ANNUITY & LIFE PRINCIPLES
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Chapter 1

LET’S DISCUSS ANNUITIES

AN ANNUITY IS...

By definition: “A sum of money payable yearly or at other regular intervals” based upon a contractual relationship between the person covered (the Contract Owner) by the annuity and the insurance company (Insurer) through which the investment is made.

Annuities have been around a long time. They have been available in the United States for more than 100 years and several hundred years in some other countries.

Although annuities are sold only through the insurance industry (i.e., insurance agencies, brokerage firms, investment advisors, financial planners, banks, savings and loans institutions), they have nothing to do with life insurance or insurance coverage.

Guarantees are dependent upon the type of annuity purchased.

The two types of annuities are:

- If a set rate of return is desired, the contract owner can choose the Fixed Annuity; and
- If a conservative to aggressive investment is desired, the contract owner can choose the Variable Annuity. In this way, the owner can choose where the money should be invested.

PRINCIPALS

The participating parties in an annuity plan are the:

- Insurer (insurance company);
- Contract Owner;
- Annuitant; and
- Beneficiary.

THE INSURER

There are many reasons why life insurance and the annuity can work hand-in-hand to offer the contract owner the ultimate in protection.
An annuity guarantees an income, no matter how long life continues. While life insurance provides protection against dying too soon, annuities provide protection against living too long. The annuity contract will define guidelines pertaining to:

- Additional Investing;
- Withdrawals;
- Cancellations;
- Penalties; and
- Guarantees.

**Documentation**

The purchase of an annuity is structured in the same way as the purchase of a CD or mutual fund – through an application and/or agreement between the investor (Contract Owner) and the financial institution (Insurer). The contract owner must supply an application furnishing the following information:

- Name;
- Current address;
- Social Security number of the contract owner;
- Name, Social Security number, address, sex and date of birth of the annuitant;
- Investment options;
- Type of money used;
- Signature of the contract owner; and
- Signature of the annuitant.

**Contract Owner**

It is the contract owner’s right to choose and manage the investment options:

- Add additional funds;
- Withdraw any portion of the monies;
- Change contract parties (i.e., annuitant, contingent annuitant, contingent owner);
- Will any and/or all portions of the contract;
- Terminate the annuity;
- The contract owner does not have to be one individual, but must be a legal adult. If the contract owner is a minor, the policy must list the minor’s custodian; and
• The contract owner can also be a couple, a partnership, a trust or even a corporation.
ANNUITANT

Any person who the contract owner chooses to name as the annuitant (i.e., him/herself, family member, friend) must be currently living and must meet the insurance company’s age restrictions for the annuity. Generally, the annuitant must be under age 75 at date of signing, though this may vary depending upon the insurance company’s regulations. In addition, though the contract owner has the option of changing the annuitant at any time, most annuities require the stipulation that the new annuitant was alive when the original contract was executed. An annuitant is like the insured in a life policy; however, the annuitant cannot:

- Control the contract;
- Make withdrawals;
- Make deposits;
- Change the parties to the contract; or
- Terminate the contract.

A life insurance policy names an insured party and remains in effect until:

- The owner terminates the contract;
- The owner fails to make premium payments; or
- The insured dies.

An annuity remains in effect until:

- The contract owner makes a change; or
- The annuitant dies.

BENEFICIARY OR MULTIPLE BENEFICIARIES

The beneficiary(ies) of an annuitant can be family members of the annuitant, individual(s), trusts, a corporation or a partnership. The annuity application has the flexibility of allowing multiple beneficiary designations, at the prior discretion of the contract owner. For example, a beneficiary designation may be apportioned so that the spouse of the contract owner will receive 70 percent of the annuity, and his three children will receive 10 percent each.

The contract owner can retain complete control over the annuity investment during his/her lifetime by naming him/herself as contract owner and annuitant, while naming another as beneficiary(ies).

The contract owner has the freedom to:

- Name any individual or group of individuals as beneficiary(ies);
- May apportion funds;
- Change beneficiary(ies) at anytime and without consent from present beneficiary(ies); and
- Hold multiple titles.
Multiple Titles

The contract owner has the option of assigning multiple titles to him/herself, the annuitant or the beneficiary.

If the contract owner designates a living trust or a corporation as the beneficiary, the corporation or trust can only be the contract owner and/or beneficiary. The annuitant must be a living individual meeting the insurer's age restrictions (couples excluded).

Other uses for annuities:
- College education;
- Insurance settlements;
- Uninsurability; and
- Charitable giving.

THE ANNUITY STRUCTURE

The Process

Investment options may include certificates of deposit, government bonds, mutual funds, money market accounts, real estate and annuities.

A client investing in an annuity must complete an application. Once the application has been submitted to the insurer, the contract owner receives the contract, which contains a summary of the application, the rate of expected return on the investment(s) and type(s) of investments selected.

Single Payment Immediate Annuity

$’s Invested → Annuity Period

Single Payment Deferred

$’s Invested → Accumulation Period → Annuity Period

Periodic Payment Deferred

$’s Invested → $’s Invested → $’s Invested → Accumulation Period → Annuity Period

Remember with a single payment immediate annuity, the accumulation period is eliminated. After the purchase of the annuity, the annuitant goes directly into the annuity period.
A RENEWAL RATE IS…

The interest rate credited to an annuity in the years following the initial rate. The renewal rate and the new money rate differ in the following respects:

- The investments that the insurer is buying today is known as the new money rate; and
- The investments that the insurer bought when the annuity was originally purchased are known as the renewal rate.

The Contract Owner should carefully investigate the insurer’s renewal rate strategy for any differences.

ANNuity Premium Amounts

Most common is a single premium, where the insurance company promises to pay the annuitant an amount each period (monthly, quarterly, semiannually, or annually).

The second method is level premium. Here the premiums are paid in periodic payments over the years prior to the date on which the annuity income begins. The premiums can be paid yearly, semi-annually, quarterly, or monthly.

The next premium payment option is “flexible premium.” This is where the purchaser has the option to vary the amount of each premium payment, as long as it falls between a minimum and maximum amount.

PREmium Computation Factors

The insurance companies use multiple factors in determining the premiums:

- The annuitant’s age will determine how long to have to make income payments to the annuitant;
- Statistics say that the annuitant’s sex plays a role. Statistics will show that women live longer than men. Therefore, a woman would receive more income payments than a man of her own age;
- Assumed interest rate is calculated in by the insurance companies;
- The next factor is the annuitant’s amount of periodic income and the guarantees the insurance company made to the annuitant in regard to the total number of payments the annuitant will receive; and
- The last factor is the “loading” for the insurance company operating expenses.

LIFETIME GUARANTEED RATE (FIXED-DOLLAR ANNUITIES)

The minimum interest rate that is guaranteed for the life of the annuity is known as the lifetime guaranteed rate. Each state department of insurance, through their own jurisdiction, mandates that annuities provide a lifetime guaranteed interest
rate; therefore, most insurance companies offer rates of three to five percent on this type of annuity. The Contract Owner can opt for receipt of guaranteed income payouts on a monthly, quarterly, semi-annual or annual basis.
MONEY BACK GUARANTEE

This is a major selling feature in many annuity contracts due to no market risk for the Contract Owner. The Contract Owner is protected and the Insurer assumes the risks involved.

Contract Owner Satisfaction is guaranteed, depending upon the Insurer’s principal language. If the Contract Owner is not satisfied with his annuity, within the Insurer’s allotted timeframe, he can get all of his money back. The Insurer may also provide a guarantee on surrender charges that will not affect the principal, thereby allowing the Contract Owner to get back his entire initial premium.

SURRENDER CHARGES

Insurance companies vary in principal language to protect the Insurer just as guarantee of principal protects the Contract Owner. In most annuities, surrender charges are dissolved over a five to ten year period (ten percent fee partial withdrawal not included). There may be an annual percentile decrease in surrender penalties or the annuity may have a fixed surrender charge, such as the first six month’s interest.

THE BAILOUT CLAUSE OR ESCAPE CLAUSE

The Bailout Clause or Escape Clause is another protection for the Contract Owner. Some Insurers will waive surrender charges under certain circumstances (i.e., nursing home confinement, terminal illness diagnoses). In addition, the agreement between the Insurer and the Contract Owner can allow for utilization of the bailout clause if the interest rate decreases below a certain level.

ARE THERE DIFFERENT WAYS TO INVEST MONEY?

Both the fixed-rate and variable annuity have an accumulation period (effective the moment investments are selected) and a payout period.

Accumulation Period
- Fixed Annuity – Interest is credited.
- Variable Annuity – Investment results are credited.

Payout Period
- Benefits are disbursed.
- Can provide a guaranteed amount for a guaranteed period of time.

A Single-Premium Deferred Annuity
- Investment is made in one payment.

A Flexible-Premium Deferred Annuity
• Contract owner can make one or more payments of various amounts.
**What are the Risks?**

The potential for long-term growth in an annuity is exceptional; however, as with any type of investment, caution and scrutiny should be utilized. Their potential is dependent upon the market and the investments chosen.

**What are the Advantages?**

- An annuity is a safe vehicle for investment and can be easily monitored.
- An annuity offers tax-deferred growth on earnings.
- An annuity provides resources that can last as long as needed.
- An annuity can offer a money back guarantee.
DIFFERENT TYPES OF ANNUITIES

INCOME AND INVESTMENT
The two major applications for the Contract Owner are the need for income and options for investment. The application required is dependent upon when the need for income occurs.

**AN IMMEDIATE ANNUITY**
An immediate annuity can provide income, in some cases, in as little as 31 days after purchase of the annuity. For example, if the contract calls for monthly installments payments, they will begin one month after the date of purchase. These annuities are specifically designed for those customers who need to receive a specific amount of money each month. These can be used as the sole source of income or as an income supplement. Payments may be made, depending upon the need, on a monthly, quarterly or annual basis. The amount of the check the client receives will not fluctuate and the actual dollar amount of the checks is in direct relationship to the total annuity investment.

An important note to remember is: If the insurance company is going to begin paying the annuitant shortly after the purchase of the contract, then the immediate annuity must have been paid by a single payment.

The market for annuities and large investments is very competitive. Several insurance companies should be contacted. Check rates and specific payouts intervals (five, ten, fifteen and twenty years, for example) on the intended annuity investment amount. Then compare the differences in the returns on the investment.

**A DEFERRED ANNUITY**
A deferred annuity is used to receive income payments at some further point in the future. It offers growth and flexibility for growth either over a long or short period of time.

A deferred annuity can be paid for by a single premium, annually, semi-annually, quarterly, or monthly installments over a period of time.

Unlike the “immediate annuity” the deferred annuity payments to the annuitant begin after a designated period of time has elapsed from the purchase.
date.

The contract owner can receive a certain dollar amount of income each year and can direct how the balance is to be reinvested. This deferral process gives the Contract Owner the flexibility of automatic reinvesting, withdrawal of a portion of the principal or termination of the investment.
Investment options include the following.

**A Fixed Rate Annuity**

Premiums paid for fixed rate annuities are invested with the insurance company’s general funds, chiefly in fixed income types of securities, with the ultimate purpose of providing a level annuity income.

Though the fixed-rate annuity affords the Contract Owner a guaranteed rate of return, that rate is dependent upon the length of time the funds will be invested. Though the most common maturity periods for annuities are one, three and five years, the longer the commitment, the higher guaranteed rate of return for the contracted period.

With a fixed annuity, the Contract Owner is protected against rising or declining interest rates, stock market gains or losses and insurance company profits or losses by assuring safety of principal and the exact interest the money will earn. This assurance is very appealing to the conservative investor, allowing the knowledge of specific projections.

However, the moderate to aggressive investor can utilize this type of annuity as a stabilizing factor in his overall portfolio. With the guarantee that a fixed annuity allows, the diversified investor, along with other investments (i.e., real estate, stocks, bonds, gold, mutual funds), can feel secure in his overall investment program.

**A Variable Annuity**

Premiums paid for variable annuities go into separate accounts where the company is permitted more investment freedom than with its general funds. Separate accounts are generally invested in common stocks and other securities expected to increase in value as prices increase. The ultimate purpose is to provide an annuity income, which will maintain its purchasing power in inflationary times.

For those investors who do not desire a guaranteed rate of return, the variable annuity is an option. Many investors have the flexibility to investigate the theory of the bigger the risk, the bigger the return.

The variable annuity can be comparable to a mutual fund in the respect that it offers a choice of funds in which to invest. Though this choice can provide variety, it can also burden the investor with the challenge of making the right choices (i.e., stocks, bonds, money market) regarding options and combinations of funds. Since the Insurer plays no part in directing the investments, total control is up to the investor. No profits earned or losses incurred will be absorbed by the insurance company. All profits earned and losses incurred are absorbed by the investor.
For historical information, the first variable annuity was marketed by the College Retirement Equities Fund (CREF), established in 1952. This product was sold in association with the Teachers Insurance and Annuity Association (TIAA).
A Hybrid Annuity

Some insurance companies offer investors the ability to invest in a variable annuity with diversification among several different sub-accounts. This part fixed, part variable annuity is known as a hybrid annuity.

### Important Characteristics

Shared characteristics of both variable annuities and fixed annuities

- Retirement income as their primary purpose
- Purchase methods are the same
- The same types of annuity options
- The same concept of accumulation and annuity periods
- Partial surrender provisions
- The guarantee of expense and mortality

### Important Differences

Differences between variable annuities and fixed annuities

- There is no guarantee of the principal, interest or the amount of payment
- The annuitant bears investment risks
- Variable annuities are regulated by the state and federal government

### Annuity Comparisons

#### TYPES OF ANNUITIES

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<td><strong>Immediate</strong></td>
<td>Single Premium</td>
<td><strong>Deferred</strong></td>
</tr>
<tr>
<td>-OR-</td>
<td></td>
<td>- Single Premium</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Level Premium</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Flexible Premium</td>
</tr>
</tbody>
</table>

#### PAYOUT OPTIONS

<table>
<thead>
<tr>
<th>LIFE ANNUITIES</th>
<th>TEMPORARY ANNUITIES</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Straight Life</td>
<td>- For a designated period</td>
</tr>
<tr>
<td>- Refund Life</td>
<td>- For a designated amount</td>
</tr>
<tr>
<td>- Life with Period Certain</td>
<td></td>
</tr>
<tr>
<td>- Joint Life</td>
<td></td>
</tr>
<tr>
<td>- Joint and Survivor</td>
<td></td>
</tr>
</tbody>
</table>

18
MATCHING THE RIGHT ANNUITY TO THE RIGHT CLIENT

When determining which type of annuity to recommend, consider the client’s investment and income goals and objectives.

