paid by the end of the grace period.
12. When accumulated dividends are not enough to pay an entire premium, coverage is extended in proportion with the amount of premium paid.

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DIVIDEND OPTIONS

If a life insurance contract is a participating policy that means that the policy owner is entitled to an annual dividend paid by the insurance carrier. Participating policies affords the policy owner the opportunity to participate in the earnings of the insurance company through dividend payments.

The following are the ways in which a policy owner may use his or her dividends:

- Cash Payment.
- Reduction of Premium.
- Accumulation at Interest.
- Paid-up Additions.
- One-year Term.

CASH PAYMENT

Under this dividend option the insurance company sends the insured a check equal to the amount of the declared dividend payment.

REDUCTION OF PREMIUM

The premium due on the policy for the upcoming year will be reduced by the amount of the current year's declared dividend and the balance becomes the new premium due for the upcoming year.

ACCUMULATION OF INTEREST

The dividend may be held by the insurance company to accumulate with interest paid at the rate that is specified in the contract.

The insured has the right to withdraw the accumulated dividends at any time.

Should the accumulated interest and dividend be on deposit with the company at the time of the insured's death, the accumulated interest and dividend will be paid along with the policy proceeds.

PAID-UP ADDITIONS

This option enables the insured to receive additional amounts of life insurance by using the dividend to purchase paid-up additions. The additional insurance will be the same kind and subject to the same provisions as the original policy. Again, on the insured's death paid-up additions of insurance will be paid up along with the policy proceeds.

ONE-YEAR TERM

Some policies permit dividends to purchase one-year term coverage. The amount of the one-year term coverage would be added to the face amount of the base policy in the event of the insured's death.

FOCUS POINTS

1. Some life insurance policies are participating contracts.
2. Participating policies permit the policy owner to participate in the earnings of the insurance company.
3. Policy owners participate in the earnings of an insurance company through dividend payments.

4. Dividends can be used through cash payment, reduction of premium, accumulation of interest, paid up additions, one year term.
5. Under Cash Payment the insurance company pays the dividends directly to the insured.
6. Reduction of Premium applies dividends to the upcoming premium payment.
7. Accumulation of interest applies the dividends that are held by the company to accumulate interest for the benefit of the insured.
8. The insured has a right to withdraw the accumulated dividends at any time.
9. At the time of the insured's death the accumulated interest and dividends would be paid in addition to the policy proceeds.
10. Dividends may be used to buy up additional insurance under a Paid Up Additions option.
11. Some policies permit dividends to purchase one-year term coverage, which would be added to the face amount of the base policy in the vent of the insured's death.

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LIFE INSURANCE POLICY RIDERS

In life and health insurance the word "rider" is used in lieu of endorsement. The effect is the same in that riders modify the coverage of the basic policy the same as an endorsement would.

The most commonly used riders in life insurance policies are:

- Waiver of Premium.
- Accidental Death and Dismemberment.
- Guaranteed Purchase Option.

WAIVER OF PREMIUM

This rider protects the insured in the event he becomes totally disabled. The waiting period usually is six months, and if the insured continues to be disabled after the six-month waiting period the premium payments on the policy will be waived. Many policies will also refund the premium that was paid by the insured during the six-month waiting period. The cost for this coverage is a bargain to say the least and no policy should be sold without this rider.

ACCIDENTAL DEATH AND DISMEMBERMENT

The amount paid in the event of accidental death of the insured is usually the same as the policy's regular face amount. Therefore, if death occurs as the result of an accident the beneficiary receives twice the amount of the face value of the policy. Some agents may better recognize this benefit when it is referred to as "double indemnity."

As a rule, the accidental death rider is very carefully worded to define exactly under what circumstances this benefit will be paid. The most liberal of the definitions is "accidental bodily injury." The less favorable wording would be that death must occur "by accidental means."

For example using "by accidental means" if an insured died from a broken neck after intentionally diving into the shallow end of a swimming pool the policy would not pay the accidental death benefit because the action of diving into this pool wasn't accidental. However, if the insured accidentally fell into the pool and drowned the benefit would be paid. Under the "accidental bodily injury" definition the intentional diving into the pool would have been paid.

Normally, the death caused by the accident must consummate itself within 90 to 180 days of the incident. Under the dismemberment rider payment is made to the insured rather than the beneficiary.

Benefits typically are paid for:

- ❑ Loss of Sight.
- ❑ Loss of Hand or Hands.
- ❑ Loss of Foot or Feet.

Regarding the loss of hand or foot, the loss typically must involve "complete severance through or above the wrist or ankle joint." Loss caused by amputation is excluded unless medically necessary and as the result of an accidental injury.

GUARANTEED PURCHASE OPTION

This option is used most frequently with whole life insurance rather than term insurance. Under this option the company guarantees the insured that he or she may purchase additional amounts of coverage without evidence of insurability. These additional purchases usually are made at specific time intervals or events that change your family status.

For example some policies permit additional purchases of life insurance under the following circumstances:

- Every fourth policy anniversary year.
- The insured purchases a new home.
- The insured gets married.
- The birth of a new child.

The premium charge for the additional coverage is typically based on:

- The type of insurance purchased.
- The insured's age at time of exercising option.

FOCUS POINTS

1. In life and health insurance the word "rider" is used in lieu of endorsement.
2. "Riders modify the coverage of the basic policy.
3. The most common riders in life insurance are waiver of premium, accidental death and dismemberment, and guaranteed purchase option.
4. Waiver of Premium protects the insured should he or she become totally disabled.
5. There is usually a six-month waiting period on a Waiver of Premium rider.
6. Under some Waiver of Premium policies the insured is refunded the premium paid during the 6-month waiting period.
7. Under Accidental death and Dismemberment in the event of accidental death the policy pays twice the amount of the face value.
8. The benefit under Accidental death and Dismemberment is often referred to as "double indemnity."
9. Under most policies death caused by an accident must consummate itself within 90 to 180 days of the accident.
10. Under Dismemberment Rider the loss of a hand or foot must involve the "complete severance" through or above the wrist or ankle joint.
11. Loss caused by amputation is excluded unless medically necessary and as the result of an accidental injury.
12. Guaranteed Purchase Option is used frequently with whole life insurance rather than term insurance.
13. Guaranteed Purchase Option permits the insured to purchase additional amounts of insurance without evidence of insurability.
14. Additional purchases are usually made at specific time intervals or as a result of certain events.
15. Premium charged, under a Guaranteed Option, is typically based on type of insurance purchased and the insured's age.

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LIFE INSURANCE UNDERWRITING

The purpose of life insurance underwriting is to develop a profitable book of business for the insurance company.

In order to accomplish this goal the life insurance underwriter attempts to provide coverage for a diversified group of insured's where the expected death rate is the same or lower than what is expected of the population as a whole.

UNDERWRITING FACTORS FOR INDIVIDUAL COVERAGE

Life insurance is priced on a class basis. Perspective clients of the insurance company are classed on the basis of a number of factors that help to predict expected mortality rates.
The principal rating factors are:

- Age.
- Sex.
- Health.
- Occupation and Avocation.
- Personal Habits.
- Foreign Travel or Recent Immigration.

