Powered by ExamFX - Online Training & Assessment

Select Chapter

Study Chapter

The Basics of Life Insurance

In selecting a life insurance product for their clients, insurance producers must consider the need(s) that the applicant is trying to meet: providing replacement income for survivors, extinguishing debt, funding education, providing for special needs beneficiaries, creation of an estate, payment of estate settlement costs (federal and state death taxes, last illness and burial costs, or probate fees), business buy/sell, or key-person coverage.

Life insurance offers a way to replace the loss of income that occurs when someone dies. The insured is usually a contributor to household income and/or responsible for homemaking and/or childcare. A life insurance policy is a contract between an individual (as the insured person) and the insurance company or "carrier" that is providing the insurance.

A good life insurance program does more than just replace the loss of income that occurs if the insured dies. It should also provide money to cover the new costs that arise after the insured's death, such as funeral expenses, taxes, probate costs, the need for homemaking and childcare, and so on.

Life insurance can be a unique wealth creation tool that provides the needed amount of tax-free liquid capital upon death. Depending on the plan of insurance, it may also create capital for lifetime needs.

Life insurance costs can vary greatly based on the age and health habits of the policyowner, the amount of insurance purchased, and the type of policy chosen. A life insurance policy may afford greater indemnity when the death is accidental. When insurance pays out twice the face amount of the original policy upon an accidental death, the coverage is known as double indemnity.

A. The Basic Definition of Life Insurance

A working definition of **life insurance** begins with understanding why the concept of insurance originally developed. In all lives, uncertainty exists about what will happen tomorrow, next month, and next year. The future holds unknown events; some will be positive, and others will be negative. Negative events include the possibility of loss. Insurance is specifically concerned with financial loss.

For example, because most people own and rely upon the availability of cars, they can envision the financial loss that will occur if the car is damaged in an accident. As a result, people buy auto insurance to protect themselves against the uncertainty — the risk they take by driving — that they will suffer a financial loss if an accident occurs.

Life insurance is designed to protect against the risk of death. The risk of death exposes a family or a business to certain financial risks, such as burial expenses, paying off debts, and loss of family income and/or business profits. Different types of life policies exist specifically designed to meet unique needs of the insured and their beneficiaries. An individual has the opportunity to shop all the best insurance companies to obtain the maximum coverage at the best insurance value.

That is not the only aspect about life insurance that is important, however. It is of utmost importance for an individual to evaluate his or her particular circumstances in life. What are the client's plans? Is he or she fresh out of college or raising a family? On the other hand, individuals may be mid-40s or mid-50s when they shop for life insurance. The needs at that time would be considerably different.

B. Meeting the Client's Needs - The Basic Purposes of Life Insurance

1. Paying Death Benefits

The best understood and most obvious purpose of life insurance is to pay a death benefit to survivors when the insured person dies. Paying death benefits was the original purpose of life insurance policies and continues to be the major reason people buy life insurance. Life insurance paid at the time of death can be used for many purposes, including the following:

- Providing ongoing living expenses for survivors;
- Retiring a mortgage on the survivors' home;
- Establishing a fund for children's future college costs;
- Paying off other debts when the insured person dies;
- Paying death expenses, such as medical and funeral costs;
- Buying out a surviving partner's interest in a business; and
- Replacing income lost by the death of a key employee.

Although those are traditional uses of life insurance, contemporary policies can provide additional benefits, whether the insured person lives or dies.

2. Major Classifications of Life Insurance

Term Life Insurance

A **term** insurance policy provides life insurance coverage for a specified period (or term) usually expressed in years. Term insurance policies are issued for a period or "term" of between 1 and 40 years in duration and most provide the insured the guaranteed right to renew into a subsequent term at guaranteed rates without evidence of insurability.

Premiums for term insurance remain level for the term of the contract (1 year, 5 years, 10 years, up to 40 years) and will increase for each successive term of coverage. Term insurance comes in several different varieties, which will be discussed throughout the remainder of this course.