Once you have determined the client’s goals (i.e., comfortable retirement, real estate purchases, children’s college educations), evaluate realistically the dollar objectives. Determining the client’s expected standard of living will determine how much the client must invest at what rate of return.

TIMEFRAME AND OBJECTIVES

<table>
<thead>
<tr>
<th>A FIXED RATE ANNUITY would be appropriate for:</th>
<th>A VARIABLE ANNUITY would be appropriate for:</th>
</tr>
</thead>
<tbody>
<tr>
<td>An investor with a limited timeframe of only one or two years</td>
<td>An optimistic or aggressive investor with a timeframe of less than two years; or The average investor with a timeframe of three or more years.</td>
</tr>
</tbody>
</table>

Clients who can wait for investment returns should consider equity instruments such as stock since common stock and equities generally perform better than other assets over time. However, most conservative investors still consider stocks too risky.

Since risks cannot be calculated in advance, every client should be advised to evaluate carefully available investment choices.
Chapter 3

ADVANTAGES OF ANNUITY INVESTING

MORE CAPABILITIES

An annuity provides more capabilities than any other type of investment available.

CLIENT INVESTMENT PROTECTION

The fixed-rate annuity investment is unequaled by all investment standards. The annuitant cannot suffer a loss of principal, interest rate is guaranteed, every dollar invested is guaranteed, no investment risk, interest earned guaranteed, and the contract owner can terminate the contract at any time.

The fixed-rate annuity investment is also very flexible. The annuitant can withdraw at anytime all of or part of the policy accumulated value. The annuitant must be aware that the accumulated account has been earning interest on a tax-deferred basis so he or she must pay income taxes on the amount withdrawn.

There is also flexibility in the way the account contributions can be made. He or she can elect to invest more than the predetermined amount or elect not to make any further premium payments, at which point, the annuity would be considered paid up in a reduced amount.

Due to the fact that the investor decides the type of investment and the dollar amount to be invested, variable annuities are not as safe as fixed-rate annuities.

INSURANCE COMPANY FINANCIAL POWER

Due to the sheer volume of insurance companies, they collectively own, manage or control more assets than all of the oil companies in the world combined and more assets than all the banks in the world combined. It was the insurance companies that came to the rescue of the banking industry during The Depression, not the federal government.

INSURANCE COMPANY RESERVES

By law, insurance companies are required to set aside reserves when a fixed rate annuity is purchased. These reserves can be used for settling withdrawals and redeeming annuities, and cannot be used to pay any other non-related annuity items (i.e., bad debts, overhead, claims).
Since the insurance company’s annuity business represents their smallest source of revenue, other profit centers money is used for this reserve fund.
The investor is protected by a legal reserve pool, which has mandatory membership for insurance companies in most states. The reserve pool’s purpose is to carryout the liabilities and obligations due the Investor, should the original Insurer go out of business.

**Insurance Company Ratings**

As with any business, insurance companies have independent ratings. Even though annuities may have a perfect track record, the Insurer’s rating should also be taken into consideration. For a fixed rate annuity, investors prefer an “A” or “A+” rating. For variable annuities, since earnings are not dependent upon the Insurer’s solvency, the ratings are not so disconcerting.

A.M. Best, the oldest rating company in the United States, rates companies in much the same manner as our public school system.

<table>
<thead>
<tr>
<th>RATING</th>
<th>DEFINITION</th>
</tr>
</thead>
<tbody>
<tr>
<td>A+</td>
<td>Superior</td>
</tr>
<tr>
<td>A to A-</td>
<td>Excellent</td>
</tr>
<tr>
<td>B+</td>
<td>Very Good</td>
</tr>
<tr>
<td>B</td>
<td>Good</td>
</tr>
<tr>
<td>C+</td>
<td>Fairly Good</td>
</tr>
<tr>
<td>C to C-</td>
<td>Fair</td>
</tr>
</tbody>
</table>

*Other rating sources to look at are Standard & Poor’s and Moody’s*

**Vital Performance**

Though the interest rate (usually around 4 or 5 percent) guarantee depends on the annuity, fixed-rate annuities offer a specific and fully guaranteed rate of return for a specified period.

**Professional Management**

The professional management team plays a very important role in the annuity field and each member is, therefore, considered a specialist in his/her field. These specialists are licensed, regulated by the federal government, state insurance department, highly skilled and trained to focus on a certain segment of the marketplace. As with overall ratings, independent sources track performance of annuities.

Specialized publications, such as *The Wall Street Journal* can provide excellent articles on annuities and annuity performances.
OPTIONS FOR WITHDRAWAL

Both fixed rate and variable annuities provide for withdrawal options; however, any withdrawal may be subject to a penalty, or surrender charge. However, most insurance companies permit annuity withdrawals of up to ten percent (usually based on the principal) per year without cost, penalty or fees. Some insurance companies will permit withdrawals up to fifteen percent per year. When considering withdrawal options, consider that the restrictions applying to withdrawals will eventually disappear and that there are an estimated 75 percent of all people investing in annuities who never remove any money.

VARIABLE ANNUITY — GUARANTEED DEATH BENEFIT

Upon the death of the annuitant, the variable annuity provides that the beneficiary will receive the greater of the principal, plus any ongoing additions, or the value of the account on the date of death. An older person desiring a high-income stream will find the variable annuity guaranteed death benefit an ideal investment. It is based on the sum of all investments made by the owner, or value on the date of death, whichever is greater.

The guaranteed death benefit will last until either:

- The annuitant terminates the contract;
- The annuitant annuitizes the investment;
- The annuitant dies; or
- The annuitant reaches a certain age, usually 75 or 80.

DECEDENT PROBATE

The value of an annuity will not be included when the gross estate is valued for probate purposes; therefore, all annuities avoid probate.
Chapter 4

DISADVANTAGES OF ANNUITY INVESTING

PENALTIES, RISKS AND EXPENSES

Although there are very few disadvantages with respect to investing in annuities, and most of them will never affect the client, there are a few to take note of.

**IRS Penalties**

All annuities are subject to IRS penalty, regardless of annuity type. Withdrawals made prior to the annuitant attaining the age of 59½ years are subject to a ten percent penalty. The exceptions to this rule are if the annuitant dies or becomes disabled, or takes a portion of the annuity’s assets paid out as income on a regular basis (annuitization).

Monies accumulated are not tax-free; however, they can be deferred and can also be indefinitely postponed. Taxes can be further deferred if any of the following occur:

- The surviving spouse remarries;
- The surviving spouse is named as the annuitant and the new spouse is a beneficiary;
- When both spouses die, the beneficiary would be able to postpone taxes for up to an additional five years;
- The tax liability will be the value of the annuity at time of death less the amount invested, and then multiplied by the beneficiary’s tax bracket percentage. The contract owner is wise to withdraw money from the annuity when in the lowest tax bracket.

**Insurance Company Penalties**

Withdrawn funds of up to ten percent per year, after the first year, are not subject to penalty. The surrender charge applies only when amounts are withdrawn in excess of the free withdrawal privilege. The Insurer’s penalty schedule should be investigated prior to purchasing an annuity, as terms vary.

Surrender charges are not applicable if the annuitant dies or becomes disabled; or if withdrawals are limited to those allowed under the free withdrawal
privilege; or systematic withdrawals of ten percent per year are made; or the penalty period has lapsed.
Risks

Loss of investment is one risk faced by the annuitant in a variable annuity:

- Economic risk due to the uncertainty of our economy, world affairs, conflicts, wars, recessions, depressions or a total collapse of our economic system;
- If an investor is “locked in” to a fixed interest rate and we are experiencing a period of rising interest rates; or
- If the investment does not keep pace with inflation.

Ongoing Expenses

The annual contract maintenance charge can never be increased during the life of the contract and usually ranges between $25 and $50, is reported on the Insurer’s fourth quarter statement and will be deducted from the then current value of the annuity.

Mortality and Expense Fees

Mortality and expense fees are otherwise known as the guaranteed death benefit. This fee represents a source of profit for the Insurer as it is levied against the account balance each year and is used to fund the Insurer’s overhead, commission and set up costs and death benefit claims costs. Though the mortality charge most commonly is 1.2 percent, it can range from 1.1 percent to as high as 1.5 percent. This fee is usually described in a prospectus and remains unchanged throughout the life of the annuity.

Annuitzation at Age 59½

At age 59½, annuitization can be utilized so that a portion of the annuity’s assets are paid out as income on a regular basis. Only a portion of the amount withdrawn is subject to taxation; however, when a lump sum is taken, the entire growth and interest becomes subject to income taxes.
Chapter 5

ANNUITY TAXATION

THE BASICS

A personal tax advisor should always be consulted, as insurance agents are not trained or qualified to provide tax advice. The understanding of basic annuity taxation only allows an agent to help people accumulate more money, not provide tax advice.

Ten Percent Excise Tax Penalty

Tax advantages are extended for retirement purposes by the government. Tax advantages are also extended to the taxpayers who do not use the annuity for retirement. All interest withdrawn prior to the owner attaining the age of 59½ is subject to a 10 percent excise tax penalty. However, the 10 percent excise penalty can be avoided under certain circumstances:

- Taxpayer disability;
- Distribution from a pre-8/14/82 annuity;
- Death of owner (but death of annuitant for annuities issued before 4/23/87);
- Payment from an immediate annuity where benefits commence within one year of purchase;
- Payment from a structured settlement; or
- Substantially equal payments over taxpayer’s life expectancy.

Exclusion

The annuitant will receive equal payments when and if the owner annuitizes (applies their annuity value toward a settlement option). Unlike withdrawals, the contract owner does not pay full taxes on the payments. An exclusion ratio is applied to each payment received, which stipulates that a percentage of each payment is considered a return of the owner's cost basis and is tax-free. The balance, however, is taxable.

The exclusion ration can be calculated by dividing the expected return into the total of all premiums paid into the contract.
Example
Assume an annuity was purchased one year ago for $80,000. It is now worth $88,000. The total of all premiums paid in the contract equal $80,000. Further assume that the contract owner wants to annuitize and elects the settlement option of a 5-year Period Certain (60 months) where monthly payments will be $1,667.00 a month. The expected return is $100,000 ($1,667.00 multiplied by 60 months).

Therefore, 80 percent of all payments to the contract owner are income tax free ($80,000 of $100,000 = 80%). For annuities using a life contingency, calculate life expectancy using government tables to determine the expected return.

Effective with all annuity starting dates after December 31, 1986, payments become fully taxable after the owner recovers the total of all premiums paid into contract (determined by adding all dollars excluded from taxes). After the contract owner has lived beyond his life expectancy (as calculated when payments began), payments then become fully taxable.

Withdrawal
Depending upon the annuity purchased, withdrawals can be taxed in one of two ways.

Prior to August 14, 1982, annuities were structured with FIFO accounting (first in, first out), which allowed the principal to remain tax-free. On August 14, 1982 and thereafter, annuity taxation changed to LIFO (last in, first out), which allowed for taxation on withdrawals since interest is withdrawn first. This is appealing to the customer since most are now paying taxes on interest even if they don’t withdraw it.

SECTION 1035(A) OF THE INTERNAL REVENUE CODE (IRC)
Section 1035(a) of the Internal Revenue Code provides the ability to transfer money from one annuity to another annuity income tax-free. Note that such transfers should be reviewed carefully.

The Contract Owner may elect to perform any of the following:

- Assign the old annuity contract (if premiums are non-qualified) to the new insurance company;
- Exchange the entire annuity (cannot transfer some of the money);
- If there are loans outstanding, repay loans before exchanging;
- Parties designated in the old contract as owner, annuitant and/or beneficiary should again be designated in the new contract; and
Customers should consult with their tax adviser before the exchange.
ANNUITY TAXATION BASICS

- Taxes are only paid when interest is withdrawn;
- Just like the IRA, the 10 percent excise tax penalty exists;
- The exclusion ratio allows clients to receive income partially income tax-free; and
- Section 1035(a) exchanges are a way to move annuity money income tax-free.
Chapter 6

COMPARING MUTUAL FUNDS & ANNUITIES

SIMILARITIES AND DIFFERENCES

Mutual funds and annuities are alike in some respects and differ in others. The following table provides a general listing.

<table>
<thead>
<tr>
<th>SIMILARITIES</th>
<th>DIFFERENCES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Easy in which to invest;</td>
<td>Commissions;</td>
</tr>
<tr>
<td>Easy to monitor;</td>
<td>Taxation;</td>
</tr>
<tr>
<td>Professional management;</td>
<td>Performance;</td>
</tr>
<tr>
<td>Outstanding track records;</td>
<td>Withdrawal Options;</td>
</tr>
<tr>
<td>Investment options;</td>
<td>Investment Choices;</td>
</tr>
<tr>
<td>Options to increase the investment;</td>
<td>Safety.</td>
</tr>
<tr>
<td>Options to withdraw funds; and</td>
<td></td>
</tr>
<tr>
<td>Dollar-cost averaging.</td>
<td></td>
</tr>
</tbody>
</table>

**Commissions**

<table>
<thead>
<tr>
<th>Mutual Funds</th>
<th>Annuities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Range from 1 to 8.5 percent</td>
<td>No commission</td>
</tr>
<tr>
<td>Usually subtracted from the investment</td>
<td>No commission is required on additional contributions</td>
</tr>
</tbody>
</table>

**Taxation**

Income taxes are imposed on certain mutual fund earnings:

- The dividends or interest generated by the securities;
- Capital gains from the sale of stocks or bonds; and
- Profits received upon the sale of shares or when changes are made within the mutual fund family.
Income tax is determined by the performance (amount of dividends, interest or capital gains) of the mutual fund, which is out of the investor’s control and is subject to income tax. However, the investor can control the profit received upon the sale of shares or when changes are made within the mutual fund family.

On the other hand, investments in a fixed-rate or variable annuity grow and compound tax-deferred indefinitely. Profits are only subject to income taxes when withdrawals are made and are only paid on that portion of the withdrawal that is considered accumulated growth and interest.

**VITAL PERFORMANCE**

There are not as many professional managers available with annuities as there are with mutual funds. However, annuity managers have a better overall performance record.