AGE

Mortality rates are measured in terms of deaths per one thousand persons and this of course increases with age. Thus, the older you are, the more life insurance costs because you are closer to death than a younger person.

SEX

Women in the United States live seven years longer than men. Therefore, cost for life insurance on a woman is lower, based on a three-year age difference, than on a man of the same age. For example, a thirty-year old male would pay the same premium as that of a 33-year-old female.

HEALTH

The health of an individual as well as the health history of their family helps the underwriter to determine if the applicant presents an average or better than average risk to the insurance company.
In evaluating an insured's health the company will consider whether the applicant or family members have had any of the following illnesses:

- Cancer.
- Heart Disease.
- Hypertension.
- Diabetes.

As a rule, persons whose health history include the above diseases will likely have a higher than normal mortality rate. Most insurance companies are now offering discounted rates to non-smokers due to the link between smoking and lung and heart disease.

OCCUPATION AND AVOCATION

Since certain occupations pose hazards such as flying and scuba-diving, applicants who engage in these hobbies are likely to have a higher than normal mortality rate.

PERSONAL HABITS

If a life policy exceeds $100,000.00 in coverage the insurance company will more than likely investigate the personal circumstances of the insured's life. For example, areas such as alcohol or drug use, poor driving record or financial problems may be taken into consideration.

FOREIGN TRAVEL OR RECENT IMMIGRATION

People who travel or reside outside the United States may be exposed to diseases not commonly found in this country. Additionally, mortality rates vary from country to country. Therefore if a person is applying for life insurance shortly before leaving the country special medical tests or a postponement of coverage may take place.

UNDERWRITING ACTIONS

Based on the information that the underwriter receives from the applicant one of following three actions may be taken:

- Rate the applicant standard and charge the normal premium.
- Rate the applicant substandard and charge a higher premium.
- Decline the coverage.

In addition to the above three actions many insurance companies recognize preferred risks and they will actually reduce premiums.

FOCUS POINTS

1. The purpose of insurance underwriting is to develop a profitable book of business for the company
2. In order to accomplish the goal of profitability for the company an underwriter attempts to provide coverage for a diversified group of insured's.
3. Profitability is accomplished by insuring a group of insured's where the expected death rate is the same or lower than what is expected of the population as a whole.
4. Life insurance is priced on a class basis.
5. Perspective clients are classed on the basis of a number of factors that help to predict expected mortality rates.
6. The principal rating factors are age, sex, health, occupation and avocation, personal habits, and foreign travel or recent immigration.
7. Mortality rates are measured in terms of deaths per one thousand.
8. Mortality increases with age, thus causing insurance premiums to be higher with age.
9. Because women in the United States live longer then men, insurance for a woman at any specific age is lower than a man at the same age.
10. The health of an individual helps the underwriter to determine if the applicant presents an average or better than average risk.
11. The health history of an individual's family helps an underwriter further evaluate risk.
12. Individuals that either have hobbies or occupations that pose hazard are likely to have a higher mortality rate.
13. Alcohol, drug use, poor driving record or financial problems are taken into consideration by an underwriter.
14. Because people traveling or residing outside the United States may be exposed to diseases not commonly found in the U.S., an underwriter analysis the risk as part of the consideration.
15. Mortality rates vary from country to country
16. Some insurance companies recognize preferred risks and reduce the actual premium.

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DELIVERING THE POLICY

POLICY EFFECTIVE DATE

The effective date of a life insurance policy is very important since this is the date on which coverage begins. The policy effective date may also have additional significance with regard to the incontestable and suicide clauses.

The incontestable clause gives the insurer, usually two years, that amount of time to contest the policy on the basis of material misrepresentation, fraud, or concealment in the application.

The suicide clause excludes coverage for death by suicide during the first two years of the policy.

To determine the effective date of the policy, we must examine the principal of contract law known as "offer and acceptance".

If a proposed insured signs the application and submits it with the first premium to the company, an offer to buy insurance has been made by the proposed insured.
If the insurance company issues the policy, as applied for, then the fundamental of offer and acceptance occurs. That is, the proposed insured has made an offer to purchase a life insurance contract, and the insurance company has accepted that offer.

It is assumed that the premium was submitted with the application. However, there are two other possibilities to consider regarding the effective date of the policy.

The first occurs when an application is submitted without the premium. In this case, the applicant has made no offer. The applicant has only extended an invitation to the company to make an offer.
The insurance company makes the offer when it issues a policy as applied for and delivers it to the applicant. Further, the offer is accepted when the applicant pays the premium, assuming any other conditions have been fulfilled and this date becomes the effective date of the policy.

In situations where the initial premium does not accompany the completed application, most companies state in the application that the proposed insured must be in good health at the time of policy delivery before coverage becomes effective. So, before accepting the initial premium and leaving the policy, the agent must obtain a signed statement of the prospective insured's continued good health. This statement and the initial premium are then transmitted to the company.

The final possibility occurs when the premium is submitted with the application but no receipt is given. If this is the case, then the policy's effective date is generally date that the policy is issued and delivered.

Delivery of the policy constitutes the company's acceptance of the applicant's offer - the application and initial premium.

A policy is considered delivered when:

- The policy is actually handed over in person.
- It is mailed to the policyholder.
- It is mailed to the agent for unconditional delivery to the policyholder.

Delivery, then, does not usually have to be accomplished by the manual transfer of the policy to the policyholder. Delivery accomplished by means other than a manual transfer is called "constructive delivery".

If a policy is not, or cannot, be delivered as defined previously, then the policy is not in effect, as policy delivery has not been accomplished. Two other situations need to be addressed.

- ❑ **Inspection Receipt.** When the applicant wants to examine the policy for a time before paying the initial premium, and the policy is left with the applicant for inspection, he or she should sign a receipt for the policy referred to as an "inspection receipt". This acknowledges that the policy is in the insured's possession for inspection purposes only and that the initial premium has not been paid and that the insurance is not in effect.
- ❑ **Backdating.** An applicant may ask the company to give the policy for which they are applying a date earlier than the application date. The reason for backdating is usually to obtain a lower premium. Premium paid for life insurance depends, among other factors, on the insured's age. So, in order to obtain a lower insurance age, and, as a result a lower premium, backdating is used.

AGENTS RESPONSIBILITIES

The agent should deliver the policy to the client as soon a possible after the policy is issued. This is especially important when no premium was submitted with the application because the coverage will not become effective until the policy is delivered and the first premium paid during the continued good health of the proposed insured.

The agent also has a responsibility to explain the policy's provisions, riders, and exclusions. If the policy is rated, the agent should explain why the policy was issued that way.

FOCUS POINTS

1. The effective date of an insurance policy is the date on which coverage begins.
2. The incontestable clause gives the insurer, usually two years, to contest the policy on the basis of material misrepresentation.
3. A suicide clause excludes coverage for suicide during the first two years of a policy.
4. A signed application together with the submission of the first premium constitutes an offer to buy insurance by the proposed insured.
5. When an insurance company issues a policy, as applied for, acceptance occurs.