Cash Value Life Insurance

Cash Value or **Whole Life Insurance** is sometimes called whole life because, unlike term insurance, premiums generally remain level for the insured's entire life (whole life). For the purposes of this course, we will use the term Cash Value to denote this type of coverage because the existence of cash value is what separates this type of coverage from term insurance. To keep the premium rate level in cash value insurance, the premium in the early years of the policy is higher than the actual cost of protection.

Part of this extra premium builds a cash reserve that helps to pay for the policy in later years as the cost of protection rises.

The insurance company invests these cash values to build a reserve to offset the increased cost of insurance in the latter years of the policy. Some cash value policies guarantee a minimum growth rate on the accumulation of cash values and some cash value model policies do not guarantee future cash values. Most policies built on the cash value concept pay only the death benefit when the insured dies, but some policies built on the cash value model pay both the death benefit and the accumulated cash values when the insured dies. Like term insurance, cash value policies come in several different varieties which will be discussed throughout the remainder of this course.

Now that we have a basic understanding of the two main categories of life insurance, we will explore what all life insurance policies (term and cash value) have in common to better understand the differences and how these differences impact product structure and price.

Mortality Assumptions

Mortality assumptions are at the core of all life insurance policies, whether they are term or cash value policies. These mortality assumptions are based on the mortality tables prescribed by regulators.

States require that when reserving for a life insurance policy, the insurer must use the 1980 Commissioners Standard and Ordinary Mortality Tables, unless the Commissioner or Director of a state decides to require the use of a newer table locally.

In addition, the reserve valuation method is prescribed by law. The requirements of the legal reserve system of insurance laws are designed to ensure that insurers reserve a sufficient amount in their legal reserve accounts to actuarially meet policyholder obligations.

Reserve Requirements

When calculating required reserve amounts, the actuaries must focus on the net amount at risk for a particular policy. The net amount at risk should reflect how much risk the insurance company is assuming for a particular policy.

Since the mortality tables dictate the mortality assumptions that must be used when determining reserve amounts, we will use a few simplified examples of how these tables affect required policy reserves.

Sample Mortality Rates

Below is a section of the 1980 Commissioners Standard and Ordinary Mortality Tables showing the mortality rate for all male nonsmokers (ages 35 through age 44).

1980 CSO Male Nonsmoker Mortality Rates

Age (nearest birthday)	Mortality per 1,000
35	1.69
36	1.77
37	1.88
38	2.00
39	2.14

40	2.29
41	2.47
42	2.65
43	2.86
44	3.07

These mortality tables numerically express years of actual mortality experience and allow insurance companies to accurately predict losses in a population of individuals who all represent a similar risk.

Risk Pooling

Insurance companies employ actuaries who use these mortality tables and statistical calculations to effectively pool risks together. *For example,* if 100 people all face a 1% risk of dying in a given year, then statistically, one person will die within the population of 100. Common sense would dictate that if each of the 100 people were to contribute $1 to a risk pool, they could afford to insure all 100 individuals for $100 each, effectively insuring the 1 out of 100 that is expected to die. However, if 2 people out of this population were to die, the risk pool would not be able to pay a $100 death benefit to the second person who dies.

Statistics show that as long as risks are similar, the more risks pooled together, the more accurately losses can be predicted. If we follow the same example as above, but assume that 10,000 people with a 1% risk of dying in a given year pool their risks together, we are much more likely to experience loss results within the expected range of 100 deaths (10,000 × .01).

This risk pooling process is often referred to as “the law of large numbers” or “the law of averages” and helps insurance companies accurately predict losses and determine the appropriate premium to charge.

3. Cash Accumulation

As life insurance policies evolved, more emphasis was placed on the cash values that accumulated in policies as premiums were paid. Certain policies have features allowing cash accumulation that may be used by the insured person who does not die. *For example*, a policy might accumulate cash values that would be payable to the policyowner when he or she reaches a certain age or after the policy has been in force for a specified number of years.

A cash value life insurance policy builds guaranteed or nonguaranteed cash value, depending on the type of life insurance purchased. This cash value builds as the policyowner pays premiums. These values are further enhanced, since taxes on the money's growth are deferred. This cash value can be accessed through a loan provision. If the insured of a cash value life insurance policy dies while a policy loan is outstanding, the loan balance is subtracted from the death benefit paid to the beneficiary.