<table>
<thead>
<tr>
<th>Mutual Funds</th>
<th>Annuities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Due to size, buy stocks and bonds that are not first choice</td>
<td>Invest in specifically selected stocks and bonds</td>
</tr>
<tr>
<td>SEC requires adherence to diversification rules</td>
<td>IPO purchase availability</td>
</tr>
<tr>
<td>Certain amounts of assets are kept in cash (reserves) to cover partial or complete liquidations</td>
<td>Withdrawals are much less frequent</td>
</tr>
<tr>
<td>Limited investment options and management styles from which to choose</td>
<td>Variable annuities offer a choice of many different management styles</td>
</tr>
<tr>
<td>Rate of return not guaranteed</td>
<td>Rate of return can be guaranteed</td>
</tr>
<tr>
<td>Possible funds loss</td>
<td>Fixed rate annuity insures no loss of funds</td>
</tr>
<tr>
<td>Professional management</td>
<td>Professional management</td>
</tr>
</tbody>
</table>

Variable annuities generally outperform the top mutual funds. A variable annuity has investments in specifically selected stocks and bonds. A stock that is going public for the first time (IPO) is a prime choice for the variable annuity investor. Mutual funds keep certain amounts of assets in cash to be used to settle partial or complete liquidations. Since withdrawals are much less frequent with annuities, this situation can be avoided.

**PROTECTION**

When it comes to minimizing risk and increasing return, every variable annuity has inherent features designed for the Insurer’s protection.

The annuity professional management team is educated and experienced in providing the investor the goal for which he seeks. Their continuous research

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enables constant monitoring to provide the right investments necessary to achieve the investor’s objectives. Through diversification, any risk is spread among many securities, thus reducing the possibility of losing a substantial amount of money due to any one security.
The investor’s investment portfolio remains totally separate from the insurance company’s general investment portfolio. Results in variable annuity portfolios are affected only by those investments held within the investor’s portfolio.

**Switching Privileges**

Providing money is not moved too often, most variable annuities money to be moved among the portfolios, usually without charge. When interest rates or market conditions change, transfers among portfolios keep earnings high.

Should the death of the investor occur during the accumulation phase of a variable annuity, the beneficiary will receive the greater of the entire amount of the annuity premiums, less withdrawals, or current value of the investment.

**Withdrawal Options**

Withdrawals and liquidation parameters are the same in mutual funds as they are in annuities.
GROUP PLAN ANNUITIES

TAX SHELTERED ANNUITIES
Under Section 403(b) of the Internal Revenue Code, private or public school personnel, charitable, educational, tax-exempt, religious, non-profit organization members are eligible for Tax-Sheltered Annuities (TSAs). A tax-sheltered annuity is comprised of the following:

- It is purchased from an insurance company;
- Contracts are issued to either an individual or a group;
- The participant may choose a variable, fixed or a combination plan;
- The participant’s contributions may vary yearly;
- The insurance carrier receives deposits directly from the employer;
- Contributions are outlined in a salary reduction agreement;
- Contributions are made via payroll deductions on a pre-tax basis; and
- Social Security tax (FICA) is withheld on the employee’s salary deduction amounts.

INDIVIDUAL AND GROUP CONTRACTS COMPARED
If the participant is participating under a group contract, he will receive an individual certificate of verification. Since the actual contract is between the participant’s employer and the insurance company, a group contract differs from an individual contract.

<table>
<thead>
<tr>
<th>Individual Contract</th>
<th>Group Contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>Guarantees exist until the contract ends</td>
<td>Guarantees last for a certain period of time</td>
</tr>
<tr>
<td>Participant can take contract with him or her when they change jobs without any penalty</td>
<td></td>
</tr>
</tbody>
</table>

Several options are available to a participant who changes employment. He can:

- Freeze the account;
- Transfer all or part of the program to one offered by a new employer, providing the new employer is eligible to participate in a TSA program; or
• All or part of the monies may be transferred to an IRA.

There should be no tax consequences if the changeover is properly made.
WITHDRAWALS OPTIONS WITHOUT PENALTIES

Under certain circumstances, money may be withdrawn without penalty, such as:

- Financial hardship;
- Disability;
- Death; and
- Termination of employment.

VARIABLE FUNDS

An insurance carrier must be registered with the Securities and Exchange Commission (SEC) to be able to offer variable annuities and must provide the investor with a prospectus prior to the purchase. With little or no cost, the policyholder can transfer between fixed and variable annuities if a companion fixed-rate account is purchased.

TSA TAX BENEFITS

The participant’s taxable income is reduced on contributions made to a TSA. Those participants who are in a lower tax bracket can minimize tax consequences on withdrawals. Once contributions are invested, the participant’s money compounds tax-deferred.

ACCUMULATION PERIOD

The time in which the employer sets aside money into the TSA that has been deducted from the participant’s income is the accumulation period.

The employer contributions can be made with before-tax dollars on a bi-weekly, semi-monthly or monthly (most common) basis. The participant’s contribution is deposited into the account and invested under the options previously chosen by the participant. There may be a transaction charge or a quarterly or annual maintenance fee.

PAYOUT PERIOD

The payout period is the time when the participant opts to receive his money (usually at retirement). There are a number of ways in which the participant can choose to receive these funds. A partial payment or a lump sum can be chosen. Monies can be rolled over into an IRA or a TSA.

To receive monthly, quarterly or annual payments, the contract can be annuitized. The amount received is dependent upon the offered rate, the selected annuity option and the actual amount being annuitized.
The rate paid by the insurance company is based a certain amount of monthly income per month for each $1,000.00 of cash invested in the annuity.
CREDITING & INTEREST

In order to determine the current interest rate credited to the participant’s account, the portfolio average and the banding method must be understood.

The Portfolio Average

What the insurance company has earned on its entire portfolio of investments during the given year is a reflection of the portfolio average from which the insurance carrier forms a composite rate and the policy owners are credited with that amount. This method is best used when interest rates are declining.

The Banding Method

Utilizing a year-by-year method of crediting accounts is called the banding approach, which bands the participant's contributions for that particular year. This method is best used when interest rates are rising.

Two-tiered Interest

Should the participant make a partial or total liquidation of the account, the two-tier approach credits the contract with a lower rate of interest. However, there is a substantial charge for withdrawals and this charge may never disappear. Accounts are credited at an artificially low rate if a minimum payout or period is selected. In many states, this method has been considered unfair and, therefore, those states have banned its use.

Current Trends

Rather than using a calendar-year method, many companies now use a quarterly, monthly or even daily method in valuing the rate of interest credited to accounts; thus allowing the flexibility of changing the credited rate in a quicker timeframe in the event that it is too high in comparison to the actual yield of the insurance company’s portfolio.

Market Value Adjustment

In this method, the fund balance, not the yield, is adjusted upward or downward, completely opposite of the interest rate movements.

Variable Options

The variable TSA offers the investor a range of options from aggressive stock portfolios to money market funds and, therefore is a good alternative to the more conservative fixed-rate TSA.

Contributions

The IRS limits the annual amount of total contributions allowed. In addition, the insurance company sets guidelines on the amounts of contributions allowed even though the employee makes the majority of all contributions.
The employee’s contribution amount is calculated based on a percentage of pay and are deducted from the employee’s paycheck and sent to the insurance company on a bi-weekly, semi-monthly or monthly basis.
**Transfers**

Contributions may also be made by transferring funds from one company to another or from one sub-account to another offered by the same insurance company. Reasons for implementing transfers:

- The portfolio performance of the current company is unsatisfactory;
- Employment change;
- The participant’s new employer does not have a TSA;
- Ability to take risks has changed; and
- Retirement date has changed.

**Retirement Options**

Options for retiring participants:

- Leave the funds in the account to compound and grow until a future date;
- Withdraw all or a portion of the money;
- Receive payments over a fixed period of years;
- Select a rate (fixed or variable);
- Transfer the money to another insurance company; and
- Roll over into an IRA.

**Loans**

Loans from the TSA are permitted by some insurance companies; and are governed by the IRS in the following manner:

- A loan is taxable if it exceeds 100% of the employee’s account or $10,000, whichever is less, if the account is less than or equal to $10,000;
- A $10,000 or greater loan will be taxed if the participant’s account is more than $10,000 but less than $20,000;
- If the value of the account is over $20,000, a loan will be taxable if the amount of that loan is 50% of the value of the account, or $50,000 whichever is less. The $50,000 amount referred to here is reduced by any net loan repayments made by the employee during the preceding 12 months;
- Loans, with the exception of real estate related loans, must be repaid within 5 years;
- Should the loan not be repaid in time, any amount that is still outstanding will be immediately subject to taxation. It may also be subject to a 10% tax penalty;
- If a loan is in default, the insurance company is required to notify the IRS and the participant.
• Should the loan ever exceed the value of the employee’s account, any excess is taxed.
PROTECTION

It is suggested that the borrower contact his insurance company to discuss possible safeguards, since TSA loans have the potential for adverse tax and penalty consequences. In addition, late payments should be avoided as they can be termed as a technical default. Technical defaults allow the insurance company to deduct payments due from funds in the account; thus putting the participant in a withdrawal situation due to the forced payments.

TSA EXPENSES

It is important to note that virtually every tax-sheltered annuity has expenses. Insurance companies obtain fees as Explicit or Implicit.

Explicit

These charges are clearly defined and direct, and they are often much lower than implicit charges. Under the following circumstances, these charges may be applied regularly throughout the year:

• At time of account valuation;
• At receipt of contribution;
• At time a loan is made; or
• At time of a withdrawal.

Implicit

These charges are made indirectly. The difference between the returns actually earned by the insurance company and the amount credited to the account could produce an implicit charge.

TSA AMENDMENTS

A TSA contract, with the permission of the participant, can be amended in a rather broad manner. Amendments can affect the amount of any charges made, future credited interest, annuity rates per $1,000.00 annuitized and many other provisions in the contract.

DEATH BENEFITS

The processing time for death claims once the death certificate has been received is about two weeks. Most insurance companies do not charge a fee for liquidation of an account due to death; most companies pay out the total value of the account. The death benefit can be paid out in a lump sum or it can be annuitized by the beneficiary.
Chapter 8

SUMMATION & QUESTIONS

A Tax-Deferred Annuity is...
A tax-advantaged product. An alternative to most other financial investments, in which long term financial needs are addressed.

A Major Advantage with Annuities is...
All funds are tax-deferred until withdrawn. This enables the customer to build a substantial fund for retirement and provide an income that he cannot outlive.

The Annuity is a Safe Alternative because...
The Insurer who issues the annuity backs the annuity value thereby making an annuity desirable for anyone who wants a safe way to reduce taxes and who wants to decide when to pay taxes.

The Average Annuity Purchaser is...
Typically, the annuity purchase is not spending immediately the interest earned on his taxable alternative. The average age of the purchaser is 55 years old with an average premium of $20,000.

What Money is Used to Invest in An Annuity?
The purchaser can invest funds from maturing CD's, passbook savings accounts, money market accounts and/or treasury bills.

The Annuity is Not for Everyone
Those who need current income should not consider the deferred annuity. Though it is one of the safest ways to accumulate dollars on a tax advantaged basis, only monies designated for short-term needs should not be invested in an annuity. The purchaser should also have at least six months’ worth of income on deposit outside of the annuity.

Are Ceilings in a Tax-Deferred Annuity Imposed by the IRS?
Since the tax-deferred annuity is specifically designed as a retirement supple-
ment, if pre-tax dollars are withdrawn before age 59½, the government imposes a 10% excise tax penalty. However, no ceiling is imposed and the purchaser does not need earned income to qualify.
CAN PRINCIPAL BE WITHDRAWN BEFORE INTEREST?
Even though a withdrawal of principal is tax-free and free from penalty by the IRS, the government views that interest earnings come out first. And, should any portion of a withdrawal exceed interest earned, it would be a tax-free return on principal.

IF THE ANNUITY IS PAYING AN INTEREST RATE LESS THAN OTHER FINANCIAL ALTERNATIVES…
Consider this…Section 1035(a) of the Internal Revenue Code provides a no-risk feature by allowing annuity owners to transfer funds from one annuity to another, thereby keeping the investment monies tax-free. Interest on many alternatives currently available is taxable every year.

HOW IS THE INTEREST RATE DECLARED AFTER THE 1-3 YEAR INITIAL GUARANTEE PERIOD?
Renewal rates are determined based upon current market conditions and the insurance company's portfolio.

CAN THE CUSTOMER KEEP TRACK OF THE ANNUITY BALANCE?
The customer receives an annual annuity value statement from the insurance company.

DOES THE ANNUITY MATURE?
An annuity does not mature after the initial interest rate guarantee period. It continues to accumulate interest on principal until the time of surrender of settlement.

CAN THE ANNUITY AVOID PROBATE?
Probate can be avoided if a named beneficiary other than the estate is named.

IS THE ACCUMULATED INTEREST TAXABLE TO THE BENEFICIARY?
When the beneficiary receives the tax-deferred interest, he will be taxed on the monies collected. However, if the spouse of the deceased contract owner is the beneficiary, the beneficiary may decide, as the then customer, to continue the annuity and postpone taxes. If the deceased contract owner had named someone other than his spouse as beneficiary, the monies must either be totally withdrawn within five years or be received over the beneficiary’s life expectancy (this option must be elected during the first 12 months following the contract owner’s death).
**WHY SHOULD I BE SO CONCERNED ABOUT RATES?**

Rates are very sensitive. Even a fraction of a percent can be very important in calculating the returns on an annuity. Rate shopping is a critical factor when choosing an annuity. Actually, the insurance company itself is of secondary importance.
**IS PROFESSIONAL MANAGEMENT REALLY THAT IMPORTANT?**

Investing in an annuity is like hiring a professional administrator to manage your funds. Their professional oversight helps take the day-to-day worry out of stock and bond fluctuations and downgrades. The professional management team works so you don’t have to.

**WHAT IS THE COMPARISON BETWEEN AN ANNUITY AND AN IRA?**

Some experts say that the annuity picks up where the IRA leaves off. The purpose of an annuity is directed to after-tax dollars and can be used to fund an IRA. Therefore, monies deposited into the annuity are not deductible. Due to this fact, there is no ceiling imposed by the government on how much premium can go into an annuity, nor do distributions have to begin at age 70½. Below is a table of comparison.