6. If an application is submitted without a premium, the applicant has only extended an invitation to the company to make an offer.
7. Offer and acceptance occur when the applicant pays the premium.
8. When the initial premium is paid at delivery, the proposed insured must be in good health at the time of policy delivery before coverage becomes effective.
9. Delivery of the policy constitutes the company's acceptance of the applicant's offer, application and premium.
10. A policy is considered delivered when the policy is hand delivered, mailed to the policyholder or mailed to the agent for unconditional delivery to the policyholder.
11. Delivery accomplished by means other than manual delivery is called "constructive delivery."
12. The applicant should sign an "inspection" receipt when the individual wants to examine a policy for a time before paying the initial premium.
13. Backdating of a policy is permitted.
14. The reason for backdating a policy is usually to obtain a lower premium.
15. An agent has a responsibility to explain the policy's provisions, riders, and exclusions.

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SUMMING UP THE APPLICATION

Three terms with which an agent should become familiar are: Applicant, Insured, and Policy owner. The applicant is the person applying to the company for insurance, either on the applicant's own life of the life of another; the insured is the person whose life is covered by the policy; and the policy owner is the person who has the ownership rights in the insurance policy. The majority of policies are issued on the application of the person to be insured, who is also the owner of the policy.

In the typical situation, the policy owner, the applicant, and the insured will be the same person. There are, however, many policies issued where someone other than the insured applies for and owns the policy. The situation in which someone other than the insured is the policy owner is called "Third party ownership."

This type of arrangement is often found in family situations where, for example, a wife will insure her husband, or vice versa, or a parent will insure children. Third-party ownership is also often found in business situations, where a business insures the life of a key employee, for example. Another common third-party ownership arrangement is where a creditor owns a policy on the life of a debtor.

INSURABLE INTEREST

For a life insurance policy to be issued, an "insurable interest" between the insured and the policy owner must be present. In this regard, it is necessary to examine insurable interest from two standpoints. Look at the situation in which a person applies for insurance on the life of another; look at insurable interest when a person applies for insurance on his or her own life, and examine the conditions that must be present to satisfy the insurable interest requirements in each of these situations.

To purchase life insurance on the life of another, an insurable interest in the life of the proposed insured must exist. This means the policy owner must benefit, either emotionally or financially, by the insured continuing to live. Generally for an insurable interest to exist, the potential emotional loss must arise from love and affection that grows from a close blood relationship, or marriage. And, of course, where ones' own life is concerned, each person has an unlimited insurable interest in his or her own life.

Suppose that a life insurance policy could be sold when no insurable interest requirements existed. If a person could apply for insurance on the life of another without this interest, then the policy owner would stand to gain, and suffer no emotional loss, by the insured's death. As such, a life insurance policy would constitute a mere wager which would be clearly against public policy, and therefore illegal.

Remember, an insurable interest arises out of a close blood relationship. While this is basically true, being the relative of a potential policy owner does not automatically establish an insurable interest. For example, under most circumstances a person would probably find it difficult to establish an insurable interest in an aunt, uncle, or cousin unless the policy owner could show that a significant financial or emotional loss would result upon the death of the relative.

Example: Assume George has loaned a substantial amount of money to his cousin. George wants to purchase a life insurance policy on his cousin's life. George will be the policy owner, and his cousin will be the insured.

POLICY OWNER AND CREDITOR

Another important aspect of insurable interest is the relationship between a policy owner and a creditor. This relationship brings about another type of insurable interest.

Example: A creditor can establish an insurable interest with a debtor. For instance, assume a bank loans $5,000 to an individual. Obviously, the bank will suffer financially if the debtor dies before the loan is repaid. This fact establishes the insurable interest between the bank and the debtor. For this reason, the bank can purchase life insurance on the life of

the debtor and receive the death benefit of the life insurance policy, but only in an amount, which reflects the balance of the unpaid loan, should the debtor die prior to repaying the loan.

Insurance purchased by a creditor on the life of a debtor must be in an amount that approximates the size of the debt. So, if a debtor owes a creditor $1,000, it is unlikely that the creditor could purchase a $10,000 life insurance policy on the life of the debtor.

For this reason, most credit life insurance purchased on the life of a debtor has a reducing death benefit which keeps pace with the diminishing loan balance. Therefore, if a debtor owes $5,000 to be repaid over a period of five years, the death benefit might begin at $5,000 to match the original amount of the loan. However, this policy would eventually reduce to $0 at the end of five years when the loan has been repaid.

COMPLETING THE APPLICATION

The application is a life insurance company document containing questions and information, which the company uses in evaluating the insurance risk and in properly preparing the policy, if one is issued. The agent completes the application by asking the applicant the questions.

The information requested on the application generally includes items such as the applicant's full name and address, age, sex, marital status, occupation, medical and family histories, present physical condition, and a description of the type and the amount of insurance applied for. It also includes the name of the person who is the beneficiary of the insurance along with data on other insurance owned and applied for, as well as whether or not the applicant was ever refused life insurance.

In view of the importance of the application, it is essential that the application be completed fully and accurately. If the application is incomplete, the underwriting process and policy issue will be delayed until the necessary information is obtained. And the company depends upon accurate information to make a proper evaluation of the proposed insured.

Sometimes an agent will need to correct an application. There may be a mistake in completing the form, or the applicant may remember some fact that requires an addition to or change in the information already recorded. In such a situation, erasures, additions, or alterations of any kind MUST BE INITIALED BY THE APPLICANT.

CONCEALMENT, REPRESENTATIONS, AND WARRANTIES

As noted previously, the application is intended to reveal facts about the proposed insured that the company feels will be pertinent to making a decision about whether or not to insure the applicant. The insurance company uses the information supplied on the application, in large part, to make the decision about whether or not to issue the policy.

If the information submitted by the applicant is incorrect or incomplete, the insurance company may be forced to void the contract later on the grounds of a concealment, material misrepresentation, or warranty violation.
CONCEALMENT occurs when an applicant conceals or fails to disclose known facts. To void a contract in most states, the concealment of facts by the proposed insured must be material to the selection of the risk, and it must be done with the intent to defraud. If knowledge of the concealed fact would have influenced the company to accept or reject the risk, concealment has occurred and the contract may be voided.
MISREPRESENTATION is just what it implies. Any material misrepresentation made by the applicant can also provide grounds for the company to void the policy.

Assume that an applicant tells the insurance company that she visited the doctor for the treatment of a cold. Instead, she visited the doctor for a heart condition. Assume also that her condition was serious enough for the company to have refused to issue the policy if all the facts had been known. Since she failed to correctly inform the company about the true reason for visits to her doctor, and since the misrepresentation is material, material misrepresentation has occurred.

There is a close relationship between the terms material misrepresentation and concealment. An easy way to distinguish them is to remember, if a material fact is omitted, that is concealment. If a material fact is not presented truthfully, that is material misrepresentation. And, for concealment and misrepresentation to exist, there must be generally be intent to defraud the insurance company.
Because of the harsh consequences of warranty rule enforcement, nearly all states now have statutes providing that all statements made by the applicant for life insurance are representations and NOT WARRANTIES. In simple terms, a representation is a statement that is true to the best of the applicant's knowledge.