The policyowner can borrow from the policy’s accumulated cash value by taking a loan at competitive interest rates. The policyowner can use these funds in any way that he or she wishes, such as making a down payment on a home, financing a new car, or even starting a business. The loan privilege is a characteristic cash value life insurance, but the policyowner must remember that borrowing against the policy’s value reduces the insurance protection.

Note: Cash value insurance is a broad heading used for any type of life insurance that accumulates cash values and can take many policy forms. Cash value life insurance is sometimes referred to as **permanent life insurance**.

4. Estate Building or Conservation

A life insurance policy can provide for the income needs of surviving dependent family members. Whether this means children or a spouse, there will be a need for cash stabilization. A life insurance death benefit can also pay federal and state death taxes and other estate settlement costs. It can be used to pay debts, to provide for children's education, or to meet special financial demands of physically or mentally handicapped/learning-disabled children, parents, or other dependents with physical or mental limitations.

Another principal use of life insurance is to shift wealth from one generation to another in the most cost-effective manner, and can also be used to relieve survivors of financial management burdens by providing an inexhaustible lifetime annuity.

Life insurance policies can also create an instant estate to benefit a charity. Making a financial gift to a favorite charity is a goal shared by many people. A substantial gift during one's lifetime may seem to be out of reach, but a policyowner will be able to do just that using life insurance. This is an overview of the many areas for which a life insurance policy can be used and can cushion the lives of many people.

C. The Basic Uses of Life Insurance Policies

The main use of life insurance is to protect a family or dependent from the premature death of an income contributor. An insured individual who has a spouse and children depending on his or her income may need to consider other situations in his or her life that are in need of security. If there are business associates who depend on a key person for the operation of the company, the firm may need to insure his or her life for the future of the business.

The last thing that family members or business associates need to worry about is coping with the financial consequences of an untimely death. Without the breadwinner, a family may not be able to meet mortgage payments, provide for college expenses, or prepare for retirement. Immediate and future family needs may need to be put on hold as a result of death, whether untimely or not, just as business operations could be turned upside down.

1. Death Benefits

When traditional types of life insurance are written with a certain death benefit – let's say $100,000 – the face amount of the policy remains in effect as long as the policyowner pays the premium. However, if the policyowner doesn't pay the premium, the insurance can end. One important feature of some life insurance policies is that the death benefit is adjustable. It could be $100,000 at the beginning of the policy period, but it might drop down to $50,000 at some point and later rise to $175,000. Within certain limitations, the policyowner controls these adjustments.

2. Replacement Income

A life insurance policy can replace income for the survivors during a readjustment period of 2 or 3 years after the policyowner's death. If the family is a two-income family, it takes time to adjust to one paycheck instead of two. If the policyowner is the sole wage earner, and has young children at home, the spouse's need for a readjustment period is obvious.

In general, determining how much life insurance an individual needs means deducting the sum total of the income that would be lost upon the insured's death from the sum total of the family's ongoing financial need. It also means calculating the impact of inflation and building in enough "extra" to counteract inflation's effects.

3. The Use of Life Insurance with Home Mortgage Loans

Policyowners can purchase life insurance to provide the cash needed to pay off a home mortgage if the breadwinner dies. To accomplish this, a policyowner can purchase a decreasing term policy for the same amount as the original mortgage. The term policy is designed to decrease as the mortgage principal is paid down.

Another alternative is to purchase a level cash value life insurance policy. The idea is that the cash value increases as the mortgage decreases. When the cash value reaches the same amount as the mortgage, the policyowner can use it to pay off the mortgage early.

Another concept is to buy additional amounts of life insurance in your personally owned life insurance plan to pay off the mortgage and consider accelerating the mortgage by paying an additional amount of principal with each mortgage payment.

Both of these approaches would pay off the mortgage at the death of the insured and will also facilitate the early payoff of the mortgage if the insured lives.

Chapter Complete

© 2020 ExamFX All rights reserved.