<table>
<thead>
<tr>
<th>ANNUITY</th>
<th>IRA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Anybody can purchase</td>
<td>Only those with earned income can open an IRA</td>
</tr>
<tr>
<td>No limit on contributions</td>
<td>Limits the annual contribution</td>
</tr>
<tr>
<td>No deductions are allowed for payments into an annuity</td>
<td>Can be tax deductible</td>
</tr>
<tr>
<td>Can provide guaranteed income for life</td>
<td>Cannot provide guaranteed income for life</td>
</tr>
</tbody>
</table>

**WHAT AFFECT DOES TAX DEFERRAL HAVE ON ME?**

As long as the interest remains in the annuity contract, the investor pays no taxes on the interest earned. Therefore, the funds are working for the investor instead of being paid to the federal government in the form of taxes.

**IS MY MONEY GOING TO BE AVAILABLE IF I NEED IT?**

In general, liquidity features are contained in an annuity contracts. Depending upon the structure of the annuity, withdrawals of fixed dollar amounts may be made without penalty. However, the investor may incur surrender charges. In general, the surrender benefit is equal to the contract value less any surrender charges upon surrender of the contract.

**WHAT PENALTIES OR TAXES MIGHT BE INCURRED IF I WITHDRAW THE ENTIRE ANNUITY AND THEN PUT THE ENTIRE AMOUNT BACK?**

Though most insurers provide a grace period for withdrawals, the IRS will impose a tax when entire funds are withdrawn, even with the intention of reinvesting the full amount.
**HOW DOES THE INSURANCE COMPANY CHARGE FOR ITS SERVICES?**

The most common charge imposed is the surrender charge, though the charge will vary from one insurance company to another. After the contract-specified number of years, surrender charges will be incurred.
Is There Any Reason Why Contributions Can’t be Made to Both a TSA and a Regular Annuity?
Contributions to both are permitted, although it is suggested that the majority of the contribution be invested in the TSA, thereby minimizing expenses and fees incurred.

Why Do the Rates of Return Differ in TSA Accounts?
The calculations in determining rate of return and fees are more complex because TSAs are group annuities, therefore involving a larger number of participants.

What is the Difference Between TSAs and Regular Annuities?
TSAs contribute before-tax dollars and other annuities are funded with after-tax dollars and the TSA is only available to certain employment classifications.

What If I Disagree With Changes in My Group Annuity?
As with any group involvement, each individual is subject to the decisions of the collective. Even though each individual provides his own input, the majority rules. One individual’s financial plans or goals may differ from that of the group as a whole. The respective individual would need to end his participation in the group.

Why is There More Information Available on Mutual Funds Than Annuities?
Advertising is a great tool. Since the brokerage industry can make more money selling mutual funds than annuities, fund executives spend more on marketing. The insurance industry spends less on marketing annuities. Publications feature the mutual fund with more intensity because they are easier to understand.

How Do Results Compare on a Regular Basis?
Financial publications offer comparisons and performance results on fund and annuity accounts.
Chapter 9

LET’S DISCUSS THE LIFE INSURANCE POLICY

CONTRACTUAL AGREEMENT

The life insurance policy is a contractual agreement (a legal contract) between two parties (a policy owner and the insurance company) in which a premium (sum of money) is paid to insure that, upon the individual’s death, a stated amount of money is paid to a previously named beneficiary, under the stated conditions in the contract. The individual purchasing that policy expects you, the agent, to be professional with the knowledge necessary to advise them regarding their insurance planning.

REASONS AND USES FOR LIFE INSURANCE

Upon the death of the insured, expenses will need to be handled by those left behind. Not only will there be burial and funeral expenses, there may be outstanding debts due at the time of death. Federal and state death taxes, inheritance taxes and any costs required to administer the estate must be paid.

There may be unexpected financial needs that the money can be provided for. It could be used to provide an education for the children, or provide the means in which to purchase a new home or to pay off an existing mortgage.

The money does not necessarily have to be used for personal expenses only; it can be utilized to provide benefits for business situations as well. Some companies may incur profit losses when a key employee dies. A life insurance policy can be used to negate or lessen those losses. If the deceased is the owner or part owner, the life insurance money can be used as a buy-out instrument or be used as collateral for loans. Or it can be used to benefit the existing employees in the way of retirement plans.

IN SUMMARY

From a personal standpoint or from a business standpoint, life insurance money can be used for any of the following expenses.
<table>
<thead>
<tr>
<th>PERSONAL</th>
<th>BUSINESS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Burial and funeral expenses;</td>
<td>Losses incurred after death</td>
</tr>
<tr>
<td>Outstanding debts;</td>
<td>Loan collateral</td>
</tr>
<tr>
<td>Death and/or inheritance taxes;</td>
<td>Insurance fund</td>
</tr>
<tr>
<td>Probate expenses;</td>
<td>Retirement plans</td>
</tr>
<tr>
<td>Education;</td>
<td>Buy-out interest</td>
</tr>
<tr>
<td>Real estate purchase; and</td>
<td>Employee fringe benefits</td>
</tr>
<tr>
<td>Income replacement.</td>
<td>Replacement cost of key employee</td>
</tr>
</tbody>
</table>

**LIFE INSURANCE AS AN INVESTMENT**

Life insurance can be used as an investment option. It is possible with life insurance to create an immediate investment value with a single premium payment. This creates a secure asset with a reasonable rate of return and eliminates the need for professional management. The amount insured and the method used to pay for premiums are the purchaser’s choice.

**THE LIFE INSURANCE APPLICATION**

**APPLICATION PARTICIPANTS**

In order to process a life insurance application successfully, four participants must be identified (the insured, the applicant, the policy owner and the beneficiary).

**THE PROPOSED INSURED**

The person upon whose life an application has been submitted to the insurance company as a request for coverage.

**THE APPLICANT**

This is the individual who has filed an application for the life insurance policy. The applicant does not, necessarily, have to be the proposed insured.

**THE POLICY OWNER**

The person who normally pays the premiums for the policy and usually retains all rights, values and options relating to the policy.
THE APPLICATION

An application form must be filled out and given to the insurance company in order for a person to purchase life insurance.

This application is considered a formal request; therefore, many companies require the proposed insured to complete the application in the presence of an agent. The signature on the application form represents that the signor has presented true and correct information to the best of his/her knowledge and attests to the accuracy of the information that the application contains. If the applicant is not the insured, then the proposed insured must also sign the application. The soliciting agent’s signature is also required.

The underwriters and the insurance company can then use the data provided in the form to determine if a policy will be issued.

INCORRECT APPLICATIONS

If any information on the application has been found to be in error, the corrections must have the approval of the proposed insured, which is indicated by his initials beside each change. The agent would normally return the incorrect application to the proposed insured in order to acquire those initials and then reprocess the application.

Some insurance companies hire outside reporting services to conduct the inspection, thereby correcting any mistakes that may be costly to the insurance company. Therefore, it is important that all information on the application is true and correct as so stated by the applicant’s signature to avoid any reprocessing.

Therefore, the agent plays an important part in the application process. You, the agent, are the only representative of the insurer who actually sees the proposed insured face-to-face. The information obtained while filling out the application, plus the agent’s comments are very important parts of this process.

INCOMPLETE APPLICATIONS

Insurance companies rely on the information provided in the application by the proposed insured. If that information is incorrect or incomplete, it means that the insurance company made a decision on assuming a given risk that could result in a severe loss to their company.

The insurance company can terminate the entire contract even after the policy has been issued, and can do so from the date of issue. The cancellation of any policy, however, must occur before the incontestability clause takes effect.
REPRESENTATIONS

A Representation is any statement that is made on an application. It is a depiction of the truth as believed by the applicant and so indicated by his signature.
**WARRANTIES**

A warranty is an absolute guarantee that all statements made on the application are true; therefore, no statement on an application is considered a warranty.

**MISREPRESENTATIONS**

A Misrepresentation is a statement (representation) made that is untrue and presented falsely without intent.

**FRAUD**

Fraud is the intentional perversion of the truth in order to induce another to part with something of value or to surrender a legal right. The second party involved suffers a loss. Fraud is committed when a person makes an intentional misrepresentation of what is known to be a material fact with the intent to gain advantage.

**CONCEALMENT**

Concealment is the intentional omission of facts. A misrepresentation is unintentional, but concealment is a known disguise of facts.

Certain facts need to be given to the insurance carrier during the time of the application, and the withholding of those facts is considered concealment.

**CONDITIONAL RECEIPT**

The insurance agent should collect the first full installment from the applicant at the time of the application. A conditional receipt should be given to the proposed insured at the time of the collection. It is not a full receipt, as it is based upon the condition that the insurance carrier will issue the policy.

The conditional receipt is located at the bottom of the application and provides protection to both the proposed insured and the insurance agent. It provides protection for the proposed insured as it indicates that the agent has indeed collected the first full payment. It also provides protection for the agent as it spells out that the issuance of the policy is subject to the approval of the insurance carrier.
CONDITIONAL RECEIPT                       NO. A123456

RECEIVED of ____________________________________________________ Dollars the first _____ premium on proposed insurance for $_____ on the life of ___________________________ for which Part I of an application bearing the same number as above is this day made to the Life Insurance Company. If a satisfactory Part II of the application is furnished to the Company and if the Company shall be satisfied after such investigation and such medical examinations as it may require that the proposed insured on this date insurable and qualified under the Company’s rules and standards for insurance in the amount and on the plan applied for and at the premium specified herein, the insurance applied for shall take effect and be in force subject to the provisions of the policy applied for from the date of this receipt; If not so insurable and qualified, no insurance shall take effect hereunder, and the payment evidence by this receipt shall be returned.

Dated ___________________, 20____. ________________________________ Agent.

CONDITIONS UNDER WHICH THIS PAYMENT SHALL CAUSE INSURANCE TO TAKE EFFECT

If the Company shall be satisfied that, on the latest of the date of the application and the dates of all medical examinations required by the Company, all persons proposed for insurance were acceptable under the Company’s rules as standard risks for all the insurance requested in the application.

Then, the insurance requested in the application shall take effect as of the latest of the date of the application, the dates of all medical examinations required by the Company, or such other date as may have been requested in the application.

If insurance takes effect under the exact conditions stated above, any balance of the full first premium for the insurance requested in the application may be paid within 60 days following the date of receipt. If any such balance is not so paid, the insurance shall continue only for such proportionate part of the first premium interval as this payment bears to the full first premium.

The above stated receipt is conditional because the agent cannot guarantee that the policy will be issued. The conditional receipt further explains to the proposed insured that the policy will be issued subject to the approval of the insurance company.
DEATH BEFORE ISSUANCE OF THE POLICY

If the death of the proposed insured occurs before the issuance of the policy, one of the following will happen:

- If the insurance carrier would have approved the application, and therefore issued a policy, the beneficiary would receive the proceeds of that policy; or
- The proceeds will not be paid to the policy’s beneficiary if the insurance carrier would not have approved the application and issued the policy. Instead, the premium would be returned, which is indicated in the conditional receipt.

MINOR APPLICATIONS

The proposed insured can be of any age. States differ on what age a person needs to be to be considered an adult. Insurance companies consider the age of 15 as adulthood. Any person 15 or older can apply for a life policy.

Any minor (14 or younger) must have the assistance of an adult signature (i.e., parents/grandparents, court-appointed safeguard for the well-being of the child) in order to apply for a life policy.

POLICY EFFECTIVE DATE

The policy effective date is vital as it indicates the date in which the policy’s full protection takes effect.

The full protection, contestable period and the suicide clause all begin on the policy effective date.

Then, after a certain period of time, the insurer cannot cancel the policy for any reason other than nonpayment of the premiums.

BACKDATING POLICIES

Policies can be backdated a maximum of six months and are allowed by most companies. There are several ways in which backdating can be beneficial.

If the proposed insured can save an age by just one year, it could result in a lower premium. Ten-times backdating can be used to accomplish this.

If the proposed insured needs to coordinate income patterns, backdating can assist the policyholder to accomplish this goal.

If the proposed insured is either under the minimum or over the maximum age requirements, backdating can open the window to permit acceptable age limits.
Backdating policies can:

- Lower the policyholder’s premium payments;
- Coordinate income patterns; and
- Permit acceptable age requirements.

**Providing Adequate Insurance**

In order to carry adequate insurance, the rule of thumb is that an individual should carry life insurance equal to five or six times their annual earnings. Most families are underinsured in America today.

**Oncoming Expenses**

When a person dies, the insurance will be needed to cover many expenses. The purpose of life insurance is to provide for these costs.

**Estate Settlement Needs**

Monies will be needed for:

- Burial and funeral expenses;
- Administration expense;
- Estate tax;
- Any type of installment debt (current monthly bills); and
- Medical or last illness expenses.

**Readjustment Timeframe**

If the deceased should be the head of the family, the loss of income can be devastating as well. Life insurance can provide enough funds so that the family can continue to receive the same amount of income for their family’s future living expenses.

**Dependency Period**

The dependency period is the time following the readjustment period when the children are growing in age, and expenses for them rise. This period lasts until the youngest child of the family reaches age 18.

**Blackout Period**

When the youngest child reaches the age of 16, and the widow/widower has not reached the age of 60, social security benefits are temporarily suspended. This is what is known as the blackout period. When the surviving spouse
reaches the age of 60, social security benefits can begin again.
**Special Needs**

There may be special needs that require sufficient funds:

- Mortgage payoff;
- Surviving spouse retirement fund;
- Children/grandchildren’s education; and/or
- Emergency or unexpected expenses.
Chapter 10

LIFE INSURANCE VARIETY

THE SEVEN TYPES OF LIFE INSURANCE

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

**Term Insurance**

Term insurance is insurance for a specified period that provides for no payment to the insured, except on losses during the period, and that becomes void upon its expiration. Term insurance is the most basic life insurance. Some of the features are explained below.

**Temporary Protection**

At the end of the policy period, if the insured is not deceased, the policy expires. This period can be from one to twenty years or until the insured reaches a specified age. Term Insurance is purchased for protection only and has no cash value, savings, or refund feature.

The insured purchases the policy for “peace of mind,” but he/she has to die before the insurance proceeds are distributed.

Normally, term insurance has a lower premium per $1,000 of insurance coverage than permanent insurance. This is due to the fact that term policies do not build any cash value and so no money is repaid to the insured if he/she is still alive when the term policy expires.

**Renewable**
Term insurance can be renewed for additional periods of time without requiring proof of insurability. The amount that the premium will increase is determined by the age of the insured at the time of renewal.
Convertible

The term insurance policy can be exchanged for a different type of cash value policy without proof of insurability.