OBTAINING NECESSARY SIGNATURES

After the application has been fully and accurately completed, the agent must obtain the necessary signatures on the application. The applicant must sign and so must the proposed insured, if someone other than the applicant. The proposed insured's signature in a third-party ownership situation is required to show his or her consent to being insured under the policy. The agent will also sign as witness to the applicant's (and proposed insured's) signature.

MINORS

A life insurance contract between a minor applicant and the life insurance company is binding on the company, but the minor can back out of the contract at his or her option and receive back at least part of the premiums paid for the insurance.

Because of this problem, many states have adopted statutes that provide that a minor of a certain age or older has the legal capacity to enter into a life insurance contract that is binding on both the minor and the company. The age limit can be as low as age 14. Generally, the special age limit applies only to insurance on the minor applicant's life. Also, the beneficiary usually must be a close relative.

In addition to the signatures on the application, other signatures will usually be required. The applicant generally must sign an authorization form allowing the company to obtain medical information from physicians, hospitals, etc.

Because of the confidential nature of such information and possible legal restrictions on giving out unauthorized medical information, a signed authorization is necessary before the company can have access to the data.

The rules of the Medical Information Bureau (MIB) and the Fair Credit Reporting Act require written notification to the applicant. The agent should explain these notifications. The applicant will be asked to sign receipts acknowledging that the notices were received. Depending on company practice, these receipts may be combined with the medical authorization.

In addition to signing as witness to the applicant's signatures, the agent will be required to complete and sign the agent's report which is commonly part of the application form. Also, if the initial premium is paid, the agent will generally issue a premium receipt to the applicant. The agent should complete and sign this receipt, carefully explaining its provisions to the applicant.

PREMIUM RECEIPT

When the applicant pays an initial premium at the time the application is completed, it is customary for the agent to give the applicant a premium receipt to show that the money was received. The premium receipt is significant because it is intended to provide coverage, under certain circumstances, before the policy is issued and delivered. The coverage provided by the premium receipt is, therefore, an incentive for the applicant to pay the initial premium when the application is completed, rather than waiting until policy delivery.

When the premium receipt is issued, the agent should explain its effect to the applicant. However, there are several different types of premium receipts, so it's important to understand each type and to recognize how the consequences of each of the receipts differ.

There are two major types of premium receipts: (1), the conditional receipt, and, (2), the binding receipt, which is also called a temporary insurance agreement. Conditional receipts may be further divided into two types: (1) insurability, and (2) approval.

THE INSURABILITY CONDITIONAL RECEIPT provides that insurance will become effective as of the date the receipt is issue, IF the applicant is found to be insurable as of that date.

> **EXAMPLE:** The application for insurance is made on January 14th. The application and a check for the initial premium is submitted on that date. The insurance company subsequently determines that the applicant is insurable as applied for, and issues the policy on February 14th. The effective date for this policy is January 14th, the date the application and check were originally submitted because the applicant was insurable on that date. Most companies use the insurability type of conditional receipt.

The ***APPROVAL*** type of conditional receipt also provides that the policy will become effective on the date of the receipt. However, it becomes effective only if the application is actually approved.

> **EXAMPLE:** An application is submitted on July 19, together with the initial premium. The applicant is given an approval type of conditional receipt on that date. If the applicant dies on July 23rd as a result of an accident, and the company had not approved the application by that date, the applicant would not be insured, even though he or she was insurable on the date of the application. The applicant has no life insurance protection during the period of time the company is determining insurability the approval type of receipt.

THE BINDING RECEIPT also called a temporary insurance agreement. The agent gives the temporary insurance agreement to the applicant when the initial premium is paid. However, the temporary insurance agreement provides life insurance coverage IMMEDIATELY, even though the company's underwriters have not as yet determined the insurability of the proposed insured.

If the proposed insured dies while the temporary coverage is in effect, the company will be liable for the full amount of the death benefit applied for, subject to any limitations as to maximum amount specified in the receipt.

FOCUS POINTS

1. The Applicant is the person applying for insurance.
2. An Applicant can insure his or her own life or the life of someone else.
3. The insured is the individual whose life is covered by the policy.
4. The policy owner has the ownership rights to the policy.
5. In the majority of policies the applicant, the insured, and the owner are the same individual.
6. "Third Party Ownership" is when someone other than the insured is the policy owner.
7. One form of "third Party" ownership is a business insuring the life of a key employee.
8. Another form of "Third Party" ownership is a creditor insuring the life of the debtor.
9. For a life policy to be issued, an "insurable interest" between the insured and the policy owner must be present.
10. Insurable interest is defined in that the policy owner must benefit, either emotionally or financially, by the insured continuing to live.
11. Insurable interest arises out of a close blood relationship.
12. Insurance purchased by a creditor on the life of a debtor must be in an amount that approximates the size of the debt.
13. Most credit life insurance policies have a reducing death benefit to keep pace with the diminishing loan balance.
14. An application is an insurance company document, which the company uses in evaluating the insurance risk.
15. The applicant must initial corrections made to a loan application.
16. If the information submitted on an application is incorrect, an insurance company can void the contract later on the grounds of concealment, material misrepresentation, or warranty violation.
17. Concealment occurs when an applicant conceals or fails to disclose known facts.
18. If knowledge of the concealed fact would have influenced the company to accept or reject the risk, concealment has occurred and the contract may be voided.
19. The concealment of facts by the proposed insured must be material to the selection of the risk and done with intent to defraud.
20. A material fact not presented truthfully, with the intention to defraud, is called material misrepresentation.
21. Both the applicant and the proposed insured must sign an insurance application.
22. A life insurance contract between a minor and an insurance company is binding on the company, but not the minor.
23. In some states statutes permit individuals as young as 14 years old to be of legal age to enter into an insurance contract.
24. Applicants normally sign an authorization form allowing the company to obtain medical records.
25. An agent's signature as witness to the applicant's signature is required on the insurance application form.
26. A premium receipt is significant because it is intended to provide coverage, under certain circumstances, before the policy is issued and delivered.
27. An Insurability Conditional Receipt provides that insurance will become effective as of the date the receipt is issued, if the applicant is found to be insurable.
28. The agent gives a Binding Receipt, also called a temporary insurance agreement, to the applicant when the initial premium is paid.
29. Under a Binding Receipt life insurance coverage is effective immediately, even though the policy has not yet been underwritten.
30. If the insured dies while the Temporary Coverage is in effect, the company will be liable for the full death benefit minus the limitations.

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RISK SELECTION AND CLASSIFICATION

Once the agent submits the completed application to the life insurance company, the company must evaluate the proposed insured's acceptability for life insurance. If he is acceptable, the company must then decide if the insurance will be issued at the normal premium or, because of some increased risk of death, at a higher than normal premium.

It is important to keep in mind that risk selection begins before the application reaches the company. The process actually begins with the agent when the company instructs its soliciting agents on the classes of people it is willing to insure. If the prospective insured obviously does not meet the standards, no application should be completed.

The agent is very important in the selection process since the agent is often the only person connected with the company with any personal knowledge of the proposed insured.

UNDERWRITING FACTORS

The first factor, closely related to mortality is **AGE**. As age increases, the chance of death increases. The **SEX** of the proposed insured is also a factor that affects longevity. Statistics show that women live longer than men do generally speaking.