Term Insurance policies can be purchased in an assortment of ways.

- **Yearly Renewable Term** - This policy is effective for a one-year period only; however, the policy owner can renew the policy each year if desired in successive one-year periods.

- **Five, Ten, Fifteen, or Twenty Year Term** - This policy is effective for any designated time period. The premium remains the same during the policy’s active status. At the end of the designated time period, the policy owner has the option of renewal; however, the premiums would increase at that time.

- **Term to Age Sixty Five or Seventy** - This policy is effective only until a specified age has been reached. The premium remains the same during the policy’s active status. The policy owner has the option of converting the policy to a cash value policy at anytime prior to the expiration date.

- **Decreasing Term** - This policy’s value gradually decreases over the specified time period of the policy. The premium remains the same during the policy’s active status; however, the face value decreases as time passes. For instance, a $100,000.00 policy issued for a decreasing term of 30 years could decline to as little as $50,000.00 by the end of the twentieth year and to zero by the end of the thirtieth year.

- **Reentry Term** - This type of term insurance allows for lower premiums; however, the policy owner must show proof of insurability during a specified time period, usually every one to five years.

**Whole Life Insurance**

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

**Ordinary Life Insurance**

This type of insurance is a form of Whole Life Insurance. Under the ordinary life insurance, the policy owner is provided with lifetime protection until the age of 100. The premiums remain the same during the policy’s active status. Should the insured live to reach the age of 100, the full face value will be paid without death having to occur.
**Limited-Payment Life Insurance**

This is the second basic type of Whole Life Insurance. The premiums remain the same during the policy’s active status, but the payments are limited to a specified number of years. Once the time period has passed, the policy is considered paid in full. These Limited-Payment policies can be issued for ten, twenty or thirty years, and their cash value is high. However, because of the time restrictions, the premiums are higher than in an ordinary life insurance policy.

**Endowment Insurance**

Endowment Insurance is another form of Whole Life Insurance. In an endowment insurance policy, proceeds are paid to the named beneficiary if the insured’s life should expire within a specified time 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 combine insurance protection with savings and are considered investments. A Universal Life Policy is considered to be a flexible premium deposit fund that is combined with monthly renewable term insurance.

**Basic Characteristics**

- Flexible premium;
- Broad adaptability;
- Financial protection;
- Long-term cash accumulations;
- Interest sensitive product;
- There is a stated investment return; and
- Cash withdrawals are permitted.

**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.
**VARIABLE LIFE INSURANCE**

The face amount of the Variable Life Insurance policy cannot be decreased. However, it can be increased. The insurance carrier maintains a separate account in which the premiums are invested in equities or other investment options. Should this separate account do well on its investments, the face value of the policy will increase. However, if this account does not do so well, the face value of the policy will decrease. Keep in mind, though, that the face amount can never be reduced to an amount lower than the original face value. The Variable Life Insurance policy can be used as a viable defense against inflation, which causes the reduction of the real purchasing power of the life insurance death benefit.

**ADJUSTABLE LIFE INSURANCE**

This type of Whole Life policy is flexible in various ways. It allows for changes to be made in its face amount, the protection period, the premium payment amount and the duration of the premium-paying period. A cost of living provision can also be attached to the life policy, which will maintain the real purchasing power of the insurance death benefit.

This type of insurance allows the policy owner the flexibility of making adjustments as situations change. It is frequently referred to as Life Cycle insurance because it is designed to conform to different periods in the insured’s life.

As the life of the policy owner changes, so can the Adjustable Life policy:

- Adjust the amount of insurance;
- Adjust the period of protection;
- Adjust the dollar amount of the premiums paid; and
- Adjust the time period for paying premiums.

**MODIFIED LIFE INSURANCE**

This type of the Whole Life Policy allows the policy owner to make lower premium payments for an initial period of three to five years. After that time, the premiums will increase. This Modified Life Insurance can be extremely attractive to individuals expecting increases in income over time.

The lower premium payments are slightly more than rates for Term Insurance, but considerably less than for an ordinary Life Policy issued at the same age.

One type of Term Insurance converts into an ordinary life policy for the initial time period. The policy owner pays lower premium rates for the first three to five years, and higher rates for the latter time period.
In another type, charging lower premiums during the initial time period but higher premiums during the latter allows the insurance carrier to redistribute the premiums.
FAMILY LIFE INSURANCE

This Whole Life Policy is structured so that all family members are insured under one policy. The amount and types of life insurance coverage is broken down individually for each member of the family.

Example

<table>
<thead>
<tr>
<th>Family Member</th>
<th>Type of Insurance</th>
<th>Insurance Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Head of household</td>
<td>Ordinary Life</td>
<td>$50,000.00</td>
</tr>
<tr>
<td>Spouse</td>
<td>Adjustable Life</td>
<td>$25,000.00</td>
</tr>
<tr>
<td>Child up to age 18</td>
<td>Term Life</td>
<td>$10,000.00</td>
</tr>
</tbody>
</table>

Under the Family Life Policy, Term Insurance can be converted to some form of permanent insurance.

Newborn children are usually covered automatically after a fifteen-day waiting period and there is no additional premium to cover them. Typically, the children’s protection can be converted up to five times the face amount without proof of insurability.

SOME COMPARISONS OF PERMANENT LIFE POLICIES

<table>
<thead>
<tr>
<th>POLICY</th>
<th>DEATH BENEFIT</th>
<th>TWO DEATH BENEFIT OPTIONS</th>
<th>PREMIUM</th>
<th>MORTALITY RATES</th>
<th>CASH VALUE</th>
<th>INVESTMENT OPTIONS</th>
<th>PARTIAL SURRENDERS</th>
</tr>
</thead>
<tbody>
<tr>
<td>WHOLE LIFE</td>
<td>Fixed</td>
<td>No</td>
<td>Fixed</td>
<td>Fixed &amp; Guaranteed</td>
<td>Fixed &amp; Guaranteed</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>VARIABLE LIFE</td>
<td>Variable</td>
<td>No</td>
<td>Fixed</td>
<td>Fixed &amp; Guaranteed</td>
<td>Variable, No Guarantee</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>UNIVERSAL LIFE</td>
<td>Adjustable</td>
<td>Yes</td>
<td>Flexible</td>
<td>Current, Guaranteed Maximum</td>
<td>Current, Guaranteed Minimum</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>VARIABLE UNIVERSAL LIFE</td>
<td>Variable &amp; Adjustable</td>
<td>Yes</td>
<td>Flexible</td>
<td>Current, Guaranteed Maximum</td>
<td>Variable, No Guarantee</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>
Chapter 11

LIFE INSURANCE COMPANIES

Life insurance companies are typically organized as either stock companies (owned by stockholders) or as mutual companies (owned by policy owners).

STATE LICENSING

An insurance company must be licensed (admitted) to do business in any state and cannot sell insurance in that state until it is.

THE STOCK LIFE INSURANCE COMPANY

A stock life insurance company is owned by stockholders; hence the name, “stock life insurance company.” It is not necessary for stockholders to be policy owners as well; they may or may not be. But it is necessary for them to own stock in the company.

It is the stockholders role to elect a board of directors to manage and guide the company. It is the board of directors’ role to direct the company in such a manner as to ensure that the corporation makes a profit for the stockholders. If the company is successfully profitable, the stockholders receive dividends for each share of stock owned.

THE MUTUAL INSURANCE COMPANY

Policy owners who “mutually” own the company own the respective mutual insurance company. A mutual company has no stockholders and is run solely by the policy owners’ duly elected board of directors. Any profits realized by the mutual company are passed on to the policy owners as dividends, resulting in the reduction of insurance cost. This cost reduction is considered to be the return of an “overcharge” of premium.

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.
Most mutual insurance companies issue participating life insurance policies. These policies provide the policy owner a portion of the profits realized by the insurance company. An insurance company can realize profits in any number of ways.
Listed are just a few:

- Savings realized in death claims due to a lower mortality rate;
- An increase in the interest earned; and
- Reduction in expenses.

When this happens, the policy owner receives a share of the profits in the form of policy dividends. However, a client must realize that neither stock companies nor mutual companies are better than the other. They both have their own attributes.

**FRATERNAL BENEFIT SOCIETY**

A fraternal insurer is a type of social and benevolent organization whose members are comprised of a commonality. This mutual criterion may be based on any number of factors such as religion, occupation or nationality.

It is a non-profit organization and exists for the benefit of its members or their beneficiaries. A fraternal provides a multitude of benefits for its members, one of which is life insurance.

Each state regulates the insurance laws of its own fraternal benefit societies. Generally, the organization must possess the following criteria in order to be classified as a fraternal benefit society.

- Benefits only for its members and their beneficiaries;
- Is a non-profit organization;
- Is organized without capital stock;
- Is organized on the lodge system; and
- Must have a governing body.

Being organized on the lodge system means that the organization must have local lodges or chapters and hold regularly scheduled meetings. Ritualistic ceremonies are often a part of the fraternal. These meetings are designed to carry on the activities of the society for the betterment of its members.

Each fraternal benefit society must have a governing body. This body defines the organization’s bylaws or constitution and works to serve the organization as a whole. The members or their respective delegates elect the officials.

**GOVERNMENT INSURANCE PROGRAMS**

Throughout history, the U.S. Government has established social insurance programs and has become the largest insurer in the world. Among these are:

- Social Security;
• Medicare; and
• Disability and Unemployment programs.
Government insurance programs have been created in order to meet society’s needs when private insurers have failed to do so or when private insurers would have been subjected to adverse selection. Government insurance programs can make compulsory a program lacking equity in order to cover fundamental risks and to redistribute income.

**Reciprocals**

A Reciprocal is comprised of individuals (subscribers) who are both the insured and the insurer. Each member of the group insures each other member.

Each Reciprocal is governed by an administrator, known as the attorney-in-fact, so appointed by the subscribers through a broad power of attorney. The administrator receives a percentage of the gross premiums paid by the subscribers.

The liability of the subscribers in the Reciprocal is limited to administrative expenses, attorney-in-fact expenses and any losses that might occur. The Reciprocal returns any unused premiums to the subscribers.

**Lloyd's of London**

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 principals and methods as Lloyd's of London.

**Financial Status of Insurers**

Much attention and publicity is given to the failures of financial institutions in this day and age. Due to this publicity and changing economic conditions, clients would be well advised to take into consideration the ratings that are independently performed by such companies as A.M. Best Company, Standard
and Poor’s, Moody’s Investors Service, and Duff and Phelps. These companies are usually paid a fee by the insurance companies to provide these ratings. Each of these independent rating services focuses on different aspects, though they have similar rating scales. A.M. Best Company studies profitability, leverage and liquidity, while Standard and Poor’s focal point is on claims. Each has its own rating scale.
- A.M. Best Company – Studies Profitability, Leverage and Liquidity
  - A++ (Superior) to C- (Fair) and lower
- Standard and Poor’s – Claims and the ability to pay
  - AAA (Superior) to D (Insurers placed under an order of liquidation)
- Moody’s Investors Service – Measures financial strength
- Duff and Phelps – Measures claims paying ability and managerial stability

In addition to these independent rating companies, the National Association of Insurance Commissioners measure company performance and provide the Insurance Regulatory Information System (IRIS) with analytical reports. This information is available to other agents as well.
Chapter 12

POLICY PROVISIONS

CLAUSES & PROVISIONS

Agents should read every provision in every policy sold; however, most do not. Keep in mind that these policies are contractual and, therefore, so are their provisions. These provisions dictate to the policy owner what action is permissible and what action is not permissible. Agents should be familiar with each of the following policy provisions.

OWNERSHIP CLAUSE

Generally, the applicant and insured of a Life Insurance policy are one in the same. However, the owner can wear several hats, so to speak. He can be the applicant, the insured, and/or the beneficiary. The policy owner is the possessor of all contractual rights pertaining to the Life Insurance policy. And can, therefore, make certain changes under the Ownership Clause without the consent of the other parties named in the policy; such as, change the beneficiary, select a settlement option, and even appoint a new owner. The necessary forms are available through the insurance carrier.

ENTIRE CONTRACT CLAUSE

The Entire Contract Clause testifies to the fact that the Life Insurance Policy, along with the application represents the contract between the insurer and the policy owner in its entirety.

Neither company rules, nor oral understandings have any bearing on the contract unless they were included in the policy or the attached application prior to the policy being issued.

Only the policy owner can make any changes to the Life Insurance Policy after it has been issued. Such changes or additions are called riders, endorsements or amendments. The insurance carrier cannot make any changes or terminate the contract unless there has been a misrepresentation or concealment found on the application or the policy owner failed to pay the premiums.
INSURING CLAUSE

The heart of the insurance policy is the insuring clause. It contains the basic promise of the life insurance company to pay a specified sum of money upon the death of the insured.
INCONTESTABLE CLAUSE

The Incontestable Clause was designed to protect the beneficiary if the insurance carrier attempts to deny payment of a death claim. The insurance company has two years from the date of issuance of the Life Insurance Policy to contest the contract if an irregularity is found. Should the insured die and the insurance company finds an irregularity after the two-year period, the claim cannot be disputed and must be paid. Any allegations by the insurer concerning statements made in connection with the application cannot be easily contested if the insured is deceased. Therefore, the policy cannot be contested and, should the insured die after that time, the death claim must be paid.

SUICIDE CLAUSE

The Suicide Clause was designed to protect the insurer. It prohibits any individual from purchasing a life insurance policy with the sole intent of committing suicide. If the insured commits suicide within two years of the policy issuance date, the insurance company will not pay the face amount of the policy. Only a refund of the premiums paid will be issued to the beneficiary.

MISSTATEMENT OF AGE

The Misstatement of Age Clause allows for the fact that the insured’s age may be incorrect (misstated) in the application. If the insured dies and it is found that the age was misstated, the beneficiary would receive the value of the policy less any adjustments that would need to be made to compensate the insurance company.

A life insurance policy’s premiums are based largely on the age of the insured. Normally, the older the insured, the higher the premium payments. If someone had been paying lower premium rates due to the fact that the age was misstated on the application, the difference between what the individual should have been paying and what was actually paid would be deducted from the beneficiary’s proceeds.

GRACE PERIOD

If the policy owner fails to make the premium payments, the insurance company will not immediately cancel the policy. The insurance company will allow a specified period of time (usually 30 or 31 days) in which to pay the overdue premium. This Grace Period is a big advantage to the policy owner. Should the insured die during the Grace Period, the overdue premium payment is deducted from the policy proceeds.

REINSTATEMENT CLAUSE

The Reinstatement Clause comes into effect when the overdue premium has passed its Grace Period, and the policy has been canceled for non-payment of funds. If the insured wishes to reinstate the contract, all overdue premiums...
plus interest must be paid. The lapsed policy can only be reinstated within the stated specified period of time from the date of cancellation. If you go beyond the stated specified period of time, a new contract must be purchased. It is often wiser to reinstate a contract rather than purchase a new one. Most likely, the premiums would be higher on a new contract due to the insured’s age advancement.
There are other criteria that must be met:

- The insured must provide evidence of insurability. Some insurers will waive this condition for lapses of less than two months;
- Any loans must be repaid; and
- The policy must not have been surrendered for its cash value.

**Beneficiary Designation**

Upon the death of the insured, the beneficiary is the individual or group previously named in the policy to receive the proceeds of that policy.

**Primary Beneficiary**

This is the individual or group named in the policy that would receive the proceeds of the policy.

**Contingent Beneficiary**

If the Primary Beneficiary were deceased, the proceeds would be paid to the Contingent Beneficiary.

**Revocable Beneficiary**

This appellation gives the policy owner the power to change the beneficiary at his discretion any time without prior consent from the beneficiary.

**Irrevocable Beneficiary**

This appellation prohibits the policy owner from changing the beneficiary without the beneficiary’s consent.

**Specific Beneficiary**

This appellation means that a named beneficiary is specified and known (i.e., the wife, the husband).

**Class Beneficiary**

This appellation means that a named beneficiary is not specified, but rather is a member of the group receiving the proceeds (i.e., children).

**Privilege of Change Clause**

This provision gives the policy owner the ability to be able to exchange one plan for another under the specified conditions under which the insurance
company will allow such change that it doesn’t expose itself to adverse risk selection.
Example
If the policy owner, who had been paying for several years, just found out he had terminal cancer and only has a few years to live, he now knows that he can get the same coverage amount by switching to a term insurance policy and pay less in premiums. So he asks the insurance company to switch his policy to a five-year term policy.

The insurance company cannot allow this change. It would be unfair to the other policy owners, as well as to the insurance company. This change would expose the insurance company to adverse risk selection.
Chapter 13

PREMIUMS

SINGLE AND PERIOD PREMIUMS
The consideration paid to the insurance company for the life insurance protection is called the premium. The policy does not go into effect until the first premium is paid in full based on the mode of payment that the policy owner chooses.

SINGLE PAYMENT PREMIUMS
When a policy is originally purchased, the policy owner has the option of paying the premiums in full with one single payment. The single payment method is not used as frequently as the period premium payment plan due to the large amount that is normally required. However, should the insured die during the early stages of the policy, the proceeds to the beneficiary would be higher than with the period method.

PERIOD PREMIUMS
This method is more popular due to the fact that it allows the policy owner the leeway of making smaller regularly scheduled payments rather than a large one-lump sum. Should the insured die during the early stages of the policy, the proceeds to the beneficiary would be lower than with the single payment method. Also the policy owner will have a higher annual outlay of premium dollars for this type of payment mode.

PARTS OF THE PREMIUM
The following are the basic influences that affect the costs of premiums.

MORTALITY
Insurance companies use statistics to analyze the projected mortality rate for different age groups. As an individual grows older, the cost of insurance increases, since growing older increases the chance of death. If the mortality rate is higher for individuals in the 40-50 year range than in the 30-40 year range, more claims will be paid on the 40-50 age group. Therefore, insurance coverage for individuals in that age group would be higher, thus making premium charges higher.

INTEREST EARNED
Insurance companies use the monies collected from premium payments to in-
vest in other sources such as stocks and bonds. The interest earned from these outside investments is credited to the bottom line, or profit level, of the insurance companies. This, in turn, allows the insurance companies to utilize a fund from which to pay all death claims and help offset insurance costs.
EXPENSES

All of the overhead costs that insurance companies have reflect a debit in the bottom line, or profit level, of the companies. In addition to the expense of paying death claims, insurance companies incur other miscellaneous expenses as well. Among miscellaneous expenses are commissions, salaries, advertising, marketing, and medical examinations, just to name a few.

NET PREMIUM

Net premium is when the insurance company determines how much the policy owner must pay to obtain coverage based on the proposed insured’s mortality rate. Then the insurance company deducts from that amount a portion of the interest it’s assumed this money will earn.

GROSS PREMIUM

Once the net premium has been computed, the insurance company then adds the third factor called the expense factor, or "loading," to this net premium to arrive at the gross premium. The gross premium is what the policy owner actually pays.

MORTALITY AND INTEREST FACTORS

In order to calculate the net premium, an insurance company must predict the probability of death claims to be paid each year. A Mortality Table is calculated using the past history of deaths occurring in different age groups. Though an insurance company cannot determine when an insured will die, it can, through the analysis of past history and age statistics, project how much monies will be paid in death claims on an annual basis. In order to make projections of future mortality as accurate as possible, large groups of people must be followed for a long period of time.

LEVEL PREMIUM CONCEPT RESERVES

Since most policies are purchased by the period payment method, the net single premium is converted to the Net Level Premium. The early renewable term premium increases as the insured’s age and mortality risk increases. Therefore, the premium can be low during the early years of an insured’s life and rise dramatically as the individual ages; sometimes making premiums cost-prohibitive to older aged individuals.

In an effort to combat this unaffordable rise in premiums, the level premium plan was developed. This plan keeps the premium payments the same throughout the life of the policy; thereby making the premium higher in the younger years, but lower and more affordable in the later years of life, when a lower payment may be needed more.

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.

Through the investing that insurance companies do with the premium overage amounts...
collected in the early years, the company accrues funds to cover the shortage that occurs in the later years and to meet projected policy claims. Reserve funds are required by state laws, and regulations stipulate that the mortality table and the projected rate of interest be used in the calculation of the required minimum legal reserves.
**Insurance Age**

There are two methods used to establish the insurance age of the insured. The insurance age is not necessarily the actual age.

Some companies use the age of the insured’s last birthday to determine the insurance age. This method is the more commonly used method.

Some companies use the rounding off method. If the insured’s next birthday is over six months away, then the age of the individual’s last birthday is used to establish the insurance age. However, if the insured’s next birthday is less than six months away, then the age of the individual’s next birthday is used to establish the insurance age.

Even though two people may turn the same age within the same year, it does not mean that their insurance age is the same.

**Example**

<table>
<thead>
<tr>
<th>Insured</th>
<th>Policy Date</th>
<th>Birthdate</th>
<th>Age</th>
<th>Age</th>
<th>Premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>John Doe</td>
<td>August 1</td>
<td>January 5</td>
<td>30</td>
<td>31</td>
<td>$100.00</td>
</tr>
<tr>
<td>Jane Doe</td>
<td>August 1</td>
<td>March 4</td>
<td>30</td>
<td>30</td>
<td>$85.00</td>
</tr>
</tbody>
</table>
Chapter 14

EXCLUSIONS, RESTRICTIONS & SETTLEMENT

EXCLUSIONS AND RESTRICTIONS ON LIFE POLICIES

In the earlier years, life insurance policies had written exclusions that informed the insured of the circumstances under which the policy proceeds would not be paid. Today you, the agent, should be aware of some of the most common exclusions and restrictions.

- War or Military Service Exclusion – Written in two manners: (1) As a status clause that excludes payment of the policy proceeds if the insured died while in the military; and (2) as a results clause that excludes payment if the insured died as a result of a declared war.
- Aviation Exclusion – This exclusion restricts payment of the benefits in cases of death from aviation activities, except when the insured was a commercial airlines fare-paying passenger.
- Hazardous Occupation or Hobby Exclusion - Prevents policy proceeds from being paid if the insured died as the result of his/her dangerous job or interest.

However, some of these activities may be covered for an additional premium in today’s type policies.

SETTLEMENT OPTIONS

OVERVIEW

Settlement of the Policy takes place when death claim benefits are paid to the beneficiary(ies). At one time these insurance policy proceeds were only paid in a “lump sum” method. This may cause many problems for the beneficiary. While settlement options are not required by law, most policies have them today. Following are some of the options available:

- Lump Sum;
- Fixed Installments;
- Proceeds and Interest;
- Life Income;
- Joint Life Income; or
• Another mutually agreed upon method.
Lump Sum Settlement

Following the death of the insured, the beneficiary receives proceeds in one single payment. This option may cause problems for the beneficiary such as:

- No investment expertise;
- Immature – “Spending spree;” and
- Grieving spouse – Unable to handle money matters.

Fixed Years Installments

The beneficiary may wish to receive the proceeds in equal monthly installments rather than in one lump sum. The amount paid in the installment method is dependent upon the policy proceeds, the interest earned on the principal and the number of years chosen by the beneficiary that payments are to be made. The beneficiary retains the right to withdraw all or part of the remainder of the proceeds at any time. If the beneficiary dies before receiving the full amount of the policy proceeds, the money remaining is paid to the contingent beneficiary, if one is named in the policy, or to the estate of the primary beneficiary.

Proceeds and Interest

The beneficiary may opt to receive interest payments while the insurance company holds the policy proceeds. The insurance company can pay a higher interest rate than the pre-established minimum rate, but it cannot pay a lower rate.

The beneficiary retains the right to withdraw all or part of the remainder of the proceeds at any time. If the beneficiary dies, the money left will go to either the deceased beneficiary estate or the secondary beneficiary, if named in the policy.

Life Income

This option gives the beneficiary a certain amount in equal monthly payments for either the lifetime of the beneficiary or for a predetermined number of years. The amount paid in monthly payments is determined by the policy proceeds, the beneficiary’s sex, the beneficiary’s age at the time scheduled payments begin, as well as the period certain for which payments are guaranteed.

Should the beneficiary die before the period certain concludes, the beneficiary’s designated successor will receive the remainder of the proceeds in the same manner.

Joint Life Income

With this option, the proceeds may be paid to two beneficiaries in equal
monthly installments as long as either one or both payees are alive. This option may be used when the insured normally contributes to the support of parents. This would supply the parents (beneficiaries) monthly income for the remainder of their lives.

Under the joint life income plan, the beneficiaries typically cannot opt to receive the remainder of the proceeds in a one lump sum payment.
**Fixed Amount Installments**

This settlement option instructs the insurance company to make equal payments in an amount chosen by the policy owner or beneficiary at predetermined intervals. All proceeds continue to earn interest and are held by the insurance company. Should the amount of payments be greater than the amount of interest earned, the difference would be paid out of the balance of the proceeds until all of the interest and total proceeds have been exhausted.

The beneficiary retains the right to withdraw all or part of the remainder of the proceeds at any time.

**Other Agreement Methods**

It is possible, with the mutual agreement of the policy owner and the insurance company that special payment plans be made to the beneficiary.

**Example**

John Doe (the insured) dies and leaves a fixed amount to be paid to his wife (the beneficiary), Jane, for 20 years on a monthly installment basis. Should Jane Doe die after 10 years, the remainder of the proceeds can then be dispersed to their children in one lump sum.
Chapter 15

NONFORFEITURE OPTIONS

NONFORFEITURE OPTIONS

Should the policy owner get into a situation in which he cannot continue to make the premium payments, the nonforfeiture options can be utilized. By using this option, it is possible for the insured to continue to gain value from the policy. There are five nonforfeiture options available.

The five nonforfeiture options are as follows:

- Cash Surrender Value;
- Reduced Paid Up Insurance;
- Extended Term Insurance;
- Automatic Loan Provision; and
- Dividend Accumulations to Avoid Lapse.

Cash Surrender Value

The policy owner may want to surrender the value of the policy for cash. For the first two to three years, there may not be a cash surrender value, but as time passes, premiums are paid and interest is earned, the cash surrender value increases. Any outstanding loans would be deducted from the surrender value and the cash is usually paid in one lump sum. This action, of course, terminates the policy.

So, if Denise has a policy with a stated cash value of $5,000 and still owes $500 (including interest) on a previous outstanding loan from the cash value, the insurance company would give her, on the cash surrender value option, a total of $4,500 ($5,000 minus $500).

Extended Term Insurance

This option differs from the reduced paid-up insurance, as it does not allow the policy to continue to earn interest, increase cash value and pay dividends, if dividends are applicable.

It does, however, allow the face amount of the policy to remain the same for a specified period of time. The policy will contain a table that illustrates the length of time the face amount of the policy will remain the same during any
given surrender year.

Several factors are necessary to calculate this timeframe:
• The policy’s cash surrender value;
• The age of the insured at the time premium payments ceased; and
• The insured’s gender.
Now, if there is a policy loan outstanding at the time the extended term option is exercised, the insurance company will first deduct the loan outstanding from the cash surrender value of the policy. The reduced cash value will then provide term coverage for a shortened period of time, and for a face amount that is likewise reduced by the amount of the loan outstanding.

**Reduced Paid-Up Insurance**

The policy owner has another option available. He may request that the cash value of the policy be used to pay for the policy itself. This action would not terminate the policy, but would keep a reduced amount of paid-up insurance in force under the same policy.

Most policies contain a table that illustrates how much the cash value in any given year would reduce the face amount of the policy in that same year. This option allows the policy, though reduced, to continue to earn interest, increase cash value and pay dividends.

Remember that the reduced paid-up policies are of the same type of insurance as the original policy except that all riders, including those for disability and accidental death, are eliminated.

**Automatic Premium Provision**

This option empowers the insurance company to use some of the policy’s cash value (by way of an automatic loan) to pay any premium not paid by the policy owner before the expiration of the grace period.

**Dividend Accumulations to Avoid Lapse**

Dividend accumulations can be used to pay any premium not paid by the policy owner before the end of the grace period. If the dividend amount is less than the premium payment amount, the coverage will not lapse, but will be recalculated on a prorated basis. At the end of the extended coverage period, a new grace period will be calculated.
Chapter 16

DIVIDEND OPTIONS

Participating Policy

In a participating policy, the policy owner interacts in the insurance company earnings through annual dividend payments. The policy owner can use these funds to reduce the policy premium, purchase an addition to the policy, accumulate interest, purchase a one-year term policy, or the policy owner can opt to receive a cash payment.

Cash Dividend Option

The insured receives a check from the insurance company that is equal to the declared dividend amount.