PHYSICAL CONDITION:

The proposed insured's health also affects life expectancy. Actually, there are several health-related factors that a company will examine. One of these is the person's physical condition. Diseases such as heart disease, high blood pressure, liver disease of cancer can obviously affect life expectancy.

A person's height, weight, and weight distribution can also be a health related factor in underwriting. Generally, overweight has a more serious impact on underwriting than underweight. Overweight people have a higher than normal mortality rate and excess weight can also increase the dangers from conditions such as heart disease and high blood pressure.

Knowledge of the proposed insured's family history is another factor that is useful in selecting and classifying the risk. Statistical evidence indicates that longevity is linked to heredity. If the proposed insured's parents have lived to an old age, then there is and increased probability that the proposed insured will also have a long life.

On the other hand, if the family history shows a pattern of early deaths from heart disease, for example, and if the proposed insured suffers from some impairment that increases the danger of heart disease, such as excess weight or high blood pressure, the underwriters are going to carefully consider the potential for an early death.

OCCUPATION:

A number of years ago, occupation was a primary factor in selection. With the advent of automation, industrial safety programs, and improved working conditions, the impact of occupation on mortality has decreased. And relatively few occupations today are listed by insurers as requiring an extra premium.
Even today, certain occupations with a high accident hazard, such as explosives handling, are associated with a greater than normal mortality. A second major group of occupations shows an additional hazard because of exposure to dust, poison, or radiation. The occupation of crop duster is one that is very dangerous. Thus, the insurance company generally has two choices available to it if a crop duster applies for life insurance. Issue the policy at an increased premium or decline to issue the coverage all together.

The proposed insured's hobbies can also affect the risk. Activities such as sky diving, skin diving or auto racing obviously have a bearing on insurability. The habits and morals of the proposed insured are also important in risk selection. Misuse of alcohol or drugs, for example, may cause the company to decline the coverage. The individual's personal reputation, character, and personal habits are also considered in evaluating the risk.

The financial situation of the proposed insured is also a factor. The company will examine not only the relationship between income and the amount of insurance to guard against the danger of over insurance, but also to assess the proposed insured's ability to pay for the insurance requested.

SOURCES OF INFORMATION

The application processed has been reviewed several times in this course, and it's importance in determining the acceptability of the proposed insured for life insurance has been discussed. The application is a primary source of information about the proposed insured's age, sex, marital status, occupation, and other items.

AGENT'S REPORT

Another source of information is the agent's report. Most companies require the agent who completes the application to fill out such a report. The agent's report is usually on the back of the application. The report generally contains questions about the agent's personal knowledge of the proposed insured and about the proposed insured's financial position.

Information about the purpose of the insurance and whether or not the insurance is intended to replace other coverage is commonly requested. The agent's report is obviously important in view of the fact, as mentioned, that the agent may be the only person connected with the company with any personal knowledge of the proposed insured.

MEDICAL EXAMINATION

Another source of information is the medical examination, which affects underwriting when an examination is required as a part of the selection process. A urine sample and/or blood test may also be required. The medical examiner will record the proposed insured's answers to questions about medical and family histories and otherwise report the findings of the physical examination. In cases where a medical examination is not required under the company's underwriting rules, the policy is issued non-medical" and the agent will ask the questions about the proposed insured's medical and family histories.

ATTENDING PHYSICIAN'S STATEMENT

If the company wants more detail about medical information revealed in the application or medical examination, it may obtain and attending physician's report or statement from the proposed insured's physician. The attending physician's report is only requested when elaboration on medical information is desired. This report is another insurability information source.

MEDICAL INFORMATION BUREAU

The "Medical Information Bureau" is another source of information. The MIB is a nonprofit organization that was established by life insurance companies to make possible the exchange of pertinent underwriting information among life insurance

companies. The information is composed chiefly of medical facts, both favorable and unfavorable, about applicants for life insurance. A member company must report to the MIB if it finds certain specified impairments in the individual during the selection process.

In underwriting a policy, MIB information may be used only as an alert signal. Every member company is also required to make its own independent underwriting investigation. In addition, insurance cannot be denied nor can an extra premium be charged solely on the basis of information supplied by MIB.

MIB rules require that every applicant be given a written notice that (1) the company may make a brief report of information to the MIB, (2) if the applicant applies for insurance with another MIB member company or makes a claim to such a company, the MIB will furnish information on the applicant to the company upon request, and (3) if requested by the applicant, the MIB will arrange disclosure of any information on the applicant in its files. However, medical information will be disclosed only to the applicant's physician.

If the applicant questions the accuracy of any information, he or she can seek a correction through the MIB. Further, the applicant must sign an authorization permitting MIB information to be disclosed to member companies.

INSPECTION REPORTS

Inspection reports come from various consumer-reporting agencies. These are another source of underwriting information. These reports, called consumer investigative reports, cover credit information, as well as information about an applicant's personal habits, lifestyle, reputation, health, occupation, and so forth. Although company practice varies, these reports are often only obtained when larger amounts of coverage are involved. The information for the report is obtained through personal interviews with the individual's friends, neighbors, and associates.

The "Fair Credit Reporting Act" requires that the proposed insured be informed in writing that such an investigation may be made. The notice must also inform the person that, upon a written request, the company will furnish information concerning the nature and scope of the investigative consumer report. If coverage is denied or a higher premium charged as a result of such information, the proposed insured must be so notified and given the name of the consumer reporting agency.

TYPES OF RISK

Based on the insurability information obtained from the various sources, a company will usually classify a proposed insured in one of three ways; (1) standard risk, (2) a substandard risk (also called a special class, impaired, or under average risk), or (3) an unacceptable or uninsurable risk.

The great majority of proposed insured's are STANDARD risks. This means that they are exposed to a "normal" risk of death and are charged the regular or standard premium for the coverage. About 90% of proposed insured's are acceptable on a standard basis.

Some individuals who do not qualify as standard under a company's underwriting rules are declined coverage by the company because they have an unacceptable high probability of death. These are the UNINSURABLE risks.
Other proposed insured's are subject to higher than normal mortality rates but are still acceptable risks. These are the SUBSTANDARD risks. Because of the greater mortality risk, members of the substandard group are charged a premium that is higher than the standard premium. The individual is charged extra premiums for the coverage because of the hazards applicable to that person. A hazard is a condition that increases the chance of loss. Among the factors that may cause an individual to be classified as a substandard risk are:

- An existing medical condition, such as a heart murmur or hypertension.
- Past medical history of a condition that may recur or may have adversely affected life expectancy.
- An occupation that involves an increased risk of accidents or subjects the workers to an unhealthy environment.
- The moral hazard, the existence of morals or habits, such as misuse of alcohol or drugs, which increase the chance of loss.

Some companies also use a "preferred risk" classification. A preferred risk might qualify for an even lower premium than a standard risk. Other companies, however, use the term "preferred" in reference to their standard risks. Agents must know the risk classification systems of the companies they represent.

RATED POLICIES

Consider the factors that impact an applicant's life span and how these factors are evaluated by life insurance underwriters to determine if a life insurance policy should be issued at standard rates. So long as an applicant is a standard risk, the company will issue the policy and charge a premium that is standard for others in the applicant's group.