Reduction of Premium

The declared dividend can be applied to the current policy, thereby reducing the premium amount due for the year.

Accumulation of Interest

The amount of the dividend payment can continue to be held by the insurance company to accumulate interest at the specified rate.

If the insured’s death should occur while the monies are still held, the amount of the dividend plus the interest is payable to the beneficiary along with the policy proceeds.

Remember that with respect to leaving dividends to accumulate at interest, that this money has nothing to do with the cash value accumulations of a permanent policy. This means that the dividends left at interest can be used in a cash emergency. The policy owner can withdraw them without affecting the cash value of the policy.

Paid-Up Additions

The policy owner can use the dividend funds to purchase additional insurance on the same policy, thereby increasing the face value of the policy.
The amount of paid-up addition to a life insurance policy is therefore dependent upon the amount of the dividend and the insured’s attained age. If the insured’s death should occur, the additional insurance is payable to the beneficiary along with the policy’s original proceeds.
**One-Year Term**

Some policies allow the policy owner to purchase a one-year term policy with the dividend funds, based upon the attained age of the insured.

In the event of the insured’s death, the amount of the one-year term coverage is payable to the beneficiary along with the original policy proceeds.
Chapter 17

LIFE INSURANCE POLICY RIDERS

A rider is used in an insurance policy in the same way as an endorsement, to make alterations in the original policy. Riders attach to the original policy to provide specialized or additional needs not found in the original contract.

RIDER ILLUSTRATION

<table>
<thead>
<tr>
<th>Term Rider of $50,000 for Special, Unexpected, or Additional Needs</th>
</tr>
</thead>
<tbody>
<tr>
<td>PERMANENT POLICY $100,000</td>
</tr>
<tr>
<td>5 years</td>
</tr>
</tbody>
</table>

Now, let’s take a look at the three most common life insurance riders.

**Waiver of Premium**

In the event that the policy owner becomes totally disabled, this rider protects the insured from having the added burden of policy premiums.

Usually, there is a six-month waiting period from the beginning of disability in which premiums must continue. After the six-month timeframe, if the insured remains totally disabled, premium payments will be discontinued (waived). In addition, some policies state that the premiums that were paid during the six-month waiting period will be refunded to the insured.

Now, this premium rider does subject the insurance company to greater risks than they would have experienced if the rider was not included in the policy because it, in reality, provided that the insurance company will pay the premiums if the insured becomes totality disabled. Any policy should be sold with this rider, as the cost for this coverage is minimal, comparatively speaking.

There are certain exclusions that are found in the waiver of premium rider, self-inflicted injury, injury received in military service in time of war and while committing a crime.

**Accidental Death and Dismemberment**

This rider (ADR) is also known as double indemnity. In the event of acciden-
tal death, twice the original face amount of the policy is paid to the beneficiary. Accidental death can be defined two ways.

**Accidental Bodily Injury**

If death is caused through accidental means, even if the accident occurred as a result of an intentional event, benefits are paid.

**Example**

If the insured climbed on top of the roof of his house to make repairs, and he fell off the roof causing his death, benefits are payable to the beneficiary.

**Accidental Means**

Death caused through accidental means would indicate that all events surrounding the death must be accidental or the benefits are not paid.

**Example**

If the insured climbed on top of the roof of his house to get the neighbor’s cat, and he fell off the roof causing his death, benefits would not be paid due to the fact that the insured intentionally climbed the roof in the first place.

Benefits are paid to the beneficiary. Normally, the death caused by the accident must occur within 90 to 180 days of the incident.

As with the waiver of premium and the disability income riders, there are some exclusions:

- Death resulting from a self-inflicted injury;
- Death while committing a crime; and
- Death as a result of war.

With the dismemberment rider (AD&D), benefits are paid for loss of sight or limb(s). The loss of a limb must involve “complete severance through or above the wrist or ankle joint.” Amputation is excluded unless medically necessary due to an accidental injury.

These benefits are paid to the insured rather than the beneficiary.

**Guaranteed Purchase Option**

Some policies permit additional purchases of life insurance in increments of $5,000, $10,000 or $15,000 without requiring evidence of insurability under certain circumstances. Life changes such as marriage, birth of a new child or purchase of a new home could cause the insurer to want to increase the face value of the life insurance policy.

Some insurance companies permit the option of purchasing additional insurance every fourth policy anniversary year.
The premium charge for the additional coverage is usually based on the age of the insured at the time of exercising the option and the type of insurance purchased.

This option is used most frequently with whole life insurance rather than term insurance.
Chapter 18

LIFE INSURANCE UNDERWRITING

UNDERWRITING FACTORS FOR INDIVIDUAL COVERAGE

Once the completed application is received, the insurance company must evaluate if the applicant is an acceptable risk. The whole purpose of the life insurance underwriting process is to select or reject risks that are submitted to them.

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

MORTALITY RATING

Mortality rates are the principal instrument used for establishing premium rates on life insurance policies. Mortality rates are measured in terms of deaths per one thousand persons. Several factors are taken into consideration to establish the class basis for insurance coverage rates.

AGE

It is the natural course of life that the chance of death increases with age. Therefore, premium rates increase as age increases.

SEX

Overall, women in the United States live seven years longer than men. This longevity gives women a lower premium rate than men of the same age.

OCCUPATION AND AVOCATION

Through the years and increased safety precautions and programs by employers, the impact of an individual’s occupation has decreased substantially. However, there are still some occupations that carry a higher than normal risk factor and, therefore, carry a higher premium rate.

Insurance companies provide their agents with guidelines on recognizing these high-risk occupations. An occupation such as airplane pilot would have
a higher risk factor than a bus driver. Based upon these guidelines, the insurance company can choose to either issue the policy at a higher premium rate, or deny coverage altogether.
PERSONAL HABITS

Another important factor that is considered for insurability is the insured personal habits and moral fitness. Habits such as alcohol or drug use, financial trouble, or a poor driving record could play a role in determining a higher premium rate.

An individual’s reputation and character are also taken into consideration, as well as financial status. It must be determined that the applicant cannot only afford to pay the premiums, but is not over-insured as well.

HOBBIES

A higher premium rate would also apply to any individual who participates in a hobby that could cause a higher risk of untimely death (i.e., skydiving, rock climbing, auto racing).

HEALTH AND PHYSICAL CONDITION

The health of an individual affects life expectancy, and therefore plays a key role in establishing the risk factor involved with insuring an individual. The underwriter must take into consideration any illnesses such as cancer, heart disease, hypertension and/or diabetes. These illnesses cause a greater than average risk of untimely death in an individual.

Since a person’s height, weight and weight distribution can have a key affect on an individual’s life longevity, these factors too must be taken into consideration. Generally, overweight people are more susceptible to conditions such as heart disease and high blood pressure, and therefore have a higher than normal mortality rate.

An individual’s family health history is also a contributing factor due to heredity. It has been statistically proven that, taken as a whole, an individual’s parents’ life span can have a direct effect on that individual’s likelihood of emulating the same. If an individual’s parents lived a long and healthy life, chances are pretty good that the individual will do the same. On the other hand, if an individual’s parents both died at a younger age due to illness or disease, chances are that the individual will not enjoy a long life either.

However, most insurance companies offer discounted rates for exercising good health habits such as non-smoking.

MEDICAL INFORMATION BUREAU

There is another source of information that is used before the insurance company makes a
final decision. It is called the Medical Information Bureau. This nonprofit agency has
information files that applicants have disclosed before, or that have been furnished by
physicians. Applicants have the right to know any of this information that MIB has on
file for them. The applicant has recourse against inaccurate information that is prescribed
by the Fair Credit Reporting Act.
FOREIGN TRAVEL OR RECENT IMMIGRATION

Individuals who travel outside the United States pose a greater risk, as they may be subjected to diseases and illnesses not normally found in this country. If an individual resides in a foreign country, and mortality rates differ from country to country, a higher premium might be applicable. An applicant may be required to have specialized medical examinations, or postponement or even denial of coverage may occur.

UNDERWRITING ACTIONS

Based upon a combination of the above factors, the underwriter determines the rate of the premiums to be charged, as well as if any coverage at all will be supplied.

- Preferred Rate – Lower Premium
- Standard Rate – Normal Premium
- Substandard Rate – Higher Premium
- Decline the Coverage
Chapter 19

DELIVERING THE POLICY

POLICY EFFECTIVE DATE

The date of a life insurance policy upon which coverage actually begins is the effective date. Everything active having to do with the policy is dependent upon the effective date and, therefore, is extremely important.

The effective date of the policy occurs when the offer to purchase is made by the proposed insured and the date in which the insurer accepts that offer. This is the contract law of “offer and acceptance.”

Normally, the premium is submitted with the application and, therefore, an offer is considered to be made to the insurance company by the proposed insured for coverage.

If a premium is not submitted with the application, it is not considered to be an offer, but rather an invitation to the company to make an offer. The insurance company makes the offer to issue a policy as applied for, delivers it to the applicant, the applicant pays the premium and this date becomes the effective date of the policy. However, most companies will include a clause stating that the proposed insured is in good health at the time the policy is delivered. The agent is responsible for delivering the policy to the insured, collecting the premium and acquiring the insured’s signature on the good health statement. The statement and the premium payment are then sent to the insurance company.

If the premium is submitted with the application, but no receipt is given, then the policy’s effective date is usually the date the policy is issued and delivered. A policy is considered delivered by manual transfer when the policy is placed into the hands of the insured, is mailed to the policyholder, or is mailed to the agent for absolute delivery to the policyholder.

Delivery of the policy dictates the company’s acceptance of the applicant’s offer. If a manual delivery is not possible, then a constructive delivery must be accomplished.

INSPECTION RECEIPT

It is possible for the applicant to have the policy in his possession without the policy being considered effective. When the applicant wants to study the policy for a time being before deciding if the policy is exactly the way he wants it, he must sign an inspection receipt. This indicates that the policy, though it is
written, is not in effect as of yet and no premium has been paid.
**Backdating**

An applicant may ask the insurance company to give the policy for which he/she is applying a date earlier than the application date. Since premiums are based upon the insured’s age at the time of policy acceptance, it is possible in some circumstances to backdate the policy to obtain a lower premium based on a younger age.

**The Incontestable Clause**

This clause gives the insurer the ability to contest the policy, based on material misrepresentation, fraud or concealment in the application. The policy usually gives the insurer a period of two years to contest the policy.

**The Suicide Clause**

If death by suicide occurs within the first two years after the effective date, the policy is excluded from coverage and, therefore, is not payable.

**Agent’s Responsibilities**

It is the agent’s responsibility to deliver the policy to the insured. The delivery of the policy must be accomplished as soon as possible after the policy is issued. Though the policy may be issued, it is not effective until the agent receives the initial premium payment. It is the agent’s responsibility to collect the initial premium payment and deliver it to the insurance company while the insured remains in good health.

When the policy is delivered to the insured, and the initial premium payment is collected from the insured, the policy is in effect.

The agent is also responsible for explaining the policy to the insured. The rates established and reasons for those rates, any exclusions, riders, or provisions should be explained to the policy owner.
Chapter 20

IN SUMMARY

APPLICATION PARTICIPANTS

There are three parties to be named in the insurance policy.

**APPLICANT**

The person who applies to the insurance company for insurance is called the applicant. A policy can be requested to insure the applicant’s life or someone else’s life.

**INSURED**

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

**POLICY OWNER**

The policy owner is the person who possesses the ownership rights.

**THIRD PARTY OWNERSHIP**

In most policies, the applicant, insured and policy owner are one in the same. However, there are policies issued to the policy owner on the life of another. Usual circumstances for this type of policy are for spousal or child coverage. An employer, to cover the life a valuable employee, can also purchase an insurance policy in this manner.

There are also situations where a debtor’s life can be insured. A policy in the amount of the debt can be issued giving the policy owner peace of mind that the debt will be paid should the insured’s death occur prematurely.

**INSURABLE INTEREST**

In the interest of public policy, a life insurance policy cannot be issued unless the policy owner has an insurable interest in the life of the insured.

That means that the policy owner would suffer some kind of emotional or financial loss by the death of the insured. If the insured were a close relative (i.e., spouse, parent, child), suffering would, obviously, be incurred by the...
policy owner, probably both financial and emotional suffering. Therefore, the policy owner has an insurable interest in the life of the insured.
Being a relative does not automatically classify a person as having insurable interest. The policy owner would have to prove that he would suffer a significant financial or emotional loss should the death of that relative occur. Taking an insurance policy out on your own life constitutes an insurable interest.

If the insured were a neighbor, there is no obvious proof of suffering and, therefore, a life insurance policy would be considered illegal. However, if the neighbor owed the policy owner a debt that, if not paid, would cause the owner a financial loss, an insurance policy on the neighbor’s life would be considered legal. If this were the case, the amount of insurance requested must correspond with the amount of the debt.

**Policy Owner and Creditor**

When an insurance policy is taken out on the life of a creditor, the insurance would contain a decreasing death benefit.

**Example**

The debtor (creditor) owes the policy owner $5,000.00. At a scheduled payment plan of $1,000.00 per year, the debt would be paid off in 5 years. Should the insured’s death occur after four years, the balance owed would be $1,000.00. The insured cannot collect the full $5,000.00 of the original face amount. If that were the case, the insured would have collected $9,000.00 on a $5,000.00 loan, giving the policy owner a direct interest in the death of the insured, rather than the life of the insured. Remember, the policy owner must have an insurable interest in the life of the insured; not benefit from the insured’s death.

**Completing the Application**

The application is a form provided by the life insurance company to supply the insurer with the information required to determine insurance risk and to properly prepare a policy.

An application usually requires the answers to the following questions:

- Applicant’s full name;
- Applicant’s address;
- Applicant’s age;
- Applicant’s sex;
- Applicant’s marital status;
- Applicant’s occupation;
- Applicant’s medical history;
- Applicant’s immediate family medical history;
- Applicant’s present physical condition;
• Applicant’s hobbies;
• Amount of insurance being applied for; and
• Applicant’s previously denied life insurance, if any.
Given the importance of the correct information on an application, the form must be filled out completely. If any information is missing, the issuance of the policy will be delayed.

In addition to completing the application in its entirety, it is also extremely important that it be completed accurately. The applicant must initial any and all corrections, additions and/or deletions made to the original application.

**Concealments, Misrepresentations and Warranties**

The application provides the insurance company with the information necessary to determine whether or not to issue a policy, and what the premium rates will be. Therefore, any misrepresentation or concealment may cause the insurer to void the policy at a later date, even if the policy has already been issued.

**Concealment**

When an applicant purposely omits disclosing known facts with the intent to defraud, and the failure to disclose these facts directly affect the risk evaluation performed, the insurance company may void the policy.

**Misrepresentation**

A misrepresentation differs from a concealment. A concealment is a hiding or omission of facts. A misrepresentation is when something is known to be incorrect and is presented as correct. It is not omitted, it is misrepresented. Any material misrepresentation made by the applicant is determined to be grounds upon which to void the policy.

Because a concealment or misrepresentation can have dire consequences, there must be intent to defraud the insurance company. Any information contained within an application is said be true to best of the applicant’s knowledge. It is not a warranty that the information is true. Therefore, with any concealment or misrepresentation, there must be general intent to defraud the insurance company.

Once the application has been completed and is ready for submission to the insurance company, the proper signatures must be obtained. The agent is responsible for acquiring those signatures and will need to sign the application as well to serve as a witness to the signatures of the proposed insured and the applicant.

**Minors**

Normally, if a life insurance policy is issued to a minor, only the minor has the option of canceling the policy. The contract is binding on the insurance company. Should the minor back out of the contract, he/she can receive back at least part of the premiums paid for the insurance.
Due to this situation, statutes have been adopted by many states that lower the age limit requirements (as low as 14) for an individual to be considered a minor when purchasing a life insurance policy. This enables the contract to be binding on both the minor and the insurance carrier. Normally, the situation calls for the policy to be on the minor applicant’s life; and the beneficiary is usually a close relative.

Given that the minor is still underage, additional signatures will usually be required to process the application.

Due to the confidential nature of medical records, an authorization form must be signed, which allows the insurer to receive medical information from physicians or medical facilities. The Medical Information Bureau (MIB) and the Fair Credit Reporting Act have made it a requirement that the applicant receive written notice from the insurer of requests for medical records. It is the agent’s responsibility to go over the provisions with the applicant, as well as have the applicant sign an acknowledgement that the notices were received. Depending upon the insurance company, the receipts and the medical authorization forms may be combined.

**PREMIUM RECEIPT**

The agent gives the applicant a receipt at the time the initial premium payment is received. The receipt can serve, under certain situations, as proof of insurance until the applicant receives the policy. To obtain this receipt, thereby having valid proof of insurance in the applicant’s possession, the applicant must make the initial premium payment at the time the application is submitted, rather than waiting until the policy is delivered.

The agent should be familiar with the types of receipts available and be able to explain the differences to the applicant at the time. There are two types of receipts; and the conditional receipt has two subcategories that need to be thoroughly understood.

- The Conditional Receipt
  - Insurability
  - Approval
- The Binding Receipt

**THE INSURABLE CONDITIONAL RECEIPT**

This type of receipt is the most frequently used. If the applicant is found to be insurable, the effective date of the policy is the date on the receipt (the date the initial premium payment was received). Even if it takes the insurance company as long as a month to process and deliver the policy, the effective date remains the date of the receipt.
The Approval Receipt
This type of receipt also states that the effective date of the policy is the date of receipt of the initial premium, but only if the application is actually approved. Should the insured die before the application is approved, no benefits would be paid, even though the applicant was insurable at the time of receipt.
The Binding Receipt

The binding receipt also states that the effective date of the policy is the date of receipt of the initial premium; however, it differs from the approval receipt. Should the insured die before the application is fully processed, the benefits of the policy are fully payable, subject to any limitations specified.
Chapter 21

RISK SELECTION AND CLASSIFICATION

The insurance agent acts as the eyes and ears for the insurance company when supplying information on insurability of the proposed insured. The agent has been supplied with the insurance company’s guidelines on acceptability. If the agent determines that the proposed insured does not fit within those guidelines, the agent should not proceed with the application.

Once the application has been submitted, it is the insurance company’s responsibility to determine the risks involved, and thereby set the premium rate.

UNDERWRITING FACTORS

In addition to the categories previously discussed, there are other factors to consider.

SOURCES OF INFORMATION

Though the application is the primary source of information about the proposed insured, there are other sources of information that must be considered to determine whether or not a policy will be issued, and the terms of that policy if issued.

• Agent’s Report
• Medical Examination
• Attending Physician’s Statement
• Medical Information Bureau
• Inspection Reports

We will look at each in detail.

Agent's Report

Since the agent is the one directly connected to the applicant, most insurance companies require the agent to fill out a report. The report is usually printed on the back of the application and, therefore, is submitted to the company at the same time.
The form contains several questions that enable the agent to report on his personal knowledge of the applicant. Information regarding the purpose of the insurance and if the policy is intended to replace another is reported.
Medical Examination

Some policies require the insured to undergo a medical examination. The medical examiner supplies the insurance company with information about the insured’s health as well as about the health history of family members. A urine sample or blood test may be required.

Some policies are issued as non-medical and, therefore, do not require the insured to undergo a medical examination. In these cases, the information on the application, as well as the information on the agent’s report, is considered sufficient enough to continue with the issuance of the policy.

Attending Physician's Statement

If the insurer decides that an expansion on the medical portion of the application is required, an attending physician’s statement may be requested. This is another information source that can provide the insurance company with more details upon which to make their necessary decisions on risk factors.

Medical Information Bureau

The Medical Information Bureau supplies insurance companies with medical facts about the proposed insured. It is a nonprofit organization and can only report the facts that it is aware of to the insurer. The insurer can use this information as another information source, but cannot deny coverage or charge higher premiums based on the information supplied by the MIB.

Since insurance companies developed the MIB, any member insurance companies have an obligation to report any facts to the MIB for the exchange of relevant underwriting information between companies.

Every applicant must receive a written notice letting them know that the MIB may be consulted to provide, or be furnished with, more information. The applicant must sign the notice indicating that he/she has been informed that:

- The insurer may report information to the MIB;
- The MIB may furnish information to any member company;
- Any information contained in the MIB files may be disclosed; and
- Medical information will be released only to the applicant's physician.

Should any discrepancies be found, the applicant can seek rectification through the MIB.

Inspection Reports
Various consumer reporting agencies can supply the insurer with consumer investigative reports (inspection reports). Under the Fair Credit Reporting Act, the applicant must be informed that such a report may be made.
To obtain this report for the insurance company, the agency can conduct personal interviews with the applicant’s neighbors, friends, family members, business associates, etc., to investigate:

- Personal habits;
- Lifestyle;
- Reputation;
- Health; and
- Occupation.

Usually, these reports are not requested unless the applicant is requesting a large amount of insurance coverage.

If any adverse information is supplied that results in coverage denial or higher premium rates, the applicant must be so notified and provided with the name of the consumer-reporting agency that performed the investigation.

**Types Of Risk**

The insurer determines the level of risk involved in providing the applicant with a life insurance policy. Not all insurance companies use the same terminology for their respective risk ratings. These are the most frequently used terms.

**Preferred Risk**

Not all insurance companies have this rating. It means that the proposed insured poses even less of a risk of loss to the insurer than a standard risk; thereby qualifying the policy owner to make discounted premium payments.

**Standard Risk**

The most common risk rating is the standard risk. This means that the insured is rated as having a normal life expectancy and charged the standard premium rate as others in the same group. On average, nine out of ten policies are rated as standard.

**Substandard Risk**

Those proposed insureds who are rated as a substandard risk are those most likely to have a shorter than normal life expectancy. These policies are furnished; however, the policy owner’s premiums will be higher than standard.

There are several factors that are taken into consideration to determine the level of risk as previously discussed. Among these are:

- A dangerous or risky occupation;
- Alcohol misuse;
• Drug misuse; and
• An existing or previous medical condition.

Any number of these poses a risk of loss to the insurer.
There is another system available when establishing risk factors and premium rates. If a proposed insured presents a substandard rate of risk, the insurer might use premiums set for someone in a higher age bracket.

Another method is called the lien system. The insured is charged the standard premium rate, but the face amount of the policy is reduced. The policy has a lien against it, and the lien is deducted in case of death. This method 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.

Uninsurable Risk

If a proposed insured represents a threat of loss to the insurer, the risk may be deemed uninsurable. This individual’s life expectancy is even shorter than a substandard risk and therefore is a high risk for loss on the insurer’s part. Coverage is denied.

Reinsurance

Reinsurance treaties can provide some security for insurance companies should a higher amount of deaths occur than originally forecast. Companies can reinsure with another insurance company who will carry some of the risk and burden should catastrophe strike. The original insurer (direct writer or ceding company) surrenders part of a risk to another insurer (reinsurer).

Two valuable aspects are served by reinsurance:

• The risk is no longer held by one company alone, but spread to another to share in any loss that may occur. In this way, neither company must absorb the total loss themselves; and

• Reinsurance also serves a financial function by relieving the original insurer of the obligation to maintain the unearned policy reserves.

These reinsurance treaties can be either facultative or automatic.

Facultative

In the forefront, both parties consider the risks, though the original insurer carries the entire risk. The reinsurer has the option of either accepting or rejecting the offer made by the original insurer. If accepted, the applicable terms are specified.

Automatic
Under the terms of the automatic treaty, the reinsurer 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.
Chapter 22

GLOSSARY OF TERMS

A

Annuitant - One who receives an annuity payout.

Annuity - A contract that pays an income for life or for a specified period.

Applicant - This is the individual who has filed an application for the life insurance policy.

B

Beneficiary - A person who may become eligible to receive, or is receiving, benefits under an insurance plan, other than as an insured.

Beneficiary, Irrevocable - A named beneficiary whose status as beneficiary cannot be changed without his or her permission.

Beneficiary, Primary - The person first designated to receive the proceeds of a policy, as named in the policy.

Blackout Period - When the youngest child reaches the age of 16, and the widow/widower has not reached the age of 60, social security benefits are temporarily suspended.

C

Cancellation - Termination of the insurance contract by voluntary act of the insurer or insured, effected in accordance with provisions in the contract or by mutual agreement.

Claim - The demand of an insured or his or her representative or beneficiary for benefits as provided by an insurance policy.

Commission - The portion of the premium stipulated in the agency contract to be retained by the agent as compensation for sales, service, and distribution of insurance policies.
**Concealment** - The intentional omission of facts.

**Conditional Receipt** - Is not a full receipt, as it is based upon the condition that the insurance carrier will issue the policy.
**Contingent Annuity** - Annuity structured so payments are contingent upon the occurrence of an uncertain event.

**Contingent Beneficiary** - Person or persons named to receive benefits if the primary beneficiary is not alive at the time the insured dies.

**Contract Owner** – The Purchaser of an annuity contract.

**Death Benefit** - The policy proceeds to be paid upon the death of the insured.

**Death Claim** - A formal request for payment of policy benefits occasioned by the death of the insured. Should be made through the agent, but may be made directly to the home office. Requires a copy of the death certificate as proof of death and is made by the beneficiary.

**Deferred Annuity** - An annuity for which payments to the annuitant are delayed until a specified future date.

**Effective Date** - The date on which an insurance policy goes into effect.

**Estate** - Assets of an individual comprising total worth. Includes any life insurance in force.

**Expiration** - The date upon which a policy's coverage ceases.

**Fixed Amount Option** - A settlement option under which the beneficiary receives a fixed amount for an unspecified period of time. Payments continue until the principal and interest are depleted.

**Fixed Period Option** - A settlement option under which the beneficiary receives a regular income for a specified period of time.

**Flexible Premium Annuity** - An annuity that allows the contract owner the option to pay or not pay the annuity premiums following the establishment of the annuity. Commonly used in conjunction with an Individual Retirement Account.
**Fraud** - The intentional perversion of the truth in order to induce another to part with something of value or to surrender a legal right.
I

**IRC** – Internal Revenue Code

**Immediate Annuity** - An annuity in which the income payments to the annuitant are to begin almost immediately -- after a period of time equal to the period between payments has elapsed.

**Insurance Department** - A governmental bureau in each state or territory (and federal government in Canada) charged with administration of the insurance laws, including licensing, examination, and regulation of agents and insurers. In some jurisdictions, the department is a division of some other state departments or bureau.

**Insurer** – The insurance company through which an annuity is purchased.

**Interest** - That which is paid for the use of money by the user.

J

**Joint Life Annuity** - An annuity under which payments are made to two annuitants for only as long as both live. When one dies, payments cease even if one remains living.

L

**Lapsed Policies** - A policy for which the policyholder has failed to make the premium payment during the grace period, causing the coverage to be terminated.

**Life Annuity** - An annuity that provides a periodic income to the annuitant during his lifetime.

**Life Annuity with Period Certain** - An annuity under which the annuitant receives payments for a specified number of years or for his lifetime, whichever is longer. If the annuitant dies before all the guaranteed payments have been made, the beneficiary receives the payments for the rest of the certain period.

**Loan Value** - The amount of cash value reposing in a policy, which may be borrowed by the insured.

M

**Misrepresentation** - A false representation can be defined as a misrepresentation
P

Policy - The contract effecting insurance and including all clauses, riders, endorsements, and papers attached to and made a part of the contract.

Policy Owner - The person who normally pays the premiums for the insurance policy and usually retains all rights, values and options relating to the policy.

Primary Beneficiary - The beneficiary named first to receive proceeds or benefits of a policy that provides death benefits.

Proposed Insured - The person upon whose life an application has been submitted to the insurance company as a request for coverage.

R

Refund Life Annuity - Provides annuity payments for the annuitant's lifetime with the guarantee that in no event will total income be less than the purchase price of the contract. If the annuitant dies before receiving this amount, the difference is paid to a named beneficiary.

Representations - Any statement that is made on an application.

Retirement Annuity – Generally, a deferred annuity under which payments are made by the annuitant until retirement age.

S

Settlement Option - A method of receiving life insurance proceeds other than in a lump sum.

Straight Life Annuity - (See Life Annuity)

T

TSA – Tax sheltered annuity.

Temporary Annuity Certain - The annuitant receives payments for a specified number of years. If the annuitant dies after the payments have started, the beneficiary receives the payments for the rest of the specified number of years.
V

**Variable Annuity** - Annuity whose payment varies with the fortunes of the investment.

W

**Waiver of Premium Provision** - When included, provides that premiums are waived and the policy remains in force if the insured becomes totally and permanently disabled.

**Warranty** – A statement made with such absolute certainty that it is guaranteed to be true.