If, because of health, age, occupation, or some other factor, the applicant is not a standard risk, then the company can choose one of two alternatives available. First, it can decline to issue the policy, or second, it can charge an increased amount for the insurance. A policy on which the company charges an increased amount is called substandard or RATED policy.

Although not as popular as it once was, another system for increasing the premium for a rated policy is called the "rate-up in age". Under this system, if an insured's true age is 40, the company might use the premiums based upon age 45. This increase in age requires the insured to pay more for insurance than those standard risks charged the usual amount for his age.

One final method of determining a premium for a substandard risk is the lien system. Under this method, the insured pays the standard premium for the age and plan, but the amount of insurance purchased by that premium is reduced. The policy has a lien against it, and the lien is deducted in case of death. The lien system, also called the graded death benefit, is seldom used in the United States except for money purchase pension plans. This method is used because, under the pension formula, the premium for a participant cannot vary.

REINSURANCE

Reinsurance is insurance for insurers. Insurance companies use reinsurance to protect themselves against the catastrophe of a large single loss or a large number of small losses caused by the same occurrence. In re-insurance, and insurer "cedes" part of a risk to a second insurer. The first insurer is known as the "direct writer" or "ceding company," while the second insurer is called the "re-insurer."

There are two types of reinsurance treaties:

FACULTATIVE:

Under the facultative treaty, initially the risks are considered by both parties, with the direct writer carrying the entire risk. Each risk is submitted to the re-insurer on the option of the direct writer, and the risk is either accepted or rejected. The terms under which reinsurance will occur are enumerated, and once the risk is accepted, those terms apply.

AUTOMATIC:

Under the terms of the automatic treaty, the re-insurer agrees to accept a portion of the direct line or of certain risks in advance. The direct writer is then obligated to cede the portion to which the treaty applies.

There are two important purposes that are served by reinsurance. First, reinsurance spreads the risk, allowing companies to protect themselves from catastrophic losses. Second, reinsurance serves a financial function by allowing the direct writer to be relieved of the obligation to maintain the unearned policy reserves of those policies reinsured. In essence, the excess capacity of the direct writer is transferred to the re-insurer.

FOCUS POINTS

1. Risk selection begins when the company instructs its soliciting agents on the classes of people it is willing to insure
2. If the prospective insured does not meet the standards, no application should be completed.
3. Because of the personal knowledge of the proposed insured, the agent is a very important element in the process of selection of risk.
4. Age, sex and physical condition are important considerations in the underwriting process.
5. Overweight people have a higher than normal mortality rate.
6. Statistical evidence indicates that longevity is linked to heredity.
7. With the advent of automation, industrial safety programs and improved working conditions, the impact of occupation on mortality has decreased.
8. Occupations that have exposure to dust, poison, or radiation represent a higher than normal mortality rate.
9. Individuals with higher than normal risk will either be denied insuring or charged a higher premium.
10. An individual's hobby has an effect on insurability.
11. Persons having activities such as sky diving, skin diving or auto racing represent a higher risk to insure.
12. Misuse of alcohol or drugs can effect insurability.
13. An individual's reputation, character, and personal habits are a consideration in evaluating risk.
14. The financial situation of a proposed insured effect insurability.
15. Besides the application, an agent's report is another source of information for the underwriter.
16. An agent's report generally contains questions about the agent's personal knowledge of the proposed insured and proposed insured's financial position.
17. An agent's report also states the purpose of the insurance and is it intended to replace other coverage.
18. In some cases medical examinations become part of the underwriting requirements.
19. When a medical examination is required usually a blood test and /or a urine specimen is also required, as well as, answers to medical information.
20. When a policy is issued on a "non-medical" basis, the agent will ask the questions about the proposed insured's medical and family history.
21. In some cases an attending physician's report is also required.
22. A "Medical Information Bureau" is another source of information.
23. The "Medical Information Bureau" is a non-profit organization that was established by insurance companies to create an exchange of pertinent underwriting information among life insurance companies.
24. MIB is an information center of medical facts about applicants for life insurance.
25. Member companies provide information to the MIB to create a central ral data source.
26. Insurance cannot be denied or an additional premium charged only on the basis of an MIB report.

27. MIB rules require that every applicant be given written notice that information is being provided to MIB.
28. An applicant must sign an authorization permitting MIB information to be disclosed to member companies.
29. Another source of underwriting is inspection reports that come from various consumer-reporting agencies.
30. Consumer reports normally cover personal habits, lifestyle, reputation, health, occupation, etc.
31. Consumer Reports generate from personal interviews with individual's friends, neighbors, and associates.
32. The "Fair Credit Reporting Act" requires that the proposed insured be informed in writing that an investigative report may be made on him or her.
33. There are three classes of risk- standard risk, substandard risk, and unacceptable or uninsurable risk.
34. The great majority of proposed insured are standard risk
35. A substandard risk is a proposed insured with a greater mortality risk.
36. Substandard risks are usually charged a higher premium.
37. An existing medical condition such hypertension can cause an individual to be considered a substandard risk.
38. Some companies also use a preferred risk category, which might qualify an individual for a lower premium.
39. Some companies use the term "preferred risk" to reference individuals in the standard risk category.
40. A policy on which the company charges an increased amount is called substandard or RATED policy.
41. A Lien Policy is applied to a substandard insured and reduces the death benefit in situations where a higher premium cannot be charged.
42. A lien Policy is also called a Graded Benefit Policy.
43. Reinsurance is insurance for insurers.
44. Reinsurance is used by companies to protect themselves against the catastrophe of a large single loss or a large number of small losses.
45. The first insurer is known as the "direct writer" or "ceding Company," while the second insurer is called the "reinsurer."
46. The two types of reinsurance treaties are Faculative and Automatic.
47. Re-insurance spreads the risk, allowing companies to protect themselves from catastrophic loses.
48. Re-insurance allows the direct writer to be relieved of the obligation to maintain the unearned policy reserves of those policies reinsured.

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ETHICS ISSUES FOR LIFE AGENTS

Whether you are a Life and Health Agent or a Property and Casualty Agent, the ethics you employee in your sales approach reflects not only on you but also the companies you represent.

Although some ethical issues are personal issues of conduct or level of integrity, other issues become violation of state laws.

In selling annuities it is critical that the highest standard of ethics be adhered to in making recommendations for products.

Are you properly outlining the risk factors involved in some choices the client may make?

- ❑ Are you properly explaining the sales and administrative charges or are they being buried away in the fine print.
- ❑ Do you know enough about the products that you are marketing not to misrepresent to the consumer?
- ❑ Are you adhering to all Security Exchange Commission Rules regarding variable products?
- ❑ Are you making sure that a prospectus is being delivered, when required by law, to the consumer prior to him or her making a decision?
- ❑ Are you adhering to all NASDA rules and regulations?

In this chapter we will be reviewing the ethical issues that face all agents in the conflict of earning a living verses serving the customer's needs.

STANDARDS AND PRACTICE

I. PERCEPTIONS OF ETHICS

A. Ethics is "the discipline that deals with what is good and bad or right and wrong or with moral duty and obligation."
B. Ethics can be approached from two levels:
   1. The philosophical level-dealing with the possibilities
   2. The practical level - dealing with the reality of every day experiences
C. Ethics is a person's perceptions or convictions about what is right or wrong.
D. Living by the Golden Rule is often the role model for sound religious ethics.
E. Society, through laws and accepted behavior patterns, imposes guidelines on how to deal with other people.

II. ETHICS FOR INSURANCE AGENTS

An insurance agent is anyone who solicits insurance or who aids in the placing of risks, delivery of policies or collection of premiums on behalf of an insurance company.

There are four areas of ethical responsibility for an insurance agent:
Responsibilities to the agent's insurer are covered under the concept of agency. The agent owes his or her insurer the duties of good faith, honesty and loyalty.

- The agent's day-to-day activities are a direct reflection of the insurer's "image" within the community.
- Responsibilities to policy owners require the agent to meet the needs of the client, provide quality service, maintain loyalty, confidentiality, timely submission of applications and prompt policy delivery.
- Responsibilities to the public require the agent to maintain the highest level of professional conduct and integrity in all public contact in order to maintain a strong positive image of the industry.
- Responsibilities to the state require the agent to adhere to the ethical standards mandated by his or her state.

III. ETHICS FOR INSURANCE BROKERS

A broker's primary responsibility is to his or her client, meaning that, the broker is charged with the responsibility of finding the appropriate insurance coverage and markets to meet a client's needs.

Brokers are held to the same standards of care as agents in terms of their responsibilities to the general public and the state.

IV. CHARACTERISTICS OF A PROFESSIONAL

The word "profession" means an open or public declaration, but has come to mean any calling requiring academic training and specialized knowledge.

Insurance agents and real estate agents are considered professionals because their business meets the following six commonly accepted characteristics of a profession:

1. Commitment to high ethical standards;
2. Concern for the welfare of others;
3. Mandatory licensing and training;
4. Formal participation in an association or society;
5. Acting with integrity and objectivity; and
6. Public acknowledgement as a profession.

FOOD FOR THOUGHT
To better understand the issues discussed take a few minutes to think about or perhaps on a separate piece of paper outline your perceptions of the following thought provoking issues.

- How can an insurance agent maintain a high level of ethical conduct in the face of competition from within his or her agency and from agents of other insurance companies?
- Why do the ethical responsibilities to an agent's policyholders differ from his or her ethical responsibilities to the public?

FIDUCIARY RESPONSIBILITIES

The two fundamental principals of an agency relationship are power and authority and the high standards of conduct expected of the agent as a fiduciary

THE CONCEPT OF AGENCY

Agency is a legal term used to describe the relationship between two parties, in which the *principal* authorizes the *agent-to,* perform certain legally binding acts on the principal's behalf.

The main components of an agency relationship are:

1. An agent is an agent of the principal, not the third party with whom the agent deals.
2. An agent has the power to bind the principal to a legal contract and its terms.
3. The acts of the agent, within the scope of authority, are the acts of the principal.

Agency can be created by:

- Appointment or Explicit contract;
  - ***Estoppel*** is the principal allows someone to act in a way that would induce a third party to believe that a person was an agent of the principal;
  - ***Ratification***-the principal later sanctions the actions of an authorized principal.

Before an individual can act as an agent he or she must have the *power* and *authority* to take action. There are three types of agency authority:

- ***Express authority*** is the authority the principal intentionally and expressly gives the agent.
- ***Implied authority*** is the authority that the principal intends for the agent to have, but does not expressly give.
- ***Apparent authority*** arises when principal permits an agent to perform acts neither expressly or implicitly authorized.

The limits to an insurance agent's authority are usually defined in his or her agency agreement and the agent must work within those perimeters.

The ethical significance of these limits to an insurance agent's authority is that an agent must serve the needs of the insurer, live up to the contract and operate within the scope of his or her authority. By entering into this contractual relationship with the insurer, the agent becomes a fiduciary of the insurer.

THE AGENT AS A FIDUCIARY

An individual whose position and responsibilities involve a high degree of trust and confidence is known as a fiduciary. An insurance producer has a fiduciary relationship with his or her insurer with regard to the following:

- **Loyalty to the insurer**-A producer must at all times act in the insurer's best interest, not his or her interests of personal gain.
- **Skill and performance**-An agent has the duty to carry out his or her actions with the care and skill because an agent represents the company to the public and must act in such a manner as not to create a tarnished image for the company
- **Full disclosure** - An agent is obligated to fully disclose all information he or she has that may affect the insurer and its ability to do business. Full disclosure is critical during the application and claims handling processes.
- **Follow up** - An agent has the obligation to act promptly in all matters regarding the insurer's business, including the duties to forward completed applications as quickly as possible.
- **Handling of premiums** - By law, payment to an agent is payment to the insurer. The agent has a fiduciary duty to turn over all funds given to him or her as specified in the agency agreement.
- **Avoiding conflicts of interest** - An insurance agent cannot serve two principals at the same time. An agent has the ethical duty to make full disclosure to an insurer in regard to any other related service he or she provides and receives compensation.
- **Responsible solicitation** - An agent has the duty to solicit only business that appears to be good and profitable to his employer.
- **Competitive integrity** - An agent cannot misrepresent or in any way defame a competitive agent or insurer. An agent must compete only on the basis of products and services he or she can provide.

The principal is responsible for the acts of its agents and owes the agent three duties:

1. Payment of compensation in the form of commissions or fees
2. Employment in return for meeting production responsibilities.
3. Indemnification or reimbursement for damages or expenses incurred in defending claims for which the agent may be liable.

Legally, a *broker* acts as an agent and representative of the applicant. However, when an insurer gives a policy for delivery to an insured, the broker becomes the agent for the insurer. Should payment of a premium be involved, payment to the broker is considered payment to the insurer.

Although, the broker technically represents the client, the ethical and fiduciary standards that apply to an agent also apply to a broker.

Employing sound ethics principles permits producers to serve both the insurer and client may consider serving both the insurer and the client without creating a conflict of interest

FOOD FOR THOUGHT

To better understand the issues discussed take a few minutes to think about or perhaps on a separate piece of paper outline your perceptions of the following thought provoking issues.

- Can an agent go beyond the authority of the written agency contract and under what circumstances?
- What are the ethical implications of agents who pursue power beyond their authority?
- What is meant by the word "fiduciary"?
- How does an agent become the fiduciary of the insurer?
- What are some of the agent's fiduciary responsibilities?
- Is working for both the principal and the insurer a breach of fiduciary? Detail your answer.

RESPONSIBILITIES TO CONSUMERS & CLIENTS

Agents fulfill their ethical responsibilities to their insurers by providing the appropriate Products to meet their consumers needs, as well as, quality service. Making sure that the consumer understands both the products and underwriting process is a critical responsibility of the agent.

The insurance agent can serve the needs of the prospect by providing the prospect with the types of policies that best fit his or her needs, in the amounts he or she can afford. In order to accomplish these goals, the agent should:

1. Obtain the required knowledge and skills to accomplish the needed objectives.
2. Educate the prospect or policy owner about the products and plans being recommended by the agent.

Additionally, the agent should be committed to, not only selling the product, but to quality service both before, during and after the sale. This means:

1. Educating the prospect about insurance products and the underwriting process;
2. Treating all information obtained with confidentiality;
3. Disclosing all necessary information so that both the insurer and the prospect can make an informed decision.
4. Keeping the prospect informed through out his application.
5. Showing loyalty to prospects, clients and insurer
6. Service begins with the application.
1. It is the agent's duty to see to it that the application is completed both accurately and completely.
2. To properly explain why required information is necessary.
3. How the underwriter will evaluate the information.
4. That accuracy and honesty are imperative in the application.
5. A prospect should be informed that failure to disclose information could result in denial of claims or policy cancellation.
6. It should be explained that a *binder* provides temporary protection while the policy is being underwritten and is not a guarantee that the policy will be issued

The agent or broker is responsible for service before and after the sale, which includes:

1. Maintaining accurate client records;
2. Maintaining complete and accurate records of all business transactions;
3. Knowledge of new coverage and products.
4. Availability and changes in products offered in the marketplace;
5. Assistance with claims processing;
6. Reviewing clients' existing policies;
7. Suggestions on updating coverage on existing policies;

Ethically an agent or broker must respect the confidential information provided by the client and must assist the client in the following areas:

1. Selecting the most appropriate policy;
2. Understanding the basic features of the policy; and
3. Evaluating the costs and features of similar plans.

Ethical standards must be used in evaluating risk management.

Risk management is the process of decision making that protects assets and income against accidental or unintended loss by identifying, measuring, controlling and treating the elements that contribute to the risk.

Two basic risk management rules are:

1. The size of the potential loss must be within the scope of the resources available to the insurer.
2. The possible benefit must exceed the costs of the potential loss.

The risk manager, agent or broker should:

1. Identify and measure the loss exposures and hazard.
2. Determine the amount of money available to pay for the potential loss; and
3. Identify various risk management techniques to deal with potential losses.

Risk management techniques include:

1. Avoidance-averting a loss by refusing to take part in something that could cause a loss.
2. Transfer- shifting risk to another entity through a contract or hold-harmless agreement;
3. Loss control-reducing the frequency or probability of loss through loss prevention or lowering the severity of loss through loss reduction.
4. Retention-holding part of the risk through deductibles or all of the risk through self-insurance.
5. Insurance-transferring risk to an insurance company.

FOOD FOR THOUGHT

To better understand the issues discussed take a few minutes to think about or perhaps on a separate piece of paper outline your perceptions of the following thought provoking issues.

- ❑ What should agents do to provide quality service to clients?
- ❑ What obligations does an agent have when preparing an application for insurance coverage?
- ❑ What obligations does an agent have to a client after the sale?
- ❑ How does an agent's ethical behavior effect the industry?

RESPONSIBILITIES TO THE GENERAL PUBLIC

Because unethical behavior by agents and brokers can effect the whole industry, the integrity and professionalism of their conduct is of utmost concern to all.

The public's perception of the insurance industry is gagged by the behavior of both insurance agents and brokers and their commitment to professionalism is the key to the public's trust of the industry.

Insurance is something that is used by many, but yet, many are unaware of how insurance works and benefits them.

The ethical agent has a duty to provide the consumer with fair and honest information of the policies and services he or she has to offer.

The Insurance Industry is regulated by both the state and federal governments with the state departments of insurance issuing rules and regulations, licensing insurers, agents and brokers, suggesting laws to legislators, examining insurers' financial operations, approving policy forms and overseeing marketing practices.

A code of ethics is employed by the industry to guide corporations, agents and brokers.

Insurance producers continuously face complex issues dealing with skill, competence, and levels of knowledge required of professionals.

Professional conduct often dictates that the client's need be put ahead of the agent's needs, be dedicated to the insurance industry and offer quality plans from quality insurance companies. The agent should develop high ethical standards, adhere to integrity and serve the interests of the client.
The public's perception of the activities of an individual agent or broker shapes the perception of the industry as a whole.

Skill, competence, professionalism and moral integrity shape public perceptions.

FOOD FOR THOUGHT
To better understand the issues discussed take a few minutes to think about or perhaps on a separate piece of paper outline your perceptions of the following thought provoking issues.

- ❑ If you observed an agent, violating ethic principals what would you do?
- ❑ What should you do?

THE ENFORCEMENT OF ETHICS

Each state regulates the ethical conduct of insurance producers by creating rules, regulations and legislation to protect the consumer.

States through an Insurance Commissioner or Director to oversee the marketing activities of agents regulates the Insurance industry.

The National Association of Insurance Commissioners (NAIC) proposes model legislation to:

Encourage uniformity in state insurance laws and regulations; assist officials in administering laws and regulations, help protect the interest of policy owners; and preserve state regulation of insurance.

Most states have laws that protect consumers against unfair trade practices such as:
Misrepresentation and/or false advertising, coercion, improper placement, or rebating.

States also prohibit unfair claims methods and practices, such as:

1. Misrepresenting policy provisions to claimants or insured's;
2. Failing to deliver a determination on a claim within a reasonable time;
3. Failing to settle claims promptly and fairly;
4. Attempting to settle a claim for less than could be reasonably expected;
5. Engaging in activities that result in a disproportionate number of complaints;
6. Failing to provide necessary claims forms; or
7. Unfair claims practices.

Insurers are prohibited from engaging in underwriting or rating that is based on race, religion, and national origin or redlined areas.

In most states the punishment for unethical practices ranges from fines to license suspension and revocation.

Once a license is revoked, normally a one-year waiting period is required for re-application. And in most states a bond will also be required.

People who set high personal and professional goals of honesty, integrity, loyalty, fairness and truthfulness will never have to deal with the penalties set by state governing bodies.

FOOD FOR THOUGHT
To better understand the issues discussed take a few minutes to think about or perhaps on a separate piece of paper outline your perceptions of the following thought provoking issues.

- ❑ Give three examples of unfair claims practices

- ❑ Give three examples of discrimination in underwriting practices:
- ❑ Give three examples of unfair trade practices:

MAKING DECISIONS ETHICALLY

When trying to make decisions ethically, ask yourself the following questions**:**

1. To whom do I have obligations?
2. Whose rights must I protect?
3. What rules apply to this situation and should be observed?
4. Would I be proud of my decision and advocate this action again?

Even the most ethical producers are often time confronted with unhappy clients who feel their claim was improperly handled. Producers can help to protect themselves by:

1. Maintaining high standards of personal ethics;
2. Having errors and omissions insurance;
3. Being diligent when recommending policies and placing business; and
4. Being committed to continuing education.

Competition and production quotas often encourage producers to look to an increased bottom line, regardless of what it takes.

An agent's moral values and standards should help to resolve this inner conflict and guide them to the right decision.

FOOD FOR THOUGHT

To better understand the issues discussed take a few minutes to think about or perhaps on a separate piece of paper outline your perceptions of the following thought provoking issues.

- ❑ Do minimum production quotes increase unethical behavior?
- ❑ What would you do to increase the professionalism in your industry?